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THE RELATIONSHIP BETWEEN THE AGE PENSION AND SUPERANNUATION BENEFITS PARTICULARLY FOR WOMEN

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This is a revised version of a paper presented at the Women and Superannuation Conference, 24-25 February 1994, in Canberra organised by the Office for the Status of Women.

1 Introduction

Australians receive retirement income from three major sources: the Government funded means tested age pension, the Government supported and privately funded superannuation system and private savings. During the last decade the Government has made many changes to both the age pension and the superannuation systems. Some of these changes have resulted from a very clear policy to shift the future provision of most retirement income from the age pension to the superannuation system. As a result, we have witnessed the introduction of compulsory superannuation for employees, tighter preservation rules for superannuation benefits and a continual refinement of the means tests.

As we reflect on the future effects of this continuing evolution, it must be acknowledged that the provision of retirement income is a long term project and the impact of these changes will not be fully seen for several decades. Nevertheless it is important that the relationship between the two major forms of retirement income provision (namely the means tested age pension and superannuation) continue to be explored and clearly understood. It is also critical that this research does not restrict itself to those who have a full time job in a career spanning 35 or more years. With higher labour force participation rates for women and the growth of part time employment, it is necessary to assess the links between the superannuation benefits likely to be received and the means tested age pension for individuals (both male and female) who have a much wider range of labour force experiences than has been traditionally assumed.

It is the objective of this short paper to explore some of these links. In Section 2, I will briefly contrast the two major retirement income systems and discuss some of the underlying problems. Section 3 will initially explore the superannuation benefits that accumulate for a female with a working career comprising full time work, part time work and periods out of the workforce. The total retirement income benefits received, after allowing for the means tested age pension, will then be considered. Section 4 will briefly discuss some alternatives for improving the integration between the two systems.

2 The age pension and superannuation systems

2.1 The age pension

The unfunded age pension was introduced by the Federal Government in 1909 and has had, for most of its history, a primary objective linked to the alleviation of poverty amongst the aged. The pension is paid from Consolidated Government Revenue each year and, as such, it represents an unfunded retirement income system. The pension is currently payable from age 65 for males and 60 for females although it is Government policy to increase the entitlement age for females to 65.

The maximum level of the pension that can be received by a person is not linked to the individual's lifetime earnings but is set by the Government and is equal to approximately 25% of the average wage for a single person and 40% of the average wage for a married couple.

In summary, the means tested age pension provides a reasonable safety net for Australians over the ages of 65 (or 60) and thereby limits the level of poverty amongst the aged population. With the aging of the Australian population, the costs of this pension, together with the medical costs for the aged, are expected to increase significantly during the next few decades unless significant changes are made. These long term revenue issues were one of the major reasons for the Government introducing compulsory superannuation in the late 1980's.

2.2 Superannuation

A mature occupational based superannuation system exhibits a number of features that contrast with the means tested age pension system.

Firstly, the accrued benefit is based on the amount of contributions paid (or years of service in a defined benefit scheme) which means that there is a link, albeit not a perfect one, to the level of an individual's lifetime earnings.

Secondly, the benefit must be preserved to age 55 although the Government has announced that this will increase to age 60 over a transitional period.

Thirdly, most Australians receive a lump sum benefit from their superannuation scheme(s). Although the majority of this money is invested to produce income, the level of this income will vary with economic and other conditions and therefore does not produce a secure level of retirement income.

Fourthly, the superannuation system, with the exception of some public sector schemes, is funded in advance so that the accumulated contributions require investment through the financial markets.

Finally, whilst the age pension is primarily aimed at the alleviation of poverty and the income received is mainly used for living costs, superannuation benefits are used for a range of purposes including the provision of retirement income, the funding of early retirement, the setting up of a new retirement lifestyle, the repayment of debts, investments, holidays and bequests. This is not the place to debate whether all these expenditures are appropriate and/or should be permitted. Rather, it needs to be noted that superannuation benefits are used for a much wider range of purposes than the age pension.

2.3 A comparison

The above paragraphs briefly outlined some of the characteristics of the two systems for providing retirement income in Australia. In essence, their primary objective is similar: the provision of an adequate and secure level of retirement income. However, there exists limited integration between the two systems. Indeed, they may be considered to be similar to a pair of tram lines heading for the same destination but never meeting. In fact, it could even be claimed that one system (with the means tests on the age pensions) actually discourages voluntary participation in the other system by placing some disincentives for personal saving in the superannuation system and beyond, during both the pre- and post-retirement periods.

It should also be noted that there exist the following fundamental inconsistencies between the two systems:

- Benefit forms: one is in pension only form whilst the other provides predominantly lump sums;
- Entitlement ages (in the future): one will be payable from age 65 while the other will be accessible from age 60;
- Inputs and outputs: one is primarily concerned with outputs or benefits (the age pension) whilst the other is based on inputs with prescribed minimum levels of contributions.

Furthermore, both systems have been subject to a number of Government changes in recent years which has resulted in the community having reducing trust and confidence in the total retirement income system. Such a result is neither desirable nor beneficial at the individual level or for the future of the Australian economy.

