



KEY OBSERVATIONS AND OVERVIEW

Key observations

- **The Australian retirement income system is effective, sound and its costs are broadly sustainable.** This is reassuring in a time of economic uncertainty associated with the COVID-19 Pandemic. But the evidence suggests there are areas where the system can be improved.
- The retirement income system is complex. **There is a need to improve understanding of the system.** Complexity, misconceptions and low financial literacy have resulted in people not adequately planning for their retirement or making the most of their assets when in retirement. Adding to complexity is the interaction with other systems, such as the aged care and the tax systems. People need better information, guidance and good, affordable advice tailored to their needs.
 - A major misunderstanding is the view that ‘retirement income’ involves the return from investing superannuation balances rather than drawing down those balances to fund living standards in retirement.
- **There are competing interests in the system.** In what is often a highly contested environment, it is important to gather the facts and establish the evidence so that objective decisions can be made about the direction of policy and what is in the best interests of the community.
- **A clear objective for the system,** agreed by the Australian community through the Government, is needed to guide policy, improve understanding and provide a framework for assessing performance of the system.
- It is suggested that the objective for the system be developed around the goal:
 - *‘to deliver adequate standards of living in retirement in an equitable, sustainable and cohesive way.’*
- What constitutes an ‘adequate, equitable, sustainable and coherent’ retirement income system needs to be clear and preferably legislated. Suggestions of the elements to be covered include:
 - **Adequacy**
 - : The system should ensure a minimum standard of living for retirees with limited financial means that is consistent with prevailing community standards.
 - : The system should facilitate people to reasonably maintain their standard of living in retirement.
 - **Equity**
 - : The system should target Government support to those in need.
 - : The system should provide similar outcomes for people in similar circumstances.
 - **Sustainability**
 - : The system should be cost-effective for taxpayers in achieving adequate retirement outcomes.
 - : The system should be sustainable and robust to demographic, economic and social change.
 - **Cohesion**
 - : The system should have effective incentives to smooth consumption and support people in taking personal responsibility for their retirement incomes.
 - : The system should interact effectively with other systems.
 - : The system should not be unnecessarily complex for consumers.
- **As at June 2019, around 71 per cent of people aged 65 and over received Age Pension or other pension payments.** Over 60 per cent of these were on the maximum rate. For most households aged 65 and over,

the family home is their main asset. Superannuation makes up a small share of their net wealth. This will change as the superannuation system matures.

- **The Age Pension, combined with other support provided to retirees, is effective in ensuring most Australians achieve a minimum standard of living in retirement** in line with community standards. Retirees receive health, aged care and other Government services worth more than the maximum rate of the single Age Pension.
- Some groups do not achieve this goal.
 - A significant number of **older Australians who are renting in the private market need additional assistance**. Increasing the rate of Commonwealth Rent Assistance will only have a small impact. A new approach is required.
- For many who retire involuntarily due to job-related reasons, the adequacy of their living standards before Age Pension eligibility age depends on the level of the JobSeeker Payment. Renters and involuntary retirees experience higher levels of financial stress and poverty than the working-age population.
- **The Age Pension is more than a safety net**. It plays an important role in supplementing the superannuation savings of retirees and allowing them to maintain their living standards. It also provides a buffer for retirees whose retirement income and savings fall due to market volatility, and for those who outlive their savings.
- Compulsory superannuation allows people to achieve a retirement income that better reflects their pre-retirement income. **As the superannuation system matures, people will increasingly fund more of their own retirement**. Nevertheless, the Age Pension will continue to supplement the retirement income of a large proportion of people, but to a lesser degree.
- Voluntary superannuation provides the flexibility for people to save more than is mandated by the Superannuation Guarantee (SG) and to make catch-up savings after periods out of the workforce. It also provides an opportunity for those not covered by the SG to make superannuation savings.
- Superannuation savings are supported by **tax concessions for the purpose of retirement income and not purely for wealth accumulation**. Yet most retirees leave the bulk of the wealth they had at retirement as a bequest.
- **The home is the most important component of voluntary savings** and is an important factor influencing retirement outcomes and how people feel about retirement. Home owners have lower housing costs and an asset that can be drawn on in retirement. If the decline in home ownership among younger people is sustained into retirement, there will be an increasing number of retirees who rent. The system favours home owners, such as through the exemption of the principal residence from the Age Pension assets test.
- The appropriate adequacy objective for a system based on compulsory superannuation is to **balance living standards across a person's working life and retirement**.
- **Saving for retirement involves forgoing consumption in working years**. With voluntary saving, people decide on this trade-off. When there is compulsory superannuation, the rate should be set at a level that balances pre- and post-retirement living standards for middle-income earners. It is challenging to set a single SG rate that suits all Australians given the variety of people's circumstances and experiences.
- A rate of compulsory superannuation that would result in people having an increase in their living standards in retirement may involve an unacceptable reduction in living standards prior to retirement, particularly for lower-income earners. This is based on the view, supported by the weight of evidence that **increases in the SG rate result in lower wages growth, and would affect living standards in working life**.
- Other than for lower-income earners, replacement rates that compare income in retirement with income while working are the most appropriate basis for assessing whether the retirement income system delivers adequate retirement incomes. Replacement rates align with the objective of achieving a

reasonable balance between living standards in working life and retirement. **The suggested benchmark replacement rate is 65-75 per cent.**

- Most recent retirees are estimated to have adequate retirement incomes. Surveys suggest retirees generally have higher levels of financial satisfaction and lower rates of financial stress than working-age people.
- Under the legislated increase in the SG to 12 per cent, **the projected replacement rate for future retirees with typical working lives exceeds the suggested 65-75 per cent benchmark rate** across most income levels. This assumes people draw down their savings in retirement. If they only draw down their superannuation at the legislated minimum rates, which many people currently do, those in the upper half of the income distribution will not achieve the 65-75 per cent replacement rates.
- **More efficient use of savings in retirement can have a bigger impact on improving retirement income than increasing the SG.** If the SG remained at 9.5 per cent, and retirement savings were used more efficiently, most people would achieve 65-75 per cent replacement rates. Most would also achieve higher replacement rates than with the SG at 12 per cent and drawing down balances at the legislated minimum rate.
- The focus of superannuation has often been on building larger superannuation balances through increased contributions. But lower fees and higher investment returns will increase superannuation balances. Crucially, **there has been insufficient attention on assisting people to optimise their retirement income** through the efficient use of their savings.
 - Retirees are generally reluctant to draw down their savings in retirement due to complexity, little guidance, reluctance to consume funds that are called ‘nest eggs’, concerns about possible future health and aged care costs, and concerns about outliving savings. Currently adding to concerns is uncertainty around the impact of the COVID-19 Pandemic.
- **Using superannuation assets more efficiently and accessing equity in the home can significantly boost retirement incomes without the need for additional contributions.**
 - A range of measures could help people have the confidence to use their assets more effectively, including focusing retirement planning on income streams rather than balances, better quality and more accessible advice and guidance, and **advancing the concept of the Retirement Income Covenant so funds guide members into effective retirement strategies.**
 - **The Pension Loans Scheme is an effective option for accessing equity in the home** for both age pensioners and self-funded retirees. The current exemption of the principal residence from the Age Pension assets test is a disincentive to using the equity in the home to support retirement incomes.
- Many stakeholders pointed to inequitable retirement outcomes for various groups, such as women, Aboriginal and Torres Strait Islander people, those with disability and those not covered by the SG.
- The Age Pension helps to reduce income inequality for these groups in retirement compared with working life. But **an individual’s superannuation balance, and retirement income, largely reflects the extent of their engagement in the workforce**, both income and years worked. Those on higher incomes make more superannuation contributions and have larger superannuation balances. For example, the gap in superannuation balances at retirement between men and women is the accumulation of economic disadvantages faced by women in working life, particularly the gap in earnings and time spent in the workforce.
- Some groups are more adversely affected than others by aspects of the design of the system. Changes raised by stakeholders that could **improve the fairness of the retirement income system** include removing the \$450-a-month threshold when the SG is paid; paying the SG on employer paid parental leave and the Government’s Parental Leave Pay; giving greater visibility of superannuation balances in divorce settlements; extending the SG earnings base to include overtime; and ensuring people receive the SG they are entitled to, such as by paying the SG at the same time as wages and better enforcing sham contracting laws. The impact of some of these changes on people’s retirement incomes may be small.

- While the **Age Pension helps offset inequities in retirement outcomes, the design of superannuation tax concessions increases inequality** in the system. Tax concessions provide greater benefit to people on higher incomes.
- **Government expenditure on the Age Pension as a proportion of GDP is projected to fall** slightly over the next 40 years to around 2.3 per cent. Higher superannuation balances reduce Age Pension costs. **The cost of superannuation tax concessions is projected to grow** as a proportion of GDP and exceed that of Age Pension expenditure by around 2050. This is due to earnings tax concessions. The increase in the SG rate to 12 per cent will increase the fiscal cost of the system over the long term.
- Voluntary superannuation contributions are largely concentrated among those nearing retirement, and particularly at the higher end of the income distribution. The evidence suggests that **tax concessions encourage saving in tax-preferred forms, but they may displace other forms of saving** and have a limited impact on overall saving.
- There are areas where superannuation tax concessions are not a cost-effective way to help people achieve adequate retirement incomes. In particular, **the cost of the earnings tax exemption in retirement will grow faster than the growth in the economy** as the system matures and provides the greatest boost to retirement incomes of higher-income earners.
- Many very large superannuation balances were built up under previous high contributions caps and are expected to stay in the system for several decades. At June 2018, there were over 11,000 people with a balance in excess of \$5 million. **People with very large superannuation balances receive very large tax concessions on their earnings.**

Overview and summary

Australians want a secure retirement and the retirement income system is a major influence in determining whether they will have the income to achieve that goal.

This review of the retirement income system was commissioned by the Government following a recommendation by the Productivity Commission. In keeping with its terms of reference, the review has focused on establishing a fact base of the current retirement income system that will improve understanding of its operation and the outcomes it is delivering for Australians.

The review was not asked to make recommendations or propose changes to policy settings.

Decisions to alter policy involve judgements and trade-offs. It is ultimately up to the Australian community — through the Government — to decide on the settings for the retirement income system. The aim of this review is to contribute to more informed decisions by improving understanding of the operation of the retirement income system with supporting facts and evidence.

The panel and secretariat consulted widely, received 426 submissions to the consultation paper it released in November 2019 and held around 100 meetings with stakeholders. Although the review is not making recommendations, a large number of submissions and stakeholders recommended changes to the retirement income system. The review did not examine all the proposed changes in detail, but in keeping with its objective of improving understanding of the system, the review did comment on some of the implications of some of the proposed changes to retirement income policy.

COVID-19: A sound retirement income system in volatile times

During the course of the review, the world was confronted with the COVID-19 Pandemic. It has resulted in many deaths, stretched health facilities, caused significant disruption to people's lives, resulted in major volatility in financial markets and led to a sizeable reduction in economic activity, a significant rise in unemployment and considerable uncertainty. It is an unprecedented situation and the full impact of the pandemic is not known. No country is immune and while Australia has responded to and is weathering the crisis far better than most countries, it has taken precedence over most aspects of life in Australia. For many, this would include considering the performance of the retirement income system.

Given the immediacy of a major health and economic crisis, many may feel that the retirement income system is not a priority. However, those near to or in retirement are understandably concerned about the volatility of the investment environment and the impact on their retirement savings.

The economic fallout from the COVID-19 Pandemic is another reminder of the need for people and fund managers to allow for the risk of market volatility. While some people are concerned about the impact on their retirement savings, surveys suggest others mistakenly believe their superannuation funds insulate them from market volatility. The returns achieved by superannuation funds may be lower in the short term, but they tend to be less volatile than market returns because professionally managed funds have invested across a range of assets. The crisis has highlighted the importance of diversification of retirement savings. And concerns over the risk of market volatility should not be at the expense of how long-term exposure to the market can boost retirement incomes over time. Most Australians are in a fund with solid returns in the long term. The crisis has also highlighted the value for those in retirement in obtaining sound advice and guidance on how they can best structure their retirement savings and income.

The extent of the COVID-19 Pandemic is far-reaching. But the importance of the retirement income system remains. **Given the current level of uncertainty, Australians should be reassured that the retirement income system is effective, sound and its costs are broadly sustainable.**

Reviews inevitably focus on identifying shortcomings and areas for improvement. Many of the submissions to this review emphasise what stakeholders think are problems. The overall impression may be that the system is badly flawed. While there are areas where Australia's retirement income system can be improved, overall, it is well placed to deal with economic volatility and the challenge of an ageing society. It is ranked very highly in international comparisons of retirement income systems.

'Many countries look to the Australian system, and similarly designed retirement systems, as exemplars in reforming their own systems.' (CEPAR, 2020, p. 4)

The Age Pension is more than a safety net that supports those who do not have the means to achieve a minimum standard of living in retirement. It supplements the income for about 65 per cent of Australians in retirement. It serves as a buffer, helping offset the decline in retirement incomes for many Australians as a result of market downturns. It also acts as a form of longevity insurance for those who outlive their retirement savings. Given current financial pressures and uncertainty facing many Australians, the existence of a sound and sustainable Age Pension is important.

Australia's superannuation arrangements are still maturing, although to date they have resulted in around 16 million Australians collectively owning close to \$3 trillion in assets. This stock of superannuation assets, which is the fourth largest in the world, is important to funding the economy and delivering retirement incomes. The investment of superannuation assets will play a significant role in the recovery of the Australian economy from the downturn initiated by the COVID-19 Pandemic.

The Government's measures to cushion the economic impact of COVID-19 included the ability for working-age people in financial stress to access up to \$10,000 of their superannuation in 2019-20 and a further \$10,000 in 2020-21. The retirement income system is designed to support the retirement outcomes for Australians and not to deal with the challenges people may face in their working lives. However, there will be emergency circumstances where the benefits of giving people early access to their superannuation will exceed those of preserving balances for retirement. Caution is needed because early access can have a significant impact on superannuation balances at retirement for younger people.

Yet if it were not for the existence of compulsory superannuation, fewer people would have savings available when faced with severe financial stress.

The economic impact of the COVID-19 Pandemic is not incorporated in the economic modelling undertaken for this review. But the modelling is aimed at helping assess the capacity of the system to deliver retirement incomes to Australians in the long term. The projections extend to 2060. The models are based on long-term trends in the economy. Economic shocks, such as those caused by the COVID-19 Pandemic, should not materially alter the analysis based on long-term trends. However, the report does look at the impact of developments such as lower wages growth, lower investment returns and short-term financial shocks.

Given the uncertainty and financial pressures confronting governments and individuals across the world, the fact that Australia has a sound retirement income system is a source of reassurance.

The need to improve understanding of the system

The overall task of the review was to help improve understanding of the retirement income system. **During the course of the review, it became increasingly evident that there are many aspects of the system where there is a need to improve understanding.** These included:

Dealing with complexity. Complexity and uncertainty, a lack of financial advice and guidance, and low levels of financial literacy are impeding people from understanding the system. As a result, some people fail to adequately plan for retirement and make poor decisions about how to use their savings in retirement.

