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Priorities for the retirement incomes review

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Alliance for a Fairer Retirement System
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Priorities for the retirement incomes review

We need to set objectives for the retirement income system

- Retirement policy involves involves **big trade-offs**: how do we manage them?
- **Replacement rates + poverty floor** is the right approach for policymakers

Most Australians can look forward to a comfortable retirement

- Current retirees **feel more comfortable** financially than younger workers
- Most **retirees in future** can expect the **same or higher living standard** as today

Compulsory superannuation should stay at 9.5%; fix pension taper instead

- Increasing **SG to 12%**: hurts workers & pensioners today; doesn't improve retirement for middle; costs $2.5b today and **still hurts budget long-term**
- Reduce **pension taper rate**: current EMTR > 100%; helps bottom 70%; costs less

Housing is the big challenge going forward

- **Pension appears adequate** for homeowners; but **renting retirees** really struggle
- Raise **Rent Assistance** by 40%; benchmark to rents paid by low-income earners
- **Exempting the home from pension assets test** will be untenable when ½ rent

We don't understand why retirees don't draw down on their retirement savings

- Spending needs decline with age & health; fear of health and aged care costs
- Unclear what role for CIPRs: what problem are they trying to solve?

What is the purpose of our retirement incomes system?

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Purposes

- Ensure some minimum standard of living in retirement
- Facilitate lifetime consumption smoothing
- Manage risks: investment; longevity etc.
- <u>Not</u> about boosting inheritances

Side constraints

- Be fiscally sustainable
- Maintain incentives to work, save and invest
- Value pre-retirement incomes too

Successive governments have refused to establish a retirement income standard

“The Government **has not set an explicit replacement rate target** for Australia's retirement income system.”

Commonwealth Treasury submission, Inquiry into superannuation and standards of living in retirement, 19/08/2002

“**It is not appropriate or practicable to set a target replacement income rate** for the superannuation guarantee. However, the rate of the superannuation guarantee can be benchmarked by reference to moderate potential replacement rates for retirees with a full history of contribution at median to average earnings.”

Henry Tax Review, *The retirement income system: report on strategic issues*, May 2009

“While governments deliver policy solutions to such issues as best they can, we need to recognise that **there is no straightforward answer to the question of adequacy**.”

Treasurer Scott Morrison, Address to the Association of Superannuation Funds Of Australia (ASFA) Conference, Brisbane, 27/11/2015

What should a new retirement income standard look like?

The right retirement target **varies from household to household**

<u>**Our target:**</u> **70% replacement rate up to 80th percentile** of workers' earnings, or roughly 1.5 times full time average earnings ($120,000)

Why not 100% replacement rate?

- Housing costs *typically* fall sharply in retirement once house paid off
- Retirees substitute expenditure for leisure
- Retirees no longer incur some work-related expenses

Why differs across income distribution?

- Replacement rates for low-income earners exceed 100%: poor before retirement; and poor afterwards
- Beyond 80th percentile individuals tend to have enough

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Existing retirees feel less stressed on subjective measures of financial wellbeing

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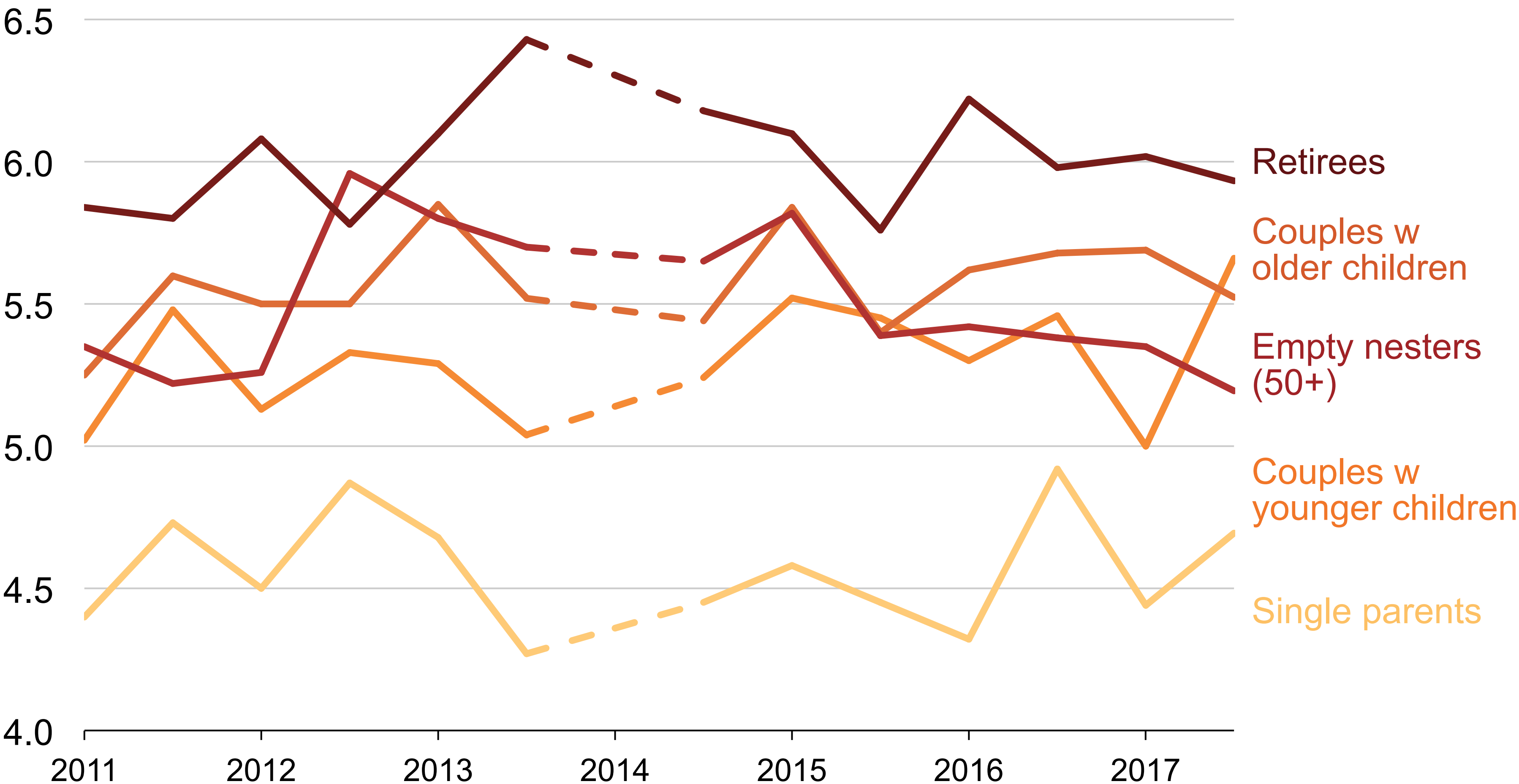
Self-assessed financial comfort



Notes: Excludes anomalous Dec 2014 survey
Sources: Members equity, Financial comfort survey

Retirees today appear to have the same or higher incomes than when they were working

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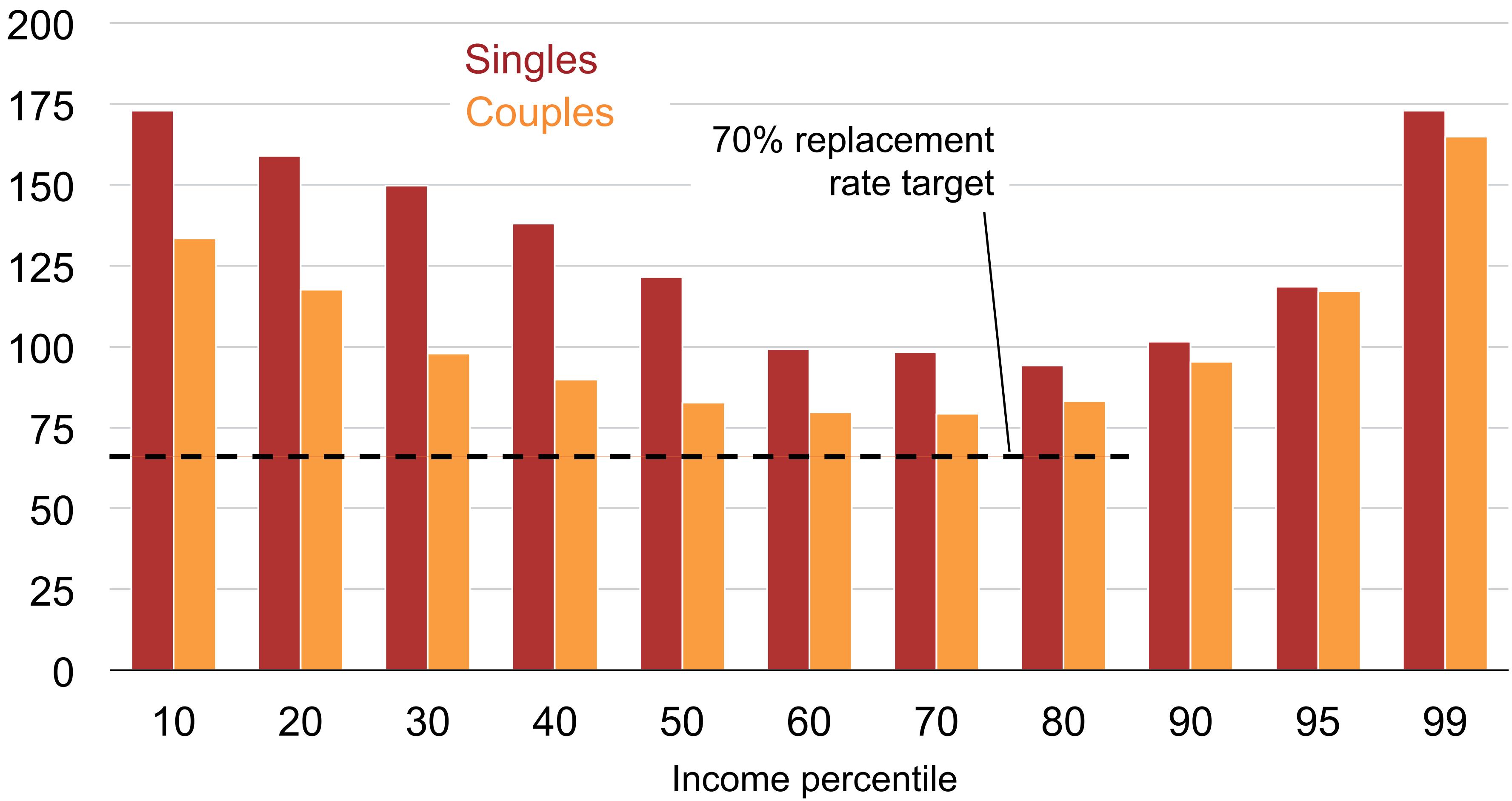
Disposable income for households aged 65-84 in 2015, relative to income for households aged 45-64 in 1995, $2015-16



Notes: Disposable income includes income of head of household and their partner, but not children. Incomes adjusted due to changes in how the ABS defines incomes between surveys.
Source: ABS Survey of Income and Housing; Grattan analysis.

