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As budget nears, retirement income system faces crisis point

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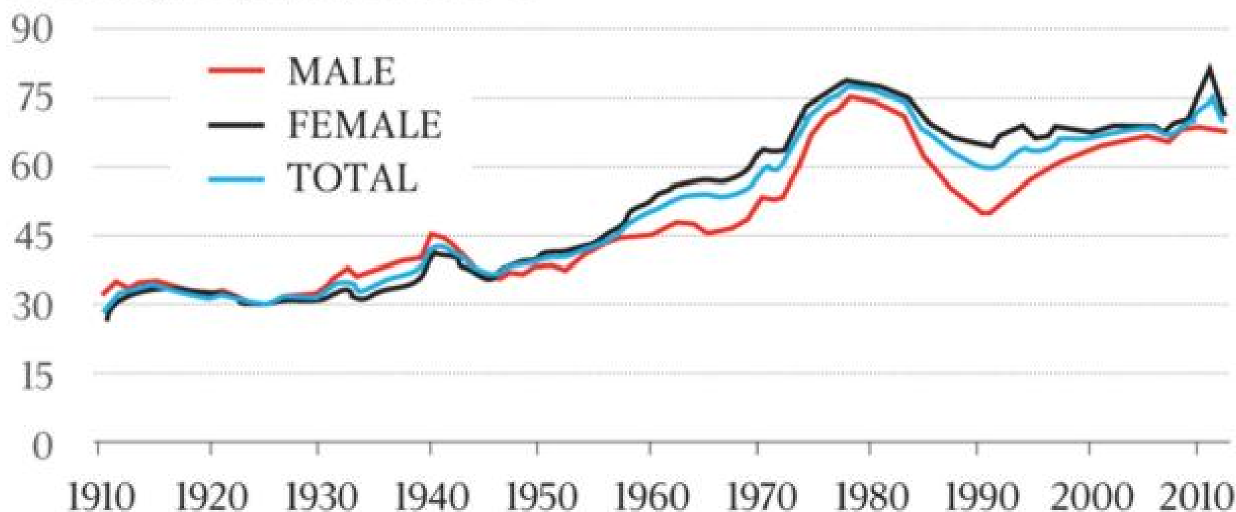

As the search for budget savings focuses on the age pension, the challenge for the government is to reconcile rigour, fairness and sustainability. With the pension intended to help those who cannot reasonably help themselves, it seems absurd that public money is going to the well-off. But in a retirement income system that is struggling to meet its objectives, simply tightening access to the pension carries risks of its own.

That is not to suggest there is a case for subsidising the rich. However, the government needs to be wary of proposals that — far from affecting high-income earners who are gaming the system — would hurt mainly middle Australia, which is already poorly served by our complex retirement income arrangements.

So while fiscal pressures justify immediate action, the government must also take up the Treasury secretary's call for a proper review of the retirement income system as a whole.

That retirement incomes would become a flashpoint is hardly surprising. In 1910, when the Invalid and Old Age Pensions Act of 1908 had just come into force, average life expectancy was 55 years for men and 56 years for women, which meant not many people lived long enough to receive the pension, much less receive it for any length of time.

Since then, however, average life expectancy has risen to 81 years for men and 85 years for

women; and taking account of likely improvements in mortality rates, a boy born today can expect to live to 92 and a girl to 94. Even more important, the remaining life expectancy of 70-year-olds is projected to rise from 17 years now to 21 years in 2055 for men, and from 19 years to 23 years for women.

But long as those life spans are, the averages do not tell the whole story. In effect, an average remaining life expectancy of 20 years implies that one in four 70-year-olds will live for a further 25 years and one in five for 30 years or more; as for couples, those remaining life expectancies imply a better than 50 per cent chance of at least one member surviving to age 95. Australians therefore face the challenge of financing what may be 30 or more years of living expenses at ages that stretch far beyond the normal end of working life.