‘There is a need for the retirement income system to be structured and communicated so that people are better able to understand and navigate the system to plan and access optimum and appropriate benefits.’ (COTA, 2020, p. 6)

The nature of retirement income. Most people die with the bulk of the wealth they had at retirement intact. It appears they see superannuation as mainly about accumulating capital and living off the return on this capital, rather than as an asset they can draw down to support their standard of living in retirement. The family home is an underutilised source to support living standards in retirement.

‘Voluminous research has been dedicated towards understanding the accumulation phase of superannuation (savings and investments during an individual’s working life) ... In contrast, little attention has been allocated to the retirement (and aged-care) phase.’ (Griffith Centre for Personal Finance and Superannuation, 2020, p. 8)

The nature of retirement. The nature of retirement has changed. For many, the transition from full-time work to permanent retirement is gradual rather than abrupt. Some people retire more than once, others are involuntarily retired. There is no mandatory retirement age for most workers.

“Retirement” can no longer be narrowly defined as a fixed point in time at which people leave the paid workforce permanently. Retirement is now a continuum between reduced participation in the paid workforce (for example, through reduced working hours and temporary employment) and leaving it altogether.’ (Australian Council of Social Service, 2020, p. 12)

The objective of the system. The retirement income system lacks an agreed objective. Differing views on the appropriate level of the SG rate stem from different views about the system’s objective.

‘Any conclusions drawn about ... whether SG rates are appropriate, and whether retirees are well served are critically dependent upon views as to the objective and adequacy of both Age Pension and superannuation.’ (First State Super, 2020b, p. 8)

Role of the pillars. The ‘pillars’ of the retirement income system are commonly seen as being the Age Pension, compulsory superannuation, and voluntary saving (including housing). Some see housing as a separate pillar. Others would add more pillars, such as labour force participation, social transfers in kind and the JobSeeker Payment (formerly Newstart Allowance). There is no agreed view on the role of the pillars.

‘Retirees do not look at their income needs in the three or four pillar approach favoured by academics and economists. We think there is great merit in looking at this issue in the way retirees practically approach solving their income need requirements because the three pillar model misses important components or

downplays other considerations.'
(Chartered Accountants Australia and New Zealand, 2020, p. 2)

Dealing with diversity. The retirement income system covers people in very different circumstances: different incomes, time in the workforce, employment situation, capacity to save, home ownership status, risk preferences, financial literacy, partnership status and life events. While the system may provide adequate retirement incomes for many Australians, there is uncertainty about if and how it can compensate for those who may fall short, such as women, lower-income renters, individuals not covered by the SG, involuntary retirees, Aboriginal and Torres Strait Islander people and those with disability.

'Dealing with heterogeneity is a major challenge with regard for setting policy ...'
(Khemka & Warren, 2020, p. 10)

Common misunderstandings and misconceptions about the retirement income system

The views below represent perspectives observed in press articles, surveys and some submissions. These concerns are real and affect how people behave. However, they are generally not supported by evidence.

Adequacy of retirement income/retirement expenditure needs

- 'I need to preserve my assets in case I get sick or need aged care.'
- 'I will need to pay for most of my health costs in retirement.'
- 'I need \$1,000,000 in superannuation for an adequate retirement income.'

Retirement income products and investment strategies

- 'The best investment strategy in retirement is very low risk, such as cash.'
- 'Investing in real estate is a better investment strategy for retirement.'

Age Pension

- 'The Age Pension is earned during working life. Taxpayers "pre-pay" for it through their taxes.'
- 'The Age Pension will become unaffordable. Most people in future won't receive it.'

Superannuation

- 'The minimum drawdown rate is what the Government recommends.'
- 'If I withdraw my money from superannuation, I must spend it.'
- 'I should only draw down the income earned on my assets — not the capital.'

The importance of establishing the facts and gathering the evidence

Establishing the facts and gathering evidence on how the retirement income system operates is important to improve understanding of the system and help address misconceptions, such as those outlined in the box above. This is the objective of this report.

The retirement income system is, however, a source of considerable public debate. This reflects the system's importance to the Australian people, the economy and the many firms involved, particularly those in the superannuation industry, which manage nearly \$3 trillion in assets and generate fees of more than \$30 billion per year.

The stakes are high because changes to the system can have significant implications for all involved: people, in terms of the level of their working life and retirement incomes; and superannuation funds, in terms of the assets they manage and the fee income they generate. As one submission noted:

‘... a balanced discussion of the retirement income system is bedevilled by narratives that serve vested interest rather than the common good.’

(Centre for Law, Markets and Regulation, 2020, p. 2)

The fact that parties have a direct interest in the system need not mean they are not interested in the ‘common good’. Nevertheless, the public debate over the retirement income system can be very intense. Many comments and statements (particularly in the media) about the way the system operates and the impact of possible changes can be more assertions than evidence based on considered assessments. Yet, they are often presented as if they were indisputable facts.

When it comes to assessing the outcome of changes to the retirement system, this inevitably involves long-term projections of 40 years or more. **There are no facts when making long-term projections.** The results depend on the calibration of the models used, the nature and comprehensiveness of the data and, most importantly, the assumptions regarding how the economy and retirement income system operate, along with the behaviour of people.

Small changes in underlying assumptions can have a significant impact on the results from modelling exercises. This is not normally highlighted when results are cited as support for a particular position being advanced.

This review focuses on the analysis, data and assumptions that go into long-term projections of the retirement income system. Importantly, it outlines in detail the assumptions incorporated in the modelling and, based on the weight of the evidence, it presents what it considers to be the reasonable assumptions to underpin long-term projections. It also incorporates substantial sensitivity analysis to assess the impact of alternative assumptions.

While the review outlines a comprehensive fact base on the operation of the retirement income system, in some areas, such as long-term projections, there are few ‘facts’ and considerable judgement is required. The review provides the evidence to help assess what judgements are appropriate, and as such, help in understanding the intense and at times divisive debate surrounding the retirement income system.

The changing nature of retirement

Retirement — voluntarily withdrawing from active working life — is a concept that only became entrenched in the 20th century. Little more than a century ago, people never really retired. They worked until they no longer could.

In 1909, the Australian Commonwealth Government introduced a national ‘old age’ pension from age 65 for men and women, later reduced to age 60 for women. At the time, it was accessed by a significantly smaller proportion of the population compared with today because life expectancy was much lower. In 1909, less than 50 per cent of men and around 55 per cent of women lived to 65. As life expectancy in Australia has increased, so have people’s expectations that they will have a substantial period of their lives in ‘retirement’.

There is no mandatory retirement age for most workers. Rather than a fixed ‘retirement age’, there are ages when someone can access their superannuation (preservation age) or when they are eligible to apply for the Age Pension. Once a person accesses their superannuation, there is no barrier to them being in the workforce.

There is also no longer an abrupt transition from being in a job to permanently retiring. People’s pathways to retirement vary. Some transition with reduced hours of work, some retire many times as

they leave and rejoin the workforce, and for some their retirement is involuntary due to ill health, caring for others or losing their job and being unable to find another.

The average age of retirement in Australia is currently around 62-65 years, with women tending to retire one to three years before men. However, people are staying in the workforce to older ages. The labour force participation rate of people aged 60-64 has increased by 22 percentage points between April 2000 and April 2020. Improved health outcomes, greater workplace flexibility and higher average levels of educational attainment have all contributed to some people staying in the workforce to older ages; a trend that is likely to continue.

What is the retirement income system?

Views differ as to what constitutes the 'retirement income system'. The terms of reference for the review referred to a three-pillar system consisting of:

- A means tested Age Pension
- Compulsory superannuation
- Voluntary savings, including home ownership

Several submissions said there were more pillars, with suggestions ranging from work; non-financial arrangements, such as pensioner discounts; JobSeeker Payment (formerly Newstart Allowance) for the involuntary retired; private intergenerational transfers; and income from insurance products purchased to protect against risks such as longevity, ill health and long-term care. These are all sources of income that people may be able to draw on in their retirement.

Many stakeholders believe home ownership should be a pillar in its own right given its significance in influencing the wellbeing and the adequacy of a retiree's income. This report highlights the importance of home ownership in achieving security in retirement — such as removing the need for income to pay for rental accommodation and providing an asset that can be drawn on to supplement retirement income.

While there are many sources of income and support for people in retirement, not all are explicitly tailored for this purpose. In contrast, the traditional three pillars involve Government measures aimed at supporting people's income in retirement such as:

- Directly funding eligible people through the Age Pension
- Requiring employers to contribute a proportion of employees' wages to superannuation
- Encouraging people with tax concessions to make voluntary contributions to superannuation

Notwithstanding this distinction, all sources of income and support people can access in their retirement need to be taken into account in assessing whether their standard of living in retirement is adequate.

One area of considerable support people receive in retirement is subsidised health and aged care services, along with tax offsets and exemptions. For example, while health spending increases as a proportion of overall expenditure for people between ages 55-80, it remains a relatively small share of total expenses in retirement. This is largely due to public expenditure on health absorbing much of the cost of ageing. The same applies for the cost of aged care services.

The concept of a three-pillar retirement income system, along the lines of the Australian system, was popularised by the World Bank in a 1994 report *Averting the Old Age Crisis* (World Bank, 1994). However, in 2008 the World Bank updated the advice it was giving countries in the design of a retirement income system. It advocated a five-pillar system, with one of the additional pillars covering financial and non-financial support outside formal pension arrangements, such as support

people receive from families, other social programs and individual assets such as home ownership (World Bank, 2008).

Many submissions raised the retirement outcomes of involuntary retirees. Older workers who lose their job and cannot obtain another one before they are eligible for the Age Pension may be able to draw down their superannuation when they reach preservation age. Otherwise, they will be relying on social security payments such as JobSeeker Payment. The position of involuntary retirees raises issues around the interface between the broader social security safety net and the retirement income system. This issue is explored in the report.

Irrespective of whether the retirement income system is defined as consisting of three, four, five or more pillars, the most important consideration is whether it is actually operating as a 'system'. That is, whether all the elements are working together in a cohesive fashion.

Cohesion is particularly important to consider because the retirement income system evolved rather than being designed as an integrated unit. For example:

- The Age Pension was introduced in 1909 and its coverage, settings and means test for eligibility have been changed many times.
- Prior to the 1986 National Wage Case, superannuation was generally limited to public servants and white-collar employees of large corporations. With the National Wage Case guidelines, provision for contributions started to be included in some industrial awards.
- The SG was introduced in 1992. Initially set at 3 per cent of an employee's ordinary time earnings, it has since gradually increased to 9.5 per cent today and is legislated to gradually reach 12 per cent on 1 July 2025.
- Voluntary contributions to superannuation are encouraged through tax concessions, although capped. The tax arrangements for superannuation and contribution limits have been changed many times.

In 2014, the Parliamentary Library (2014) listed the history of changes to the retirement income system, which ran to about 30 pages.

The cohesion of the retirement income system is explored in depth in this report.

The objective of the retirement income system and role of the pillars

The retirement income system currently has neither an agreed objective nor an agreed role for its pillars. The two are inherently linked. The role of the pillars has to be determined in terms of how they can contribute towards achieving the system's objective.

Many submissions said the absence of a clear and agreed objective was a significant shortcoming. They endorsed the need to establish an overall objective for the system as well as the role of the pillars.

An agreed objective is needed to anchor the direction of policy settings, help ensure the purpose of the system is understood, and provide a framework for assessing the performance of the system.

While the desirability of having an agreed objective was widely endorsed by stakeholders, there were a range of views as to what should be the objective.

It is not for this review to determine the objective for the system or the role of the pillars. Ultimately, this has to be agreed and endorsed by the Australian community through the Government. If the aim is to achieve consistency in the direction of retirement income policy and improve community understanding, the objective should be settled and not be subject to frequent change. For these reasons, it would be preferable if the objective for the retirement income system was legislated.

System objective

This review outlines some of the issues to take into account in developing the objective for the retirement income system. Specifically, it suggests that it be expanded around the following broad goal:

'To deliver adequate standards of living in retirement in an equitable, sustainable and cohesive way.'

What this entails needs to be elaborated. Ambiguous, vague statements that are open to interpretation will not give the required guidance.

Towards clarifying what could be covered in the suggested broad outline of the system's objective, a range of elements are canvassed that flesh out the concepts of adequacy, equity, sustainability and cohesion. It is suggested that these elements be incorporated in a description of the objective of the system.

Adequacy

A key point that needs to be clarified and emphasised is that the retirement income system is aimed at providing income to support living standards in retirement. It is not directed at building wealth per se or facilitating estate planning. While the system is focused on ensuring people have the income to support adequate standards of living in retirement, this cannot be at the expense of an individual's standard of living during their working life.

The review suggests that delivering adequate standards of living in retirement has two elements:

- 1. The system should ensure a minimum standard of living for retirees with limited financial means that is consistent with prevailing community standards.***

There is widespread agreement among stakeholders that the system should provide a safety net so that older Australians achieve a minimum standard of living in retirement and avoid living in poverty. There is also support that this minimum standard be consistent with prevailing community standards.

- 2. The system should facilitate people to reasonably maintain their standard of living in retirement.***

The system can facilitate people to maintain their standard of living in retirement through a number of ways. There can be incentives for people to save for their retirement. Saving can also be compulsory, such as the SG, which seeks to counter concerns that people will not voluntarily save enough for their retirement.

Some stakeholders say the objective for the system should incorporate an aspirational component, such as referring to a 'comfortable' or 'dignified' retirement, or 'a retirement people want and deserve'. Others point out that such aspirational objectives would involve many people having a higher income in retirement than they had in their working lives. Their concern is that, in a system based on compulsory superannuation, the required level of saving for an aspirational objective may involve an excessive reduction in the standard of living for many people in their working lives. These stakeholders believe the objective should be to smooth consumption between working years and retirement.

The degree to which an increase in the SG rate is considered to impact on wages growth influences how the objective should be framed. If an increase in the SG rate is not considered to reduce wages growth, then the impact of an aspirational retirement income objective on the required level of saving and the impact on the standard of living pre-retirement are not relevant issues.

The relationship between the SG rate and wages growth is a key issue considered in this report. The weight of evidence indicates an increase in the SG rate comes at the cost of lower wages growth.

There is a trade-off in smoothing consumption over working life and retirement. As such, the second aspect of the adequacy objective should be expressed in terms of consumption smoothing or maintaining living standards in retirement.

Equity

Stakeholders widely endorsed equity as an important principle of the retirement income system. But there were a range of views as to what this constitutes. Many submissions focused on whether particular groups in the population were achieving equitable retirement outcomes. This report examines retirement outcomes for a range of such groups. It identifies that for many, their retirement outcomes are below others, but this largely reflects factors outside the retirement income system, such as differences in people's pre-retirement income, wealth and circumstances. In retirement, the Age Pension helps to offset some of the inequities people faced in their working life that affected their ability to save for their retirement.

It is suggested that there are two elements of equity that should be incorporated in the system's objective:

1. *The system should target Government support to those in need.*

Targeting Government support to those in need is central to the design of Australia's transfer system. The most important elements of Government support in the retirement income system are the Age Pension and superannuation tax concessions, although retirees have access to other forms of Government support, such as health and aged care services.