Those entering the workforce today will be able to maintain their standard of living in retirement

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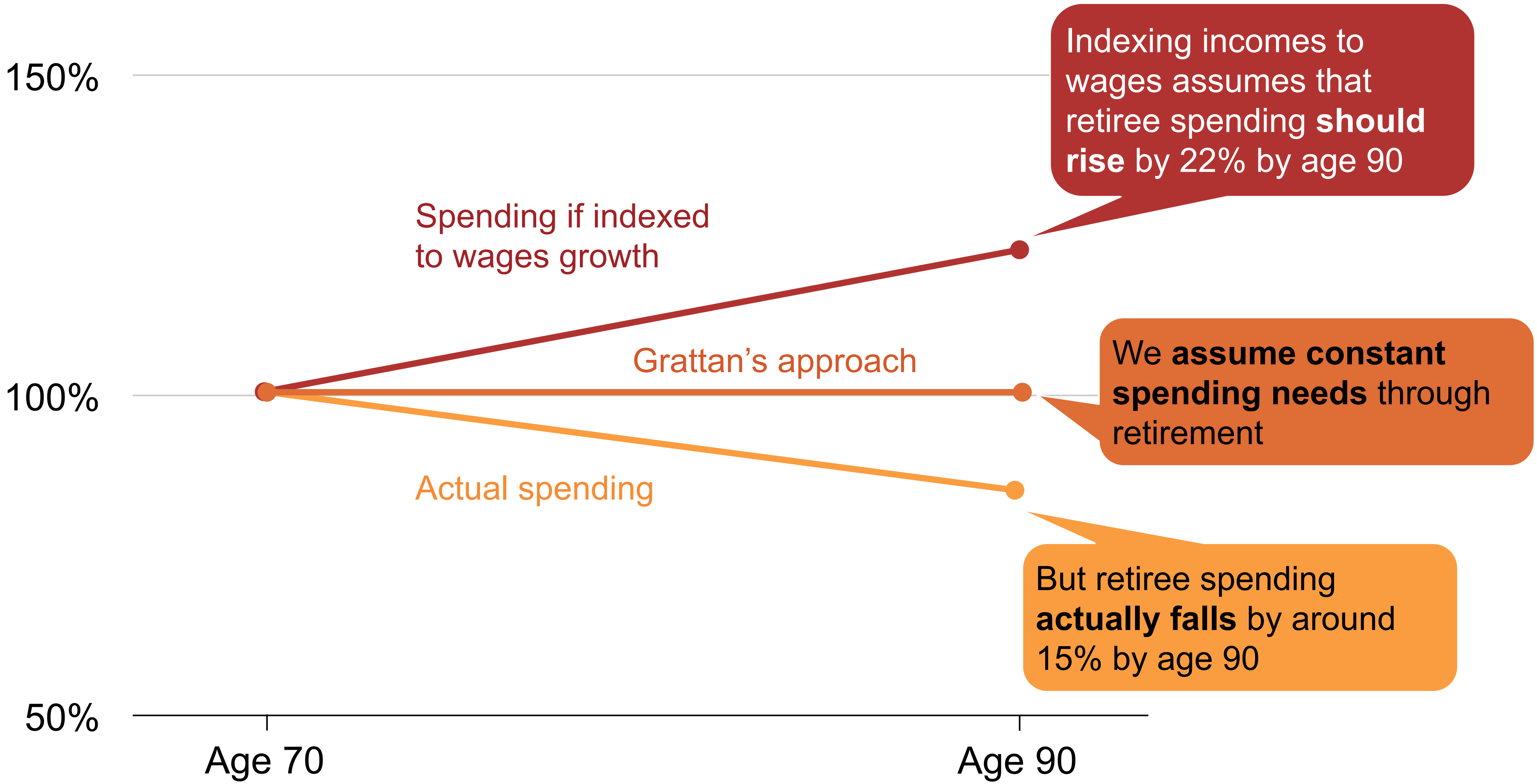
Replacement rates, by employment earnings percentile, CPI deflated, per cent

Notes: Models retirement income of a person born in 1985, who works uninterrupted from 30 to 67, and dies at age 92. Assumes wages growth falls by the amount of any Super Guarantee increase. Includes savings outside super. Employment earnings adjusted to account for movements up and down the earnings distribution. Retirement savings drawn down over 26 years to leave a small bequest in addition to the home. Retirement income deflated by CPI

Source: Grattan Retirement Income Projector

Why are our numbers different? We don't assume spending needs rise through retirement

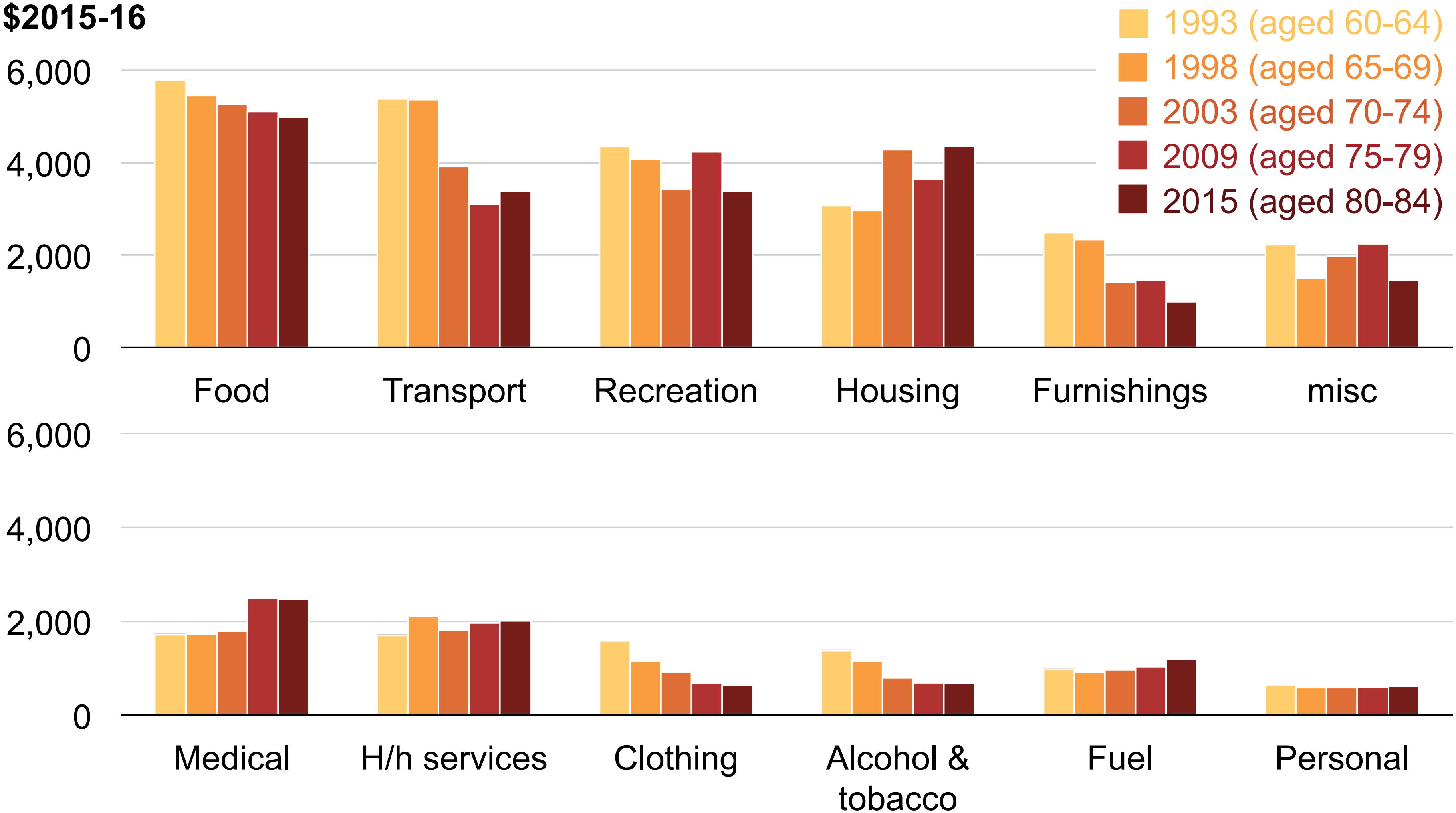
Real (inflation adjusted) retiree spending as a proportion of their spending at age 70



Notes: Assumes annual real wages growth of 1 per cent.
Source: Grattan analysis.

Lower spending in retirement is driven by food, transport, furnishings, clothing and recreation

Equivalised household annual expenditures for cohort of retiree households as they age, $2015-16



Notes: Spending from 1993-94, 1998-99, 2003-04, 2009-10 and 2015-16 Household Expenditure Survey. Each line represents a single cohort across time as they age. While the age cohorts are 5 years apart, there was a gap of 6 years between the last three HES surveys. Spending deflated by CPI.
Source: ABS Household Expenditure Survey (multiple years); Grattan analysis.

Other studies tend to use different (and questionable) assumptions

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Study	Metric	Assets included	Deflator in retirement	Do median income retirees meet their standard today?	Will younger median income earners meet the standard when they retire?
Rothman (2004)	Individual replacement rates, five years either side of age 65. No 'adequate' rate defined.	Super only.	CPI		
Rothman (2011); Rothman (2012)	As above	Super, non-super financial assets, and non-home property	CPI and wages		
Henry (2009)	Individual replacement rates for both working life and final working year	Compulsory and salary sacrifice super contributions.	CPI		
Rice Warner (2015)	62.5% of pre-retirement gross earnings	Super only, with small estimate for investment property for high-income earners.	Wage index	Not reported for median earner	No (median figures only given for population of all ages)
Committee for Sustainable Retirement Incomes (2016)	ASFA comfortable standard; lifetime replacement rates and other measures	Super only	Wage index	Most scenarios below ASFA comfortable standard	Single females, but not couples
Burnett *et al.* (2014)	ASFA comfortable standard	Super, non-super financial assets, and non-home property	Wage index	No	Couples aged 40-64 today meet standard, but not singles
Actuaries Institute (2015)	ASFA comfortable and modest standards	As above	Wage index	Couples – comfortable Singles – modest	Couples and men – comfortable Women - modest
Industry Super Australia (2015b)	ASFA comfortable standard	As above	Not stated (but wages elsewhere)	No	Couples and men but not women

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What is the trade-off between wages and superannuation?

