COMMITTEE FOR SUSTAINABLE RETIREMENT INCOMES

CSRI Position Paper: Clarifying the Purpose of the Retirement Income System

8 April 2016

Introduction

The Government has agreed to enshrine in legislation the objective of the superannuation system, to

'*serve as a guide to policy-makers, regulators, industry and the community*' and to '*provide a framework for important discussions Australia needs to have about fairness, adequacy and dignity in the superannuation system'* (The Australian Government, 20 October 2015).

While there has been much discussion, and extensive agreement, on the need to enshrine the objectives of superannuation in legislation, there has been much less discussion about what the objectives ought to be.

The CSRI strongly supports the articulation of objectives not only to guide the enhancement of Australia's retirement income system but also to guard against superannuation being diverted towards other purposes and interests such as wealth accumulation and bequests, a deposit on a house or to pay off higher education debts. Similarly, it would help to counter any calls that superannuation funds should be directed to invest for purposes other than member retirement benefits such as nation-building.

The CSRI considers that the objective(s) should relate to the whole retirement income system rather than just superannuation. For the foreseeable future most retirees will be dependent on income from *both* superannuation and the age pension, and the two systems need to be seen as complementary. Defining objectives for the whole retirement incomes system will promote this complementarity of superannuation savings and age pensions systems to achieve societal goals at a sustainable total cost to taxpayers, and avoid an inward and likely unhelpful focus on how one instrument such as (superannuation) might reduce pressure on another (such as age pensions).

In identifying its preferred articulation of the objective(s), the CSRI has had regard for the range of suggestions that have been made publicly by various Australian expert groups as well as by some international organisations (see Attachment A).

The CSRI's Preferred Articulation

The following broad considerations guided the development of a set of objectives the Committee believes could be used as a basis both for evaluating the system and for screening proposed policy changes for consistency with the objectives.

First, consistent with principles of good governance for organisations with complex missions and diverse stakeholder constituencies (Clark and Urwin, 2008), a clear mission was sought that would be capable of commanding wide community support.

Second, given the wide range of purposes that have been attributed to superannuation over the decades, a clear overarching objective was needed that would focus this part of the system on retirement income and rule out other non-aligned purposes.

Third, within a more focused purpose however, it was recognised that a range of dimensions (adequacy, equity, efficiency, sustainability) would need to be addressed by the system in a balanced way.

The proposed primary and supporting objectives of the system are listed in Table 1 and discussed below.

Table 1: Proposed Retirement Income Policy Objectives

Overarching Objective
"*To provide adequate income through all the years of retirement for all Australians, while reducing the burden of demographic change on future generations*"
Supporting Principles:
• Is fair and equitable
• Helps individuals manage financial risks
• Provides certainty with necessary safeguards
• Alleviates fiscal pressures on government from demographic change

The Committee endorses as the overarching goal of the retirement income (and superannuation) system the statement:

"to provide adequate income through all the years of retirement for all Australians, while reducing the burden of demographic change on future generations"

This statement summarises succinctly all the important elements of the system's objective as follows:

First, it places the focus squarely on *income* in retirement rather than other purposes such as wealth accumulation and bequests.

Second, it specifies an *adequate* income which, while yet to be defined, implies both the protection of the elderly against poverty and the maintenance of living standards in retirement by addressing barriers to the efficient spreading of lifetime earnings. Various benchmarks may be considered to assist in assessing adequacy including relative income measures such as replacement rates and absolute measures such as ASFA standards of 'modest' and 'comfortable' incomes. For those elderly people, who are fully dependent on the age pension, "adequacy" would be defined relative to a community norm such as a proportion of median earnings.

Third, "*all the years of retirement"* recognises the importance placed by retirees on security of income that lasts a lifetime (National Seniors Australia, August 2015) in a context where too many retirees are living frugally for fear of outliving their savings (Wu, Shang, Anthony Asher, Ramona Meyricke and Susan Thorp, 2015), and often leaving behind unplanned bequests.

Fourth, "*for all Australians*" recognises the importance of considering the equity implications of the retirement income system. This relates to more than the role of the age pension in protecting against poverty. It includes consideration of the distribution of any superannuation tax concessions and the impact of the employment-based nature of the superannuation system on the retirement incomes of those individuals (primarily women) who contribute to society through unpaid caring responsibilities for children or elderly parents.

Fifth, it recognises the need for an efficient retirement income system to contribute to the sustainability of all the sources of government expenditures relating to population aging including superannuation tax concessions, age pension costs, age care and health care.