The problems mentioned above affect, to a greater or lesser extent, almost all Australians planning their retirement. However, they are particularly acute for those who do not have a full time paid career spanning three or four decades. As many of these are women, the next section will consider a female example assuming a combination of full time and part time work together with five years out of the workforce.

3 A female example

3.1 The model

Each person has their own individual working career and it is impossible in a paper of this length to cover a large range of possibilities. Hence, for the purposes of this discussion, I will consider a single female who enters the workforce at age 20 and retires at age 60 (the current female pension age). It will be assumed that she works full time for the first ten years (ie to age 30), then remains out of the workforce for five years (say, for family responsibilities), returns in a part time capacity (which is considered to be 40% of full time) at age 35 for ten years and then works full time from age 45 to retirement.

Initially two levels of superannuation contribution will be considered. These are:
i. 6% of earnings which is the level that the SGC will reach in 1996-97, and
ii. 12% of earnings which represents the Government's long term objective.

It is also assumed that the contributions are totally paid by the employer into a defined contribution superannuation fund. The other key assumptions assumed in the projections are:

- inflation at 4% pa;
- productivity at 1% pa;
- personal promotion equal to 1% pa;
- superannuation fund earnings with an average of 5% pa real (ie above inflation) and a standard deviation of 8% pa; and
- that a lifetime inflation indexed annuity is purchased at retirement with the accumulated superannuation benefit.

Further details of the model are discussed in Knox (1994).

3.2 Superannuation income only

Figures 1 and 2 show the distribution of retirement income (expressed as a percentage of the individual's final salary) that arise from contribution rates equal to 6% and 12% of earnings respectively. Table 1 shows the mean and standard deviation for the distributions shown in each graph. As expected, the higher contribution rate results in higher pensions.

Table 1: The superannuation pension as a % of final salary

Contribution rate	6% of earnings	12% of earnings
mean	12.19%	24.37%
standard deviation	3.63%	7.26%

Figure 1: Superannuation pension from a 6% contribution

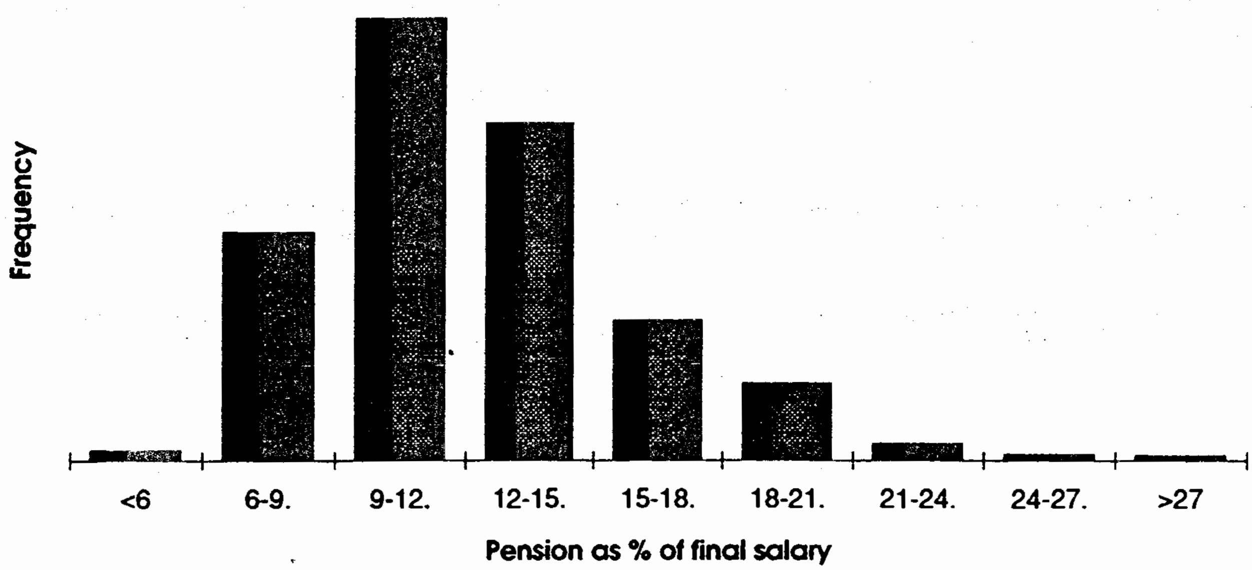
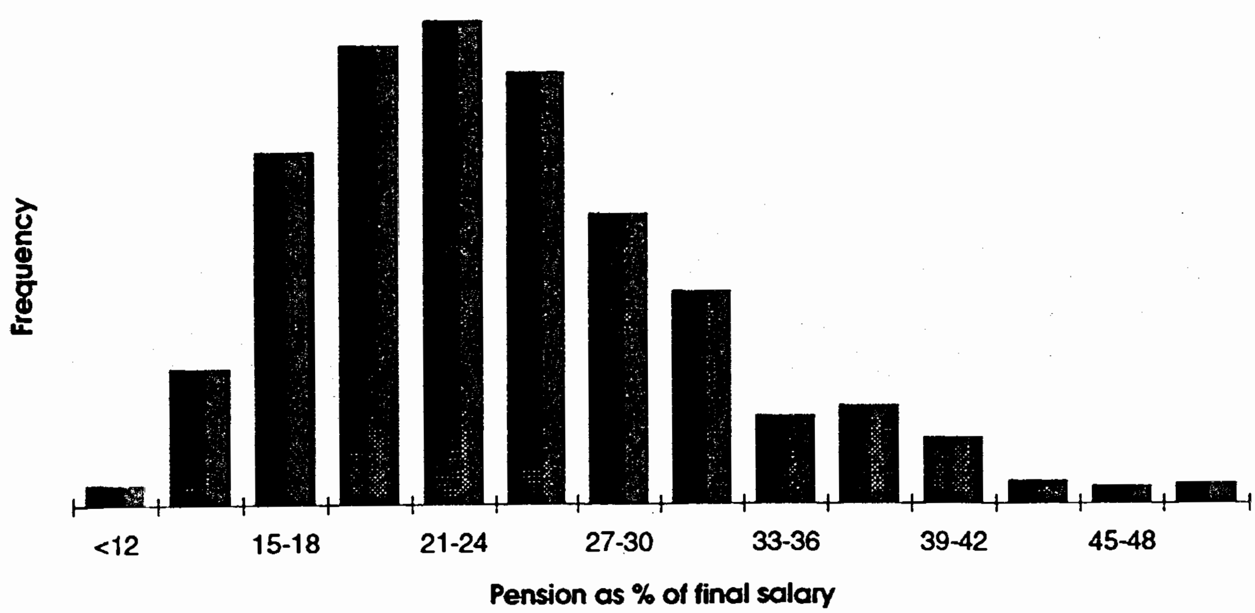