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"The cost of superannuation was never borne by employers. It was absorbed into the overall wage cost …. In other words, had employers not paid nine percentage points of wages, as superannuation contributions, they would have paid it in cash as wages."
Paul Keating, "The story of modern superannuation" 31/10/2007

"The increase in minimum wages we have determined in this Review is lower than it otherwise would have been in the absence of the superannuation guarantee increase."
Fair Work Commission, *Annual Wage Review 2012-13*, 3/6/2013

See also Freebairn, J. (2007), *Some Policy Issues in Providing Retirement Incomes*; Keegan, M. and Brown, L. (2012) (NATSEM) *Impact of the increase in the Superannuation Guarantee on wage costs in the health sector;* Rothman, G (2012) (Treasury) *Modelling the sustainability of Australia's retirement income*

Daley says that if you get super you forgo a wage increase…. It's an outrageous claim without any basis in fact. It's basically a nasty polemic."
Paul Keating, *730 Report*, 12/11/2018

Lifting the Super Guarantee to 12% costs the Budget – in both the short and long term

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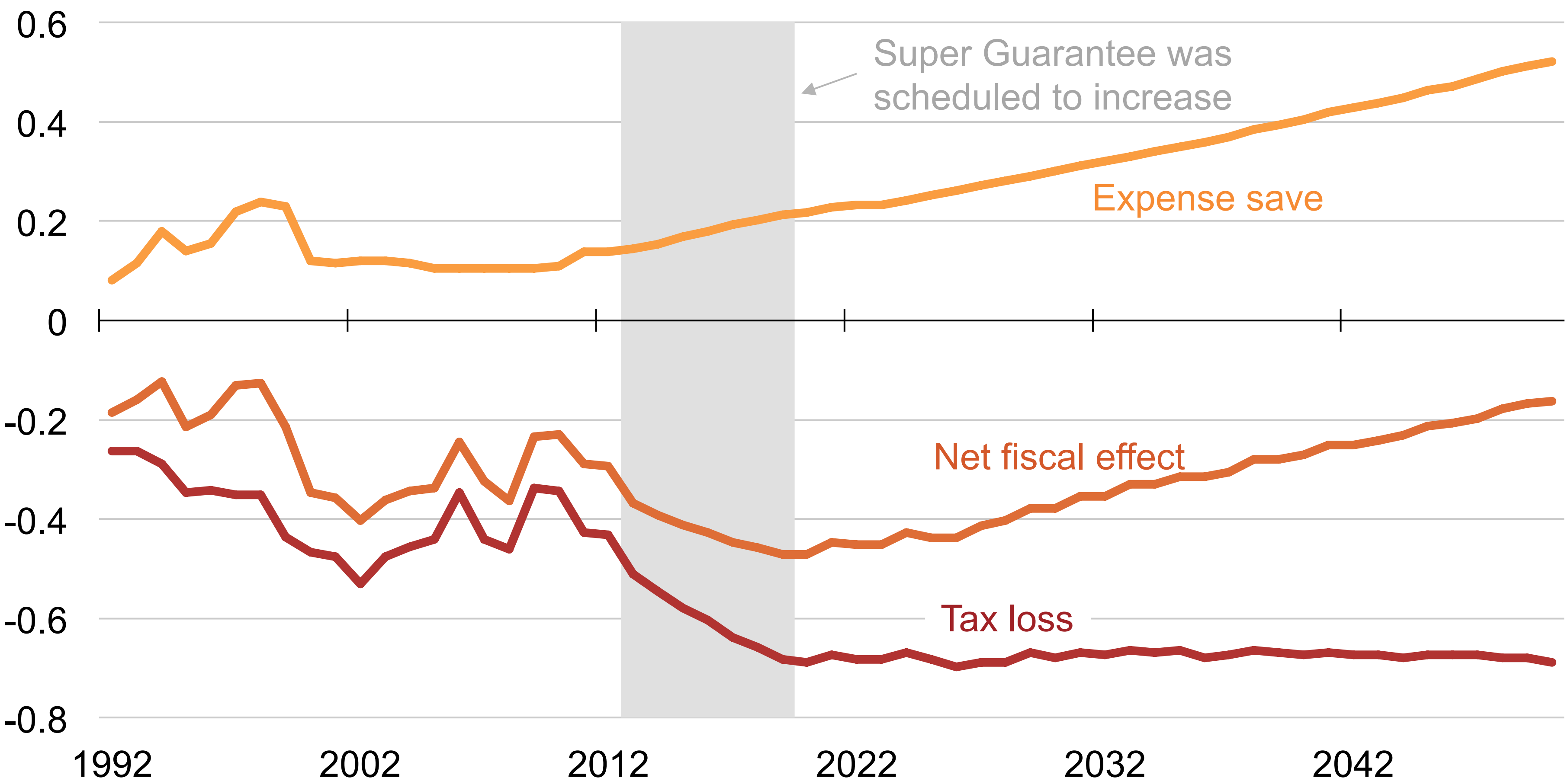
Impact on budget balance, percentage of GDP



Notes: 2010-11 Budget predicted that increasing the Super Guarantee by 0.25ppt would cost the Budget $240m in 2013-14. 2014-15 Budget predicted that not increasing the Super Guarantee by the previous Government's policy of 0.5ppt would save $440m in 2017-18. These cost estimates predated policy changes to increase Age Pension assets test taper rate and tighten of super tax breaks, which would increase fiscal savings by ~0.1% of GDP in 2018-19 (higher taper rate ~$1b, super tax changes ~$0.7b). Shaded area indicates 2010-11 Budget policy.

Sources: The Treasury Charter Group 2013; Budget papers; Grattan analysis

Increasing the Super Guarantee helps the top and the very bottom but not the middle

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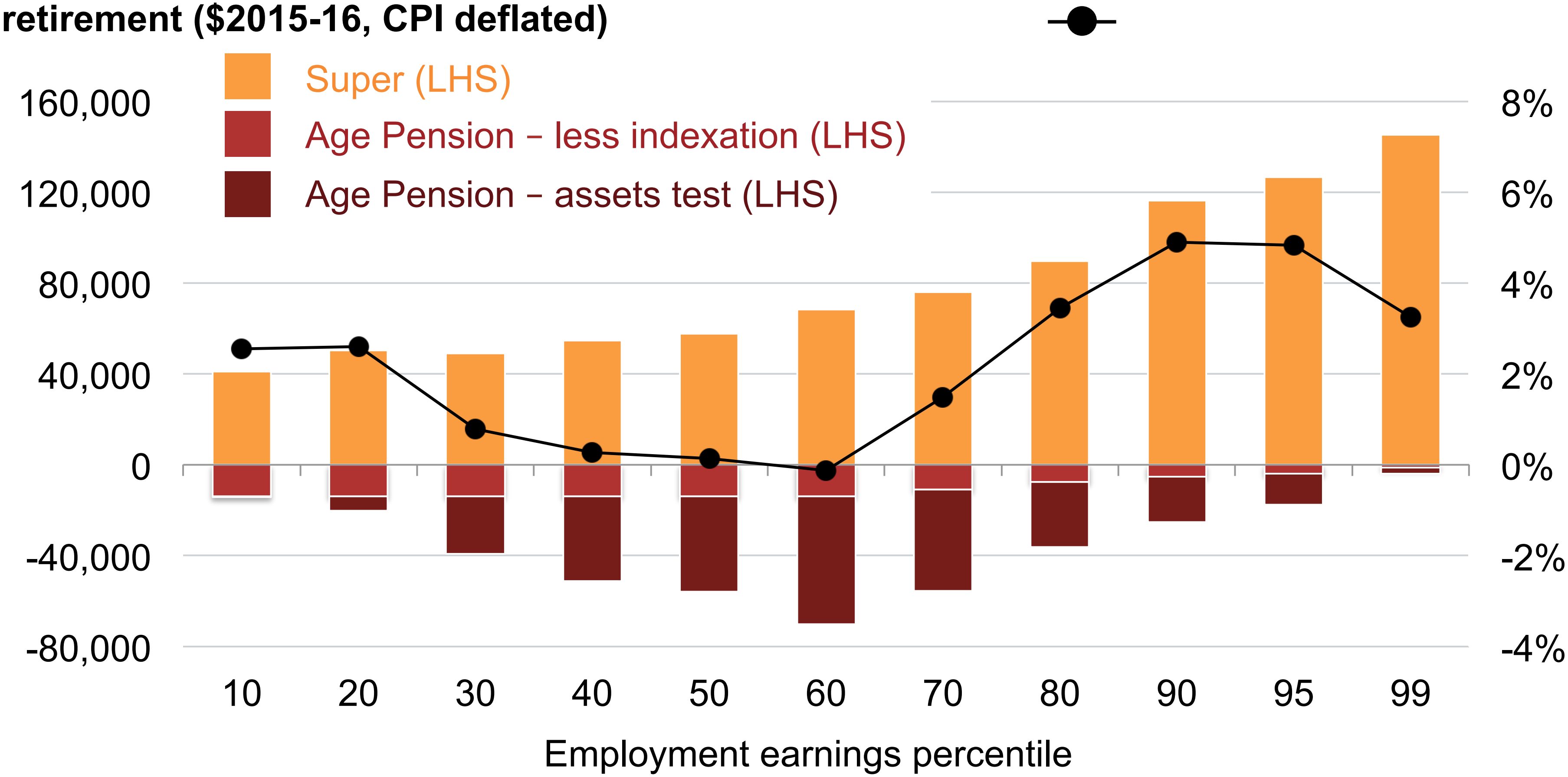
if Super Guarantee increases to 12% compared to remaining at 9.5%

LHS Change in income over 26 years of retirement ($2015-16, CPI deflated)

