The Economic and Labour Relations Review Vol. 22 No. 3, pp. 65–84

Equity in Retirement: Are All Australians Getting a Fair Deal?

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Abstract

This article evaluates the Australian retirement system using a framework of justice. Justice (alternatively, equity or fairness) is taken as requiring a full consideration of the criteria of needs, equality, liberty and just deserts, as well as matters of efficiency. Inequity occurs when the interests of weaker stakeholders are given inadequate consideration. Applying these criteria suggests that the Australian retirement system intrudes on the liberty of some groups of stakeholders inconsistently and inappropriately in mandating contributions at younger ages particularly, and by the imposition of unnecessarily bureaucratic means tests. It also fails to provide for the incapacitated older aged.

JEL Codes: G23; H55

Keywords

Annuitisation; compulsion; equity; fairness; justice; means tests; pensions; superannuation.

1. Introduction

This article evaluates the Australian retirement system, being the private superannuation industry, the Age Pension and various other subsidies and allowances, using a framework of justice. Under this framework, there are five key criteria that need to be considered in attempting to ensure justice for all participants: meeting needs, equality, liberty, recognising just deserts, and efficiency. The values are absolute in the sense that they have to be accorded positive value per se, although clearly one or another may need to be compromised if they are impossible to reconcile. The criteria need to be applied to all identifiable stakeholders. It is critical that the process by which they are applied is balanced and considered. Injustices occur when the interests of weaker stakeholders are not taken into account.

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The analysis identifies two groups whose interests are most neglected by the Australian retirement system: the very young whose parents are forced to make excessive contributions for their stage of life, and the very old who are unable to effectively delegate the management of their superannuation and who are unnecessarily harassed by means-test bureaucracy. These groups are identified after considering the retirement system using a framework of justice. Section 2 of the article provides the context with a discussion of the justice of the retirement system. It attempts to put the superannuation, tax and transfer systems into perspective and provide a sense of what is material. It proceeds to identify the core strengths and glaring weakness of the retirement income system, listing the conflicting interests that have contributed to the torrent of recent reviews — of which the Harmer Pension Review (Harmer 2009) and the superannuation aspects of the inquiry into Australia's Future Tax System (AFTS 2010), the Henry Review, are perhaps most important. Sections 3 and 4 discuss how the interests of the two weakest demographic groups are overridden by the inconsistent application of compulsion in superannuation and by weaknesses in the design of the Age Pension means test respectively. Section 5 concludes the discussion.

2. The Justice of the Retirement System

A Working Framework for Justice

While the principles of justice are hotly debated, they are not novel and would have to be mentioned in any serious application of moral philosophy to financial or social questions — as they are by Hausman and McPherson (1996, chs 7, 9, 10 and 11), for instance. Tyler and Smith (1997), in a review of the social science literature on justice, show that people are often more concerned with just procedures than just outcomes. The argument being made for the framework adopted here is that each of the criteria has an absolute value in the process: *ceteris paribus* it is never wrong to value people's needs, to create greater equality, efficiency and liberty, or to give people their just deserts. There are subjective personal differences which arise partly from the compromises that practicalities force on us, and partly from our individual experiences of injustices, both to ourselves and to others, and — let us admit — from our personal interests. Without the idea of justice, government would be based only on the whims of the powerful, and it must often be asked whether those who deny the power of justice are not doing so in order to escape its restraints. The critical issue, however, is the process rather than the result: one might justly consider a criterion or right and decide to modify it, and even override it, in particular circumstances.

In another paradigm, justice gives to each person a set of minimum human rights. Our indignation is justified if the criteria or the rights are not considered in a given process. The following expands briefly on these rights or absolutes.

- Liberty is perhaps the easiest criterion to deal with. In general, people do not like to be told what to do. Intervention of government in the lives of people is undesirable per se. No one — whether in private or in public capacity — has the right to interfere in the lives of others without good reasons.

