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A universal pension proposal for Australia

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Australian taxpayers spend almost as much on tax incentives for retirement saving as they spend on the Age Pension. An Australian think tank proposes the abolition of tax breaks for retirement saving and suggests using the fiscal savings to remove the means-tests on the Age Pension and to make it universal, just like New Zealand Superannuation.

In summary

An Australian report (*Sustaining us all in retirement – the case for a universal pension* by David Ingles and Richard Denniss) suggests that the Age Pension at Tier 1 should be universal and that the cost of removing the means-tests should be met from removing tax incentives for compulsory and voluntary retirement savings. However, the compulsory Superannuation Guarantee at Tier 2 would remain.

In the short-term, the report suggests that the changes will reduce the overall cost to taxpayers of retirement income arrangements by 30% but the main advantages will be a fairer regime that reduces the favours currently conferred on the highest earners and re-distributes those to the lowest earners. Over the long-term, the cost to taxpayers is expected to be revenue neutral as the ageing population increases the cost of the Age Pension and as superannuation balances reduce in relative terms.

The report also suggests a 25% increase in the newly-universal Age Pension. That will then look quite like New Zealand Superannuation and the report suggests it "could be expected to virtually abolish poverty amongst the aged" (page 19 of the report, accessible here). The proposed changes should also:

- reduce tax-planning as wealthier Australians currently make extensive use of the very favourable tax environment for retirement saving;
- increase labour force participation rates of those aged 55 to 65 as Australians tend to retire before the state pension age to maximise entitlements to the Age Pension (so-called 'double-dipping');
- reduce the complexity of the current regime.

There is likely to be a vigorous reaction to the report's proposals from financial service providers.

Comparing Australian and New Zealand retirement income frameworks

Australia and New Zealand are neighbours with close economic and historical links. The two countries' histories have followed parallel tracks, partly because of a shared social history. And yet in many ways, the two retirement income systems could not be more different.

Comparing retirement income systems is difficult, and caution must be exercised in comparing the features of countries' different systems. Context is everything for any kind of judgement on a single country's system, and that renders most cross-country comparisons almost meaningless.

The Australia/New Zealand case is, perhaps, different for two reasons – first, in many respects, the two countries form a common economic market; and a free trade agreement has unified markets and business links between the two. Also, migration is unfettered between the two countries; and a 'social security agreement' confers access to an age-based pension based on residence in either country[1].

Next, nearly all the major financial institutions in New Zealand are Australian-owned and there is a natural pressure from them for New Zealand to adopt Australian retirement income policies.

Here are the key features of the two systems:

- **Tier 1**: Both countries have a relatively generous Tier 1 pension. They are both payable from age 65 (increasing in Australia to age 67 between 2017 and 2023). In both cases, the full pension is payable after 10 years' residence. However, whereas 'New Zealand Superannuation' (NZS) is truly universal (after satisfying the residency test), Australia's 'Age Pension' is subject to stringent, complex income- and asset-tests[2]. Australia's is purely PAYG financed; New Zealand has a relatively small 'New Zealand Superannuation Fund' to partially pre-fund the expected outgo.
- **Tier 2:** Australia has an extensive, tax-subsidised, 'Superannuation Guarantee' (SG), accessible from age 55, that requires employers to contribute 9% of pay (rising to 12% by 2020) to defined contribution, privately managed schemes. New Zealand has no Tier 2.
- **Tier 3:** Australia has still-extensive occupational pension arrangements on top of the SG scheme and the usual private arrangements of all kinds (direct personal investments, property, business interests etc.). New Zealand has KiwiSaver, the world's first national auto-enrolment, opt-out, defined contribution scheme, again privately managed. It started in 2007 and now (2014) covers about half of the eligible population. Employers must contribute to KiwiSaver if an employee also contributes. Again, there are the usual private arrangements.

Both countries encourage financial savings for retirement through tax concessions. New Zealand has now minor concessions for KiwiSaver and a small tax break for 'portfolio investment entities' (PIEs). Australia's tax breaks are generous for both Tier 2 and formal Tier 3 retirement saving schemes and now cost about the same as the Age Pension itself.

[1] The entitlements are, however, asymmetrical because of the means-test that Australia applies. That is a major potential fiscal issue for New Zealand.