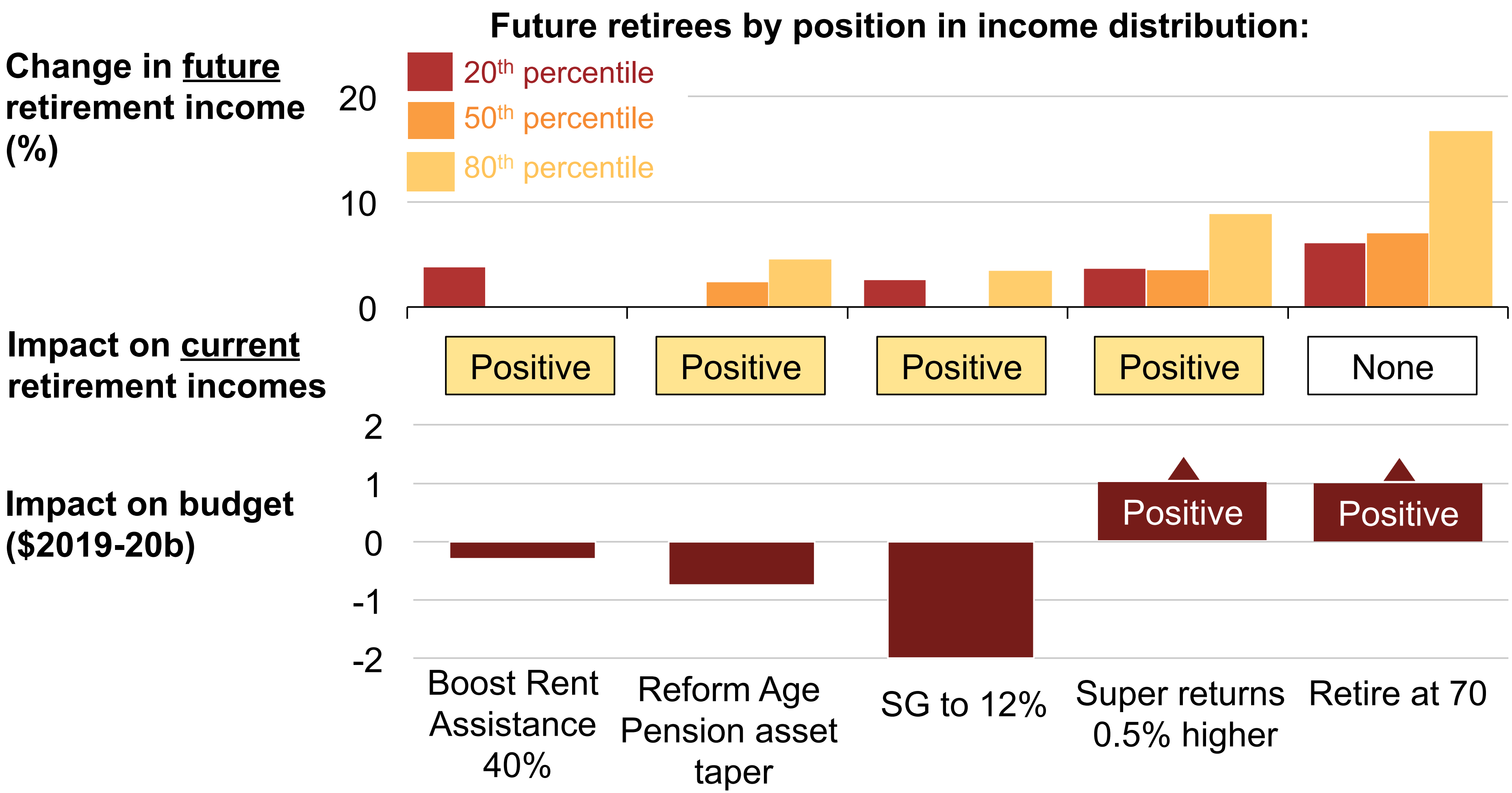
RHS Change in retirement income (%)



Notes: Models retirement income of a person born in 1985, who works uninterrupted from 30 to 67, and dies at age 92. Assumes wages growth falls by the amount of any Super Guarantee increase. Includes savings outside super. Employment earnings adjusted to account for movements up and down the earnings distribution. Retirement savings drawn down over 26 years to leave a small bequest in addition to the home. Assumes voluntary super contributions partially offset lower compulsory contributions if Guarantee remains at 9.5%.

Source: Grattan Retirement Income Projector

Boosting Super Guarantee helps less, and costs more than all other reforms



Notes: Budgetary impacts assume policy implemented in full in 2019-20. Long-term budgetary costs will differ significantly: Super Guarantee will cost less, cost of reforms to the Age Pension assets test and Rent Assistance will grow with an ageing population; cost of Rent Assistance will also rise as rates of home ownership decline. Rent Assistance scenario assumes a retiree at the 20th percentile of the income distribution is a renter and eligible for the maximum rate of Commonwealth Rent Assistance for a single, whereas 50th and 80th percentile retirees are home-owners. All other scenarios assume all retirees own their own homes for the purposes of determining Age Pension entitlements. All retirement income scenarios are for a person born in 1985, who works uninterrupted to age 67 (or age 70 in the "retire at 70" scenario) and dies at age 92 (except the "live extra five years" scenario).
Source: Grattan Retirement Income Model

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Retirees are less financially stressed than those of working age

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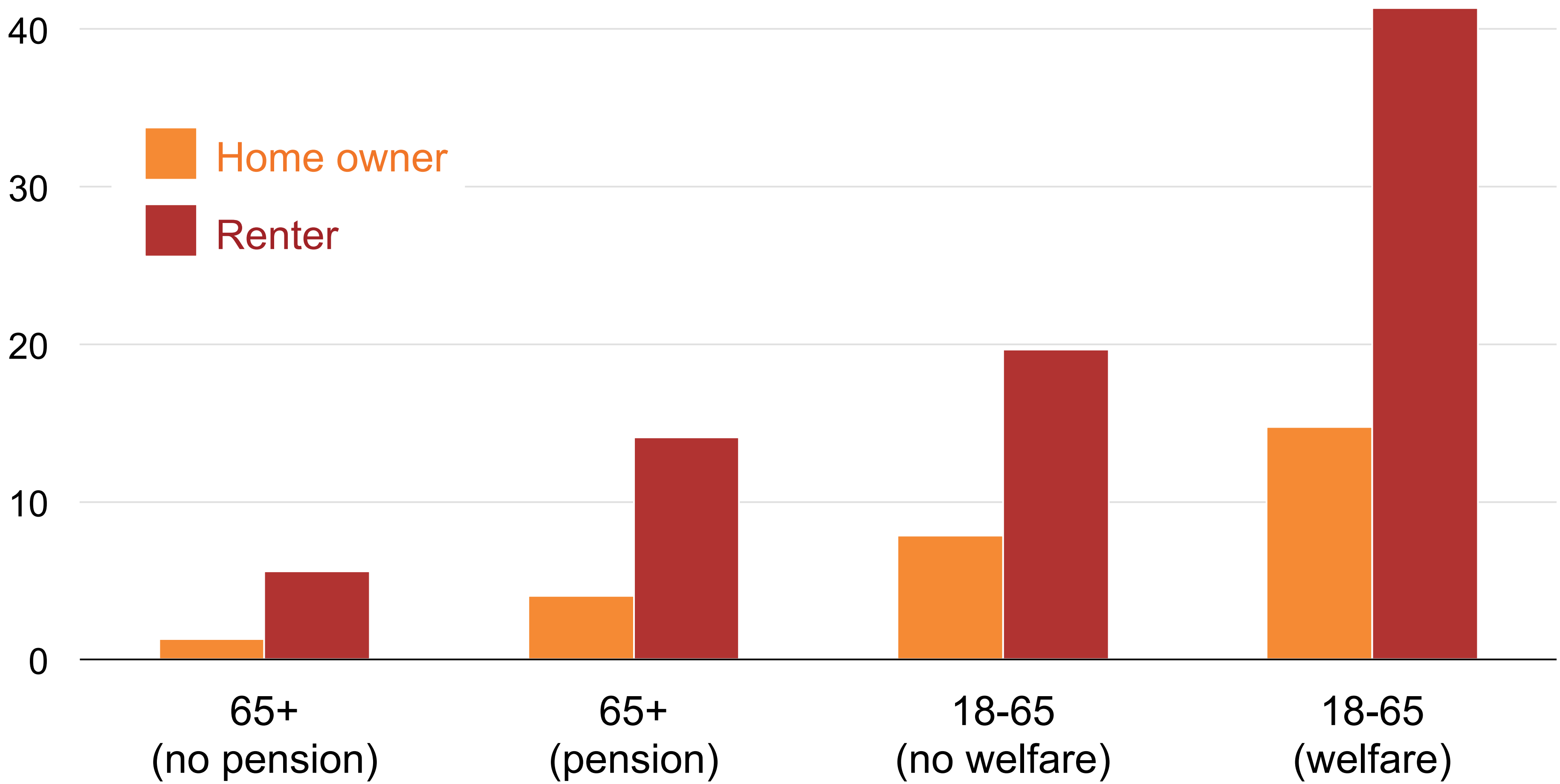
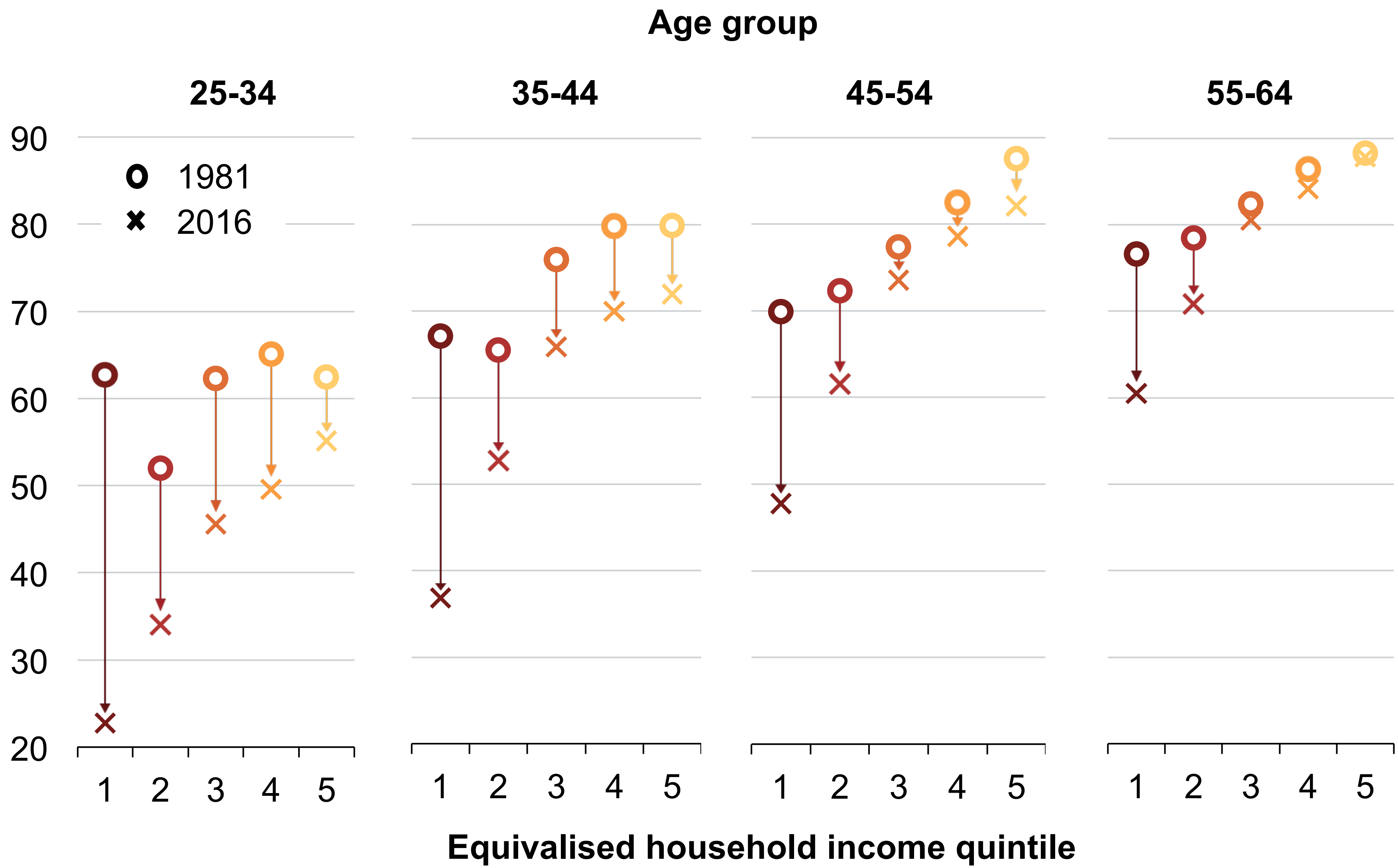
Percentage of households facing at least one financial stress, 2015-2016