- Needs relate to the wherewithal for a minimum acceptable standard of living. This too is universally accepted — although sometimes reluctantly — but the level of needs that should be met is certainly controversial.
- Equality refers to equality of welfare, interpreted broadly, of income and of status. (Equality of opportunity is one example.) Equality should incorporate both horizontal equity, which means that people in the same circumstances are treated in the same way, and vertical equity, which means that differences in treatment are proportional to the differences between the circumstances of the people concerned. In terms of taxation, horizontal equity requires those of equal income to pay equal amounts of tax. Vertical equity requires that the rate of tax applied to people of different income increases smoothly with their income and requires increasing marginal rates of tax.
- Just deserts covers both the rewards that do, or should, directly follow effort, creativity or personal sacrifice, and the penalties that do, or should, follow destructive or exploitative actions. Narrowly interpreted, justice can describe the process of ensuring that other people are not negatively affected by our behaviour.
- Efficiency is taken to include lower costs of administration and the provision of productive incentives. Efficiency is not normally explicitly considered as a right or element of justice, but it must often be considered in order to make a balanced evaluation of policy options. It is argued here that it should function as a criterion of justice. The question to ask is whether it would be unjust to fail to meet one of the other criteria because of cost considerations. If not, then efficiency would appear to act as one of the components of a framework of a just process.

A more detailed explanation and justification for the approach, especially equality and just deserts, can be found in the appendix to Asher (2010).

Equity in the System

Australia's retirement system has a number of unique features (Disney 2009), two of which are strengths and one a weakness.

- The almost universal basic pension (the Age Pension) covers permanent residents of over 10 years' standing with less than very adequate means. Supplementary benefits are also provided. There appears no reason to doubt Harmer's conclusion 'that the basic structure of Australia's pension system, with its focus on poverty alleviation … is sound' (2009: xi).
- The almost universal employment-based superannuation system is funded in advance — except for the now-closed public sector defined benefit (DB) retirement income schemes, which have built up a significant unfunded deficit.
- The glaring weakness of the Australian retirement income system — when compared with that of almost all other developed countries — is that there is no effective conversion of the accumulated superannuation benefit into lifelong pensions (again with the exception of the abovementioned cohort of public sector workers).

The Age Pension, together with the supplementary benefits and allowances, can be said to broadly address the needs criteria. A possible exception is in rental assistance for those who do not own their own homes in retirement. It is common cause that house prices and rents have risen dramatically over the past two decades, and the maximum rental assistance of $120 per fortnight for a single person does not appear to meet the costs of the cheapest available accommodation. If not a question of needs, it would certainly be one of vertical inequality between the majority who own their homes and those who do not. This issue was raised in the Harmer Review (2009: 35) but remains unresolved.

The funded defined contribution (DC) nature of the employment-based system meets the criteria of just deserts: people get a benefit directly linked to their contributions, and the system is resilient in the face of demographic transition. This can be contrasted with unfunded systems, where the next generation will have to pay higher contributions and there appears to be inter-generational inequity. The exceptions here are public sector pensions where the value of the benefits accrued exceeds past contributions and, by implication, the cost that employers (or taxpayers) thought they were incurring. Duval (1994), then Australian government actuary, emphasises the need to report appropriate accruals. Asher (2010) makes the point that all DB funds are vulnerable to manipulation — if not corruption — because the benefits are not linked to contributions.

The gaps in the lifetime retirement income provisions are addressed in more detail below. The next subsections consider the more controversial questions of whether the system adequately contributes to greater income equality, and how it is shaped by the lobbying of powerful interests. Sections 3 and 4 then address what appear to be the major shortcomings.

Does the System Promote Inequality?

The retirement income system reduces inequality by providing a public pension to those with lower incomes, but the concessions on superannuation contributions and investment earnings reduce the progressiveness of increasing personal income tax rates. The latter concessions can, however, be justified as mitigating the effect of annual calculations, which mean that those whose lifetime incomes are more concentrated — because they spend years out of the workforce — pay higher average rates of tax than others with equivalent lifetime incomes. The net impact is beyond the scope of this article, as it depends on the interaction of all elements of the taxation and welfare system. This section considers the more limited question of whether the retirement system includes any material injustices by promoting inequality.