[2] Despite these tests, only "[a]round 41 per cent of pensioners currently have their rate reduced by the means test – 32 per cent by the income test and 9 per cent by the assets test - with the role of the assets test increasing over time. However, for most pensioners, the reduction in the rate of the pension as a result of means testing is relatively small - around 73 per cent of pensioners receive over 90 per cent of the maximum pension rate and only 3 per cent receive less than 25 per cent of the maximum rate." Australian Government (2009).

Tax incentives for retirement saving

Until KiwiSaver, New Zealand had no tax incentives specifically targeted towards retirement savings. Between 1987 and 2007, the tax treatment of retirement savings was very similar to bank accounts.

A set of acronyms summarises the tax treatment of financial assets in a retirement saving context. There are three main movements of money:

- **contributions**: 'T' means that contributions to the scheme come from after-tax income; while 'E' means that contributions reduce *taxable* income before tax is deducted; also, in the case of occupational schemes, the employer's contributions are not deemed part of the employee's taxable pay.
- **investment income on the accumulation**: 'T' means that invested assets are taxed with the saver's other income; conversely, 'E' means that the assets accumulate tax-free.
- **benefits received**: 'T' means that benefits are taxed as income in the year of receipt; and 'E' means that benefits are exempt from tax in the recipient's hands.

Most countries treat 'locked-up' retirement savings on EET principles – contributions are deductible or directly subsidised through the tax system and, for employees, not deemed to be part of pay (E); there is no tax on the saving scheme's investment income (E) and the final benefits (usually pensions) are taxed as income (T). In an *expenditure tax* environment, EET is relatively neutral.

TTE is a 'neutral' treatment in an *income tax* environment. A bank account is a convenient example: savings into the account come from after-tax income (T); interest earned on the account is added to the saver's other taxable income (T) while withdrawals from the account are exempt (E). They are not really 'exempt'; they are withdrawals of tax-paid capital.

New Zealand, KiwiSaver aside[3], has TTE which means that 'retirement' savings receive no special tax treatment. Australia has 'ttE'[4] which means lower levels of tax on contributions and investment income but, overall, retirement saving schemes are greatly favoured by comparison with, say, bank accounts. On generous assumptions, Australia's ttE is broadly equivalent to the more usual EET.

Comparing costs – Australia and New Zealand

The overall fiscal costs of the retirement income arrangements between the two countries are similar, but split very differently, as explained next.

In Australia, the Tier 1 Age Pension cost $A39.4 billion in the 2013-14 year[5]. Tax incentives for retirement saving cost an additional estimated $A34.6 billion in lost tax revenues[6]. The total is about 4.6% of Australia's GDP. By 2016-17, the Australian

[3] There are modest tax concessions in KiwiSaver – an upfront 'kick start' of $1,000 and a direct subsidy on members' contributions that is capped at $520 a year.
[4] Guest (2013) summarises the tax treatment: in Australia, contributions are taxed at a flat rate of 15% to an annual cap of $A25,000. Investment income is taxed at a rate that probably averages 8% and benefits are tax-free if withdrawn after age 60. The lowest individual marginal rate of income tax is 19% after a tax-free band of $A18,200.
[5] See the Australian Government's *Budget Paper No. 1, Statement 6: Expenses and Net capital Investment, Table 3.1* accessible here.
[6] See the Australian Government's *Budget Paper No. 1, Statement 5: Revenue, Table E1* accessible here.

government expects to be spending more on tax incentives than on the Age Pension itself.

New Zealand Superannuation's net estimated cost for 2013-14 is 4.1% of GDP while the tax subsidies to KiwiSaver cost an estimated $740 million[7] or about 0.3% of GDP. The total direct cost to taxpayers is about 4.4% of New Zealand's GDP.

Currently, Australian taxpayers spend slightly more on retirement incomes than New Zealand's (4.6% of GDP vs. 4.4%).

Some issues with the Australian framework

The Australian mix of compulsion and the means-tested Age Pension has some logic. Orthodox public policy theorises that individuals should save for their own retirement and the state's role is to provide a safety net for those who do not save enough. People seem to be myopic about when to start saving and how much to save so the state will set the rules and will reduce the state pension by the eventual retirement saving accumulations. In fact, without some form of means-test on the state's pension, there seems little logic to forced private provision, like Australia's SG scheme.

