A Proposal for Integrating

Australia's Retirement Income Policy

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Abstract

Australia's retirement income system has two major sources of income: namely the age pension and superannuation benefits. Yet, there exists no significant integration between these two income sources. This paper proposes a new way forward to determine entitlement to the age pension. The proposal would significantly improve the incentives for older Australians without imposing a major increase in Government expenditure. The resulting system would maintain the safety net provisions of the age pension; provide a much better deal for retirees; have important economic benefits; and give older Australians increased choice in terms of their financial and personal affairs.

1 Introduction

Australia's emerging retirement income system has two major sources of income for retirees in the future. These are:

- the means tested and unfunded Government age pension; and
- benefits arising from compulsory funded superannuation.

In addition to these two sources of retirement income, there will also be benefits arising from voluntary superannuation (beyond the compulsory minimum), and non-superannuation personal savings. However, the level of voluntary superannuation is likely to decrease in future years as the level of the compulsory minimum rises, Reasonable Benefit Limits affect more individuals and the effects of the surcharge and other changes make superannuation less attractive relative to other savings options.

The two major sources of retirement income mentioned above lack any significant integration. Indeed, there are currently many factors that encourage individuals (both before and after retirement) to behave in a manner that maximises their personal benefits but reduce the benefits to the community of their superannuation and other savings.

Some of the well-known problems include:

- the investment of capital during retirement in a manner that maximises age pension entitlement but does not necessarily maximise investment income;
- a strong disincentive for most retirees to take up part time work due to the very high effective marginal tax rates (with the combination of the income test and income tax) which also reduces the value of the accumulated human capital to the community;
- the use of lump sum superannuation benefits to fund early retirement and then for the retiree to rely, at least in part, on the age pension for retirement income;
- an incentive to continue to live in (or even expand) the family home as it is excluded from the means tests, whereas any downsizing would realise the asset and therefore possibly affect any age pension entitlement;
- a disincentive to save both before and after retirement for many individuals as the net financial gain can be very limited;
- a complex system which is difficult for retirees, administrators, financial planners and policymakers to fully appreciate and understand; and
- considerable intrusion into the private financial affairs of many retirees.

These significant factors affect the behaviour of the increasing numbers in Australia's retired population and result in a substantial misallocation of resources within the economy. In particular, some assets are favoured (e.g. the family home) and there are also significant disincentives for retirees to enter the labour force, even on a casual or part time basis.

In addition, this lack of any meaningful integration between the age pension and superannuation discourages additional voluntary savings, as many households who have the potential to save receive very limited benefits from their extra savings. Indeed, an increase in the level of superannuation savings often results in a net increase of only 30-40% in the level of post retirement income, which does not represent a strong incentive to increase the level of voluntary individual saving for the longer term.

This paper proposes a major reform to overcome this set of problems. The next section briefly reviews the current situation. Section 3 presents some alternatives that have previously been proposed before Section 4 explains the new proposal in some detail. The following two sections discuss possible transitional arrangements and some important advantages of the proposal. Finally Section 7 outlines a further option that would be possible before Section 8 concludes the paper.

2 The current situation

The current system produces three broad groups of retirees.

1. Those with limited assets and/or income who receive the full age or service pension - currently more than 50% of the aged population. Notwithstanding the introduction of compulsory funded superannuation (through the Superannuation Guarantee (SG) Charge), there will always remain a significant proportion of the aged population whose main source of income will be the full pension.
2. Those with some assets and/or income who receive a part pension – currently about 30% of the aged population. Whilst compulsory superannuation will increase the level of superannuation benefits available in the future, a long term contribution rate of 9% will not produce sufficient retirement benefits for most individuals to be financially independent. It can therefore be expected that many retirees will continue to receive a part pension in the future.
3. Those with considerable assets and/or income who receive no pension – currently less than 20% of the aged population.

In terms of these groups, it is appropriate to consider briefly what may happen to the size of each of group in the future.

Assuming that the Australian community accepts the need for a basic level of income for all aged persons, there will always be a sizeable group within the aged population who will receive the full age pension. This will occur irrespective of the actual retirement income system. It is reasonable to suggest that this group will decrease in relative importance over time as superannuation coverage has increased significantly during the last decade.