Notes: Financial stress defined as money shortage leading to 1) skipped meals; 2) not heating home; 3) failing to pay gas, electricity or telephone bills on time; or 4) failing to pay registration insurance on time. 'Pension' and 'welfare' includes all those receiving cash benefits of more than $100 per week
Sources: ABS Household Expenditure Survey 2015-16, Grattan analysis.

Many more retirees will be renting in the future

Home ownership rates by age and income, 1981 and 2016



Source: Census; Burke et al 2014; ABS.

Far fewer retirees will own their own homes in future

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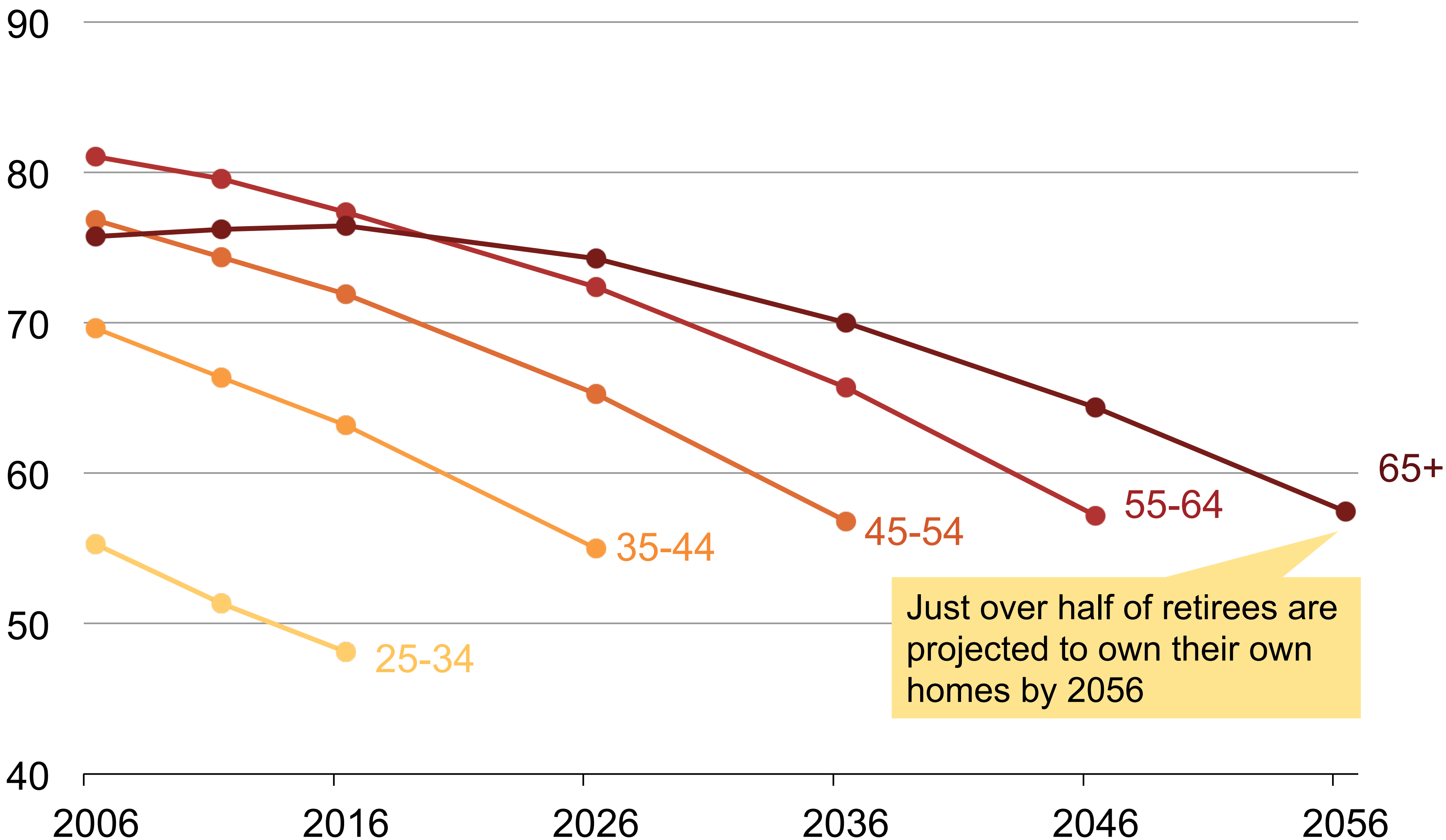
Home ownership rates by age, 2006 to 2056



Source: ABS (2018); Grattan analysis.

Boosting Rent Assistance is more targeted than increasing the Age Pension

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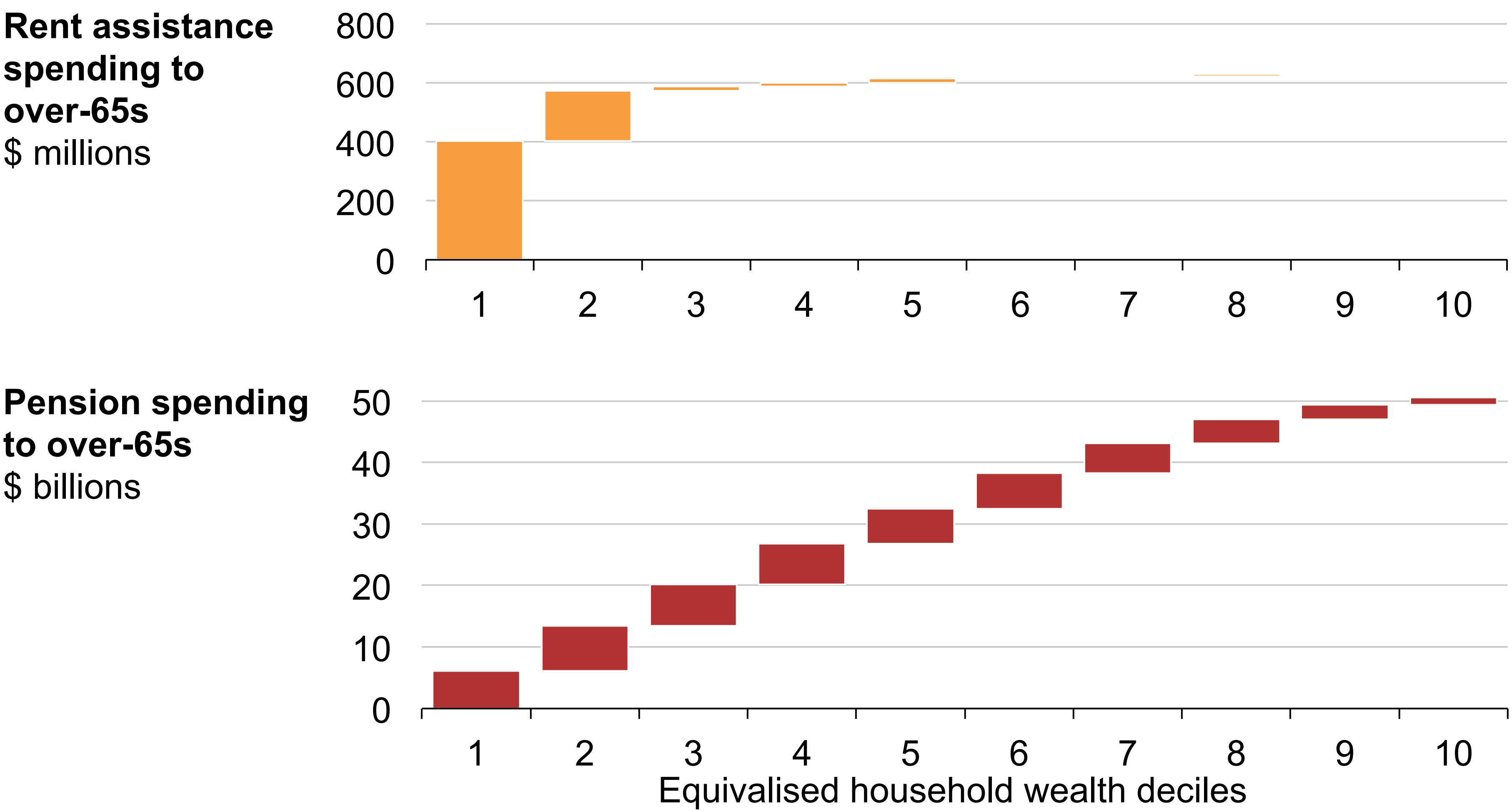
Benefits from Rent Assistance and the Age Pension for over-65s, 2015-16



Notes: "Pension" includes both the Age Pension and other government pensions and allowances, such as disability, carer or family support payments received by younger people in a household with a household head aged 65 and over.
Source: Grattan analysis of ABS Survey of Income and Housing (2017).

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Why don't people spend their savings?