Whether compulsory saving needs the additional help of generous tax incentives, as in Australia is doubtful. Incentives are about encouraging particular behaviour. If there is no choice about that behaviour, incentives are superfluous.

There are wider policy difficulties associated with all compulsory retirement saving schemes at Tier 2. Controlling human behaviour over as many as seven decades - from first employment to death in retirement – is probably too difficult.

'Compulsory' Tier 2 schemes inevitably require thickets of regulations that become more complex over time. There is so much to control and so many who might prefer to do something else; and they are constantly thinking of new ways to avoid Tier 2.

Given the natural propensity of individuals to set their own objectives and timetables, the rules cannot prevent members' changing their other behaviour to compensate as Australian evidence shows. First, the income/asset-tests that link Tier 2 (and all other assets) to Tier 1 are intricate and intrusive[8].

Second, Australians seem to retire early to collect their Tier 2 saving accounts[9] and spend those before the means-tested Tier 1 pension starts[10]. They also seem to arrive at retirement with greater debt, after 'pre-spending' those retirement savings[11].

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[7] See the New Zealand Government's *2013 Tax Expenditure Statement, Table 2* accessible here.

[8] Australian authorities require information from each pensioner on a regular basis: see here for the assets test and here for the income test.

[9] The OECD (OECD 2010) estimates that Australia's 'effective retirement age' in 2009 was 64.8 (males) and 62.9 (females). By contrast, New Zealand's was 67.1 (males) and 65.0 (females). The Australian Bureau of Statistics reported in December 2013 that the "…average age at retirement for recent retirees (those who have retired in the last five years) was 61.5 years." Men's average was 63.3 and women's 59.6 (see here).

[10] The post-retirement asset test in Australia also leads to an 'over-consumption' of housing services as the primary residence is exempt under the test: see Piggott and Sane (2007).

[11] People should aim to reduce overall debt as they approach retirement. That seems not to be the case in Australia. In the eight years to 2012, Kelly (2013) reports that retirement savings among 50 to 64 year-olds grew 48%, other financial assets by 3% and real estate assets by 58% *but* property debt increased 123% and other debt by 43%. By ages 60-64, debt was 42% of retirement saving balances.

Lastly, although large amounts have accumulated in Australia's superannuation schemes, household balance sheets show similarities to their equivalents in New Zealand[12]. This indicates that households react in expected ways to direct public policy interventions. At least some of those reactions involve 'compensatory' behaviour.

More change on the way in Australia?

The Australian government is already adjusting to the increasing costs of its overall framework. The state pension age will increase from age 65 to age 67 between 2017 and 2023. Also, some limits have been placed on the generosity of tax breaks for private provision. There is now a (generous) cap on annual contributions to tax-approved schemes for high-income earners and the tax exemptions for earnings in superannuation schemes are now "better targeted".

Further changes seem indicated:

> "Joe Hockey [Federal government's Treasurer] says Australia has no choice but to take tough decisions in the federal budget, giving his clearest signal yet the pension age will rise to 70 in the May budget..."[13]

A radical re-think

The Australia Institute (a Canberra-based think tank) proposes a more radical reform. In *Sustaining us all in retirement – the case for a universal pension*, David Ingles and Richard Denniss[14]suggest a retirement income regime that looks more like New Zealand's.

Here is a summary of what they propose:

- Abolish tax incentives for retirement saving;
- Abolish the income- and asset-tests on the Tier 1 Age Pension;
- Increase the annual amount of the Age Pension by 25%, but
- Make the Age Pension taxable as ordinary income. Currently it is effectively untaxed because of the 'Senior Australians and Pensioners Tax Offset'.

The authors suggest that proposed arrangements would, in the short-term, cost $A52 billion a year, about 30% less than the current total of $A74 billion. However, as the cost of Tier 1 increases with the ageing population and as the growth in superannuation balances reduces, it will become cost-neutral over the long-term.

The report suggests a number of advantages for the proposed regime:

(a) Tax incentives regressive: The current tax incentives are "extremely regressive" (page 5). The Australian Treasury estimated that, in 2009-10, the top two deciles of income earners received 57.7% of total concessions. One of the authors, Richard Denniss, suggests in a separate report (Denniss (2013)) that "The bottom 60% of income earners receive 27.2 per cent of superannuation tax concessions." The new arrangements would be more progressive so that it "…would more closely reflect the existing taxation rates applicable at each level" (page 2). Despite the greater impact of the means-tests on higher earners, the

[12] A 2006 household wealth comparison between Australia and New Zealand (RPRC (2010)) shows that Australians have higher proportions of wealth in retirement saving accounts (19.1% in Australia and about 4% in New Zealand) but much less in 'business investment' (7.6% in Australia and 22.2% in New Zealand).