2. *The system should provide similar outcomes for people in similar circumstances.*

The income people will have in their retirement will vary in line with the differences in their circumstances. But a central aspect of equity is that people in similar circumstances should have broadly similar retirement outcomes.

Sustainability

There are significant costs to the taxpayer in the retirement income system. The growth in those costs has to be consistent with the Australian economy's capacity and the community's willingness to pay. The review suggests two elements of sustainability:

1. *The system should be cost-effective for taxpayers in achieving adequate outcomes.*

From both community support and cost sustainability perspectives, Government expenditure should be efficiently directed towards helping Australians achieve adequate and equitable retirement outcomes.

2. *The system should be sustainable and robust to demographic, economic and social change.*

The objective of achieving adequate retirement outcomes has to be responsive to demographic, economic and social changes. This includes variations in overall economic growth, wages and investment returns. Mechanisms are needed to allow people to deal with such risks to their income in retirement.

Cohesion

Cohesion considers whether the retirement income system's processes, mechanisms and incentives are all contributing to achieve its objective. All components in the system should complement each other and work in the same direction.

Policy settings should enable people to smooth consumption over their lives in an optimal manner. This means that the system needs to help balance a person's spending and saving through pre- and

post-retirement. This includes assisting people to efficiently draw down their savings in retirement to support their standard of living. The review suggests three elements of cohesion:

1. *The system should have effective incentives to smooth consumption and support people in taking personal responsibility for their retirement outcomes.*

Encouraging people to take responsibility for their retirement income not only involves providing incentives to save, such as tax concessions, but also includes compelling people to save.

2. *The retirement income system should interact effectively with other systems.*

Retirement planning is not confined to the retirement income system. It must effectively interact with other systems, such as health and aged care.

3. *The system should not be unnecessarily complex for consumers.*

The retirement income system should be as simple as possible, although the range of issues covered are such that it will inevitably involve a degree of complexity. The aim, nevertheless, should be to keep the complexity to a minimum. Where complexity cannot be avoided, mechanisms are needed to help people understand and navigate the system, including giving them access to advice and guidance to do so.

Role of the pillars

The role of the pillars will be influenced by what the community decides should be the objective for the system. It will also depend on how the pillars interact and their effectiveness in achieving the system's objective. The review has provided information on how the pillars operate to help the community, though the Government, decide on the pillars' respective roles.

The Age Pension

The Age Pension serves two main roles. It provides a safety net for those who do not have the financial means to support a minimum standard of living in retirement. Its second role is to supplement the retirement income of a large proportion of retirees, particularly lower- and middle-income earners, to assist them (in combination with their superannuation and other savings) to maintain their standard of living in retirement. The Age Pension is a backstop for retirees who may outlive their retirement savings (longevity risk) or see the value of their retirement income fall significantly (investment risk). It also plays an important role in reducing income inequality in retirement.

Determining the balance between these roles will depend in part on the relative effectiveness, including cost-effectiveness, of the Age Pension and the other pillars in achieving the system's objective. For example, is it more cost-effective to help lower-to-middle-income earners maintain their standard of living in retirement through the Age Pension supplementing their savings? Or is it more cost-effective to increase the rate of compulsory superannuation and/or provide more generous superannuation tax concessions?

Compulsory superannuation

Improving the adequacy of retirement incomes is a key role of compulsory superannuation. Compulsory SG savings, in combination with the Age Pension, can allow people to better balance their standard of living pre- and post-retirement than if they could not access the Age Pension. However, **the SG is universal and may not suit all Australians given the diversity of experiences and circumstances.** It is therefore appropriate that the SG be set with regard to the circumstances of the average income earner with a typical working life.

While there is broad agreement on the need for compulsory savings, there are diverse views around whether the role of compulsory superannuation should be to replace or supplement the Age Pension. There are significant differences in the required rate of the SG if the aim is to replace the Age Pension rather than supplement the Age Pension. As the superannuation system matures, the proportion of retirees on the full-rate Age Pension will fall, though the Age Pension will remain a significant income source for many lower- and middle-income earners.

The sustainability of compulsory superannuation is best assessed by looking at its full budgetary impact and not just the reduction in Age Pension expenditure as the superannuation system matures. The cost of superannuation tax concessions also needs to be taken into account.

Voluntary savings

Voluntary superannuation contributions give people the flexibility to save more for their retirement than is mandated by the SG and to make catch-up savings. This is important for those not covered by the SG, such as the self-employed and those who take extended career breaks. The effectiveness and distribution of tax concessions in encouraging voluntary savings is an important consideration in assessing the role of voluntary savings in the retirement income system.

Housing is an important component of voluntary savings for most people and a major determinant of their retirement outcomes. As home owners generally have lower housing costs in retirement, they tend to have better retirement outcomes than those who rent. The home is also an asset that can be drawn on in retirement.

People also save for retirement outside the superannuation system and through home ownership. This is especially true for older Australians or workers who did not have the benefit of the SG; for example, the self-employed. These savings may take many forms, including financial assets, such as shares and bonds, business assets or bank deposits.

The performance of the retirement income system

To gather information to help improve understanding of the retirement income system, its performance was reviewed against the elements of the suggested objective for the system: adequacy, equity, sustainability and cohesion.

Adequacy

A minimum standard of living in retirement

The Age Pension is commonly thought of as providing the safety net in the retirement income system, ensuring all Australians have a minimum standard of living in retirement. But retirees are also supported by a range of other government services and concessions.

Australian retirees have access to health, aged care and other government services worth more than the maximum rate of the single Age Pension. Older Australians also pay less tax than those in employment with similar incomes, and receive concessions on a range of expenses. Most Australians aged 65 and over also have high levels of home ownership, which reduces their ongoing housing expenses.

In assessing whether Australians in retirement have a minimum standard of living, all these support mechanisms, in addition to the Age Pension, need to be taken into account. There is, however, no

one measure to determine whether retirees are achieving a minimum standard of living that takes into account community standards. Judgement is required. To help with that judgement, the review considered a range of indicators of the adequacy of retirees' living standards.

When all forms of support are taken into account, it appears **that most households in retirement are not in financial stress and are not living in poverty (Chart 1)**. The main exceptions are a number of retirees on the Age Pension who rent in the private market and those who retire before Age Pension eligibility age, particularly those who retire involuntarily.

Chart 1. Income poverty rates of retirees

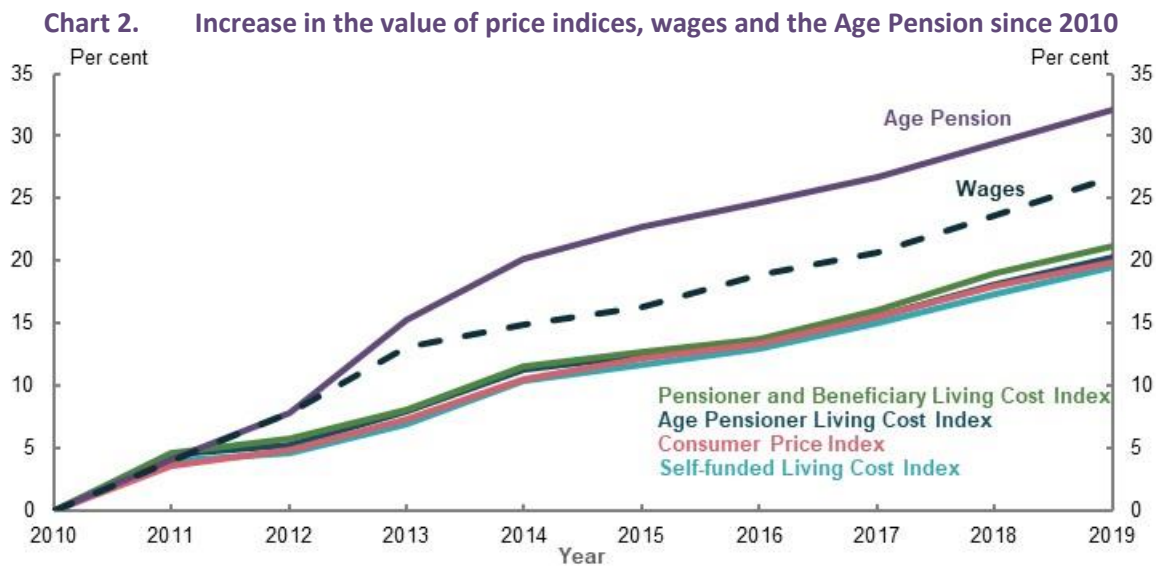


Note: Data relates to 2017-18 financial year. Elevated poverty rate defined as 5 percentage points above retiree average. Retirees are where household reference person is aged 65 and over. There is overlap between some categories, for example, early retired and renter categories. Early retired means aged 55-64 and not in the labour force. Housing costs includes the value of both principal and interest components of mortgage repayments. Source: Analysis of ABS Survey of Income and Housing Confidentialised Unit Record File, 2017-18.

Adequacy of Age Pension

The Age Pension is the main income support for retired Australians with limited financial means. A range of measures suggest **the Age Pension has kept pace with community standards**. These are:

- With low wages growth in recent years, indexation arrangements have resulted in the maximum Age Pension rate rising faster than wages since 2014. The base rate is currently about 4 per cent above the wages benchmark. For many retirees, the Age Pension provides a higher level of income than they received during their working life.
- In terms of price movements, the Age Pension has increased by 32 per cent since 2010, while the CPI has increased by 20 per cent (Chart 2).
- On international comparisons, the Age Pension is equal to 27.8 per cent of gross earnings, placing Australia eighth out of 36 OECD countries. **However, this measure does not take into account the range of other government support Australian retirees receive.**
- The maximum rate of the Age Pension is also above available absolute poverty benchmarks, such as the Henderson Poverty Line. Such benchmarks, however, do not indicate whether the Age Pension is keeping pace with community standards.



Note: Measures growth in value of indices since 1 July 2010. Wages is based on average weekly earnings, in original terms. Source: Analysis of (ABS, 2020e) (ABS, 2020q), and data provided by the Treasury.

The wellbeing of retirees

Wellbeing indicators offer another basis to assess whether retirees have a minimum standard of living. These indicators incorporate not only the impact of the Age Pension but also other forms of support. These indicators suggest that overall:

- Retirees generally have higher levels of financial satisfaction than working-age people across the income distribution
- Rates of financial stress generally decline as households approach and enter retirement

Two groups, however, have levels of financial stress well above people below age 65: those renting in retirement and those who are involuntarily retired before Age Pension eligibility age.

About one-quarter of retirees who rent privately are in financial stress, primarily because of high housing costs. Commonwealth Rent Assistance covers 75 per cent of rental costs above a minimum threshold and is capped at a maximum amount (around \$300 per fortnight for a single without dependent children). Market rents are significantly above this level.

Twenty-eight per cent of early retirees are in financial stress. Renters who retire before Age Pension eligibility age have the highest level of financial stress in retirement.

Income poverty measures

Income poverty measures have limitations because they are solely based on the retiree's income. The OECD measure of income poverty suggests poverty rates among retirees in Australia are high. But this measure does not make allowance for high rates of home ownership in Australia, which reduces housing costs in retirement and boosts living standards.

While measures of income poverty have limitations, they are useful in identifying those groups falling behind. The incidence of income poverty among older Australians has fallen over the past decade. The changes to the Age Pension in 2009 led to a large reduction in rates of income poverty. However, and consistent with the indications of retirees in financial stress, retiree renters on the Age Pension have income poverty rates well in excess of other retirees and working-age groups.

Increasing Commonwealth Rent Assistance

Because many retired renters achieve poor outcomes in terms of financial distress and income poverty, a number of submissions suggested that Commonwealth Rent Assistance be increased. Several suggested the maximum rate of Commonwealth Rent Assistance be increased by 40 per cent.

The review assessed the impact of such an increase. The maximum fortnightly payment for singles without dependent children is currently \$139.60. Payments are indexed to the CPI. A 40 per cent increase in the maximum Commonwealth Rent Assistance payment would not be sufficient to significantly reduce income poverty among retiree renters. It would only narrow the gap in the income poverty rate between renters and home owners by around 11 per cent. Nor would it do much to reduce the inequality between home owners and renters. This reflects that even after the increase, Commonwealth Rent Assistance would be a small proportion of the housing expenses faced by renters compared to home owners. The fiscal cost of such a change in Commonwealth Rent Assistance for Age Pension recipients is estimated at about \$0.4 billion in 2019-20. The cost for all Commonwealth Rent Assistance recipients is estimated to be about \$1.7 billion in 2019-20.

A larger increase in the maximum rate of Commonwealth Rent Assistance would not have a meaningful impact on reducing income poverty among retiree renters. **An alternative approach to assisting lower-income renters in retirement may be required.**

Maintaining living standards in retirement

The second element of the adequacy objective of the retirement income system is to maintain living standards in retirement. This involves smoothing consumption over working life and retirement. Saving for retirement involves forgoing consumption during working years to have the income to support consumption in retirement. Most people would not save enough voluntarily for their retirement on their own. Government intervention is required, such as the SG. Without Government intervention, many people would experience a reduction in living standards in retirement.

An individual can choose how much to save for their retirement and as such, how much consumption they are prepared to forgo in their working years. When there is compulsory saving for retirement by all employees, the aim should be to set a rate that balances pre- and post-retirement living standards. A rate of compulsory superannuation that would result in people having an increase in their living standards in retirement may involve an unacceptable reduction in living standards prior to retirement.

The review considered the trade-off between the SG and wages in detail. **The weight of evidence suggests the majority of increases in the SG come at the expense of growth in take-home wages.** This view is based on empirical research, economic theory, evidence across a number of countries, and the original policy intent of the SG. This is detailed in the report.

How the system currently maintains living standards in retirement

Lower-income earners (defined as bottom 30 per cent of all income earners) primarily rely on the Age Pension to support their standard of living in retirement. For many lower-income earners, living standards improve when they receive Age Pension payments. They may have made SG contributions and will have some superannuation (although balances will tend to be small) to supplement the Age Pension.

Middle-income earners require a combination of superannuation, voluntary savings and the Age Pension to maintain their living standards in retirement. While compulsory superannuation is an important component and its importance will grow as the system matures, it alone is not sufficient to maintain their living standards. It has to be supplemented by the Age Pension. Home ownership is

generally an important factor influencing whether these retirees achieve an adequate retirement income.

Higher-income earners (top 20 per cent of all earners) generally do not receive the Age Pension and rely on the SG, voluntary superannuation, along with other savings and their home to maintain their living standards in retirement.

Measuring whether retirement income is adequate

Submissions proposed two ways to measure the adequacy of retirement incomes — a budget standard or a replacement rate.

The budget standard is a level of income required to purchase a basket of goods and services. The ASFA ‘comfortable retirement standard’ is often quoted as an appropriate benchmark. Specifying a dollar amount for a retirement income goal is easy for people to understand.