Is fair and equitable

The principles of fairness and equity have various dimensions that are important considerations in the design of the retirement income system.

First, vertical equity suggests that government support (including age pension payments, in kind services and superannuation tax concessions) should be targeted at those least able to provide for themselves.

Second, the operation of the system needs to be reviewed to ensure that individuals with similar income and wealth levels are treated equivalently regardless of differences in the composition of their income and wealth. A significant horizontal equity issue is raised by the employment-based nature of the superannuation system and measures designed to limit exploitation of superannuation tax concessions (such as contribution caps) that may disadvantage individuals with broken work patterns.

Third, in seeking to address complex intra-generational equity issues, sight should not be lost of the importance of intergenerational equity. This includes the need to consider the income requirements of individuals before retirement, such as for housing and education, relative to their needs in retirement. It also includes progressive recalibration of the system to maintain its long-term sustainability so as to avoid the need for urgent changes down the track that would impose a greater burden on future generations.

Helps individuals manage financial risks

This supporting objective recognises that, to generate secure retirement incomes, individuals face a range of financial risks including longevity, investment and inflation risk. Managing these risks over the life course is highly complex requiring a high level of financial literacy, reliance on the choices made by trustees, and/or the help of independent financial advice.

The combined effect of sequencing risk, portfolio size effect and the exhaustion of human capital means that retirees have more limited scope to make up for losses than is possible for individuals in the accumulation phase. More effective management of some of these risks requires substantial pooling of retirees' funds.

Provides certainty with necessary safeguards

Given the long term nature of retirement planning, ongoing community confidence that the overall system will continue in a broadly similar format for many years to come is important. It is recognized though that the system also needs to adapt over time to changing circumstances and to improve. Therefore, rather than no change at all, what is more important is to avoid the risk of instability because of inconsistent policy settings.

Related to certainty is the need to avoid complexity. This is particularly important for a compulsory system as complexity inhibits individuals' ability to make decisions in their best interests, tends to facilitate over-servicing and adds to costs. In many cases, individuals and households have to deal with either or both the superannuation and the pension systems, as well as the tax system, and all the complications associated with the interactions among these.

As the Henry Review (2009) correctly noted, the additional burden caused by complexity is likely to be highly regressive and favour sophisticated and well-informed investors. People with fewer resources, and often lower financial literacy, will have greater difficulty in coping with complexity.

Particularly given the compulsory nature of Superannuation Guarantee contributions and the preferential tax treatment of superannuation, the system needs prudential oversight and should provide good outcomes in both the accumulation and retirement phases for fund members and retirees regardless of their level of engagement with the system.

Alleviates fiscal pressures on government from demographic change

This supporting objective seeks an efficient retirement income system to contribute to the sustainability of all the sources of government expenditures relating to population aging including superannuation tax concessions, age pension costs, age care and health care.

Achievement of the overarching objective in a fiscally sustainable way will be enhanced if all Australians with the ability to do so are encouraged to save for their own retirement. This seeks improved retirement incomes and/or reduced reliance on government provision by reducing regulatory and other impediments that discourage people from saving for their retirement, continuing to work when they are able to and wish to do so, and efficiently converting their superannuation balances into income streams in retirement. It also requires that, in mandating and facilitating savings for the spreading of lifetime earnings, government should target any tax subsidies towards those with modest means.

The combination of the overarching objective and the supporting objectives we believe would provide the necessary clarity of purpose to guide the enhancements in the system.

References

European Union. "Supporting Appendices Guidance Note for Preparing National Strategy Reports on Social Protection and Social Inclusion 2008-2010." (2007).

Clark, Gordon L. and Roger Urwin. "Best-Practice Pension Fund Governance." *Journal of Asset Management* 9, no. 1 (2008(B)): 2-21.

Cooper, Jeremy (Chair), Alan Goldberg, Elana Rubin, Ross Jones, Steve Tucker "A Super Charter: Fewer Changes, Better Outcomes - a Report to the Treasurer and Minister Assisting for Financial Services and Superannuation." http://www.treasury.gov.au/supercharter, (2013).

Henry, K (Chair). "Australia's Future Tax System the Retirement Income System: Report on Strategic Issues." *Commonwealth of Australia*, (May 2009).

Murray, David (Chair), Kevin Davis, Craig Dunne, Carolyn Hewson, Brian McNamee. "Financial System Inquiry Final Report." (2014).

National Seniors Australia "Outlook for Australian Seniors' Retirement Plans? Mostly Sunny with Possible Late Rain." *August* August, (2015 (A)).