However, even when mature, it is unlikely that the SG system will cause a significant increase in the size of the non-pensioner group. This result is due to the inadequate level of the minimum SG to provide sufficient retirement benefits and the changes occurring in the labour force which means that fewer individuals have full time employment for 40 or more years. In addition, increasing longevity is raising the size of superannuation benefits that are required to fund for retirement.

The net result of these trends is that the part-pensioner group is likely to become even more important in the future. Hence, the integration between the benefits emerging from superannuation and the age pension becomes a critical issue if Australia is going to develop a rational, efficient and sustainable retirement income system.

Furthermore, there is no doubt that with an ageing population and the growing superannuation system, the proportion of Australia’s total wealth held by the aged population is likely to grow significantly in the future. The allocation of this wealth also has important macroeconomic effects. It is therefore essential that the incentives for appropriate behaviour by the individual retiree are such that the outcome is improved for both the individual (in terms of retirement income) and for the economy and community (in terms of the allocation of these resources).

3 Some previous alternatives

A number of alternative proposals have been previously suggested to improve the integration between superannuation benefits and the age pension. These have included the following.

Increasing the tax on lump sum payments to make income streams more attractive (FitzGerald, 1996): This approach would retain access to lump sums but would tilt the tax system in favour of income streams. However, an increase in lump sum taxes has major problems. First, a sudden change could be seen as retrospective as previously accumulated benefits could be subject to higher tax rates or introduce complex transitional arrangements. Second, following the introduction of the surcharge, the combined tax rates on some superannuation benefits may then exceed the highest marginal income tax rate.

Removing the means tests for all retirees above a prescribed age (Institute of Actuaries of Australia, 1996): The provision of a universal pension has many attractions in terms of improving integration, simplicity and incentives. However, it represents additional costs for the Government. Hence, most advocates of a universal pension have suggested other sources of taxation including higher taxes on lump sum benefits or an income tax surcharge on higher income retirees (in effect, to claw the age pension back). The introduction of an income tax surcharge for all retirees with incomes above a prescribed level could be simple and fair. In effect, it would be replacing the combination of the means test and income tax with an income tax only system. However, a major disadvantage is that some aged persons would then have the highest income tax rates in the country, which would represent a major problem in terms of the community's perception and acceptance of the idea.

Reducing the means test taper (Ageing Agendas, 1994): The current income test operates with a 50% taper so that when added to income tax, many part-pensioners suffer an effective marginal tax rate in excess of 65%. An alternative is to ease to the income test taper, say to 25%, which would result in the effective marginal tax rate for many retirees being reduced to about 50%. The beneficial effect of this proposal at the individual level is positive but, at the same time, produces a significant increase in age pension costs. The current Government's tax reform package proposes a reduction in the taper from 50% to 40% which, whilst helpful, does not solve the problem.

Requiring retirees to take most of their superannuation in an income stream: This proposal would mean that each superannuation benefit would automatically become a pension or annuity and therefore be included in the income test. Successive Governments have been very reluctant to adopt this policy due to the widespread expectation in Australia of receiving a lump sum superannuation payment. It is noted that Canada does not permit any lump sum payment and the UK has a restriction on its size.

From this brief discussion, it is apparent that none of these proposed solutions provide a complete answer in the short term and some may not be acceptable to the Government and/or the community in the longer term. Yet, without an integrated system, the existing problems and inefficiencies in the Australian retirement income system will continue and increase in their significance.

4 A radical alternative

4.1 The basic proposal

The problems discussed above reduce the efficacy of the overall retirement income system. This will continue while the integration between the two major sources of retirement income remains either haphazard (at best) or non-existent (at worst). An important advantage of a universal pension approach is that it requires all individuals to be part of both systems and therefore integration is virtually automatic. However, such an option is unlikely to be adopted in Australia in the foreseeable future.

An alternative approach is to ensure that any assessment for entitlement to the age pension automatically includes superannuation. Here is one way forward.

> The ***financial position*** of all individuals would be assessed at a prescribed age (say 65, 67 or 70). This assessment would automatically include all superannuation benefits or future superannuation entitlements, as well as other assets. It would then provide the basis for providing the person with an entitlement to a **guaranteed portion** of the age pension for the rest of his/her life. This entitled portion would range from 100% of the age pension for those with minimal assets or income to zero for those with significant superannuation or assets.