Figure 2: Superannuation pension from a 12% contribution



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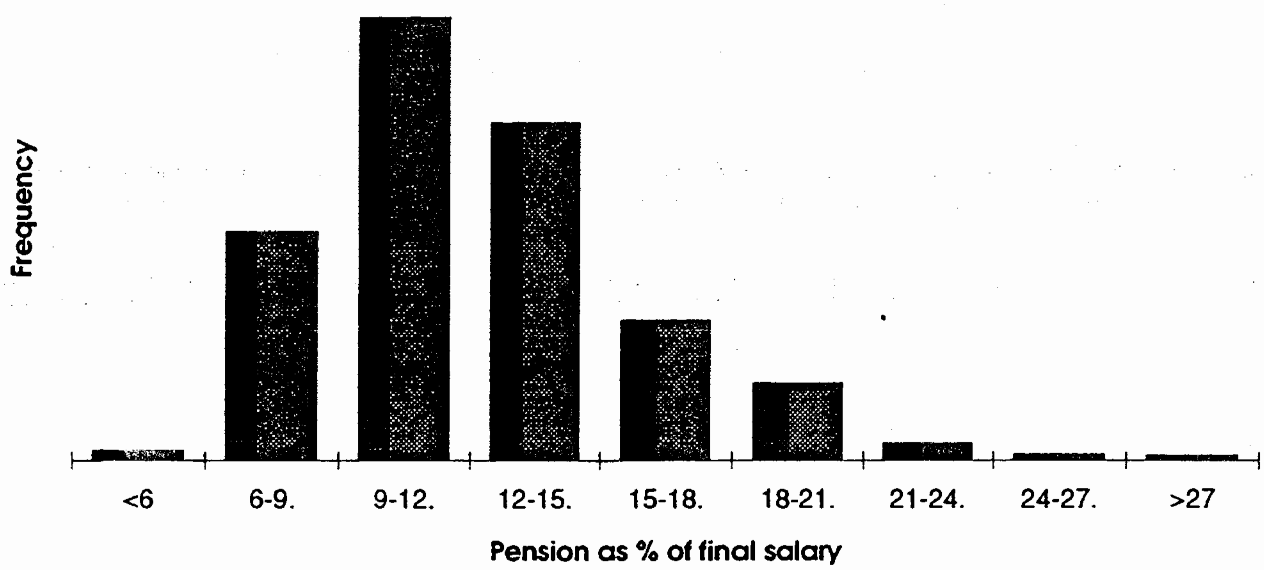