[13] As reported in the Sydney Morning Herald here.

[14] The Australia Institute Policy Brief No. 60, April 2014 (accessible here).

Treasury suggests that, over the long term, taxpayer-funded support for high earners is significantly greater than for low earners.

(b) **'Effective marginal tax rates':** The current regime sees relatively high EMTRs for pensioners from the combination of income tax and the effect of the means-tests. The current EMTRs are about 75% across wide ranges of incomes. The suggested regime will be the normal income tax treatment of all income, including the Age Pension. It should reduce presently common avoidance activities and would also reduce rates of total state assistance for the more highly paid.

(c) **'Double dipping':** As already mentioned, Australians seem to retire earlier and to borrow more in advance of the state pension age in order, apparently, to maximise their entitlements to the Age Pension from age 65. The proposed regime will eliminate the economic incentives associated with 'double dipping'.

(d) **Tax avoidance:** The favourable tax treatment of superannuation has led to a rapid growth in 'self-managed superannuation funds' (SMSFs). SMSF assets have grown rapidly and now comprise one-third of all superannuation fund assets though only 5% of individuals contribute to such funds[15]. Eliminating tax breaks will remove the reason for SMSFs. Another indicator of the very favourable ttE tax environment is illustrated by Treasury estimates that 60% of the contributions to all superannuation funds are voluntary with only 40% being attributable to the compulsory SG environment[16].

(e) **Poverty reduction:** The report suggests that the new higher rates of the Age Pension "…could be expected to virtually abolish poverty among the aged." (page 19) and reduce the present gender-biased income distribution that currently favours men in retirement.

(f) **Other effects:** A universal pension would also "resolve the issue of the preservation age" that allows access to compulsory savings ten years before the means-tests affect the Age Pension. There would no longer be incentives to spend-down retirement savings. The issue of compulsory annuitisation would also be resolved "…in the negative, as there is no public policy reason to compel annuitisation when the base benefits are adequate…" (page 20).

The authors will produce a second report that looks at different approaches to implementing the new regime.

Comments

(a) Why compulsion?

If, as the authors suggest, the new universal Age Pension "…could be expected to virtually abolish poverty among the aged", it seems at least questionable why public policy might still require Australians to save for retirement through the SG schemes. Under current arrangements, it is not logical to have compulsion at Tier 2 without the extensive means-tests that Australia has for the Tier 1 pension. If public policy forces private saving, then the state can reduce its own future financial commitment to the old.

There is at least a case to suggest that the converse applies. If the improved Tier 1 achieves the objective of eliminating poverty in old age, the state could suggest it has no public policy interest in any further provision that individuals, with their employers, decide to make. The report suggests that this seems justification enough for the removal

[15] Treasury (2014) at page 47.
[16] Treasury (2014) at page 46.

of tax breaks for retirement saving. The report did not discuss whether it should also be enough to remove the requirement to save particular amounts in particular ways.

There may be public policy grounds for further public policy interventions (such as the original KiwiSaver concept) but forcing employees to save for retirement seems difficult to justify.

(b) Risks to New Zealand reduced

The Social Security Agreement between New Zealand and Australia means that 'residence' in either country counts for the tests to qualify for either NZS or the Age Pension. That poses significant potential fiscal risks for New Zealand. If an Australian resident with either New Zealand or Australian nationality loses entitlement to the Age Pension through the means-tests, there is an economic incentive to retire in New Zealand. NZS is payable in full even if applicants have spent their entire working lives in Australia so the fiscal risk is not limited to former New Zealand residents now working in Australia.

If the Age Pension looks more like NZS, as the report proposes, that long-term fiscal risk to New Zealand from 'welfare tourists' disappears.

(c) Industry reaction

Given the scale of the Australian superannuation industry, we must expect unfavourable reactions to the report's proposals. The report was published on 22 April 2014 so it is too early for considered responses. From a New Zealand perspective, it is at least gratifying to see some of the lessons we have learned beng tested in a very different retirement incomes' environment.

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