Such a process would provide a direct link between the superannuation benefits received and the age pension and thereby significantly improve the integration within the total retirement income system.

4.2 The assessment question

Of course, the fundamental question is:

"How is a person's financial position assessed at the prescribed age?"

The best approach would be to establish the individual's access to financial resources to enable him/her to fund their retirement years. Whilst simple in theory, it is difficult to establish a relatively simple, workable and acceptable method in practice. Furthermore, for political reasons, the principal residence is often excluded from any assessment. This exclusion occurs in Australia in the current assets test and also occurs in other countries.

In view of the need to establish a practical solution, the following approach is proposed. A person's financial position at the prescribed age would be assessed as the greater of the following two tests:

> Test A: The market value of the person's assets, excluding the family home; and
>
> Test B: The value of the person's superannuation benefit entitlements, reduced by a percentage for each year (or month) that a superannuation benefit had been received prior to the prescribed age.

Test A is relatively straightforward and would include all assets, excluding the family home. The assessment of assets could operate in a manner similar to the current assets test.

Test B provides a direct link to the superannuation system or other benefits deemed to be eligible termination payments. This approach can also accommodate a range of superannuation benefits including benefits that have been received in the past as well as future superannuation entitlements. The administration of this approach should not be difficult as all eligible termination payments are recorded through the tax system.

The actual percentage reduction to be used in respect of earlier benefits can be debated. However, one option is 5% per annum. This would mean that if an individual received $200,000 five years before the prescribed age, only 75% of this amount would be counted under Test B. It could be suggested that a five per cent per annum reduction is generous and would encourage early retirement. In fact, such an arrangement would be tougher than the current system as it would automatically discourage “double dipping” from both systems.

4.3 An example

This section provides an example of how the proposal could work in practice. It is suggested that a minimum threshold should exist before the age pension is reduced and that the taper should be relatively generous to overcome some of the disincentives in the current system. Table 1 provides one example of such a scheme for a single person.

Table 1: An example of the calculating the single age pension entitlement

Value of assets/super at prescribed age	**Entitlement to age pension** **as a percent of age pension**	**Entitlement to age pension** **in current dollars per annum**
Less than $60,000	100%	$9,396 pa
$100,000	90%	$8,456 pa
$200,000	65%	$6,107 pa
$300,000	40%	$3,758 pa
$400,000	15%	$1,409 pa
$460,000	Nil	nil

It may be considered that Table 1 is too generous to the retiree and the Government should not provide an automatic entitlement to any age pension for a single individual with assets, excluding the family home, in excess of say $300,000. Yet, the announcements in the 1997-98 federal budget in respect of complying pensions will enable that situation to occur. That is, by adjusting the effect of the assets test on complying pensions, retirees with assets of more than $300,000 are able to receive a part pension.

It should also be stressed that this assessment of the individual’s financial position occurs at the beginning of the retirement years. Many retirees may expect to reduce their assets over time and subsequently become eligible for an increasing part pension. Although definitive longitudinal research is unavailable, Webb (1997) notes a previous study found that “the longer someone is on the pension the lower their income”. Hence, an assessment at the beginning of retirement is relatively tough and may actually reduce future Government pension expenditure.

Using the suggested taper in Table 1, an extra $100,000 of assets is equivalent to a loss of 25 per cent of the age pension. Assuming that the net capital value of the full age pension at age 65 is approximately $120,000, this taper is equivalent to 30 per cent. That is, the taper in Table 1 is reasonable but less steep than the current arrangements.

Additional issues arise when married couples are considered. As the level of the current age pension for a married couple is approximately 1.67 times the single age pension, one possibility is that the above asset thresholds could be increased by a factor of 1.67. That is a full pension would be payable if the level of assets were below $100,000 (that is 1.67 times $60,000). Similarly, the married couple pension would be reduced by 15% (not 25%) of the total pension for each $100,000 of assets. As the married pension is 1.67 times the single pension, this taper is equivalent when expressed in dollars. Table 2 sets out the suggested taper.