Spread over a lifetime, and looked at from their impact on the creation of a greater equality in wealth, neither taxes on superannuation nor means tests on pensions are overwhelmingly important. Given that direct or indirect contributions to retirement funding represent a relatively small part of any individual's wages, the effects of inequalities in the clawback and taxation of retirement benefits are considerably diluted. We can get a sense of materiality by assuming that the average contribution to superannuation over a lifetime is of the order of 10 per cent of annual income, in which case the following applies.

- The impact of the income and asset test on the Age Pension will usually be significantly less than the maximum clawback rate of 50 per cent of retirement benefits. This means that the maximum impact is equivalent to an increase in the average rate of tax on income of around 5 per cent over the lifetime (50 per cent of 10 per cent).
- On the other hand, the concessional tax reduction of 30.5 per cent on contributions (as applies at the current highest Australian marginal rate) reduces average tax rates by some 3 per cent for the wealthiest Australians (30.5 per cent of 10 per cent).

A tax on lifetime income of 3 per cent to 5 per cent is not insignificant. There are, however, many ways of compensating losers and recovering expenditure — of which adjusting marginal rates is by far the easiest and simplest. Given the numerous changes to tax rates that will happen to an individual and their family over a lifetime, very few of the changes to superannuation and public pension transfers can really be determined to be so material that they constitute major injustices.

Ingles (2009) identifies a number of 'rorts' where the system is open to arbitrages that yield significant short-term benefits to those able and alert enough to take advantage, but they 'undermine the redistributive nature' (ibid.: 3) rather than abolish it. As such, they do constitute injustices in favouring one group over another, and some were addressed by Henry (in recommendations 18 and 19; see AFTS 2010, Part 2, Vol. 1: 100 ff.) to reduce the regressive nature of tax concessions. Others are discussed in more detail in the next section of this article.

In spite of excluding a full consideration of this question from our scope, it is of interest whether the tax system as a whole does redistribute income. Henry analyses the impact of the tax and transfer systems and comes up with the view that the 'personal income tax and transfer system taken together is among the most progressive in the OECD' (AFTS 2010, Part 2, Vol. 1: 17). This conclusion would not be shared by all analysts. The following table suggests that Australia is less progressive overall than most other OECD countries: redistribution reduces the Gini index by 34 per cent, which is more than Taiwan, Canada, the United States, the United Kingdom and Israel, but it remains 13th out of 16 when it comes to equality of disposable income.

Table 1: Gini indices of market income and disposable income in 16 countries

	Gini index of market income %	Gini index of disposable income %	Reduction in Gini index %
Denmark 2000	23	42	47
Netherlands 1999	23	38	39
Finland 2000	25	4	48
Norway 2000	25	41	39
Sweden 2000	25	48	45
Czech Republic 1996	26	44	41
Germany 2000	28	48	43
Romania 1997	28	38	27
Switzerland 2000	28	40	30
Taiwan 2000	30	33	9
Poland 1999	31	53	41
Canada 2000	32	44	28
Australia 2001	32	48	34
United Kingdom 1999	34	51	33
Israel 2001	35	52	33
United States 2000	37	48	23

Source: From figure 6 of Brandolini and Smeeding (2008), by permission of Oxford University Press.

More recent estimates, such as those produced by the OECD (2011) and the Central Intelligence Agency (2011), indicate that inequality has reduced since then, so improving the ranking, but not to northern European levels. Such measures are, however, really only indicative. Apart from the dubious nature of the statistics — as discussed in Atkinson and Brandolini (2001) — different analyses produce significantly different results. The Australian system is particularly unusual in the following respects.

