

Retirement Income Policy – Australian solutions to behavioural problems

(Remarks at a panel on retirement income models at The McDonnell International Scholars Academy Global Forum, Brisbane, September 23, 2016)

Retirement Incomes policies face three fundamental problems reflecting human behaviour. First, many/most individuals during their working lives do not or cannot save enough to accumulate adequate wealth for a comfortable retirement. Some cannot due to life and family circumstances such as unemployment, low wages, poor health. But generally, individuals are myopic and discount the needs and risks of the future too heavily. Second, governments feel compelled to provide a “safety net”, such as a taxpayer-funded Age pension for the elderly who would otherwise live in poverty. As crucial as this is, it tends to reinforce the first fundamental problem, reducing individual incentives to save and achieve self-sufficiency in retirement. It also creates a policy risk that individuals come to regard such pensions as entitlements rather than as a safety net for those in need.

The third problem is that at the end of their working lives, individuals face personal financial management challenges which they are typically very poorly equipped to deal with. If they have accumulated adequate wealth which they must manage (rather than having some defined benefit pension), their investment planning needs to take into account such risks as longevity risk, market risk, and sequencing risk.¹ Moreover, they are faced with the uncertainty of hard to predict future expense needs for health and aged care accommodation. And for many, financial literacy is inadequate to deal with complex retirement income products, and provide protection against poor financial advice or exploitation.

In Australia the approach to dealing with the first two of these challenges has been to supplement the (century-old) universal, but means tested, age pension with a tax-favoured, compulsory, defined contribution, superannuation system for employees. The Superannuation Guarantee legislation of 1991 introduced requirements for all employers to contribute funds into individual, privately managed, accumulation accounts on behalf of workers. Those accounts are operated by institutional superannuation (pension) funds operated by industry (not-for-profit) funds, retail (profit-oriented) funds, public sector funds, or individuals (families) themselves via self managed super funds (SMSFs).

Starting at employer contributions of 3 per cent of salary, the contribution rate has increased to 9.5 per cent currently, with a targeted future rate of 12 per cent. Substantial tax benefits apply to those contributions, and individuals can make voluntary contributions out of after tax income. Earnings of the fund get favourable tax treatment in the accumulation phase, while withdrawals and earnings in the retirement mode are, currently, tax free. There is thus both a (tax) carrot and a (compulsion) stick – although the stick is somewhat disguised if workers do not perceive that take home wages would most likely be higher in the absence of compulsory employer super contributions. “Labelling” the contributions as employer contributions has, arguably, assisted in widespread support for the system among employees.

¹ Sequencing risk refers to the problem that while good and bad investment outcomes may average out over a long horizon, retirees may not be able to recover from a sequence of bad investment outcomes early in retirement.

Unfortunately, the tax carrot has been far too big and juicy. Wealthier individuals have used voluntary contributions into super as a form of tax-preferred wealth accumulation, far in excess of what is needed for an adequate retirement income. As well as equity and fairness considerations, this has contributed to concerns about the cost of the superannuation system to the Government budget. Currently this issue is receiving considerable political attention, but reform is somewhat stymied by the difficulty in getting general community support for reductions in such tax breaks.

Among the ingredients in policy reform, is overdue attention to clearly identifying the objective of superannuation – as being to supplement or substitute for the age pension in providing retirement income, rather than as being a tax-preferred form of wealth accumulation. For the majority of individuals, the age pension will continue to make some contribution to their retirement income, since even at the target contribution rate of 12 per cent, workers on average wages would be unlikely to build up sufficient private savings to achieve a comfortable retirement.

Whereas the accumulation (working-life) phase of the Australian system recognises human behavioural biases and uses compulsion, tax incentives, and default options (relating to choice of account style and account provider for those individuals who are “not engaged” with the system), this has been missing from policy towards the decumulation (retirement) phase. At retirement, individuals have been largely left to their own devices to determine how to manage the accumulated funds then available to them. Many make lump-sum withdrawals, while the most common approach has been to convert the superannuation account into pension mode (where earnings have been tax free) and gradually draw down funds for living expenses. For many, doing so in a way which maximises age pension entitlements (and related health care benefits) has been a complex financial planning problem involving financial advisers.