An alternative approach would be to consider a married couple as two single individuals and to divide their combined assets at the prescribed age by two.

Table 2: An example of the calculating the married couple age pension entitlement

Value of assets/super at prescribed age	**Entitlement to age pension** **as a percent of age pension**	**Entitlement to age pension** **in dollars per annum**
Less than $100,000	100%	$15,683 pa
$200,000	85%	$13,331 pa
$300,000	70%	$10,978 pa
$400,000	55%	$8,626 pa
$500,000	40%	$6,273 pa
$600,000	25%	$3,921 pa
$700,000	10%	$1,568 pa
$766,667	Nil	Nil

4.4 Some potential problems reviewed

This suggested approach to assess a person’s financial position at a prescribed age for age pension entitlement has some obvious difficulties. These include incentives for individuals to reduce or hide their assets prior to this age and the problem that could occur if a person’s financial position deteriorates significantly during retirement.

4.4.1 Moral hazard problems

The incentive to reduce assets to increase age pension entitlement is present within the current means testing arrangements but is clearly highlighted when a particular age is selected for assessment. However, this potential problem is reduced by the inclusion of superannuation benefits as a minimum level of assets. In addition, the slope of the taper can be used to reduce this incentive considerably.

For instance, using the above example, would it make sense for a single person to reduce their assets by $100,000 so that they can receive another 25% of the age pension, or a little more than $2,300 per annum? It must also be recognised that such misallocation of resources happens on a significant scale under the current system of means tests and, furthermore, continues throughout the retirement years. The use of a single test removes any ongoing distortion.

It should also be noted that the use of received or future superannuation entitlements as a minimum floor in the financial assessment reduces the scope for avoidance in respect of the superannuation savings that have been accumulated within a tax supported environment.

4.4.2 Deterioration of financial position during retirement

It is possible that an individual could suffer financial hardship (e.g. an investment loss) during their retirement years after s/he had been considered ineligible for a full pension at the prescribed age. In these cases, it would be reasonable for a re-assessment to occur. There already exists an objective test for hardship in terms of accessing superannuation benefits prior to retirement and a similar set of tests could be developed. The result of passing this test would be to increase the portion of the age pension that the individual receives. Furthermore, to discourage deliberate overspending in retirement, these hardship provisions could be tougher than the normal test at the prescribed age. Examples could include a lower threshold or a steeper taper.

Another factor to remember is that the deterioration of a person's financial position after receiving significant superannuation benefits would primarily occur if a lump sum superannuation benefit had been received. It has been suggested elsewhere (e.g. Doyle et al (1998), Institute of Actuaries of Australia (1998)) that all future superannuation benefits should be taxed at marginal income tax rates. If these tax rates were applied to lump sum benefits, there would exist a significant disincentive to receive sizeable lump sums. On the other hand, if lump sum benefits were received and the individual subsequently required higher age pension payments, it is recognized that significant tax would have been paid on a sizeable lump sum benefit.

An alternative approach would be to permit individuals to have their financial position reviewed every five years and, if it had deteriorated, to increase their age pension entitlement. However, whilst feasible, such an approach would remove the simplicity of a test at a single age. In addition, it would not overcome the problem of a sudden and significant deterioration of the person's financial position.

Of course, it should also be recalled that the cost to the Government of providing a pension to individuals in circumstances of financial hardship would be no greater than under the current means tested arrangements, where age pension payments increase as a person's financial position worsens.

4.4.3 Change in marital status

There will always be issues of pension entitlement when there is a change in a person's marital status. Such changes may occur through death, divorce or marriage. If all aged Australians were treated as individuals, this problem would be reduced considerably. Otherwise, it is suggested that the age pension entitlement calculated at the prescribed age could be maintained after any change in marital status. If two single pensioners marry, it is suggested that the average entitlement be used.

4.4.4 A significant increase in wealth

The current means test system adjusts the level of the age pension as changes occur in a pensioner's income or assets. Hence, if a pensioner's wealth increases significantly (say, due to an inheritance or gambling win), the level of the age pension is reduced. Under the proposal discussed in this paper, no such reduction would occur and this could be claimed to be unfair.