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Framing

- Minimum drawdown rules frame drawdown choices

Uncertainty

- Fear of unexpected **spending** (particularly health and aged care)

- Uncertain about **returns** to savings (and government policy changes)
- Uncertain about **life expectancy**, and how long savings will be needed

CIPRS can help here

Investment constraints

- Hard to draw down on illiquid assets (particularly homes)

Want to leave bequest

Reduced needs

- People have more leisure time to do things for themselves (e.g. food preparation)

Literature suggests this is the big problem

Retirees also tend to have lower spending needs as they age

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Projecting future retirement incomes: the Grattan Retirement Income Projector (or GRIP)

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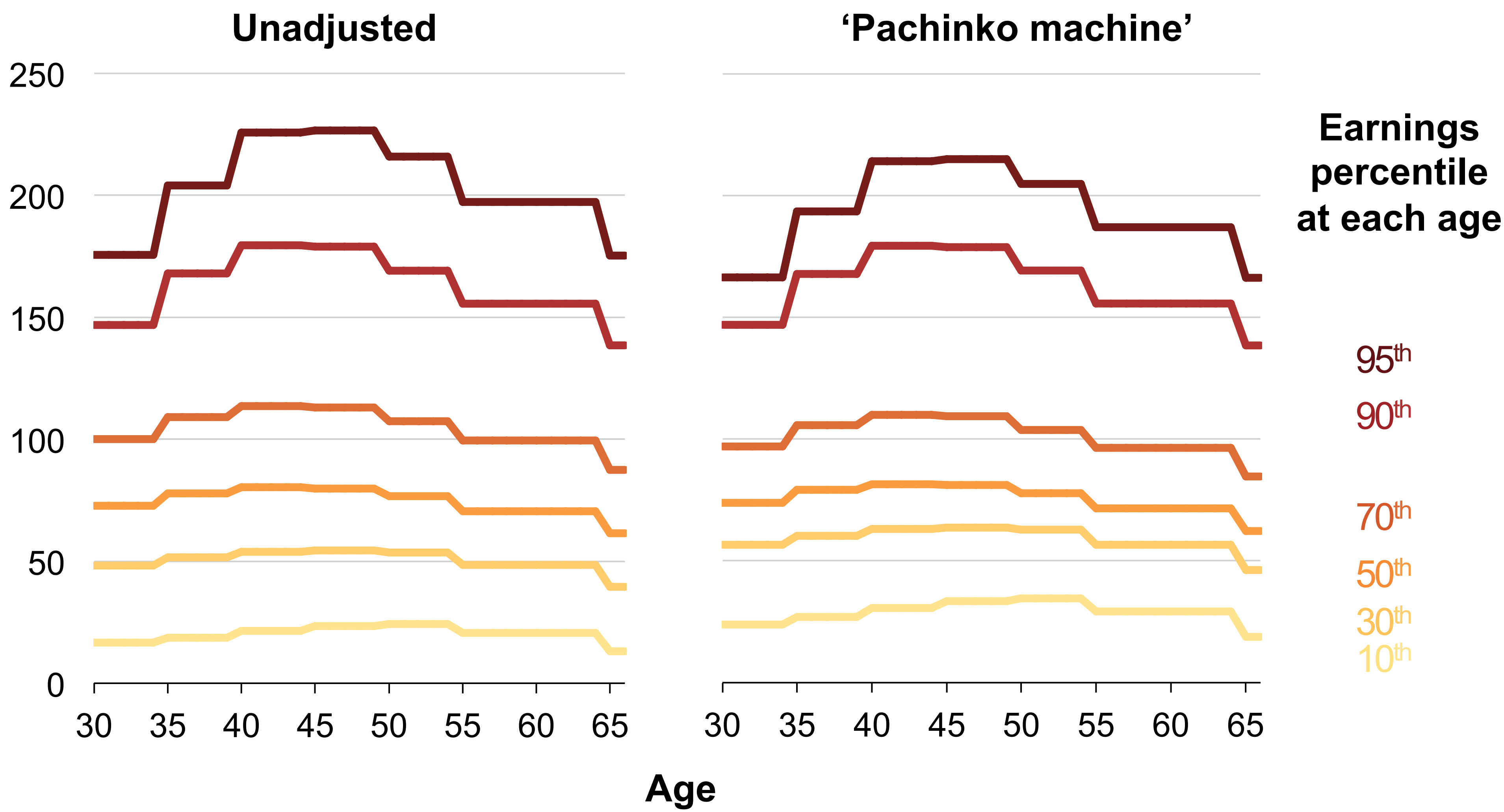
Salary income as per cent of AWOTE by age at different starting earnings points



Notes: Lifetime income adjusted using a transition matrix which reflects the likelihood of moving up and down the income distribution of the course of a person's working life.

Source: Grattan analysis of ATO Tax Statistics 2013-14; HILDA; Grattan analysis.

How we measure replacement rates: all of retirement compared to last five years working

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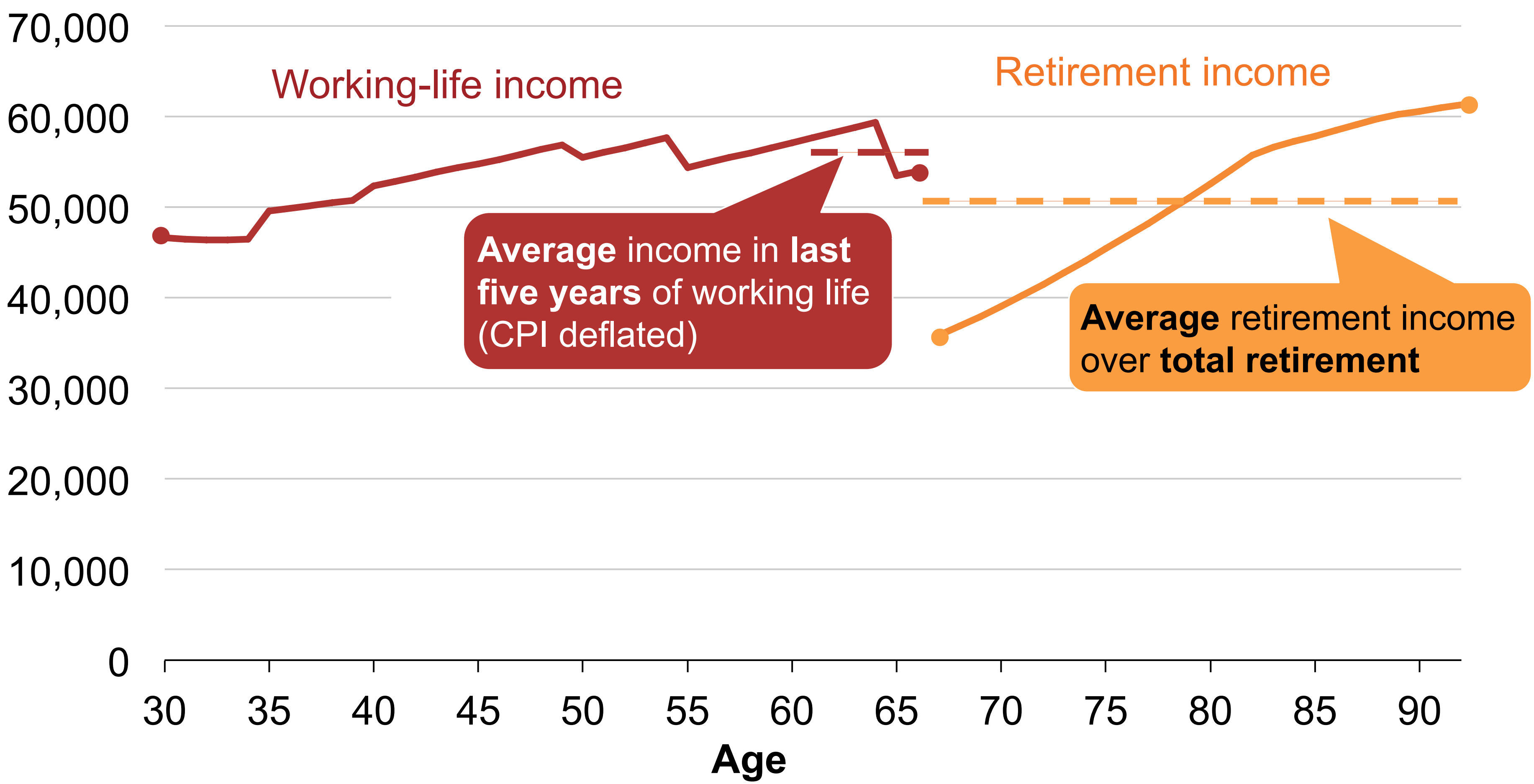
Real annual income, median earner, $2015-6 (CPI-deflated)



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Source: Grattan Retirement Income Projector:

Retirement incomes will be adequate even using less favourable calculations and assumptions

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Replacement rate for median income earner

Retirement age income comparator		Whole of retirement		
Working age income comparator	last 5 years	whole working	last 5 years	whole working
Deflation	CPI	CPI	wage	wage
Current policy	**0.89**	**0.94**	**0.76**	**0.69**
Assumptions				
Lower investment returns	0.86	0.91	0.73	0.67
Minimum draw down	0.81	0.86	0.69	0.63
No non-super savings	0.89	0.94	0.75	0.69
Policy changes				
SG remains at 9.5%	0.87	0.93	0.74	0.68
Assets test taper rate to $2.25	0.92	0.97	0.78	0.72
SG remains at 9.5%; assets test taper rate $2.25	0.89	0.95	0.76	0.70
As above + super tax breaks + SAPTO + M/care levy	0.88	0.93	0.75	0.68
Retirement age to 70 (on its own)	1.00	1.01	0.86	0.74
All of the above	0.99	1.00	0.86	0.73

Notes: "Current Policy": policy as currently legislated, including: 12% Superannuation Guarantee from 2025; retirement age at 67; existing superannuation tax breaks with indexation of relevant caps and thresholds. "Full Grattan package": SG remains at 9.5%; Age Pension asset taper rate lowered so Pension reduced by $2.25 a fortnight per $1,000 in assessable assets; SAPTO and Medicare levy changes as recommended in Grattan Institute's *Age of Entitlement* report; superannuation tax breaks tightened to $11,000 annual cap on pre-tax super contributions, $50,000 annual cap on post-tax super contributions and 15% tax on earnings in the pension phase.
Source: Grattan Retirement Income Model.