- The superannuation guarantee contributions are not usually classified as taxes, so making the tax burden appear lower under some measures.
- The public pension is almost universal and the pension for a couple is set at roughly 40 per cent of average weekly ordinary time earnings (AWOTE). This makes Australia look particularly good at eliminating relative poverty if the measure of household income is set below 40 per cent.
- There is no public earnings-related pension and the system pays lifetime annuities to a minority. This makes it look particularly weak if the poverty measure is set much higher than 40 per cent of AWOTE.
- Australia also appears to rely significantly more on means testing, as discussed further below.

There is a small point here in that the Gini coefficient measures inequality across the spectrum, while Harmer's concern to target resources to the poorest may have a relatively limited impact on the coefficient. Whether the whole system is sufficiently progressive appears to be an unanswered question, but the complexities in the system suggest the possibility of excessive influence of sectional interests, which is the subject of the next subsection of this article.

Group Interests and Ongoing Reviews

If there are few material issues with the retirement system, why then is the system subject to so much scrutiny and change? The last five years have seen the 'Simpler Super' reforms and inquiries by a Parliamentary Joint Committee, followed by Henry and Harmer, both of which reported in 2009. These were followed by the Ripoll[1] and Cooper[2] reviews, and a government announcement that it intends to increase the mandatory contributions from 9 per cent to 12 per cent — against the recommendation of Henry.

The design of the system is clearly of significant interest. To understand the debate, it is necessary to understand the group interests at stake. The first group includes the very wealthy and their tax advisors, who benefit from tax arbitrage opportunities. Ingles (2009) identifies a number of these opportunities, and he does not even mention self-managed funds, which allow private business income to be tax sheltered and which can be used to limit the payment of capital gains tax.

The second group can be called the gerontocracy. Mulligan and Sala-i-Martin (1999: 11) provide a critical insight by describing how the old in every country, with plenty of time to lobby, extract a greater share of resources and shape the pension system to maximise their power. They point out that the gerontocracy belongs to all political parties:

> Our main point is that redistribution requires political, moral, and social pressure and that this pressure is related to an allocation of time by program beneficiaries … they will retire more, lobby more and will extract transfers from the young.

Their thesis would explain tax concessions that favour the old, and how these are seldom questioned in political debates. The egregious Australian example was Simpler Super, which made superannuation benefits tax free for those over age 60 and cost some $50 billion in future taxes. (No full calculations have ever been publicised, but this figure can be extrapolated from the Explanatory Memorandum,[3] which reported an annual cost of $2.3 billion in 2009.) Conclusive evidence of the power of the Australian gerontocracy is that while the cost–benefit tradeoffs were barely considered in the introduction of Simpler Super, this was the only item explicitly excluded from Henry's terms of reference.

Harmer's report is replete with evidence of moral pressure from the elderly:

> Overwhelmingly the consultations expressed a strong view that the government should increase spending on pensions, as well as provide greater support to carers and people with disability, and for retirees in general. Forty-seven per cent of submissions from individuals and 59 per cent from organisations called for the pension to be increased. (Harmer 2009: 26)

Any national politician will confirm the pressure: the overwhelming majority of representations they receive are from the retired, often lobbying for specific concessions.

The long-term savings industry — which includes retirement funds, such as superannuation funds, insurers, and service providers, including actuaries and other professionals — is another powerful pressure group with an interest in a larger, more tax-favoured industry. It can usually be relied upon to call for the reduction of taxes on pension and superannuation fund investment income, and for increases to the level of compulsory contributions.

Public interest groups, such as non-government organisations (NGOs), can speak effectively for the rights of pensioners. They understandably interpret their role as speaking for the poorest and they play an important role in doing so. The needs of the lower middle income group can, however, often be neglected.

The power of vested interests is also revealed by the grandfathering of concessions, which are a significant cause of complexity and seldom justifiable. It is clearly unjust to penalise people for taking advantage of tax concessions allowed in previous years, but removing concessions on current and future income is not very different from changes in the rate of tax — and can frequently be justified.