However, it should be noted that very few age pensioners receive significant and sudden increases in wealth. Furthermore, the absence of any means test is likely to result in the newly acquired wealth being invested in a more efficient manner than currently occurs, so that the subsequent taxation revenue may increase.

5 Transitional arrangements

The previous section outlined how the proposed system could operate for aged Australians reaching the prescribed age. However there are now almost two million Australians receiving a part or full age or service pension and it is essential that the new system should be able to accommodate these aged Australians without a major or disruptive administrative change.

The transitional arrangements could be very simple. In effect, the new system could provide a lifelong entitlement to each current pensioner equal to the proportion of the age pension that they are currently receiving. The required steps to introduce this change would be:

- To abolish immediately the means test for those who currently receive the full age or service pension, as it is reasonable to expect that most of these individuals would continue to receive the full pension in the future; and
- To abolish immediately the means test for those who currently receive a part pension and provide them with an entitlement equal to that part pension (expressed as a percentage of the pension) for the future.

It may be suggested that these transitional arrangements are unfair to some current part pensioners as they may expect to receive an increasing part pension in future years as their income or assets reduce over time. If this were considered an issue, all current pensions could be increased by 5-10% of the full pension to allow for this expectation. Should this variation be adopted, part of the increased pension costs could be offset against the administrative savings arising from the abolition of the means tests.

An extension of these transitional arrangements, and to avoid anomalies between current and future age pensioners, would be to offer existing pensioners the option of an age pension entitlement equal to the greater of:

- their current age pension, expressed as a portion of the full age pension; and
- a portion of the age pension calculated in the same manner as suggested for future pensioners (i.e. using an assessment of their current financial position).

This approach would also ensure equity between individuals near the prescribed age.

6 Some important advantages

The proposal outlined in this paper represents a fundamental change in the Australian retirement income system. Notwithstanding this change, it is important to realise that the primary purpose of the existing means tested age pension remains unchanged. That is, the age pension would continue to provide a minimum level of income to all aged Australians and would target this provision to those in greatest financial need at retirement.

This proposal has some major advantages over the current arrangements. These include the following.

- It provides an integrated system between entitlement to the age pension and the receipt of superannuation benefits;
- It immediately abolishes all means tests and therefore encourages all aged Australians to maximise their income during retirement;
- It encourages retirees to move out of a residence that may be too large for them after the prescribed age and to maximise their income from the resulting investments;
- It encourages a much better allocation of investment resources by the aged;
- It encourages retirees to stay in the work force, even on a casual basis, as the high effective marginal tax rates would be removed;
- It costs the Government almost nothing in the short term and may even increase future taxation revenue from the aged by encouraging higher incomes;
- It is sufficiently robust to cope with changing economic or social conditions (for instance, the prescribed age could gradually increase over time);
- The future cost to the Government of the age pension can be projected with greater certainty and will not be affected by changing economic conditions (for example, a decline in interest rates currently increases pension costs due to the income test);
- Finally, it enables all aged Australians to integrate their sources of retirement income in a sensible, coherent and simple manner.

In essence, this proposal has advantages for retirees and for the Australian economy, as it should encourage a better allocation of resources owned by older Australians. It would also leave us with a four pillar retirement income system, where the integration between the first three pillars (namely the age pension, compulsory superannuation and voluntary superannuation) is very clear and there is incentive for older Australians to participate in the workforce. As the population ages and mortality continues to decline, this involvement of older Australians in the work force must be encouraged and not discouraged, as occurs in the current system.

7 A further option: buying the balance of the age pension

7.1 Pricing the age pension

The proposal outlined above involves assessing the financial position of each aged person and then determining the proportion of the age pension that s/he would receive for the rest of life. An extension of this proposal is to permit (but not compel) the individual to purchase the balance of the age pension. For example, if the individual were entitled to 60% of the age pension, then s/he would have the option to purchase the remaining 40% from the Government. This option could remain with the individual for life with the price decreasing with age.

Table 3 sets out an example of how this option could work for a single person. For the purposes of this table, it is assumed that the full single age pension is 25% of MTAWE (All male total average weekly earnings).