Figure 2: Superannuation pension from a 12% contribution

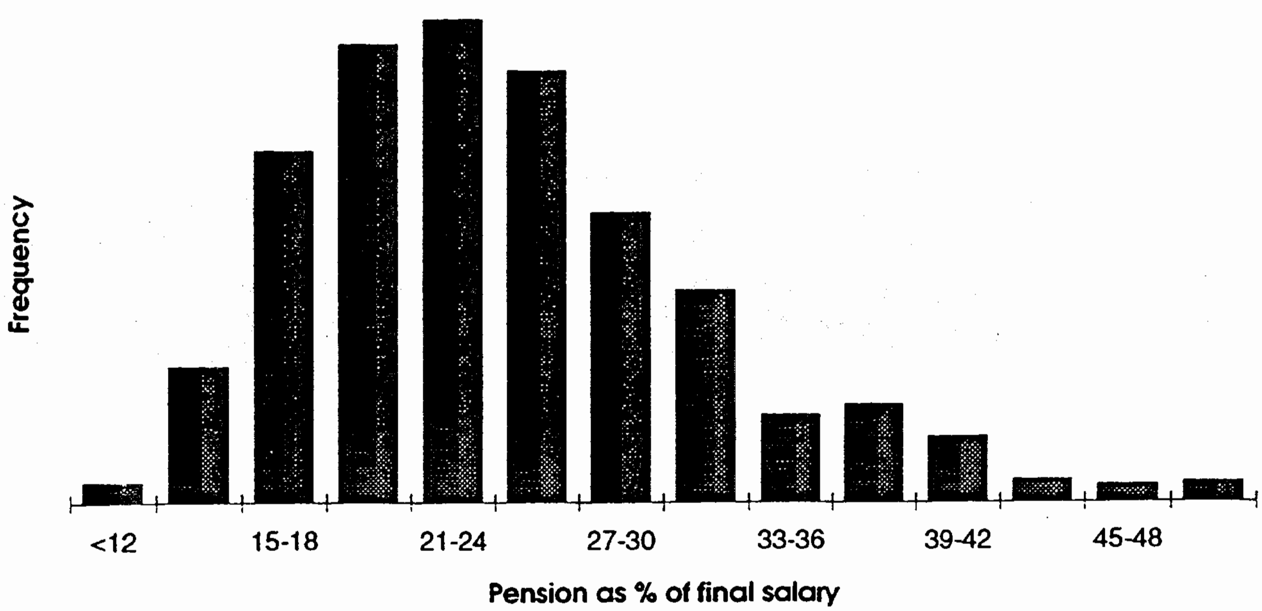
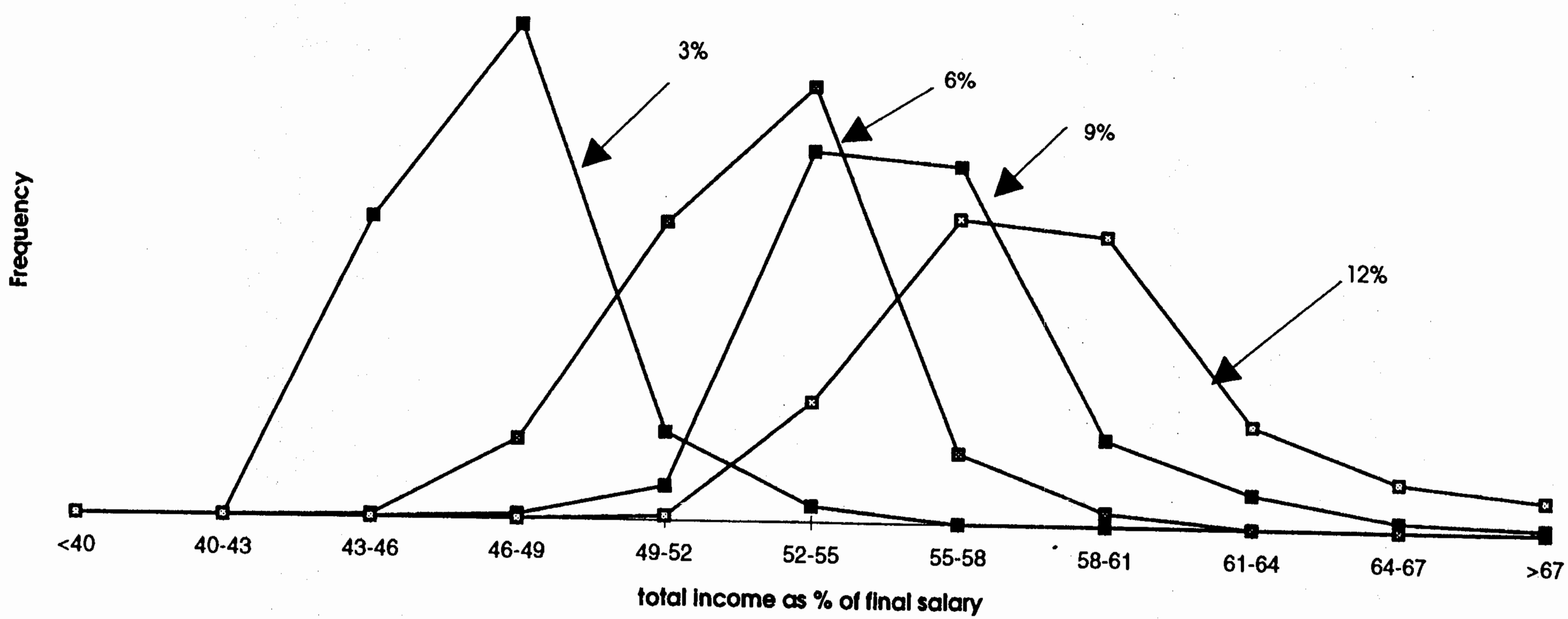


Fig. 3: Total retirement income for a $20,000 starting salary



4 Some alternatives to improve integration

The major problems of integration between a means tested age pension and a funded superannuation system need to be tackled if the Government wishes to encourage individuals on average incomes to voluntarily save for their retirement and thereby reduce future age pension and/or medical costs for the Government.

Let us consider some alternatives.