Of course, longer life expectancies, along with better health in old age and higher levels of education, should themselves cause some postponement of retirement. Indeed, the labour force participation rate of people 65 and older has already nearly doubled, rising from 6 per cent in 2004-05 to about 12 per cent today.

However, while Treasury expects half the men aged 65 to 70, and about 35 per cent of the women, to be in the labour force in 2055, the proportion of over-70s working is unlikely to rise much above 10 per cent, so that virtually all of the “older old” will have little or no income from employment. They will therefore have to rely on pensions, along with accumulated savings, to cover their costs.

Once the superannuation system is fully mature, private savings may provide a substantial source of the incomes covering those costs requires.

However, in 2011-12, the median superannuation account balance for people 60 and older in the accumulation stage (that is, who had not yet begun to draw down their savings) was just $95,000; as estimates suggest a couple needs $34,000 a year to sustain a barely spartan lifestyle, and nearly $60,000 for a lifestyle closer to the social norm, those balances are hardly sufficient to pay for the decades of retirement that lie ahead.

That makes growing pressures on the age pension inevitable; and with the number of Australians 65 and older expected to rise by 2.6 million in the next two decades, Treasury projects that spending on the pension will increase, as a share of gross domestic product, from 2.9 per cent in 2014-15 to about 3.3 per cent in 2034-35.

How much scope there is to stem that rise is inevitably controversial. The government’s original proposal to freeze the pension in real terms was ham-fisted and while it remains on the table it is scarcely credible.

As for the proposal to raise the pension age to 70, the government would have done better to follow international precedent and explore the options for adjusting the pension rate so that those who went on the pension before the standard age received a lower benefit while those who deferred retirement were rewarded.

But regardless of how those proposals eventually fare, it is pension eligibility that is receiving the greatest attention. Here too, unfortunately, there are no easy answers. At the heart of the difficulties is the fact the age pension is not especially generous, so while it prevents hardship,

it has less effect in lifting incomes than often thought.

For example, the OECD estimates that the incomes of people 65 and older in the advanced economies are, on average, 14 per cent below those of their respective populations; however, older Australians, it finds, have average incomes 35 per cent lower than the Australian population as a whole.

A substantial gap in disposable incomes also emerges from data collected by the Australian Bureau of Statistics, which shows that, even taking account of taxes, transfers and household size, 50 per cent of older couples are in the poorest income quintile, while 80 per cent are in the bottom two income quintiles.

What that data overlooks, however, is the fact the average wealth of older Australians is relatively high. Older couples' median income may be two-thirds lower than that of households as a whole, but with 82 per cent of those couples owning their home outright their median net worth is nearly 60 per cent greater.

The ABS estimates that, in 2011-12, owning a home provided a benefit (which it calls "imputed rent") that averaged $270 a week; adding that "imputed rent" back into the average income of older couples doesn't close the income gap but does about halve it.

There are, in other words, a large number of older Australians who have low incomes and so rely in whole or in part on the age pension, while having substantial net worth, much of it in the form of housing. Including owner-occupied housing in the pension means test, or developing a HECS-like system that recovers some part of accumulated pension payments from pensioners' estates, is therefore the most straightforward approach to reducing the long run cost of the public pension as it now operates.

However, without a wide-ranging political consensus, any such move would be politically suicidal. And with that option ruled out, the alternatives raise many complex problems.

To say that is not to deny that the present eligibility standards would have struck the founders of our age pension as remarkably loose. As it was originally legislated, the age pension involved a character test: the Treasury secretary could disqualify an applicant as being unworthy of public support. But even putting that aside, the income threshold above which no pension was payable, expressed as a proportion of average earnings, was about half its level today. There has been, over time, a significant relaxation of the tests, which has led to a relatively high share of older Australians receiving a whole or part pension.

But if that is so, it is partly because simply tightening the tests can have significant unintended consequences.

The proposals, revealed in this paper last week and being canvassed in the Senate, for a tougher "taper" test on investment assets and for a lower maximum value of assets a pension recipient could own before being ineligible for a part pension, are a case in point.