Table 3: An example of purchasing the single age pension

	Gross cost of the pension expressed as a multiple of MTAWE			
Percentage of pension purchased	100%	75%	50%	25%
Age of purchase				
65	4.019	3.014	2.010	1.005
70	3.268	2.451	1.634	0.817
75	2.587	1.940	1.294	0.647
80	1.979	1.484	0.990	0.495
85	1.476	1.107	0.738	0.369

Of course, a key question is: *How would the price be calculated?*

Initially, let us consider a single male with significant assets or superannuation so that he is entitled to no age pension. However, under this proposal he could elect to purchase the full age pension.

The price of the pension will be related to assumptions about future mortality and interest rates. Although it could be argued that the latest population life expectancy tables (Australian Life Tables 1993-95) should be used, it is more realistic to assume that mortality rates will continue to improve and life expectancy will therefore increase. In addition, those buying the pension are likely to have lower mortality rates than average due to the inverse relationship between wealth and mortality. For these reasons, it is suggested that ALT93-95 be used but with a reduction of 3 years in the life of the purchaser. That is, it is assumed that a 65-year-old will have the life expectancy of a 62-year-old. The actual size of this reduction can be debated but there are very good reasons to use a reduction.

The long term interest rate is also critical. In this paper, it is assumed that the rate will be 1% p.a. higher than the indexation of the age pension; that is, 1% p.a. higher than the assumed future increases in average wages. Again, the actual margin could be discussed but it is important that a fair price be paid and that opportunities do not exist for individuals to borrow in the capital markets and purchase the pension. It is also important that this real rate of interest is relatively constant over the long term and not affected by short term economic effects.

Using these assumptions for mortality and interest, the present value of an age pension of 25% of MTAWE at age 65 for a single male is 4.019 times MTAWE (i.e. 16.076 times the assumed single pension).

It is suggested that any purchased portion of the pension should be fully taxable (as would occur with any entitled portion of the pension) such that the Government would receive a portion of the pension payments back through the income tax system. The purchase price should allow for this result. Assuming an average tax rate of 20 cents in the dollar on the pension, the price of the full age pension at age 65 would become 3.215 times MTAWE (that is, 80% of 4.019 times MTAWE). In essence, this is assuming that the purchaser would only receive 80% of the pension paid, after allowing for income tax. Of course, it is noted that those who are purchasing the age pension are those with access to other assets and are therefore unlikely to be subject to the lowest income tax rates.

It may be argued that some retirees will face a higher rate of income tax and allowance should be made for this by reducing the price even further. Three points need to be considered.

a) The purchase of the age pension is not compulsory and the individual can choose whether to buy or not;
b) A single purchase price should be used for all purchasers to avoid confusion and selection against the Government;
c) High income earners are expected to live longer than the average pensioner. Hence, a relatively low level of assumed taxation increases the price, which

indirectly penalises those with higher incomes who have, on average, longer life expectancies.

It should also be stressed that this pricing approach is not designed to make the purchase of the age pension an especially attractive option to aged persons. Rather, it is designed to be fair to all stakeholders. This approach can be used to calculate the cost of a full age pension (25% of MTAWE) at various ages as shown in Table 4.

Table 4: The cost of the full age pension for a single male

Age at purchase	Gross Cost (Multiple of MTAWE)	Net Cost[1] (Multiple of MTAWE)	Net Cost[2] (Multiple of age pension)	Net Cost[3] of full pension ($1999)
65	4.019	3.215	12.860	$120,833
70	3.268	2.614	10.456	$98,245
75	2.587	2.070	8.280	$77,799
80	1.979	1.583	6.332	$59,495
85	1.476	1.181	4.724	$44,387

Notes
1 For reasons outlined above, the net cost is assumed to be 80% of the gross cost.
2 The net cost, when expressed as a multiple of the single pension, is four times the net cost, when expressed as a multiple of MTAWE.
3 The net cost in 1999 dollars is the previous column multiplied by $9,396, the current annual amount of the age pension.

As shown in Table 4, the cost of the age pension at each age could be quoted as a multiple of MTAWE or as a multiple of the age pension. The actual dollar costs could then be adjusted every time the age pension is adjusted in line with movements in the MTAWE.

The above figures relate to single males only. It is suggested that similar rates could be used for single females, which, in effect, means the adoption of unisex rates. Although this assumption favours females, most financial assets are held or have been accumulated by males (whether they be in superannuation or other forms) and a very high proportion of aged females currently receive the full pension in their latter years.