The only constraint on withdrawals from pension mode accounts has been minimum withdrawal rate requirements, which go some (very) small way to limiting the ability of individuals to use super for tax preferred wealth accumulation and bequest planning.² But many also appear to stick to the minimum withdrawal rates because of concerns about longevity risk and the unknown, but likely increasing, age-related costs of health care and assisted living. Relatively few “downsize” or use reverse mortgages to extract some of the accumulated equity in their private dwellings (which are exempt from the pension (asset) means test).

Very few retirees have invested even part of their superannuation savings in annuities as a retirement product. Tax distortions have reduced the competitiveness of annuities, but for many retirees, the age pension provides an alternative annuity income (either currently or in the future when reduced wealth and investment income enable eligibility).

² There are no inheritance taxes in Australia. Some very small recoupment of superannuation tax concessions may occur if an individual dies with a positive balance remaining in their superannuation account.

The recent Australian Financial System Inquiry³ focused on the lack of attention which had been paid to even “nudging” retirees into better financial planning choices. It recognised that neither compulsion nor introduction of “default” products made sense given that the life circumstances of individuals (and couples) at retirement are too diverse for a “one size fits all” approach. It recognised that products were needed which would assist in managing longevity risk, and that institutional super funds were well placed to identify suitable retirement products for their members and “nudge” them into better choices. Thus, Comprehensive Income Products in Retirement (CIPRs) – which might combine a mix of an individual pension account and a deferred annuity, for example -are currently being examined by super funds for offer to members approaching retirement.

Conclusion

Gradually the Australian superannuation system is adapting to deal more completely with the behavioural biases and challenges which face individuals and families in life-cycle financial planning. But it also has significant challenges in ensuring that the cost of achieving good outcomes is not excessive and does not involve adverse distributional consequences by the nature and size of the tax concessions involved.

Nevertheless, the system has strengths. Overall, Australia’s retirement income system (age pension, compulsory and voluntary tax-advantaged super) is highly regarded internationally. The Melbourne-Mercer Global Pension Index⁴ has consistently ranked Australia in the top three nations (with the Danish and the Dutch systems) overall on criteria of adequacy, sustainability and integrity. It has contributed to more individuals and couples being “on track” to achieve a comfortable level of income in retirement. It has created a new, large, sector of financial institutions (super funds) to compete with banks for household funds and investment opportunities, and created a substantial pool of long term savings.

But there remain challenges. One is the difficult question of how to ensure efficiency of privately run superannuation funds. Competition for members may simply result in wasteful advertising, since it is virtually impossible for individuals to make informed choices amongst funds which are managing money over long horizons. After all, the common mantra of the funds management industry is that “past returns are no guide to future returns”. Together with a lack of engagement with superannuation of many (particularly younger) members, effective demand side pressures for improved efficiency are weak. And there has been concern about high levels of fees and operating costs – which led to major supply side reforms in the late 2000á known as “Simpler Super”⁵ and “Super Stream”⁶. The former aimed to simplify and reduce the costs of “default” accounts for new workers not interested in making choices about superannuation funds or account type. The second was aimed at improving the operating efficiency of the accounting, information, and payments networks involved in the contributions process.

³ See www.fsi.gov.au

⁴ www.globalpensionindex.com

⁵ <http://simplersuper.treasury.gov.au/>

⁶ <http://strongersuper.treasury.gov.au/content/Content.aspx?doc=home.htm>

Another looming challenge arises from the growth of SMSFs. As member/trustees age and cognitive decline (or death of the member who has taken primary responsibility) occurs, the potential for costly mistakes and unwinding of arrangements increases. Also important is the inequities arising from interrupted work patterns or early exit from the workforce for child rearing duties, which has meant that superannuation balances, and retirement income prospects, of females are well below those of males. The self-employed are also not included in the compulsory contribution requirement, and while they are able to make voluntary contributions this is not always equivalent in scale. Looking ahead, the potential for technology and globalisation to lead to increased casualization of the workforce and increased numbers of self-employed or contractors raises another problem for a scheme focused on “employees”.

Coupled with population ageing and a low-yield global returns outlook for the foreseeable future, the challenges for retirement incomes systems based on accumulation schemes and age pensions to deliver adequate retirement incomes without adverse government budgetary are substantial.

Kevin Davis

Professor of Finance, University of Melbourne

Research Director, Australian Centre for Financial Studies & Professor, Monash University

September 27, 2016