The risks those proposals involve are readily explained. There is, for example, no doubt that imposing a higher taper rate on investment income and assets, while still excluding owner-occupied property from the means test, would reduce pension eligibility in the short term; in the longer run, however, it would induce Australians to place an even larger share of their net

worth in the family home, which is exempt from the means test, so distorting the allocation of resources and increasing the economy's exposure to housing price volatility.

At the same time, particularly for part pensioners who are close to the upper asset and income thresholds, the effect of the tougher taper would be to cushion any losses on risky investments, as a share of those losses would be offset by greater pension eligibility. As a result, Australians' superannuation portfolios would become even more skewed to high-risk assets, adding to the harm asset price bubbles could cause.

The proposals prompt other concerns as well. They are, in economic terms, no different from materially raising the tax rate on earnings or savings in retirement (as each additional dollar earned or saved attracts a higher "claw back" in the pension), with effects that are likely to be especially marked on those taking work and savings decisions at or close to pension age.

Experience is telling in this respect: the Howard government's reduction in the taper test (which reduced the effective marginal tax rate on retirement earnings and savings) was accompanied by a significant increase in older Australians' labour force participation rates.

Yes, it is difficult to disentangle the various factors involved in that increase; and yes, reducing some older Australians' eligibility for the pension may force them to work longer. But there must be a risk that the proposals would lead mainly to a fall in labour force participation and a more rapid rate of depletion of savings, causing needless economic harm for little budget gain.

All that means any such proposals would need very careful design; however, there is little sign that the complexities have been recognised, much less adequately addressed. But even if they were, it is also fair to worry about the proposed changes' distributional impacts.

In particular, it is clear that the tougher means tests primarily would affect the wealthy, as the Greens and Australian Council of Social Service argue. There are, for sure, some pension recipients who have very high non-housing net worth; but ABS data suggests they are a trivially small share of the age pension's 2.3 million recipients.

Rather, the greatest impact by far would fall on middle-income earners, whose entry into retirement largely accounts for the decline, from 68 per cent in 2001 to 60 per cent in 2011, in the proportion of their income Australians 65 and older derive from the age pension.

Those middle-income earners are remarkably poorly served by our retirement income system. The consequence is that while low-income Australians enjoy net replacement rates (a measure of the ratio of income in retirement to that a retiree had in working life) the OECD estimates are about 50 per cent, the current replacement rates for middle-income earners could be as low as half that.

It is true that replacement rates for middle-income earners are intended to rise as the superannuation system matures, but that depends on a system that, the recent Financial Services Inquiry found, has unjustifiably high costs and lacks competition, and exposes savers to income and longevity risks they are extremely poorly placed to manage.

With even very long-term interest rates at historic lows, it is difficult to believe rates of return on superannuation savings could be sufficient, during the next 10 to 20 years, to bring

replacement rates anywhere close to the 75 per cent level most experts regard as a reasonable benchmark.

There is, to that extent, a fundamental flaw in our retirement income system: while it provides some protection for those on very low incomes, and offers large tax breaks to the well-off, it is not performing as it should for middle Australia. And for so long as its current broad structure remains in place, there are few reasons to believe its performance will improve.

That is not to suggest the failings ought to be addressed by shoehorning middle-income earners into the age pension, which is best viewed as a social safety net. But, as things stand, the age pension is helping to patch over the system's flaws.

There are therefore significant dangers in narrowing the scope of the safety net before any of the weaknesses of the system have been addressed. Without the willingness to genuinely review the system as a whole, endless and poorly thought through tinkering with its parts could only make things worse.

It would be paradoxical indeed were a Liberal government, whose commitment ought to be to Robert Menzies' "forgotten people", to ignore, and likely aggravate, the difficulties they face in old age. So far, however, the government has shown few signs of having a coherent and credible strategy for retirement incomes. With the budget fast approaching, its time is running out.

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