Most workers exceed 70% benchmark even if they make no voluntary super contributions

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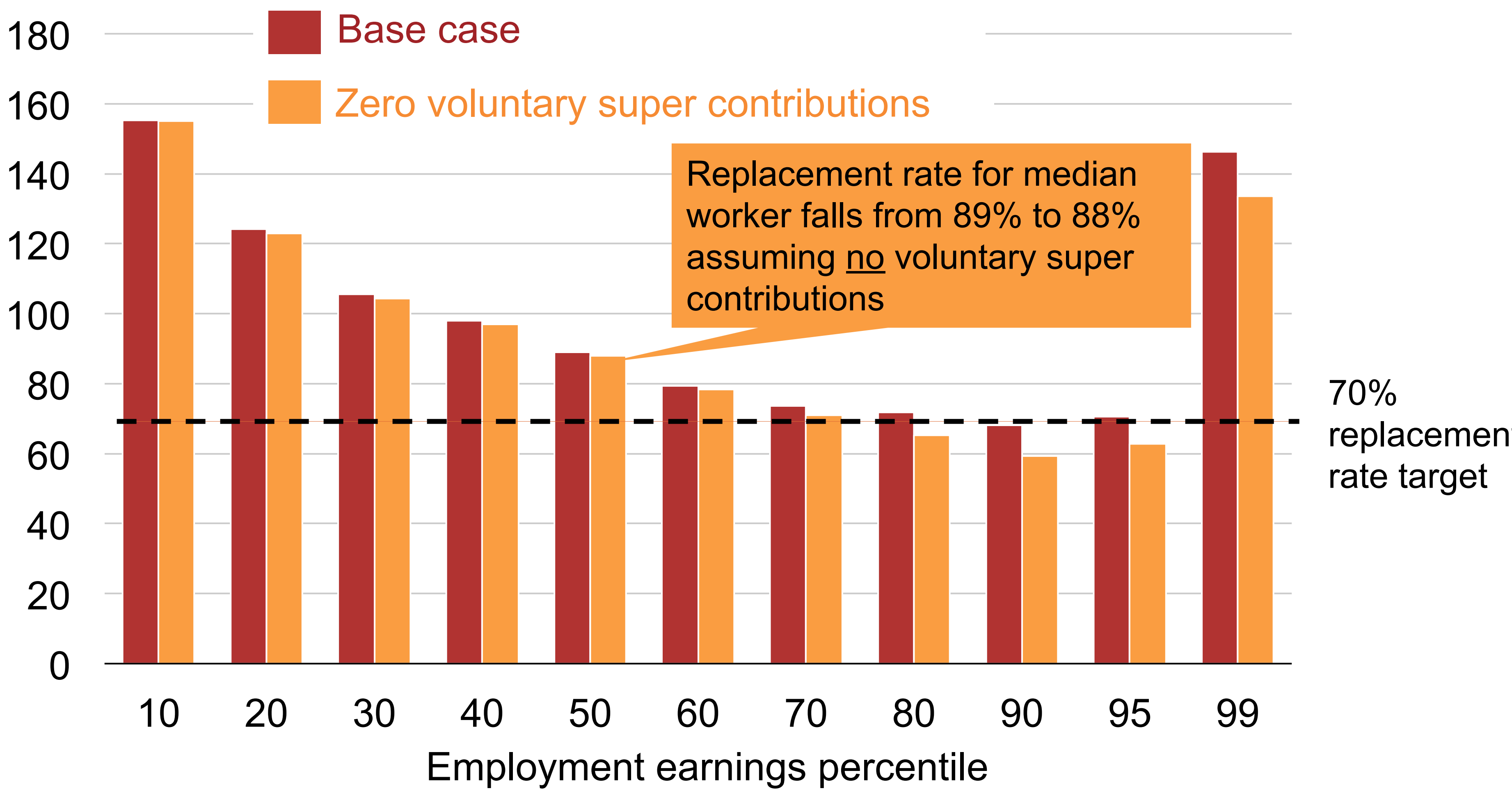
Replacement rates, by employment earnings percentile, CPI deflated, per cent



Notes: Results from modelling the retirement income of a person born in 1985, who dies at 92. Retirement savings drawn down so that small bequest is left in addition to home. "Zero voluntary super contributions scenario" assumes workers make no voluntary pre-tax super contributions – Super Guarantee contributions only. "Base case" assumes workers make voluntary pre-tax super contributions as observed in the ATO 2% sample file. Neither scenario assumes workers make post-tax contributions during their working lives.
Source: Grattan Retirement Income Model

Retirement incomes are adequate even with career breaks: they get more pension instead

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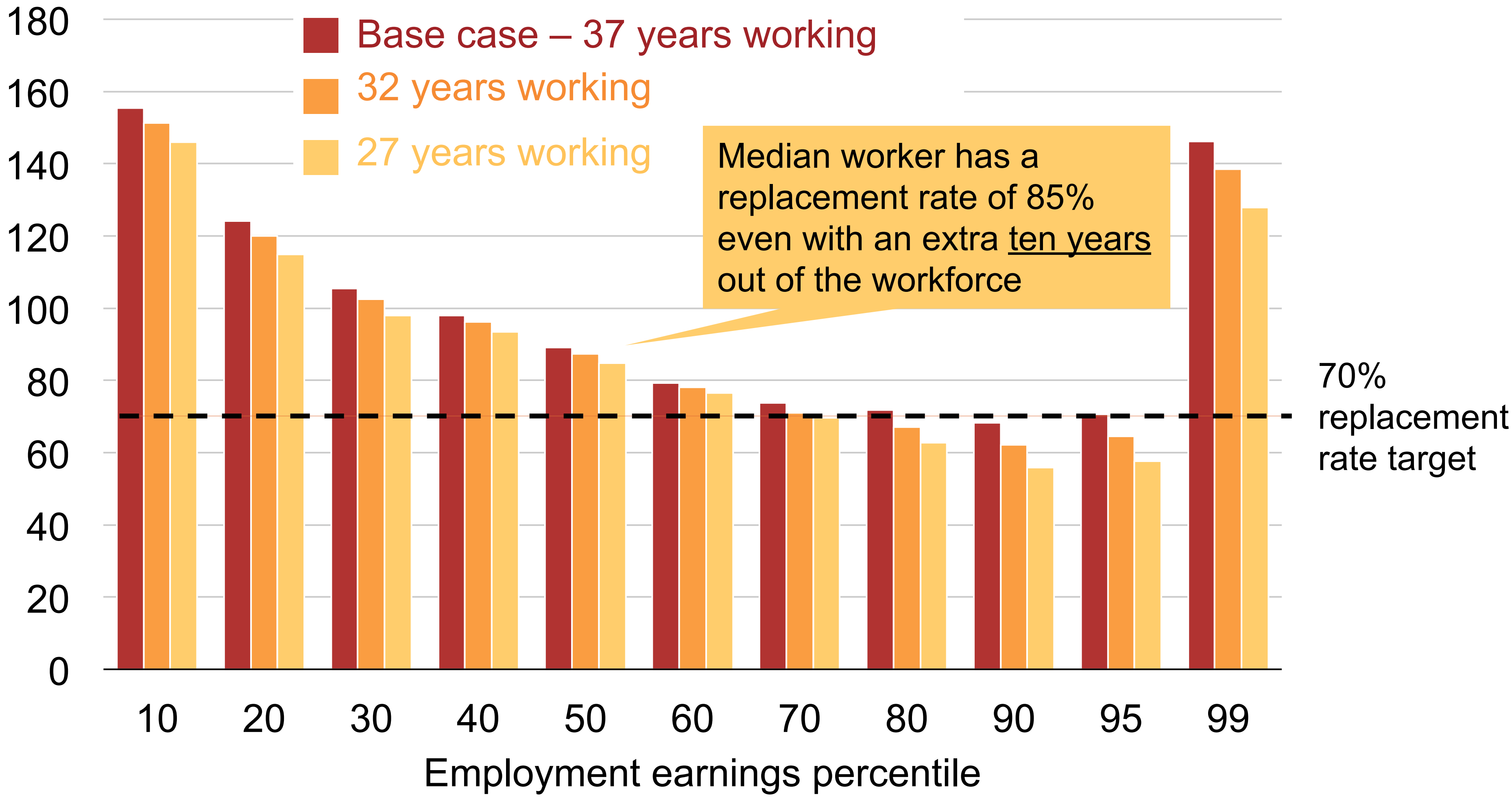
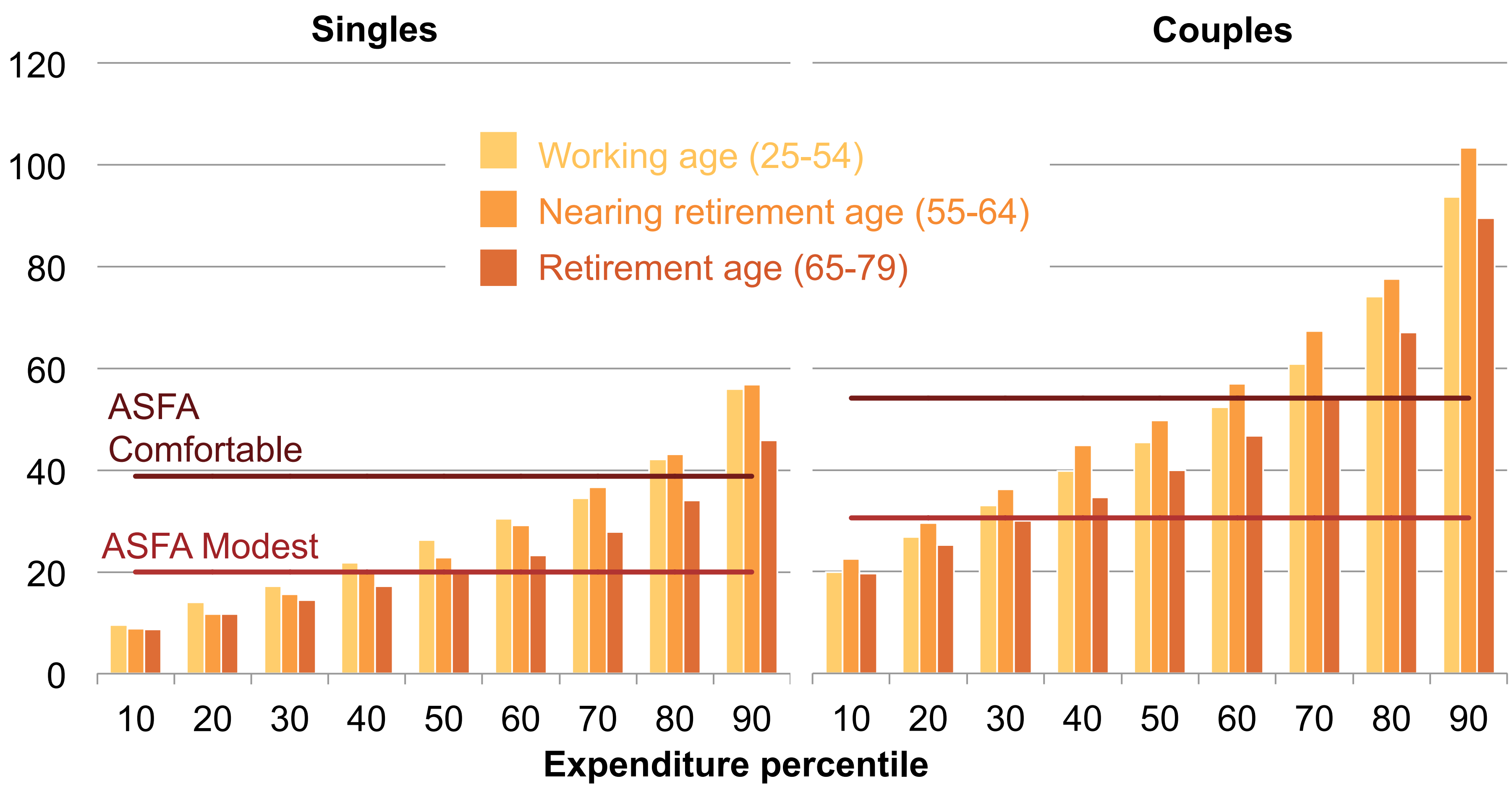


Notes: Results from modelling the retirement income of a person born in 1985, who dies at 92. Retirement savings drawn down so that small bequest is left in addition to home. Career break scenarios assume retirees start work at age 30, and take either a five or ten year career break from age 35 (until either age 40, or 45) before returning to work until age 67. GRIP includes part-time workers.
Source: Grattan Retirement Income Projector

ASFA “comfortable” standard is more than most people spend – *before* retirement

Household expenditure (ex housing), $2015



Notes: Equivalised expenditure of singles and couples, using the OECD standard that assumes that each adult increases the spending of a household by 50%, and each child increases the spending of a household by 30%; partners not equivalised as this spending is accounted for already in the ASFA couples standard. ASFA standard from September quarter of 2015. Household expenditure from 2015-16 Household Expenditure Survey.
Source: ABS Household Expenditure Survey (2015); Grattan analysis.