Using a budget standard as a benchmark for the system has major shortcomings. These include: the standard is designed for a specific group of people (the ASFA standard was originally designed for the top 20 per cent of income earners); they are subjective and the specified basket of goods may not be adequate or preferred by all; and it does not allow for the trade-off between retirement and working life. For example, the ASFA comfortable retirement standard would deliver a middle-income earner a higher standard of living in retirement than in their working life and would require a significant sacrifice in their working life to achieve this retirement standard.

Replacement rates are the most appropriate metric for assessing whether the retirement income system maintains living standards in retirement. They compare income in retirement with income while working and align with the objective of achieving a reasonable balance between living standards in working life and retirement.

The review has used a replacement rate benchmark of 65-75 per cent of disposable working-life income to assess the adequacy of retirement incomes. Evidence suggests this proportion of working-life income will allow most retirees, particularly middle-income earners, to maintain their standard of living in retirement. People generally have lower expenses in retirement, such as having paid off their home, not facing the cost of raising and educating children, and no longer needing to save for retirement.

A 65-75 per cent benchmark is broadly applicable to a wide group of retirees. However, renters require a higher replacement rate than home owners because they have higher housing costs. Lower-income earners need high replacement rates to achieve a minimum standard of living in retirement, and higher-income earners have significant savings and can maintain their standard of living with lower replacement rates.

Rate of growth of spending in retirement

The rate of growth of spending in retirement will influence whether a retiree’s income is adequate for all their retirement years. The evidence points to retirees’ needs growing in line with prices. In projections undertaken for the review, the deflator for incomes in retirement is the CPI.

The outcomes are significantly different if retirement incomes were deflated by wages. Basing replacement rates on wage-linked spending would require a level of saving that would come at a significant cost to living standards in working life.

Outcomes for current retirees

The outcomes for current retirees are influenced by past policy settings, but they give an insight as to whether the system will achieve adequate outcomes.

For retirees aged 65-74 in 2017-18, the replacement rates for middle- to higher-income earners are estimated to be generally adequate. For many lower-income earners the replacement rate is estimated to be above 100 per cent.

Qualitative surveys of retirees' wellbeing also suggest that many are maintaining their working-age living standards into retirement. The surveys suggest that current retirees:

- Generally feel happier in retirement than in working life
- Typically have the same level of satisfaction with their finances compared to just before retirement and are less financially stressed than employed people
- Are worse off financially in about 30 per cent of cases, with involuntary retirement a major cause

Outcomes for future retirees

Future replacement rates were estimated for people with typical working lives, including individuals overall, singles, couples and women. The assumptions underlying any modelling are important. The assumptions used for this review are outlined in detail in the report. Substantial sensitivity analysis was undertaken to assess outcomes with different assumptions.

The central case involved SG payments in line with planned legislated increases. The SG is 9.5 per cent to 2020-21, increasing by half a percentage point every financial year until reaching 12 per cent in July 2025. Also estimated were the outcomes if the SG stayed at 9.5 per cent.

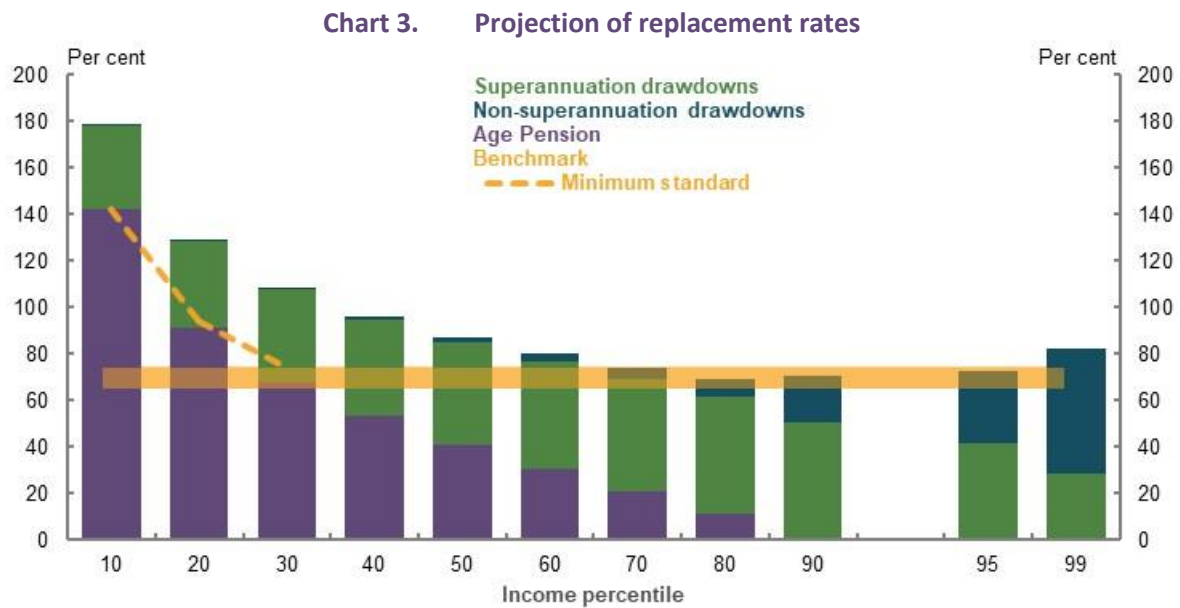
Future retirement outcomes were modelled on the basis that retirees use their superannuation assets to fund their living standards in retirement. Importantly, and in line with the policy intent of the retirement income system, it was assumed that retirees will run down their superannuation assets by age 92. It is also assumed that they will not leave bequests and will purchase a longevity product at retirement that provides them with income from age 92.

That people use all their superannuation in retirement is a critical assumption in assessing whether the system can deliver adequate retirement incomes. While this is a usual assumption for most modelling of replacement rates, it is not in line with the way retirees currently behave. **Most retirees die with the bulk of their wealth intact. However, the assumption that retirees use their assets more effectively in retirement highlights the outcomes that the system can deliver.** One of the alternative assumptions modelled includes outcomes based on how retirees currently use their assets in retirement. Contrasting this outcome with the central case assumption helps to highlight the gains in retirement income that retirees can achieve through using their assets more effectively.

Many people misunderstand the purpose of superannuation, believing that in retirement they should only draw on the return from the investment of their retirement savings and not touch the capital amount. **Yet the system is designed on the basis that people should draw down their savings to support them in retirement.**

The projected replacement rates vary across income levels but on the basis of the central case assumptions they exceed the 65-75 per cent benchmark across the range of different household types that were modelled (Chart 3). On the whole, they exceed the benchmark replacement rate for people in the bottom 60 per cent of the income distribution.

Such high replacement rates suggest that some people may be saving 'too much' for their retirement. This is particularly important for lower- to middle-income earners because most of their superannuation contributions are through the SG and they do not have the option of reducing their contributions.



Note: Minimum standard is the maximum rate of Age Pension. Replacement rates are projected for individuals commencing work in 2020 and retiring in 2060. Source: Cameo modelling undertaken for the review.

When tested under different assumptions — such as shorter working life, lower wages and lower investment returns — replacement rates are within or above the 65-75 per cent range for most income levels. A major reason that incomes remain adequate under different assumptions is the Age Pension offsetting any resulting reduction in retirement income for middle-income earners.

Sensitivity testing identified some cases where median- or average-income earners will not achieve the benchmark replacement rate. These include people with working lives less than 30 years and retiring at age 60.

Changes in financial markets, such as the decline in equity values in response to the COVID-19 Pandemic, can impact retirement outcomes. But in a market downturn, the returns achieved by superannuation funds tend to be less volatile than market values because the funds have diversified portfolios. For retirees, the Age Pension is also a significant buffer to investment earnings volatility. A decline in the value of assets and income from investments can be offset to some extent if it results in increasing a person's eligibility for Age Pension payments under the means test. And history shows that in the long run, the investment of superannuation savings has resulted in solid returns.

If people do not use their retirement savings efficiently, many will not be able to maintain their living standards in retirement even with higher SG contributions. For example, if people draw down their superannuation balances at the legislated minimum rate, as many do, those in the top half of the income distribution will not achieve a 65-75 per cent replacement rate, even with the SG rate going to 12 per cent.

Maintaining the SG rate

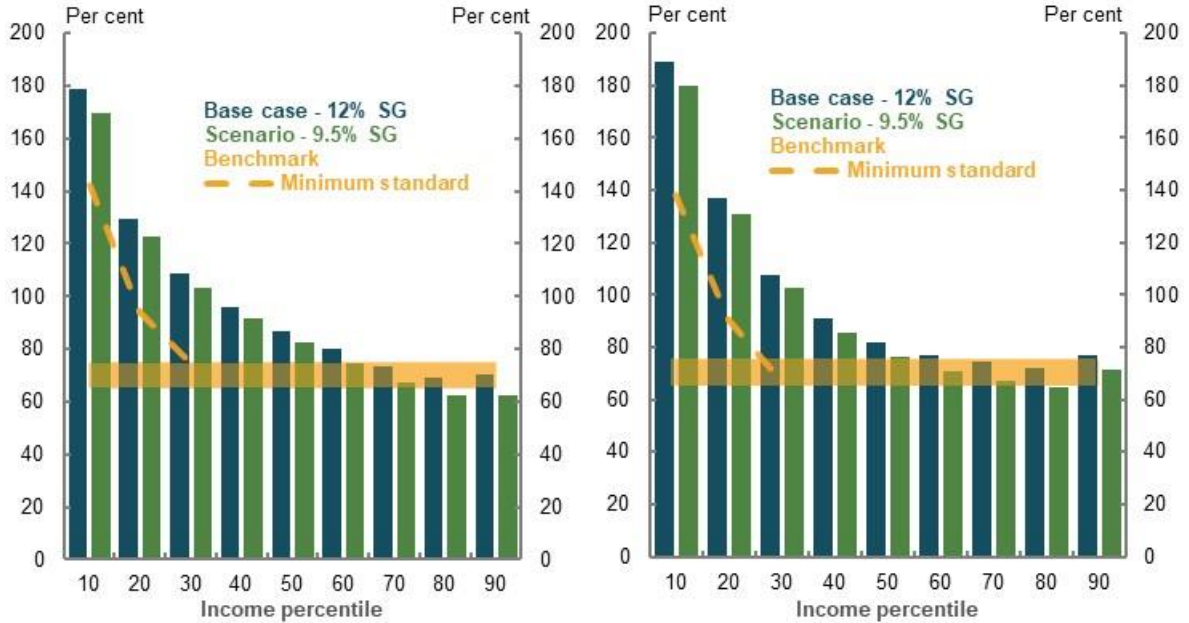
A number of submissions called for the SG rate to be maintained at 9.5 per cent. Towards improving understanding of the impact of the legislated increase in the SG rate to 12 per cent, the review considered the implications of maintaining the SG rate at 9.5 per cent.

Projections suggest that maintaining the SG rate at 9.5 per cent would:

- Lead to lower superannuation balances at all income levels than when the SG rate goes to 12 per cent.

- Result in lower- and middle-income earners having replacement rates within or above the 65-75 per cent benchmark if they efficiently drew down their retirement savings (Chart 4). The replacement rates for some higher-income groups are close to the benchmark.

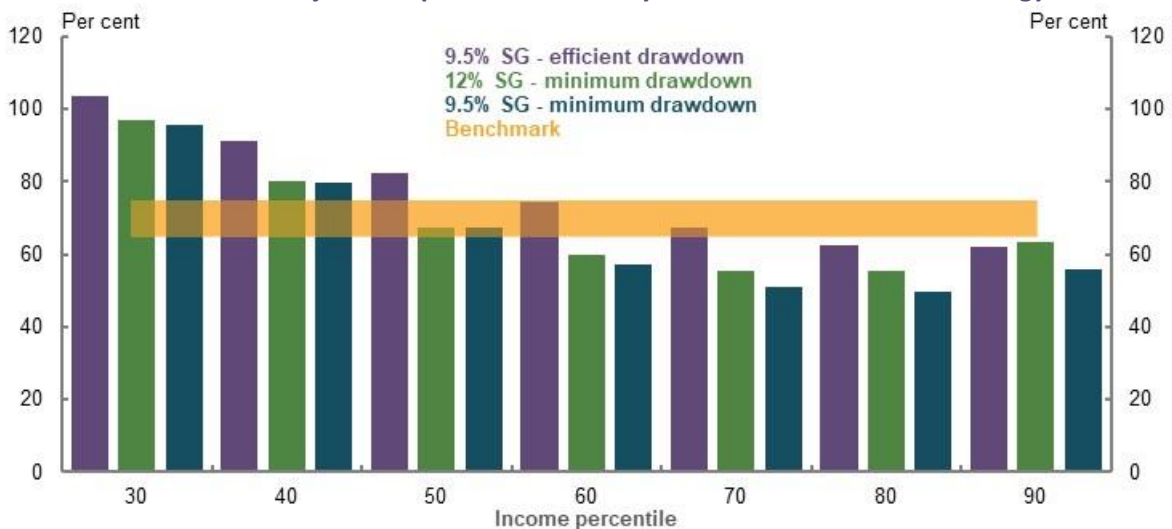
Chart 4. Replacement rates by SG rate and household type
Individuals **Couples**



Note: Deflated using review’s mixed deflator. Source: Cameo modelling undertaken for the review.

- Allow people to have higher incomes during their working life while still being able to maintain their living standards in retirement, if they used their retirement savings more efficiently. Incomes during working life are estimated to be 2 per cent higher in the longer run.
- Demonstrate the importance of efficient use of savings in retirement. **If the SG rate remained at 9.5 per cent and people made more efficient use of their retirement savings, many would have higher replacement rates than they would have with the SG at 12 per cent and drawing down their balances at the legislated minimum rate (Chart 5).**

Chart 5. Projected replacement rates by SG rate and drawdown strategy



Note: Minimum drawdown based on legislated minimum rates by age. Minimum drawdown rate scenarios do not include people purchasing a longevity product. Efficient drawdown based on review strategy where superannuation assets are fully consumed by age 92 and a longevity product. Source: Cameo modelling undertaken for the review.

- Avoid the increase in inequities associated with an increase in the SG. For example, an increase in the SG benefits men more than women.
- Result in a net increase in tax revenue, rising to around \$3 billion per year by 2030. Higher tax receipts from the reduction in superannuation tax concessions would exceed increased Age Pension expenditure until the late 2050s.

Options to boost retirement outcomes

Much of the focus on the retirement income system is currently on the superannuation balances people may need in retirement. Often, the final balance is not spoken of in income terms, and the interaction with the Age Pension in supplementing the retirement income of lower- and middle-income earners is ignored. An area where there is insufficient attention is how the use of a retiree's assets can significantly influence retirement outcomes.

In addition to increasing superannuation contributions or other savings, people have a number of options to boost their retirement income, including:

- **More effectively drawing on superannuation assets.** If drawdown rates increase from currently observed rates to those assumed in the central case in the modelling for the review, replacement rates could rise by 11 percentage points for the median-income earner retiring in 2060. In addition, all income levels would achieve replacement rates within or above 65-75 per cent.
- **Achieving better-after-fee returns,** in particular implementing the recommendations in the Productivity Commission's report, *Superannuation: Assessing Efficiency and Competitiveness*, would reduce fees and improve market returns for many people, resulting in higher retirement outcomes.
- **Accessing the equity in the home.** Using relatively small portions of home equity through the Pension Loans Scheme or similar equity release products can substantially improve retirement incomes for many people.