The first option would be to reduce the severity of both the income and assets tests. For instance, instead of an income test at the rate of 50 cents in the dollar, a reduced test of say 33 cents in the dollar could be applied. This revised test would clearly reduce the impact of the income test and may provide a greater incentive to save. On the other hand, it would increase the cost to the Government of the age pension system and not really address the basic structural issues.

A second option would be to provide superannuation benefits at much higher levels so that most retirees would not be affected by the means tests at all. Such a system would require significantly higher contributions which would increase the cost of labour to employers and/or severely reduce the living standards of employees. It is simply not practical to raise the compulsory level of superannuation contribution to 20% or higher which would be the level needed to remove most female retirees from the integration problem, as indicated in Knox (1994).

A third option would be to provide an automatic integration between any superannuation benefits received and the means tests. For instance, all retirees who receive superannuation benefits above a certain threshold could be assumed to earn a prescribed interest rate on this benefit <u>and</u> to gradually consume the total benefit over a fixed period, say 15 years. Under this system, any investment income earned on the superannuation benefit above this deemed rate would not affect a person's pension entitlement and it would therefore also encourage better investment practices. Of course, such a deemed approach would reduce the strong level of targeting inherent in the current means tests as the pension entitlements to each individual would not be adjusted on an ongoing basis. However, it would also remove the constant requirement for retirees to inform the Department of Social Security whenever their income changed as the deemed level of income could be set at retirement for the following 15 years.

A fourth option is to introduce a universal age pension from age 65 (or later) and simultaneously reduce the level of taxation support provided for the superannuation system, especially for higher income earners. It is interesting to note that the Institute of Actuaries of Australia (1994) has recently proposed such a scheme and the overall long term costs do not appear to be significantly different from the current system (see Atkinson et al, 1994). Of course, a universal pension does not provide the targeting that is implied within a means tested system. However, if it is recognised that Government support for retirement incomes is provided through a combination of age pension payments and taxation support for occupational superannuation, it is possible that the gradual introduction of a universal pension together with adjustments to the taxes on superannuation benefits may provide a more progressive overall structure as well as providing better integration and a greater incentive for voluntary saving. Such a system may be particularly attractive to women who experience a much greater range of career patterns than their male counterparts.

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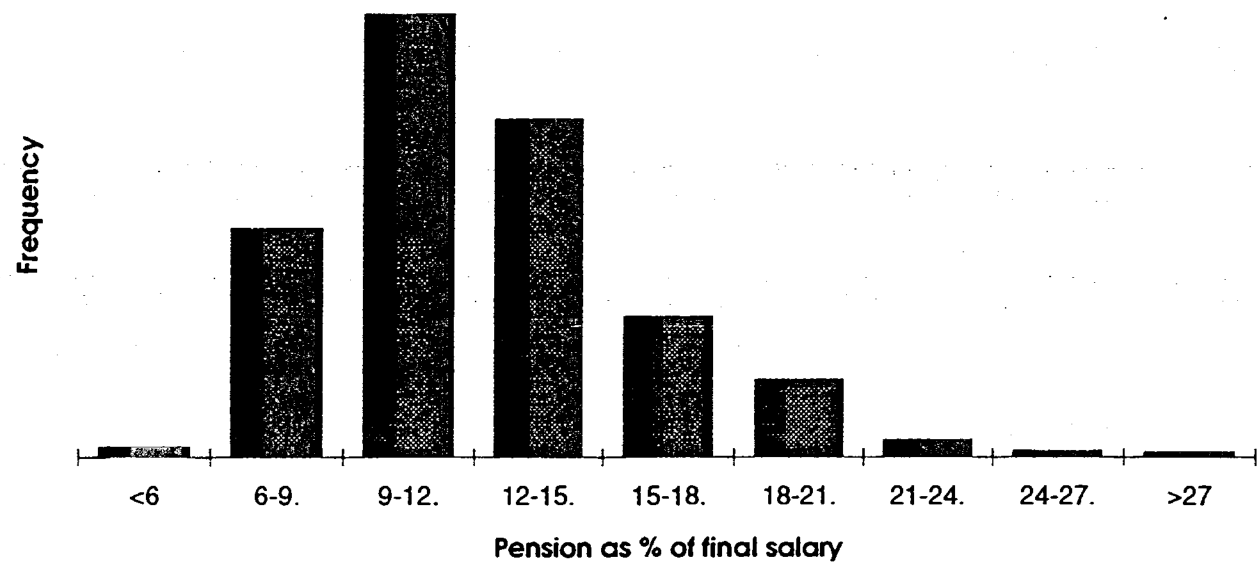
Figure 1: Superannuation pension from a 6% contribution