Reducing Age Pension taper helps bottom 80% more than increasing the Super Guarantee

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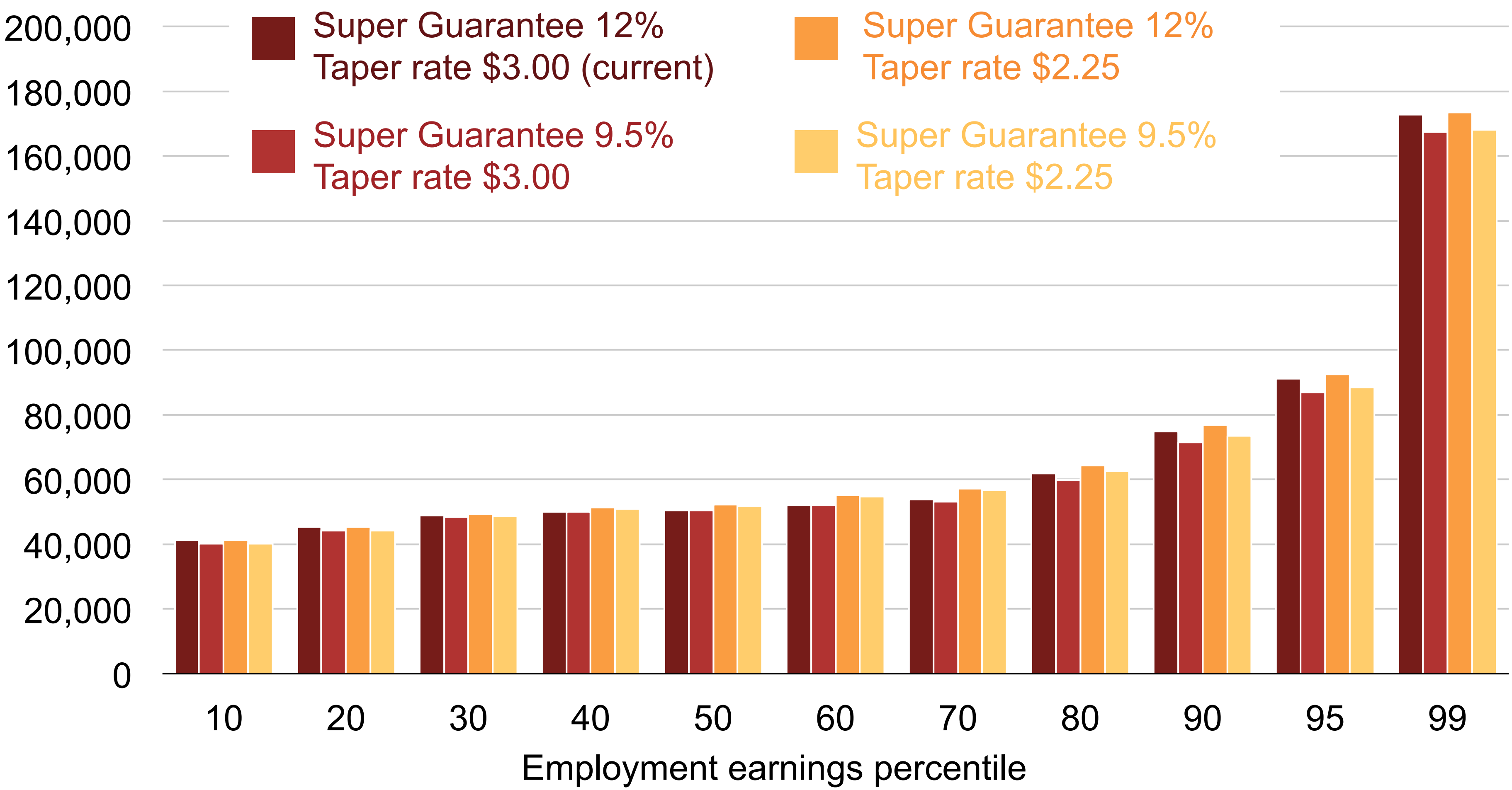
Average annual retirement income, $2015-16, CPI deflated



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Source: Grattan Retirement Income Projector

The Age Pension appears adequate compared to most standard measures of income poverty

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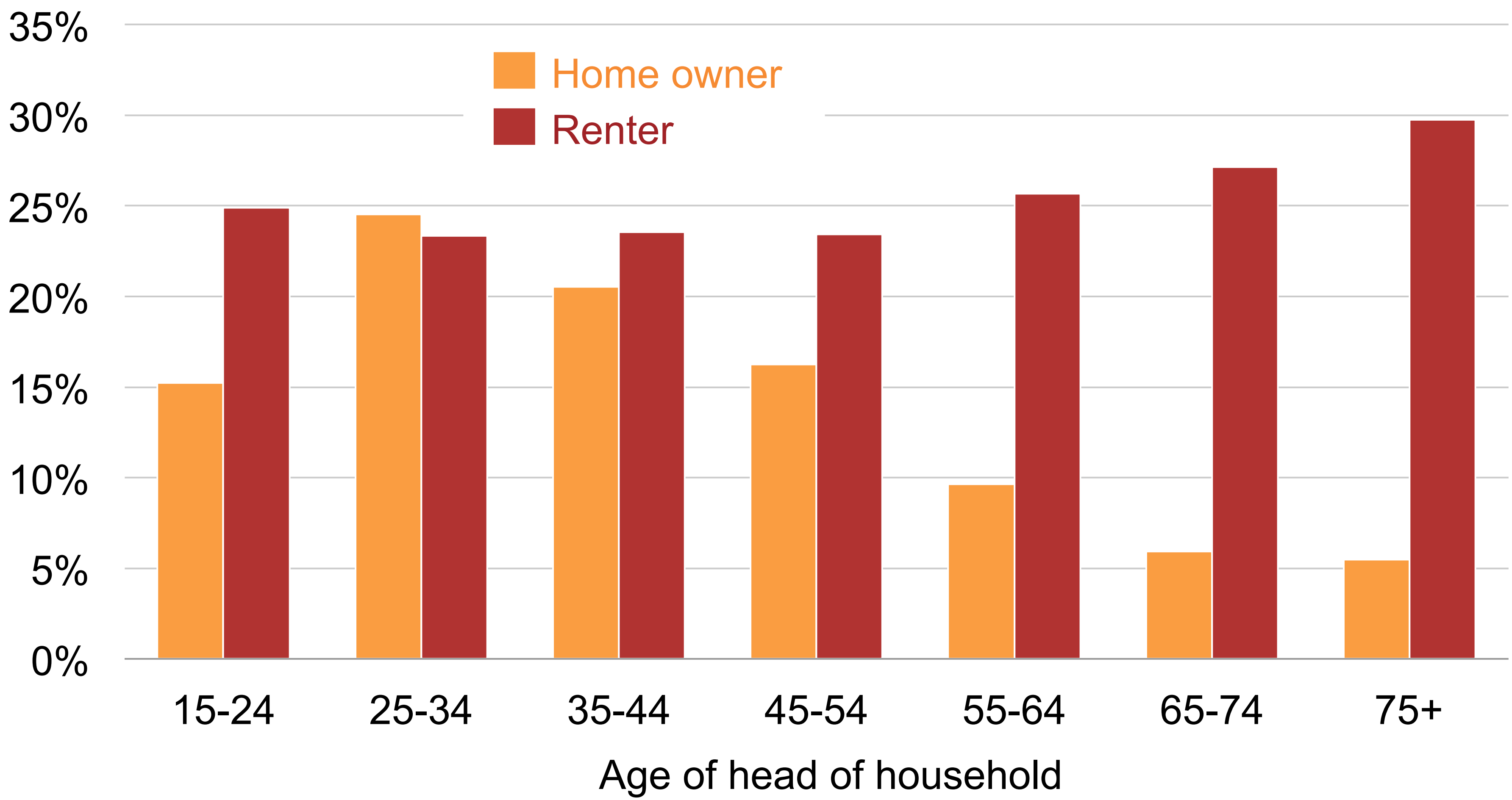
	Housing tenure	Annual value (single)	Welfare payments relative to standard	Annual value (couple)	Welfare payments relative to standard
Low Cost Budget Standards	Homeowner	$22,651	105%	$31,144	115%
	Public renter	$20,335	117%	$31,346	115%
	Private renter	$26,533	102%	$38,862	101%
Henderson Poverty Line	Including housing costs	$21,868	109%	$30,975	116%
OECD poverty (ABS equiv)	All tenure types	$23,372	102%	$35,060	102%
OECD poverty (new OECD equiv)	All tenure types	$26,300	91%	$37,191	97%
Max Age Pension + supplement	Homeowner	$23,824		$35,916	
Max Age Pension + supplement + Rent Assistance	Private renter	$27,105		$39,244	

Notes and sources: See *Daley et al* 2018 Money in Retirement: More than Enough, Table 3.2.

Homeowners' housing costs decline sharply as households approach retirement

Housing costs as a share of household disposable income, 2015-16



Notes: Housing costs include mortgage interest and principal repayments and general rates for homeowners, and rental payments for renters. Does not include imputed rent.
Source: ABS Household Expenditure Survey (2017); Grattan analysis.