Equity in the Reviews

As required by its terms of reference, the Henry Review makes frequent reference to equity (as well as efficiency) to justify its recommendations. It is suggested, however, that the concept needs a clearer definition in order to provide a framework for consideration of some of the difficult tradeoffs that have to be made, and the possibility that some interests have been given insufficient consideration.

References to equity in the Henry Review are largely consistent with the framework used here. The second of the terms of reference calls for the system to raise revenue 'to do least harm to economic efficiency, provide equity (horizontal, vertical and intergenerational), and minimise complexity' (AFTS 2010, summary: vii). Equity is later defined more fully:

> The tax and transfer system should treat individuals with similar economic capacity in the same way, while those with greater capacity should bear a greater net burden, or benefit less in the case of net transfers. This burden should change more than in proportion to the change in capacity. That is, the overall system should be progressive. Considerations about the equity of the system also need to take into account exposure to complexity and the distribution of compliance costs and risk. (AFTS 2010, Part 2, Vol. 1: 17)

The recommendations in the Henry Review that relate to superannuation are attempts to simplify tax and other complexities and inconsistencies and suggest that efficiency is the main driver. None appear to be so overwhelmingly important and advantageous that the government has seen fit to implement them, although the recommendation to permit a wider range of annuities is to be welcomed.

Harmer's view of equity is similarly consistent with the framework — although not necessarily with Henry's use of the word. His review highlights conflicts between those who believe that the system should be focused on those with the greatest needs and those who feel that all Australians 'deserve' a pension through their earlier contributions to the economy (Harmer 2009: 26).

The Harmer Review found that pensions for single people were inadequate relative to those for couples, and the increase that arose from the review does seem to produce a more equitable balance between the two. Other recommendations were largely administrative and concerned with efficiency — and have led to some simplification of the system, which is to be welcomed. Further developments on eliminating complexity and work disincentives for older people are likely, and these are also to be welcomed. The disincentives are often unfair in applying high marginal clawback rates, but it would appear to be their economic inefficiency that is leading to their removal. As discussed earlier, the difficulties of those who do not own their own homes were raised but have not been addressed.

It is suggested, however, that there are important elements of the justice framework that are missing from the reviews, which has meant that they fail to suggest protection for some weaker groups. The first is in the definition of vertical equity.

The traditional, philosophical, definition of vertical equity is that differences in treatment should be proportional to differences in circumstances. This contrasts with horizontal equity, which requires equals to be treated equally. Henry's definition of vertical equity corresponds with that in the economic rather than the philosophical definition: 'that people with low means should receive greater assistance than those with higher means, and that those with greater economic capacity should have a higher tax burden' (AFTS 2010, Part 2, Vol. 1, Glossary: 10). Not everyone would agree with the proposition that vertical equity (in the wider philosophical sense) requires a higher proportional contribution from the wealthy — but there are a variety of other arguments (declining marginal utility, the needs of the poor, the place of undeserved good and bad fortune in the allocation of goods) that are normally conclusive, either separately or taken together.

Whether the arguments are acceptable or not, the traditional view is offended by sharp discontinuities in rates of taxation or benefit withdrawal as the change in treatment is not proportional to the change in circumstances. It is suggested that vertical equity requires that the rate of tax (and benefit clawback) applied to people of different incomes should increase smoothly with their income and requires increasing marginal rates.

The concept of liberty also finds no explicit mention in either review, and it is notable that the use of 'compulsory' is fairly common and never seems to be recommended reluctantly. Both reviews are concerned with excessive complexity, but the reason appears to be inefficiency (see Harmer 2009: xvi explicitly) rather than an intrusion into liberty.

On compulsory annuitisation at retirement, Henry notes that a 'reasonable basis for policy design is the presumption that, having accumulated retirement savings, people are generally in the best position to determine how they use their assets' (AFTS 2010, Part 2, Vol. 1: 117). This does not perhaps give sufficient recognition and respect to people's right to determine their own destinies.