Equity

The performance of the retirement income system was assessed against the two suggested aspects of equity:

1. The system should target Government support to those in need
2. The system should provide similar outcomes for people in similar circumstances

The review also considered retirement outcomes for many of the groups identified in submissions as being inequitable. These included women, people who retire involuntarily, those excluded from the SG, renters, people with different income and wealth, those with disabilities, and Aboriginal and Torres Strait Islander people. Intergenerational equity was also considered.

Retirement income system or working-life inequities?

When considering groups of people with low (or lower) retirement incomes compared with others, consideration should be given to whether the retirement income system is exacerbating or compensating for inequities these people experience in their working lives.

A summary of the retirement outcomes of various groups of people follows. The overall assessment is that **given superannuation is an employment-based scheme, superannuation balances people take into retirement broadly reflect working-life inequities.** An individual's superannuation balance at retirement will reflect their employment experience: their income, length of time in the

workforce, whether working full-time, part-time or casually, and whether they receive the SG. Higher superannuation balances receive larger tax concessions and can support higher retirement incomes.

In retirement, the Age Pension helps to offset some of the inequities people faced during their working life. Those who have not had the same level of engagement in the labour market as others, for whatever reason, generally have a much lower level of superannuation and other savings in retirement. But, they typically receive higher rates of Age Pension as a result of the means test.

Some aspects of the design of the retirement income system, while not targeted at any particular group of people, have a relatively larger impact on some groups over others as the following sections show.

Equity: Income and wealth distribution

Since superannuation is an employment-based scheme, full-time, higher-income and continuously employed people make more superannuation contributions, have higher superannuation balances and achieve higher retirement incomes than lower- and middle-income people. A person's earnings and length of time in the workforce translates into higher superannuation balances and retirement incomes.

Higher-income earners also receive more superannuation tax concessions than lower- and middle-income earners. They receive the largest tax savings as a percentage of superannuation contributions over their lifetime, along with the largest tax concessions on superannuation earnings.

Most people, but particularly higher-income earners, pay less tax when they save through superannuation compared with other savings vehicles. The taxes on superannuation have a relatively flat structure, while income tax is more progressive.

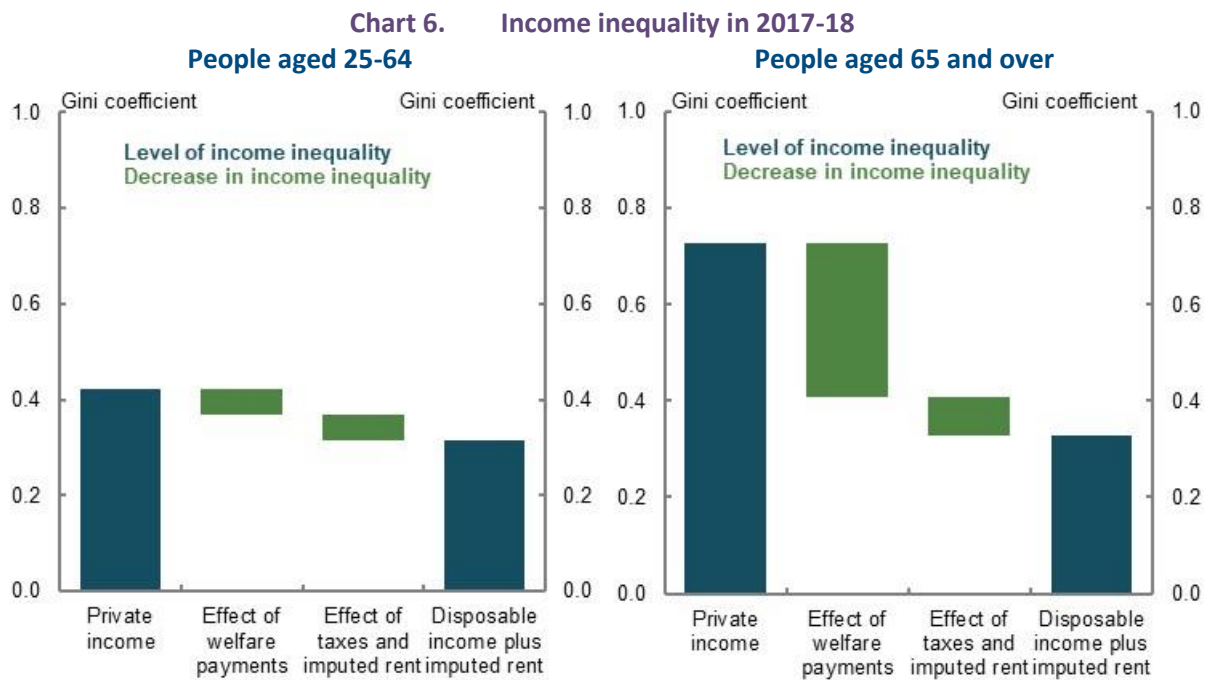
Higher-income earners make larger contributions to superannuation than lower- and middle-income earners. However, on average, even the highest income earners contribute less than the caps on contributions.

Many very large superannuation balances were built up under previous higher contributions caps and are expected to stay in the system for several decades. **At June 2018, there were more than 11,000 people with a balance in excess of \$5 million. These people receive very large tax concessions on their earnings.** A superannuation balance of \$5 million can achieve annual earnings tax concessions of around \$70,000.

Voluntary (pre- and post-tax) superannuation contributions are predominantly made by older, higher-income or wealthy people. Average pre-tax voluntary contributions increase with age and peak just before 65. Average post-tax voluntary contributions are much higher for people aged between 60-64 compared with younger people.

With higher-income earners receiving more superannuation tax concessions than lower- and middle-income earners, the superannuation tax concession component of Government support increases inequality of private incomes for people aged 65 and over.

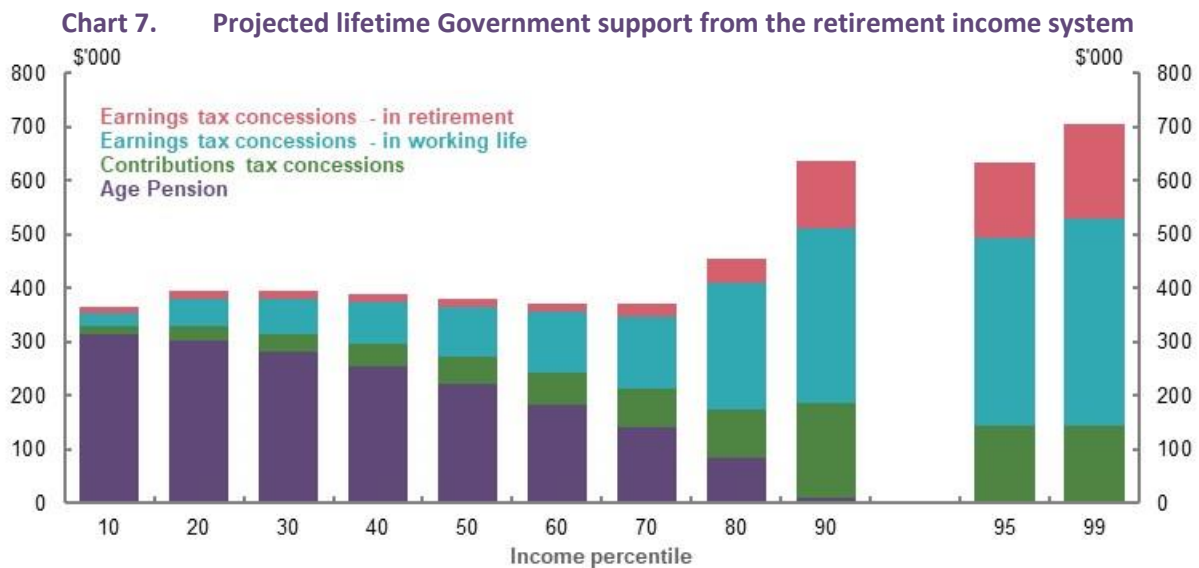
In retirement, however, income inequality reduces due to the Age Pension and benefits from government services, termed social transfers in kind. Because of the means test, people with the lowest lifetime incomes generally receive the largest Age Pension payments. The Age Pension reduces income inequality among retirees because it provides most support as a proportion of private incomes to lower-income earners. Income inequality among retirees is similar to people of working age (Chart 6).



Note: Income inequality is measured by calculating the Gini coefficient. The Gini coefficient is a value between 0 and 1. A value of 0 means that all people have the same incomes (i.e. complete equality), while a value of 1 means all income is received by one person (i.e. complete inequality). Private income refers to income from employment, businesses and investments, such as rent, dividends, royalties and superannuation earnings. Welfare payments include pensions and allowances received by the aged, disabled, unemployed and sick persons, families and children, veterans or their survivors, study allowances for students and all overseas pensions and benefits. Taxes include individual income taxes. Disposable income is equal to private income plus welfare payments less taxes. Imputed rent is the amount that a home owner saves by not having to pay rent for accommodation. All income definitions are equivalised for household size. Age of household is the age of the household's reference person. Source: Analysis of ABS Survey of Income and Housing Confidentialised Unit Record File, 2017-18.

The way the Age Pension means test operates (separately assessing a person's level of assets and income to determine their Age Pension payment) results in people with different levels of assets and/or income receiving the same rate of Age Pension in some circumstances. Some assets and income are also treated differently under the means test.

Overall, **superannuation tax concessions increase inequality in the retirement income system, while the Age Pension helps offset inequality in retirement.** One of the suggested elements of the retirement income system's objective is that Government support should be targeted to those in need. This would appear to be the case for the Age Pension. However, the combination of a system where people on higher incomes achieve the largest superannuation balances, combined with tax concessions on superannuation contributions and earnings, means that higher-income earners receive more Government support than other income groups over their lifetime (Chart 7).



Note: Values are in 2019-20 dollars, deflated using the review’s GDP deflator and uses review assumptions (see *Appendix 6A. Detailed modelling methods and assumptions*). Income percentiles are based on the incomes of individuals (whether they are single or in a couple). Source: Cameo modelling undertaken for the review.

Increases in the SG rate will increase lifetime Government support for higher-income earners by more than lower- and middle-income earners. Higher-income earners make the largest compulsory contributions. They either do not qualify for, or lose minimal, Age Pension when they retire with higher superannuation balances.

Changes to superannuation tax concessions would have the largest impact on higher-income earners. Further improvements in targeting superannuation tax concessions would improve the equity of the retirement income system.

Equity: Gender and partnered status

Many stakeholders focused on gender inequity in the retirement income system, referring to men having higher superannuation balances at retirement than women, and in turn, having higher retirement incomes than women. In 2017-18, the gap in the median superannuation balance between men and women aged 60-64 was 22 per cent.

The gap in retirement savings and retirement incomes for women is the accumulated result of the economic disadvantages faced by women in their working life — lower wages than men, more career breaks for child-rearing and caring for others, and more part-time work. The financial impacts from divorce and relationship breakdowns are also worse for women.

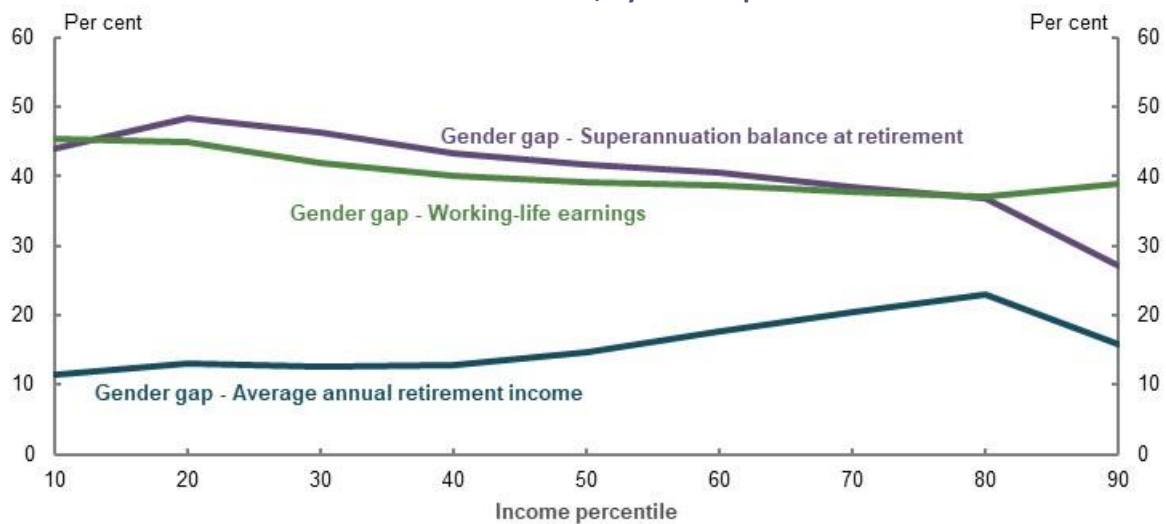
Across men and women who work full-time, the pay gap is 17 per cent. More than 93 per cent of all primary carer leave is taken by women. Research suggests having children is associated with a reduction in earnings of up to 80 per cent on average over the following 15 years, compared to women with no children.

The higher life expectancy of women means their superannuation balances at retirement need to stretch further.

As the superannuation system matures, a greater number of women (and men) are expected to have larger superannuation balances. Female superannuation coverage is increasing with female labour force participation. **In future, the gap between the superannuation balances of men and women will narrow substantially; however, it will not close while a gap remains in earnings and workforce participation.**

The gap between the retirement incomes of men and women is narrower than the gap in working-life earnings and superannuation balances. This is primarily due to the Age Pension, which helps offset some of the inequity women face in their working life. And with lower superannuation balances than men, women generally receive higher rates of the Age Pension than men because of the means test (Chart 8).

Chart 8. Projected gender gaps in working-life earnings, superannuation balances at retirement and retirement incomes, by income percentile



Note: Gender gaps are calculated relative to the relevant figure for men — that is, a 10 per cent gender gap in earnings means that women’s earnings are 90 per cent of men’s earnings. See Box 3B-3 in 3B. *Gender and partnered status* for details. The chart compares the 10th percentile for men to the 10th percentile for women, and so on. Gaps in superannuation balances at retirement and retirement incomes do not factor in the effect of voluntary superannuation contributions not made through salary sacrifice. If included, these would reduce the gaps between men and women. Calculations are based on values deflated using the review’s mixed deflator. Disaggregation of these gaps can be found in *Appendix 6D. Supplementary equity charts*. Source: Cameo modelling undertaken for the review.

While most people enter retirement as a couple, this trend is falling. In future there will be more single people in retirement, particularly women. Couples are significantly better off in retirement than single men and women. They have lower rates of poverty and financial stress, higher rates of home ownership and higher levels of wealth than single men and women in retirement.