Additional issues also arise when married couples are considered. The purchase price for a portion of the age pension should take into account the age of both individuals. It must also recognise that the pension would remain at the married couple rate while both are alive and then revert to the single rate on the death of either partner.

An important advantage of establishing this option to buy the pension (or part thereof) is that it would establish a benchmark price for the pension and therefore encourage better integration between retirement income policy and other services provided to the aged. For instance, the current fee charged by nursing homes is 87.5% of the age pension. The option of buying the age pension would provide entrants into nursing homes with a clear financial cost and the opportunity of an integrated approach between retirement income and the cost of nursing home accommodation.

7.2 Some potential problems and solutions

It is recognised that the option for individuals to purchase future age pension entitlements from the Government could generate some new problems. These include:

1. the accumulation by the Government of a significant fund (representing the dollars paid to purchase future age pension payments) which could be used in advance and not be available to pay the pension, when needed;
2. a fear that this opportunity will adversely affect the private sector annuity market; and
3. future changes to the age pension system.

However, each of these problems can be addressed.

First, the development of a fund in respect of the purchased age pensions could become very attractive to a Government to use for current expenditure and this could cause significant intergenerational equity problems. It is therefore recommended that the investment of the fund should be privatised with the mandate for the fund managers to achieve a benchmark rate of return linked to the financial markets. Such a return would improve the Government's long term funding position and would ensure that there is a reduced possibility of a Government using the money in advance of its pension obligations. It is noted that the Government has already sold the investment management of its public sector superannuation funds.

Second, whilst some retirees may choose to purchase the age pension in lieu of a private sector annuity it must be stressed that the age pension will be a very different type of pension (i.e. fully taxable with no undeducted purchase price). Further, its maximum value is at a very moderate level. Indeed, it could even be suggested that annuity markets would prosper under these proposals, as the presence of the age pension option will encourage retirees to think in terms of income streams. The removal of the means tests should also encourage a new range of income based products.

Third, it is acknowledged that there have been considerable changes to the age pension system in recent years. However, most of these changes have been in respect of the means tests that would be abolished under this proposal. Nevertheless, it is possible that future Governments may wish to adjust the level of the full age pension. It is therefore recommended that any purchased pension be expressed as a percentage of the MTAWE and not as a percentage of the age pension. Such a plan would enable a government to change the level of the pension without affecting the contract of any pension purchases.

8 Conclusions

The existing retirement income system in Australia remains fragmented and is causing significant misallocation of resources within the economy. In short, the country is not receiving the best value possible from the financial and human capital of its retirees. This problem is going to worsen as the proportion of the retirees in the population increases. It is essential that the current system be reviewed and changes made so that the new system:

- provides integration between the age pension and superannuation;
- is simple to understand;
- is considered to be fair and affordable over the longer term;
- provides retirees with the opportunity to maximise their retirement income; and
- contributes to the overall economy in the best possible way.

It is suggested that the proposals presented in this paper meet these criteria and represent a significant improvement over the current system without introducing massive disruption or significant extra costs to the Government. It must be stressed that the most important parts of the proposals are the concepts and inherent principles. The actual financial assessment of individuals or pension pricing mechanisms could be fine tuned or adjusted without destroying the overall approach.

Finally, there are a number of ways that these proposals could be presented to the community. Examples include:

The safety net of the age pension remains for all older Australians;
It represents a better deal for retirees with lower effective marginal tax rates;
The age pension is available for everyone but those with significant financial resources are required to pay for it, if they so choose;
Retirees are not compelled to act in a particular manner – they are given considerable choice in terms of their financial affairs.

Australia's retirement income system is in need of major reform. Compulsory superannuation is clearly established and its importance will increase over time. At the same time it must be recognised that the age pension will not disappear. These two sources of retirement income must be integrated. Furthermore, it is essential that the required rules and conditions encourage older Australians to maximise their retirement income, participate in the labour force (if desired) and allocate their financial resources efficiently. The proposals outlined in this paper achieve these objectives and set out a stable and robust long term strategy without causing major disruption to the existing plans of current or future retirees or to the long term finances of the Australian Government.

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