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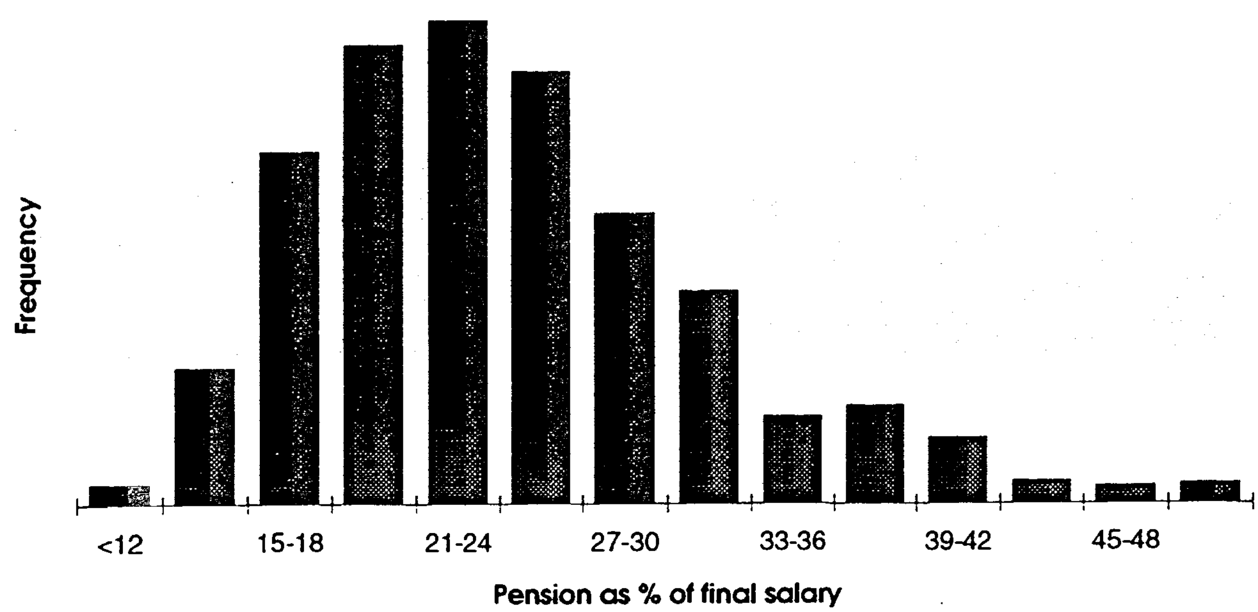