Stakeholders identified a number of changes to aspects of the retirement income system aimed at reducing the gap in retirement incomes between men and women. These included:

- **Removing the \$450-a-month threshold** when employers are obligated to pay the SG to employees. This would help low-income workers and would assist more women than men. Around 63 per cent of people earning below the \$450-a-month threshold are women. Although removing the \$450-a-month threshold would have a small effect on retirement incomes, it would improve gender equity in SG coverage.
- **Paying superannuation on employer paid parental leave and Government Parental Leave Pay.** This would have a small impact on narrowing the retirement income gap between some women and men, improving gender equity in SG coverage. Receiving superannuation on paid parental leave and Parental Leave Pay would reduce, to a small degree, the impacts of career breaks taken by women to raise children.
- **Disclosing superannuation balances in divorce settlements.** Superannuation is generally able to be divided up in family property settlement following a divorce, although it is challenging to ensure that all superannuation assets are disclosed. A measure was announced in 2018 but has yet to be implemented, whereby the ATO could provide accurate and timely information to courts on superannuation balances.

- **Reducing superannuation tax concessions for higher-income earners.** Superannuation tax concessions predominantly benefit higher-income earners and there are more higher-income men than women. Reducing superannuation tax concessions for higher-income earners would reduce the degree to which gender gaps in working-life incomes translate into gaps in superannuation balances.
- **Increased support for lower-income retirees who rent.** This would assist women because more women than men rent in retirement.
- **Increasing the SG rate.** Increasing the SG rate would not reduce the gender superannuation balance gap and would benefit the retirement incomes of men more than women.

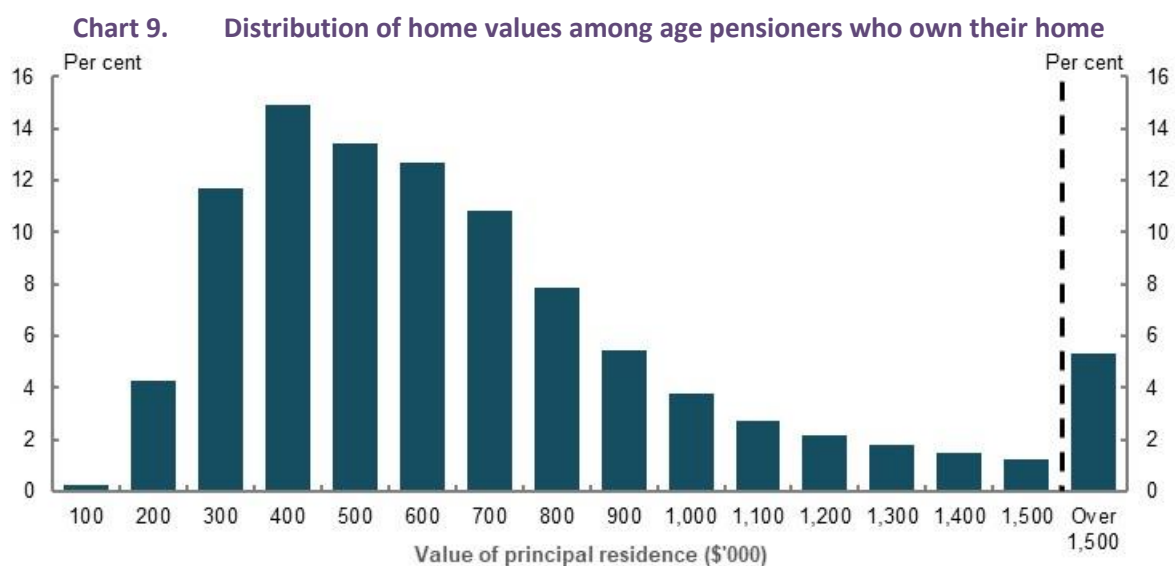
Equity: Home ownership status

The retirement income system does not appear to be delivering an appropriate standard of living for many retiree renters. Owning a home has a positive influence on a person’s standard of living in retirement. Whereas, in retirement, renters have higher levels of financial stress. A significant proportion of retiree households that rent are in income poverty, which is even higher for single retiree renters.

Retiree renters have much higher housing expenditure than retirees who own their home. Consequently, renters have lower disposable income after housing costs. Although Commonwealth Rent Assistance provides additional support to retiree renters, it is far below the level that would bridge the gap in their living standards compared to home owners.

Renters and home owners may have different outcomes in retirement. The question is whether this is influenced by the structure of the retirement income system, or whether it reflects other influences. For example, it may reflect that renters do not have sufficient financial capacity during their working lives to buy a house. Compared to renters, home owners in retirement generally have higher levels of wealth. In addition, some retirees may be renting because of relationship breakdowns.

A key aspect of the retirement income system favouring home owners is that the principal residence is excluded from the assets test for the Age Pension. Regardless of the value of the house, a home owner can receive the same Age Pension as a renter (Chart 9), all other things being equal.



Note: Horizontal axis labels indicate home values up to that amount (e.g. \$200,000 includes homes over \$100,000 up to \$200,000). Source: Department of Social Services analysis of payment data, June 2018.

This suggests that wealthier retirees (in terms of the value of their homes), can receive the same Government assistance as those less wealthy (either retirees who rent or home owners with houses of lesser value).

Renters have a higher assets test free area, although only a small proportion of retirees benefit from the higher threshold. Nevertheless, those renters who hold wealth above the Age Pension assets test free area in forms other than a house receive less support than home owners with the same level of wealth. The renter will receive less Age Pension than the home owner. As such, they will have to self-fund a higher proportion of their retirement income compared with a home owner.

The declining trend in home ownership among Australians has created concerns that an increasing number of retirees may be renting in future. This is an important factor to consider in terms of whether the retirement income system will be able to continue to deliver adequate retirement outcomes. It may also increasingly bring into question whether home owners and renters are treated equally in the retirement income system.

Some stakeholders suggested that if a retiree's principal residence was part of the Age Pension assets test, this would help equate the treatment of home owners and renters. If the home were included in the assets test, some home owners would no longer be eligible for the Age Pension. Others would receive less Age Pension. In response, home owners may be more inclined to access the equity in their home to fund their retirement. To the extent that this takes place, home owners would be self-funding their retirement income to a greater extent than at present. This would be more in line with what is currently the case for retiree renters with a similar level of wealth as home owners. One of this report's themes is that a more optimal retirement income system would involve retirees more effectively drawing on all their assets, including the equity in their home, to fund their standard of living in retirement.

Renters on the Age Pension and with low wealth need additional assistance to bring their retirement income more in line with minimum standards of adequacy, which is a suggested objective for the system. This would help reduce levels of income poverty and financial stress.

Many stakeholders called for an increase in Commonwealth Rent Assistance to address the difficulties facing lower-income retirees who rent. About 22 per cent of all recipients of Commonwealth Rent Assistance receive the Age Pension. It is part of the broader social welfare system, and changing the rate of Commonwealth Rent Assistance would affect more than just Age Pension recipients. The review assessed the implications of increasing the rate of Commonwealth Rent Assistance. It would not have a meaningful impact on reducing income poverty among retiree renters.

Equity: SG coverage

The SG is a mandatory entitlement for most employees and does not cover the self-employed (around 17 per cent of the workforce). Around 90 per cent of employees are covered by the SG. Some employees are excluded.

The main exemption is employees who earn less than \$450 before tax in a calendar month with an individual employer. About 300,000 people, or 3 per cent of employees, are affected by this exemption. They are mainly young, lower-income, part-time workers — around 63 per cent are female. The exemption means affected workers receive less remuneration for the same hour of work as an unaffected colleague.

The original reason for the \$450-a-month threshold was to reduce the administrative burden on employers. But this reason has diminished with the digitalisation of payrolls. Measures have also been taken to reduce the impact of fees and insurance premiums on small balances, which was another reason for the threshold.

Removing the \$450-a-month threshold for SG payments would not materially improve retirement outcomes, but would improve equity of the system, particularly for women and lower-income workers.

Another exemption from SG coverage is overtime pay. The salary base for the SG is ordinary time earnings, which excludes overtime pay. Overtime is significant in some industries (such as mining, construction and manufacturing). Forgone SG on overtime can significantly affect the superannuation balances and retirement incomes of the employees affected. Applying the SG to ordinary time earnings is a legacy from the occupational superannuation arrangements prior to the SG. Including overtime pay within the coverage of the SG would improve the equity of the system.

Not all employers meet their obligation and make SG payments to their employees' superannuation accounts (the 'SG gap'). The total amount of the SG owed to employees was estimated to be about \$2.3 billion in 2016-17. Lower-income workers in accommodation and food services, and construction are particularly affected. Young employees missing out on the SG are significantly impacted because they miss out on the benefits of compounding returns. Generally, those not making required SG payments are smaller employers.

Developments such as Single Touch Payroll require employers to report tax and SG information to the ATO at the same time they pay their employees. This will improve and expedite ATO oversight of SG compliance. On average, non-compliance continues for around 18 months, which reduces employee superannuation balances – especially if the company becomes insolvent and is unable to make good the deficit.

The self-employed are not required to contribute to a superannuation fund on their own behalf. There are approximately 2.2 million self-employed people. Requiring self-employed people to make SG payments on their behalf would boost their superannuation balances and diversify their retirement savings. But it would reduce their ability to invest in their businesses. It would also be difficult to determine the equivalent contribution base for the self-employed.

Self-employed people generally have lower superannuation balances than employees. But many have other assets, such as business assets, which result in them having similar wealth profiles as employees when approaching retirement. Small business owners also benefit from a number of capital gains tax concessions.

Sham contracting may see some employees misclassified as contractors and missing out on the SG. Enforcing sham contracting laws would help these people receive SG payments.

The superannuation balances of gig economy workers may be lower than those of employees because of forgone SG. The difference is likely to be small because the gig economy is not the primary source of income for most people.

Stakeholders identified a number of changes to SG coverage aimed at improving equity within the retirement income system. These include:

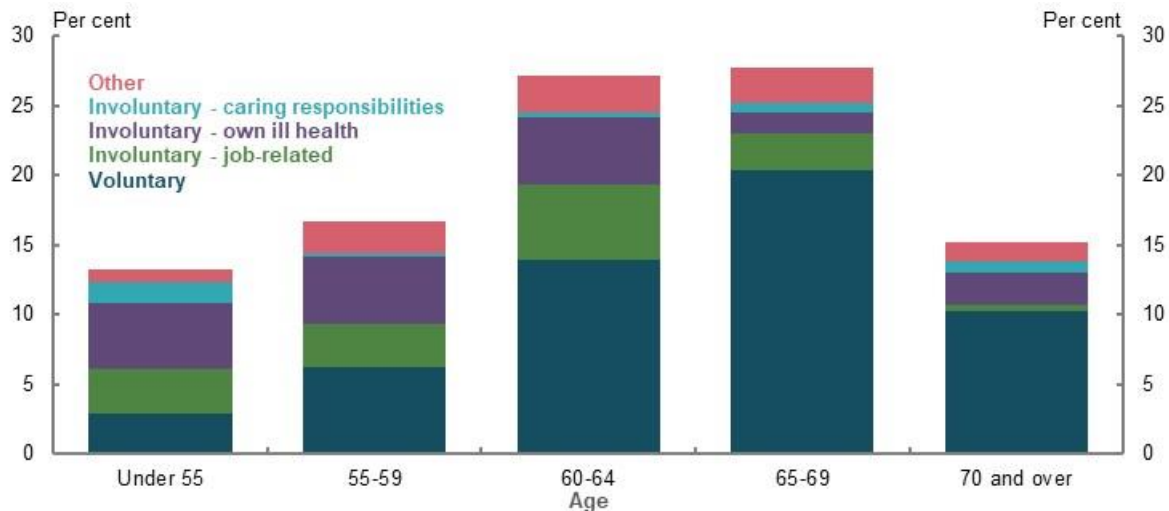
- **Removing the \$450-a-month threshold.** This would improve equity of the system, particularly for lower-income women but would not materially improve retirement outcomes.
- **Expanding the earnings base that attracts the SG to include overtime.** This would boost superannuation balances and retirement outcomes of about 20 per cent of employees, particularly in mining, manufacturing and construction jobs.
- **Continuing to ensure people receive the SG they are entitled to,** through increased transparency to employees and the ATO of SG obligations and payments.
- **Paying the SG at the same time as wages.** This would make it easier for employees to monitor SG compliance. While this would reduce the time employers have to meet their SG obligations, it would limit the build-up of SG liabilities.
- **Enforcing sham contracting laws** to ensure that employees receive their SG entitlements.

Equity: Age of retirement

A large number of people do not choose when to retire (Chart 10). They may lose their job and cannot obtain another. They are effectively forced to 'retire' from the workforce earlier than they intended and with less retirement savings than they planned.

Involuntary retirement before Age Pension eligibility age is more common among people with lower wealth and people with lower education levels. It is also more prevalent in blue-collar occupations.

Chart 10. Proportion of people retiring, by retirement age and reason



Note: Proportion is of people who retired between July 2013 and June 2019. Assumes the age of retirement is equal to the age of ceasing last job. The reasons for involuntary retirement are split into own ill health, job-related and caring responsibilities. Own ill health is from 'own sickness, injury or disability' response. Job-related is from 'retrenched/dismissed/no work available', 'own business closed down for economic reasons', and 'unsatisfactory work arrangements' responses. Caring responsibilities is from 'to care for children/pregnancy' and 'to care for ill/disabled/elderly' responses. Given the small sample size of the two response options that make up the 'caring responsibilities' category, these figures should be used with caution. Source: Analysis of (ABS, 2020p).

People aged 55 and over have similar levels of unemployment and underemployment as people aged 25-54, although they are generally unemployed or underemployed for longer periods than those at younger ages.

A person who retires before Age Pension eligibility age generally has lower levels of retirement savings and wealth, and in turn, lower retirement incomes than if they retired after reaching Age Pension eligibility age. They are also more likely to spend some of their retirement savings before becoming eligible to receive the Age Pension. However, the impact of their lower retirement savings is moderated somewhat through Government pensions and allowances, especially the Age Pension, and social transfers in kind.

JobSeeker Payment is the main income support for many involuntary retirees until they reach Age Pension eligibility age. In some situations, the difference between the Age Pension rate and the standard JobSeeker Payment rate results in a substantial increase in income when an involuntary retiree becomes eligible for the Age Pension. In contrast, significant numbers of involuntary retirees receive the Disability Support Pension or Carer Payment, which delivers roughly the same social security income as the Age Pension.

Increasing the superannuation preservation age or the Age Pension eligibility age would adversely affect a significant number of people who retire involuntarily before these ages.