The Australian Government. "Improving Australia's Financial System, Government Response to the Financial System Inquiry." (2015).

Wu, Shang, Anthony Asher, Ramona Meyricke and Susan Thorp. "Age Pensioner Profiles: A Longitudinal Study of Income, Assets and Decumulation." *ARC Centre of Excellence in Population Ageing Research* Working Paper 2015/17, (2014).

ATTACHMENT A

OTHER SUGGESTIONS FOR SYSTEM OBJECTIVES

Other Suggestions for System Objectives

Some insights may be gleaned from the European Union's 2007 adequate and sustainable pensions work programme objectives.

Adequate and sustainable pensions by ensuring:

(1) adequate retirement incomes for all and access to pensions which allow people to maintain, to a reasonable degree, their living standard after retirement, in the spirit of solidarity and fairness between and within generations;

(2) the financial sustainability of public and private pension schemes, bearing in mind pressures on public finances and the ageing of populations, and in the context of the three-pronged strategy for tackling the budgetary implications of ageing, notably by: supporting longer working lives and active ageing; by balancing contributions and benefits in an appropriate and socially fair manner; and by promoting the affordability and the security of funded and private schemes;

(3) that pension systems are transparent, well adapted to the needs and aspirations of women and men and the requirements of modern societies, demographic ageing and structural change; that people receive the information they need to plan their retirement and that reforms are conducted on the basis of the broadest possible consensus.

While the articulation, as reproduced above, is perhaps overly detailed and gives no sense of relative importance, it does have obvious relevance for the wider Australian retirement income system. Elements of the above are also evident in the objectives proposed by various Australian experts for the superannuation component of the retirement income system.

The Charter Group (2013) concluded that, at a high level, the objectives of the Australian superannuation system are to:

- *provide an adequate level of retirement income;*
- *relieve pressure on the Age Pension; and*
- *increase national saving, creating a pool of patient capital to be invested as decided by fiduciary trustees.*

The Financial System Inquiry Report (FSI Report 2014) suggested that the specific objective of the superannuation system is *"to provide income in retirement to substitute or supplement the Age Pension*". It further proposed a number of sub-objectives, namely to:

- *facilitate consumption smoothing over the course of an individual's life;*
- *help people manage financial risks in retirement;*
- *be fully funded from savings;*
- *be invested in the best interests of superannuation fund members;*
- *alleviate fiscal pressures on government from the retirement income system; and*
- *be simple and efficient, and provide safeguards.*

The Retirement Income Consultation paper (AFTS 2009) identifies five principles for assessing a retirement income system, namely that it should be:

- *broad and adequate, in that it protects those unable to save against poverty in their old-age and provides the means by which individuals must or can save for their retirement;*
- *acceptable to individuals, in that it considers the income needs of individuals both before and after retirement, is equitable and does not bias inappropriately other saving decisions;*
- *robust, in that it deals appropriately with investment, inflation and longevity risk;*
- *simple and approachable, in that it allows individuals to make decisions which are in their best interests; and*
- *sustainable, in that it is financially sound and detracts as little as possible from economic growth.*

What is common about both the FSI (2014) and the Charter Group (2013)'s articulations is the clear recognition that superannuation is about income in retirement rather than wealth management. Both, however, place arguably an undue focus on superannuation's role in relieving pressure on the age pension instead of focusing on containing total costs including the cost of superannuation tax concessions. Having said that, the FSI (2014) implicitly acknowledges the need to contain the cost of superannuation concessions in its sub objective "*alleviating fiscal pressures on the budget*".

Overall, the FSI (2014) adopts a more comprehensive set of objectives than the Charter Group (2013) including reference to important matters such as facilitating consumption smoothing, financial risk management in retirement and simplicity and efficiency. Despite the FSI's more comprehensive set of objectives, like the Charter Group (2013), it omits reference to effects on income distribution, fairness, equity or coverage as goals of the system.

This compares with the AFTS (2009) that gives some prominence to the principle of '*acceptability*' that recognises 'equity' including the need to balance pre retirement and post retirement income requirements. It also includes the principle of '*broadness*', recognising the importance of extending coverage of superannuation to improving levels of adequacy. AFTS (2009) however lacks an overarching primary objective that can serve as a clear mission.

ACOSS defines the purpose of the retirement income system to "*alleviate poverty and facilitate people saving enough to enable them to have a decent standard of living in their post-working age life*". In doing so, ACOSS is seeking not to set too high expectations for retirement income given the competing needs of working age people of limited means who have received significantly reduced government support over the years.