Fig. 3: Total retirement income for a $20,000 starting salary

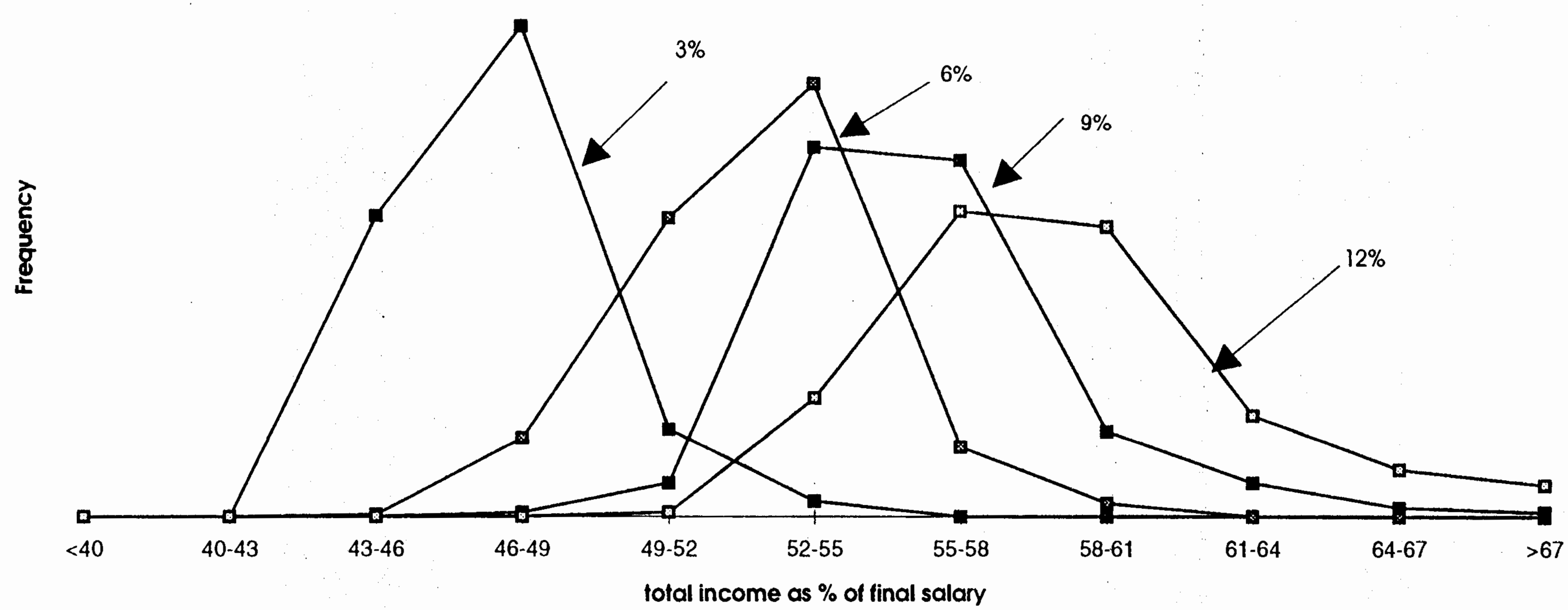
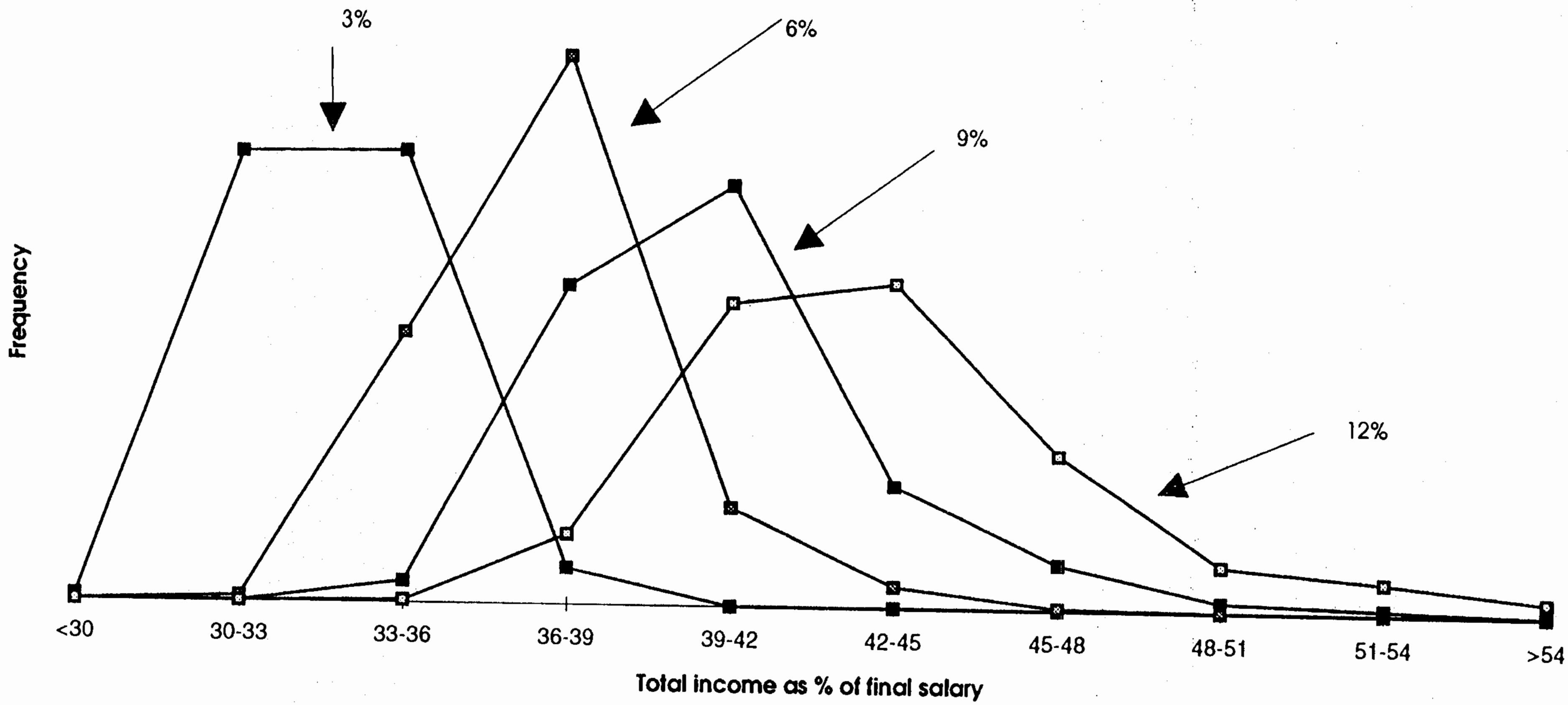


Fig. 4: Total retirement income for a $30,000 starting salary



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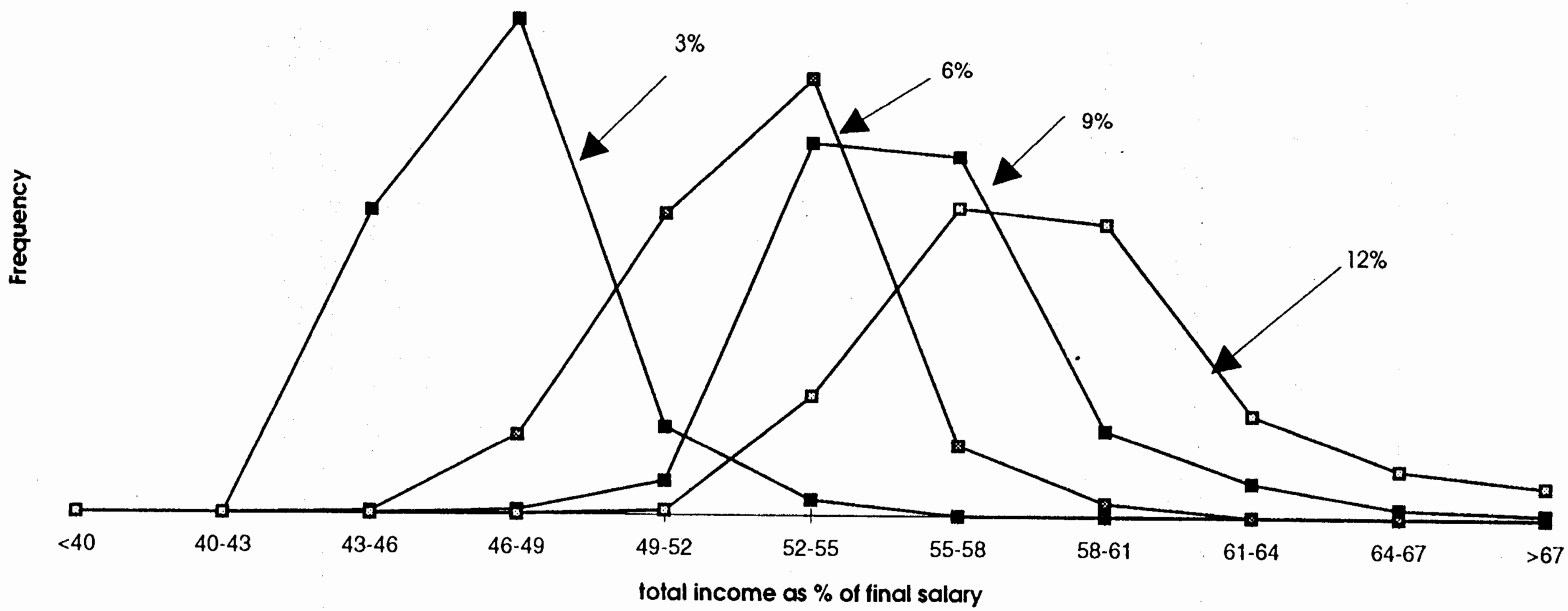