It is challenging for retirement income settings to cater for people who retire early and involuntarily. Factors to consider include:

- Setting the SG rate high enough to compensate for the possibility of involuntary, early retirement would result in many people being required to save more than they need for an adequate retirement income. This would come at the expense of their standard of living during their working lives.
- Lowering the Age Pension eligibility age only for people in certain industries or occupations who are more likely to retire involuntarily, would be difficult to administer and may lead to inconsistent outcomes between similar people. Moreover, the eligibility age for the Age Pension is currently a major factor influencing when people choose to retire. Lowering the eligibility age for the Age Pension could encourage people to voluntarily retire at an earlier age. This would leave them with lower retirement savings to support them over a longer period of retirement. It would also increase pressure on the sustainability of the Age Pension.
- One of the main equity concerns raised in submissions was that many early, involuntary retirees relied on Newstart Allowance payments, which were significantly below the payment rate of the Age Pension. More generally, many stakeholders said the rate of Newstart Allowance was too low. The JobSeeker Payment has replaced Newstart Allowance and the JobSeeker Payment rate has been temporarily increased as part of the Government's response to the COVID-19 Pandemic. As the JobSeeker Payment is available to people who are not in full-time work and meet the eligibility requirements, any change to the payment rate would need to consider broader policy objectives.

Using the income support system is a more efficient and targeted way of supporting those who retire early and involuntarily.

Retiring beyond Age Pension eligibility age increases retirement incomes. This is primarily driven by investment returns, compounding returns and fewer years in retirement.

Equity: Aboriginal and Torres Strait Islander people

The working-life inequities of Aboriginal and Torres Strait Islander people translate into inequities in retirement incomes. They also face additional challenges that reduce their ability to engage with the retirement income system.

On average, Aboriginal and Torres Strait Islander people have lower superannuation balances and retirement incomes than the total population.

Lower retirement incomes than the total population reflect working-life disadvantages: lower wages, lower labour force participation, lower private savings and rates of home ownership, lower rates of SG coverage and higher rates of disability and involuntary retirement.

Aboriginal and Torres Strait Islander people also face challenges such as accessing banking and financial services, identification verification and laws that do not recognise kinship structures. These challenges are compounded by mistrust in the system due to historical injustices, and generally lower levels of financial literacy compared to the total population.

Aboriginal and Torres Strait Islander people have lower life expectancies compared with the rest of the population. This means that Aboriginal and Torres Strait Islander people are less likely to reach superannuation preservation age, resulting in unspent retirement savings. Those reaching retirement spend less time on the Age Pension compared with the total population.

In retirement, the Age Pension significantly reduces working-life income inequality between Aboriginal and Torres Strait Islander people and non-Indigenous people. Aboriginal and Torres Strait Islander people are more likely to receive the maximum rate of the Age Pension than non-Indigenous people.

Increasing the preservation age would further increase the already high proportion of Aboriginal and Torres Strait Islander people who die before accessing their superannuation.

Lowering the preservation age for Aboriginal and Torres Strait Islander people would reduce the probability of them dying before accessing their superannuation, but it may encourage those with a similar life expectancy to the general population to retire early, to the detriment of their retirement incomes.

Increases in the SG rate would have limited effect on the retirement incomes of Aboriginal and Torres Strait Islander people and would come at the expense of working-life income. Given a large proportion of Aboriginal and Torres Strait Islander people are not in the labour force, many are not covered by the SG and would therefore not receive the benefit of an increase in the SG rate.

The rate of the Age Pension is an important factor in determining the retirement income outcomes of Aboriginal and Torres Strait Islander people.

Equity: People with disability

People with disability retire with less superannuation and other savings than those without disability. On average, the more severe a person's disability, the lower their retirement savings.

The lower average superannuation balances of people with disability reflect lower working-life participation and earnings. The age a person acquires their disability therefore affects their retirement savings: those who acquire their disability later in life are more likely to have higher retirement savings than someone who acquires their disability early in life.

The median weekly income in 2018 of those aged 15-64 with disability was \$505, compared with \$1,016 for a person without disability. Around 53 per cent of people with disability are in the labour force compared with 84 per cent of people without disability. People with disability are more likely to receive income support prior to retirement.

The Age Pension and social transfers in kind to meet health expenses, help improve retirement income equity relative to working life for those with and without disability. Overall, retirees with disability have similar rates of poverty and financial stress as the total retired population.

Increasing assistance to renters would benefit those with disability, as a larger proportion of people with disability rent in retirement compared with the total population. The Age Pension rate and Pensioner Concession Card are also important in determining whether those with disability have adequate retirement incomes.

Equity: Intergenerational

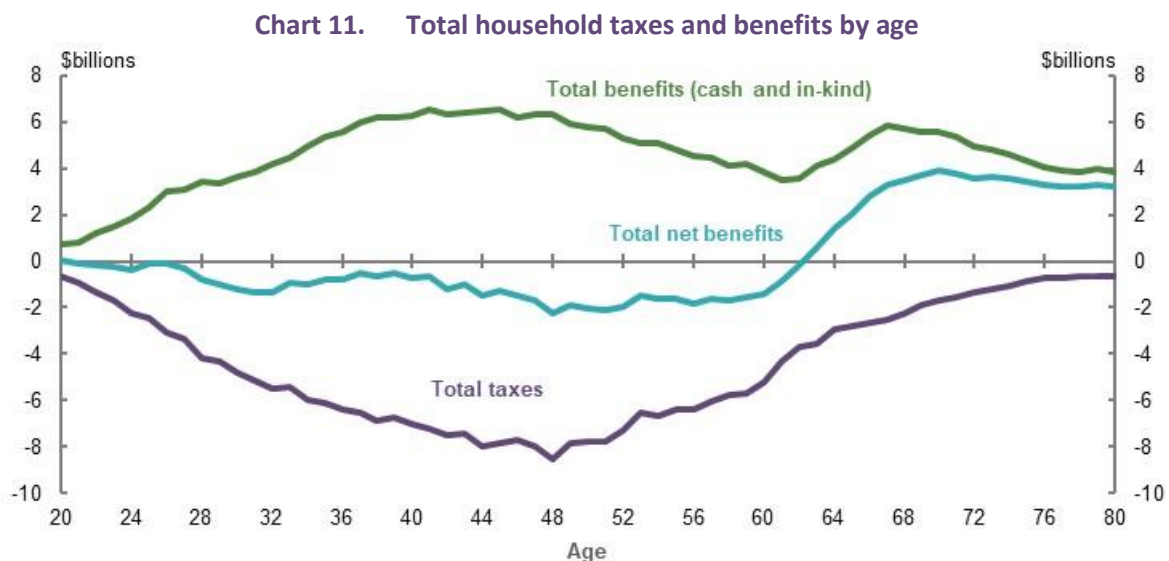
Intergenerational equity covers cost-sharing across generations. In the case of the retirement income system, the issue is the extent to which the cost of meeting the retirement incomes of one generation is being borne by another.

The superannuation system largely supports intergenerational equity. It encourages people to rely on their own savings to meet their retirement income needs.

The significant tax concessions that support superannuation are broadly consistent with intergenerational equity. Under current arrangements, working-age people mostly pay for and benefit from superannuation tax concessions. Retirees can receive superannuation earnings tax concessions, which are taxpayer funded and hence the cost is borne by working-age people.

The Age Pension involves cost-sharing across generations. Unlike some other countries, Australians do not contribute to a national fund to cover the cost of the Age Pension. This cost is borne by the current working population.

While the Age Pension involves a transfer of income from one generation to another, there is a so-called ‘generational bargain’ where today’s working-age Australians expect the generation after them to support them, such as through funding the Age Pension, in the same way they supported the generation that preceded them (Chart 11).



Note: 2015-16 data. Net benefits refers to all taxes paid minus all social transfers (cash and in kind). Source: Replication of (Wood, et al., 2019), which is derived from (ABS, 2018c).

Given the Australian population is ageing and birth rates have fallen, the ratio of working-age people relative to retirees is decreasing. This means the annual cost per working-age person of the Age Pension and superannuation earnings tax concessions retirees receive is expected to rise. This means that successive generations will have to contribute more in dollar terms during their working lives to fund these benefits for retirees.

Whether the cost of the Age Pension and superannuation earnings tax concessions retirees receive is ‘affordable’ to future generations will depend on wage growth. If future real wage growth averages 1 per cent per year,¹ the proportion of income transferred from working-age people to fund these costs is projected to be broadly similar in 40 years’ time. If, however, there is no real wage growth, the cost of the Age Pension and superannuation earnings tax concessions retirees receive as a proportion of the wages of working-age people is projected to rise substantially.

The maturing of the superannuation system will mean more Australians will have higher retirement savings and the proportion of the eligible population receiving the Age Pension will decline. This is expected to reduce the cost of the Age Pension borne by the next generation.

The ability of different generations to accumulate retirement savings has varied:

- Better targeting of superannuation contribution rules has meant older people have had the opportunity to contribute more to superannuation than younger people can.
- Younger people will generally benefit from superannuation contributions across all of their working lives, compared with older people who may have only received superannuation for part of their working years.
- Rising residential property values over recent decades have benefited home owners and increased the wealth of many retirees. A similar growth in property values cannot be assumed for

¹ Over the past 20 years, annual real growth of average weekly earnings averaged 1.0 per cent.

younger home owners. The rise in property prices may preclude some people from becoming home owners.

Inheritances are significant, representing the transfer of wealth from one generation to another. They are not distributed equally and increase inequity within the generation that receives the bequests. Most people die with the majority of wealth they had when they retired. If this does not change, as the superannuation system matures, superannuation balances will be larger when people die, as will inheritances. Superannuation is intended to fund living standards of retirees, not to accumulate wealth to pass to future generations.

Measures stakeholders raised that could impact intergenerational equity included:

- **Increasing the SG rate.** This would increase the extent of each generation self-funding, as a smaller share of each generation's retirement incomes would be funded by the Age Pension.
- **Encouraging people to spend more of their savings in retirement.** This would likely reduce wealth inequality among future generations.

Sustainability

The fiscal cost of the retirement income system is an important factor influencing its sustainability. It has to be consistent with the Australian economy's capacity to pay.

If Government expenditure on the retirement income system continues to grow faster than the rate of growth of the economy, the sustainability of the system could come into question.

The fiscal cost of the system is best measured as a share of GDP and of the Budget. The two largest costs of the retirement income system are Age Pension expenditure and the cost of superannuation tax concessions. Measuring the cost of superannuation tax concessions is not straightforward because it is not an outlay but revenue forgone. The analysis in this report estimates the cost of superannuation tax concessions by comparing actual revenue received with what might have been received in the absence of the concession, against an income tax benchmark. The rationale for this approach is outlined in detail in the report.

Sustainability not only depends on the capacity of the economy to pay for the cost of the system but also the willingness of the Australian community to do so. This will depend on whether people have confidence in the system and its integrity and believe it to be cost-effective in delivering adequate and equitable outcomes. The system also has to be adaptable to changing circumstances, such as economic shocks.

Future costs of the system

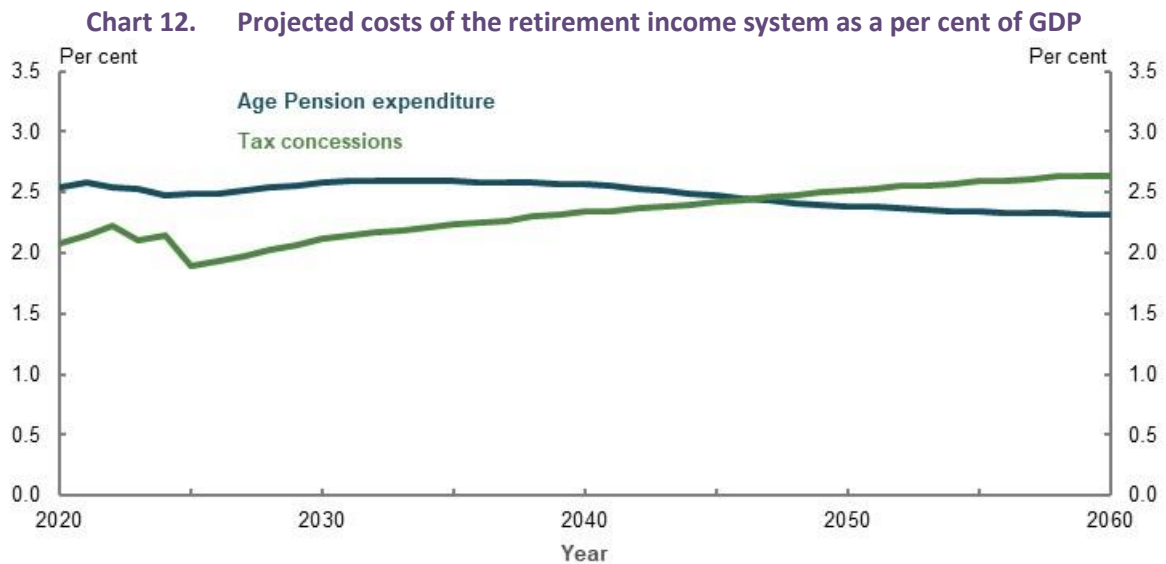
Government expenditure on the Age Pension is projected to fall over the next 40 years from 2.5 per cent of GDP today to 2.3 per cent in 2060.

Around 71 per cent of people over Age Pension eligibility age received Age Pension or other pension payments as at June 2019. Notwithstanding an ageing population, this proportion is projected to fall to 62 per cent in 2060. There is also a shift toward people receiving a part-rate pension (rather than the full-rate pension), rising from 38 per cent of age pensioners today to a projected 63 per cent in 2060. This shift is the result of higher superannuation balances and the impact of the means test, particularly the assets test, in determining eligibility for the Age Pension.

In contrast, as the superannuation system matures, **the cost of superannuation tax concessions is projected to grow as a proportion of GDP such that by around 2050 it exceeds the cost of Age Pension expenditure as a per cent of GDP** (Chart 12). This is the result of growth in the cost of earnings tax concessions.

The cost of superannuation contributions tax concessions is a function of wages, contribution rates and population growth. However, caps on concessional contributions and tax paid by very high-income earners restrict the growth in the cost of contributions taxes relative to the growth in GDP.

Over the next 40 years, the cost of superannuation earnings tax concessions is projected to grow as a percentage of GDP. The cost of earnings tax concessions is a function of the growth in the size of superannuation balances and the projected rate of return. Both of those are projected to exceed the projected growth in GDP.



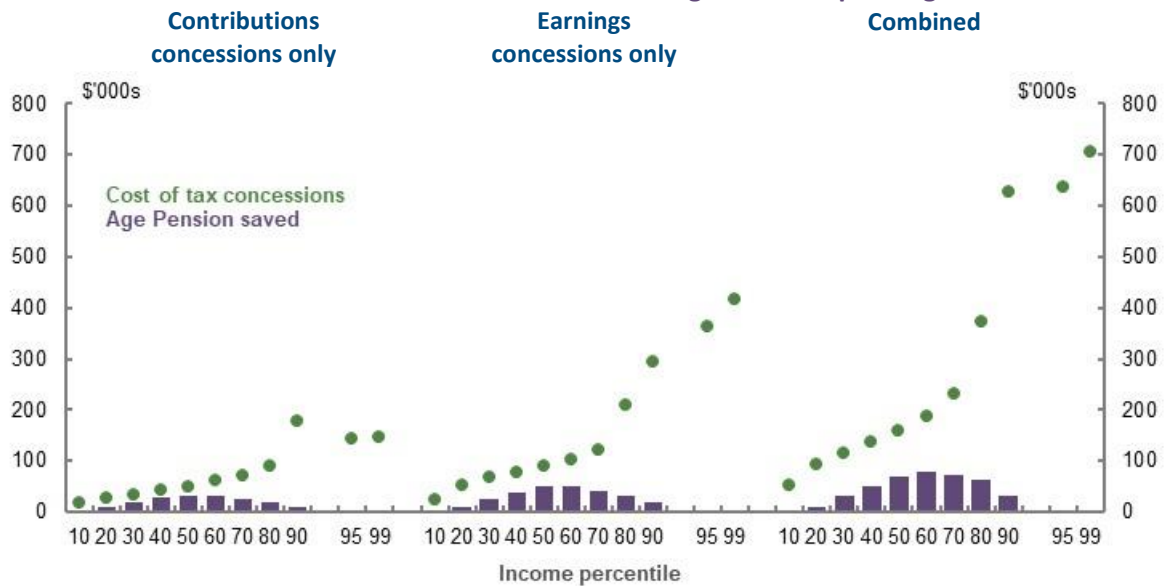
Source: Treasury estimates for the review using MARIA.