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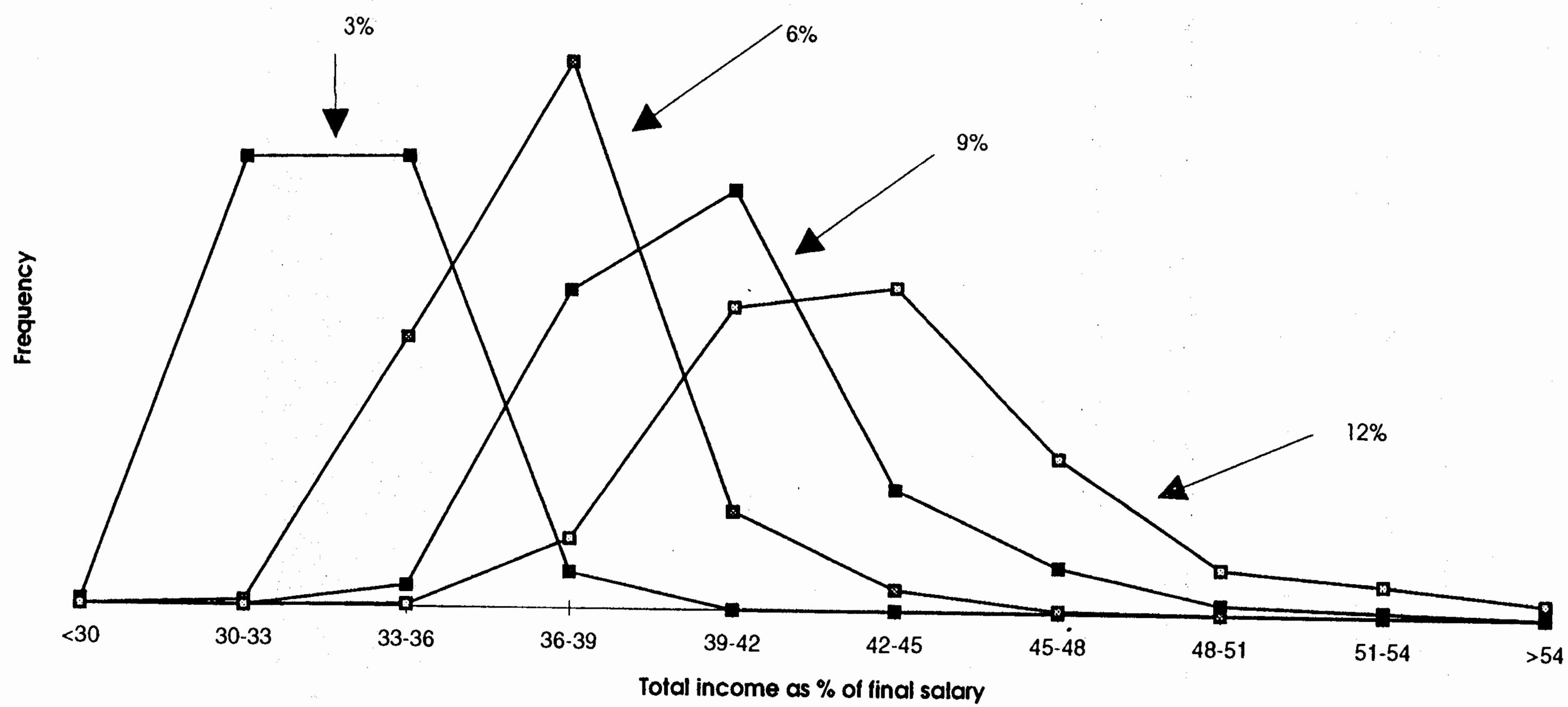

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