Cost-effectiveness

The Age Pension and other pensions, such as service pension, together provide retirement income support to around the bottom 70 per cent in terms of income distribution. It allows those without means to achieve a minimum standard of living in retirement and supplements the income of middle-income earners so they can maintain their living standards in retirement. Age Pension means testing has promoted the sustainability of the Age Pension, with expenditure projected to fall moderately as a proportion of GDP.

To the extent that superannuation tax concessions are contributing to higher superannuation balances of lower- to middle- income earners, they help to reduce Age Pension expenditure. But the main influence behind the growth in superannuation balances is the SG. Tax concessions are largely concentrated among higher-income earners who are close to and above preservation age. **Across the income distribution, the lifetime cost of superannuation tax concessions is projected to outweigh the associated Age Pension saving (Chart 13).**

Chart 13. The interaction of tax concessions and Age Pension spending over a lifetime



Note: Values are in 2019-20 dollars, deflated using the review's GDP deflator. See *Appendix 6A. Detailed modelling methods and assumptions*. Source: Cameo modelling undertaken for the review.

Other costs

Social transfers in kind (such as health and aged care expenditure) provide substantial support to retirees. The cost of social transfers in kind attributed to households aged 65 and over has increased from 2.3 per cent of GDP in 2003-04 to 3.3 per cent in 2015-16. Aged care costs, in particular, are expected to grow as a per cent of GDP as a result of the ageing population.

Another major cost in the system is superannuation fees, for which projections are uncertain, but are expected to grow alongside the growth in balances.

Measures to improve sustainability

Recent changes to superannuation taxation, such as the introduction of the transfer balance cap, have improved the sustainability of the system. A number of submissions called for further changes to superannuation tax concessions to improve the equity and sustainability of the retirement income system.

Changes to contributions tax concessions would increase the system's cost-effectiveness. While contributions tax concessions are not projected to increase the cost of the system over time, they do not significantly contribute to reducing expenditure on the Age Pension and disproportionately benefit older people with high balances. Changes to contributions tax concessions such as the 2017 reforms, which introduced tighter caps on voluntary contributions, can stem the future flow of earnings tax concessions. Changes to earnings tax concessions would increase the system's cost-effectiveness and directly contribute to improving its sustainability by reducing the growth in costs relative to growth in GDP. In particular, the cost of the earnings tax exemption in the retirement phase is likely to grow as the superannuation system matures. **Extending earnings tax to the retirement phase** could also simplify the system by enabling people **to have a single superannuation account for life** and would improve the sustainability of the system.

Changes to superannuation earnings tax concessions would improve equity, and in turn boost public support for the system.

Cohesion

The retirement income system should be cohesive in that all its drivers, processes and incentives contribute to the achievement of the retirement income system objective.

The system is a combination of Government compulsion, such as the SG, and efforts to encourage people to save for their retirement, such as through additional tax concessions. A coherent system should avoid as much complexity as possible, but to address complexity, it should have the mechanisms, support and incentives that help people to optimise their standard of living in retirement. This includes helping people navigate the retirement income environment through retirement defaults, guidance and facilitating access to affordable advice.

The report considers the experience of the system in this regard in detail. The evidence suggests that all the mechanisms and incentives may not be working as intended, or working well together.

In particular, the effectiveness of superannuation tax concessions in supporting retirement outcomes can be questioned.

In addition, the system focuses on the accumulation of savings for retirement, but insufficient attention is given to how people can best use their savings to support their living standards in retirement, such as drawing on their superannuation balances or accessing the equity in their homes.

Saving for retirement

There are tax concessions for both pre- and post-tax superannuation contributions, and tax concessions on the earnings of superannuation funds. Tax concessions compensate contributors for consumption forgone. They are intended to encourage people to make voluntary superannuation contributions — part of the ‘third’ pillar of the retirement income system.

Most people make concessional contributions at or near the SG rate. Around a quarter of people make voluntary contributions. This highlights the importance of the SG in increasing retirement savings for most people.

Voluntary contributions provide flexibility for those outside the compulsory system to contribute to superannuation, such as the self-employed and those with interrupted working careers. Those making voluntary contributions are generally older people and higher-income earners, although saving in any form is closely related to income and age. The main reason people say they do not make voluntary contributions to superannuation is budgetary constraints — their priority is to meet current expenses.

Tax concessions appear to have a limited impact on increasing voluntary savings. Studies suggest they encourage saving in tax-preferred forms, such as superannuation, but this largely displaces other forms of saving. As a result, there is almost no net increase in saving. Those making the largest contributions — higher-income earners and older people — are less likely to require an incentive to save for their retirement.

The self-employed, who are not covered by the SG, make voluntary contributions and can also save in forms other than superannuation, such as in other financial assets, business assets or investment properties.

Government co-contributions have a limited impact on superannuation contribution rates and household savings.

The high effective marginal tax rate generated by the Age Pension means test could represent a disincentive to save, particularly for middle-income earners, but there is little evidence that the Age Pension means test is affecting how much people save pre-retirement.

Many submissions called for a reversal of the 2017 change in the taper rate for the assets test in the Age Pension. The review canvassed the impact of reducing the taper rate from \$3 per \$1,000 to \$2.25. Such a change would:

- Benefit retirees in the top half of the wealth distribution in the near term
- In future, as the superannuation system matures, boost the replacement rates for middle-income earners, although their replacement rates already exceed the 65-75 per cent benchmark
- Provide a reward for additional saving, although it would lessen the incentive to draw down savings in retirement
- Have a fiscal cost in 2019-20 of \$1 billion, which would grow to 0.20 per cent of GDP in the long term

Investing for retirement

The two main assets held by people when they retire are their home and their superannuation. For lower- to medium-income workers, their main asset is their home. But superannuation balances will increase as the superannuation system matures.

Home ownership is an important influence on a person's standard of living in retirement. Housing costs are generally lower in retirement and the house is an asset that can be drawn on to boost retirement income. Although as noted below, few people do so.

Favourable treatment of a person's principal residence in the Age Pension assets test may encourage people to overinvest in their home. There are also strong incentives outside the retirement income system encouraging home ownership.

Many people take little interest in the investment returns being achieved by their superannuation fund. The exception is people approaching or in retirement, who are sensitive to fluctuations in their superannuation balances when there is an economic shock such as the one caused by the COVID-19 Pandemic. More generally, the complexity of the system may deter people from taking an interest in the investment performance of their superannuation. This is also influenced by SG payments being compulsorily made by employers and as such, superannuation is outside a person's area of focus. However, as highlighted in the Productivity Commission's report *Superannuation: Assessing Efficiency and Competitiveness*, the investment performance of a person's fund can have a major influence on their superannuation balance at retirement.

Incentives to work

Discouraging people from retiring early voluntarily can increase retirement incomes. There is no mandatory retirement age for most workers, just ages when people can access their superannuation or are eligible to apply for the Age Pension. The eligibility age for the Age Pension and the preservation age have a strong influence on when people retire. People who are able to choose when they retire generally do so when they feel confident they have the income they think they need for financial security.

The financial incentives to encourage people to continue to work include income tax reductions for people over 65, pension Work Bonus, Work Test for superannuation contributions, and transition to retirement arrangements. **The evidence suggests that incentives to encourage people to continue to work have a limited impact on people's decisions to retire.**

In 2018, 4 per cent of people on the Age Pension had declared earnings from work. Nevertheless, workforce participation of Australians over 65 is increasing as more Australians are working past Age Pension eligibility age.

Surveys suggest people over 55 are generally happy to be retired, and a sizeable proportion of people retire before Age Pension eligibility age. However, many of these people retire involuntarily. The main reasons for involuntary retirements are own ill health, caring responsibilities and job-related issues, such as a reluctance to hire older workers — ageism. For people who retire before they want to, financial incentives to keep working are not relevant. Addressing the barriers that force people into retirement — such as reducing employer bias against older workers, retraining older workers and increasing flexibility between work and caring responsibilities — would be more effective in assisting people to stay in the workforce.

Drawing on assets to maximise retirement income effectively in retirement

In a coherent system, mechanisms would not only encourage people to save for their retirement but also to use these savings effectively to support their standard of living in retirement. **A common theme throughout this report is that the focus is on the accumulation phase of the retirement income system and insufficient attention is given to the retirement phase.** The evidence indicates that retirees tend to hold on to their assets and leave significant bequests, even though surveys suggest people do not prioritise leaving a bequest. If people drew down more on their assets, they could have a higher standard of living in retirement. Alternatively, they need not have saved as much as they did for retirement and could have had a higher standard of living during their working years.

Some retirees do, however, consume more of their assets in retirement than others. For example, non-home owner age pensioners consume their assets faster than other households, and people with low balances draw down their superannuation at a much higher rate than those with larger balances.

Factors that contribute to low drawdown of assets in retirement include:

- Complexity and little guidance on how to maximise retirement incomes
- Reluctance to consume funds that are called ‘investments’, ‘savings’ or ‘nest eggs’
- Adopting the minimum drawdown rates required for a superannuation pension account
- Concern about possible future health and aged care costs
- Concerns about outliving savings

Some of the **measures raised in submissions to help people use their retirement savings** more effectively to support their standard of living in retirement include:

- Funds providing regular estimates of an individual’s retirement savings being expressed in terms of an income stream rather than balance at retirement
- Educating people that their health and aged care costs are heavily subsidised by the Government
- Emphasising that the Age Pension provides a safety net for people who outlive their savings or when the value of their retirement savings falls significantly
- Amending the minimum drawdown rates so that income is delivered when people are more likely to consume it, namely earlier in their retirement rather than the current drawdown rates, which are highest at ages 85-90
- At retirement, guiding people towards products that deliver an income stream and provide protection against market fluctuations and outliving savings

Few retirees use the equity in their home to support their standard of living in retirement. The options available to do so include reverse mortgages, equity release schemes, home equity loans and downsizing. Reverse mortgages are the main product available, but usage is low.

Two Government measures to encourage retirees to access the value of their home to fund their retirement are the:

- Pension Loans Scheme — This is effectively a reverse mortgage for age pensioners and self-funded retirees, where income from the scheme is not assessable in the Age Pension means test.
- Downsizer contribution — This allows people aged over 65 to contribute up to \$300,000 to superannuation if they sell their home.

Use of the Pension Loans Scheme is limited. Between 1 July 2018 and 17 January 2020, more than 9,000 people made downsizer contributions.

Dealing with complexity

The retirement income system is complex and hard to navigate. The broader retirement environment is also complex and involves many uncertainties, as can be seen in the context of the COVID-19 Pandemic. **This complexity and uncertainty, combined with a lack of assistance, guidance or advice, and low financial literacy, makes it hard for people to make well-informed choices about their retirement income.**

Adding to complexity is the interaction with other systems, such as aged care, the tax system and other benefits available for older Australians.

Reducing complexity

Submissions raised a range of ways to tackle the complexity of the retirement income system. These included simplifying the design of the system by removing the Age Pension means test and creating a universal pension. Another suggestion was to have a one-off means test. There were also suggestions to improve the administration of the Age Pension, such as reducing reporting requirements and using data sharing to pre-fill forms and make application for the Age Pension easier.

A merged means test

Some stakeholders suggested merging the income and assets tests in order to reduce the complexity of the Age Pension means test. It would be challenging to design a merged means test without compromising some of the retirement income system objectives of adequacy, equity, sustainability and cohesion. An example of a merged means test is outlined in the report.

Default products in the retirement phase

The pre-retirement phase of the retirement income system has substantial compulsion and defaults, and as a result, people do not have to make decisions about their superannuation contributions. For example, the SG involves compulsory superannuation contributions, which come with default mechanisms for selecting a superannuation fund and products. A downside of defaults is that people fail to engage with their superannuation. The Productivity Commission (2018a) suggested default settings be set to encourage people to make active choices, but also to protect those who do not.

The retirement phase is more complex than the pre-retirement phase, but little guidance is available to help people choose their retirement income products. To address this, stakeholders suggested:

- Advancing the **Comprehensive Income Products for Retirement** concept and making available regulated, simple and safe retirement products

- Developing the proposed **Retirement Income Covenant** under which superannuation trustees would be required to develop a retirement income strategy, and provide guidance to help retirees choose a retirement income product
- **Introducing defaults**, and while recognising the difficulty of designing an optimal default given that people's circumstances vary, making pre-selected or 'soft' default products available. Alternatively, similar to approaches in some other countries, it could be mandatory that part of a person's retirement savings be taken as an annuity
- **Limiting options offered**, such as the UK approach where every defined contribution pension has only four investment pathways

Retirement advice and guidance

Submissions raised a range of proposals aimed at giving people more information, guidance and better advice tailored to their circumstances.

The evidence suggests that **most people do not seek advice about retirement income planning**. Barriers against seeking advice include cost, small finances and lack of trust.

People need advice and assistance to make better informed decisions. But the advice has to be sound. Assessments by regulators and the Hayne Royal Commission, identified weaknesses and misconduct in financial advice. Reforms are underway to remove conflicts of interest for those giving advice and to improve their education. Superannuation funds are uniquely placed to provide advice and guidance because members have to contact their fund to commence a retirement income product. But funds can have a conflict of interest between the interest of members and maximising funds under management. Funds are also restricted in what they can consider when providing intra-fund advice. Changes would need to be made to the regulatory framework to facilitate funds providing more guidance at retirement.

Automated or digital advice could be more accessible and affordable. The take-up of such advice is currently low, with people lacking trust in this form of advice and thinking it should be free.

There may also be a role for the Government to provide comparison tools to help consumers compare products. Some submissions suggested expanding ASIC's MoneySmart website and the Financial Information Service.

Overall, in terms of the cohesion of the system, the evidence suggests that:

- The SG is effective in increasing savings for retirement, while tax concessions appear to have a weak influence on overall savings behaviour
- Retirement income projections, greater use of longevity risk management products and more financial advice and guidance would lead to higher drawdown in retirement
- Reducing complexity would lead to better retirement outcomes for individuals
- Carefully designed defaults, guidance from superannuation funds, as well as accessible and affordable advice at retirement, would help people get better outcomes in retirement