3. Compulsory Saving

The main argument made for compulsion is that people are myopic and will otherwise not save enough for retirement, as is repeated in the Harmer Review (Harmer 2009: 17).

The failure of both reviews to consider the issue of liberty has also meant that they made no attempt to justify imposing compulsory contributions on the young, and they have missed a fundamental inconsistency in the current system. A just outcome requires a just process that considers the main criteria: there appears to be no justification for the intrusion of compulsory contributions into the expenditure patterns of younger but not older adults.

Myopia and Dementia?

If intellectual capability is to be the measure, it is the aged rather than the young who are more likely to require paternalist guidance. The Australian Institute of Health and Welfare (2007) estimates that the prevalence of dementia among the old rises from 2 per cent at age 70, to 8 per cent at age 80, to more than 20 per cent at over age 85 — as against less than 0.1 per cent for younger ages. Kasten and Kasten (2011) present evidence that 'otherwise healthy senior clients may experience substantial declines in cognitive function over time, even without clinical dementia … Pre-retirees and retirees tend to have hyper loss aversion'. Broe (2005: 18) found that more than 50 per cent of his sample of New South Wales pensioners over age 75 had some difficulty in controlling their finances.

Excessive Burden on the Young

The Henry Review's modelling shows that the combination of pension and mandatory superannuation savings already delivers a replacement rate of over 100 per cent to perhaps the quartile of Australians with the lowest lifetime average earnings. Compulsory contributions at 9 per cent are too high to smooth consumption.

Younger liquidity-constrained families who are attempting to repay mortgages are also subjected to a distortion of their lifetime consumption patterns and to potential financial loss. La Cava and Simon (2003) provide evidence that younger people in Australia suffer more from liquidity constraints. It seems likely that these have negative consequences. Taylor et al. (2006) note the psychological cost, which Fischer and Liefbroer (2006) find may, in turn, contribute to higher divorce rates and the associated social costs.

Again, there appears to be no justification for this distortion to the lifetime consumption patterns of younger Australians — and the possible loss of benefits through the workings of the means tests.

It is sometimes suggested that younger people would be better off not buying their homes, as rents are low relative to house prices. This is possibly true for

lower income people, who are effectively shut out of the housing market by high prices. It is, however, often more than balanced by the tax concessions and non-financial benefits of home ownership.

Relative equity returns were particularly high in the 1980s and 1990s, but have not been particularly impressive in the past decade — nor were they in the 1970s, before the Australian Stock Exchange was formed. Thus, in two of the last four decades, equity returns have been less than average home loan rates, and it has not paid to borrow to invest in equities. Borrowing to invest in fixed interest securities — which make up a significant part of superannuation assets — is very unlikely to be profitable. Tax and expenses are likely to cause losses of 1.5 per cent per annum on the portion of the assets invested in fixed interest securities. There is a significant offset to these costs if superannuation payments are taken tax free at age 60, but it can be shown that (under current rules) there is a net cost to those under the age of 45.

Australian Prudential Regulation Authority (2011) statistics showed that funds produced an average return of 5.3 per cent in the seven years to end 2010. Reserve Bank of Australia (2011) statistics show that standard mortgage rates averaged 7.5 per cent over the same time. People with mortgages have therefore been made worse off over the past seven years, and the same can easily happen again.

It should also be noted that many of these young liquidity-constrained people are borrowing at interest rates significantly higher than the standard mortgage rate. The oft-repeated encouragement that compound interest makes it better to save earlier is often wrong: compound interest works against you if you are borrowing, and so loan repayments yield better returns.

Part of the problem appears to be a failure to appreciate how costs fluctuate over the lifetime. Rice Warner Actuaries (2010) report that the Australian Senate and the major industry bodies believe that replacement rates of 65 per cent (or so) of pre-retirement income are appropriate targets for post-retirement income, and they perform calculations to determine the superannuation savings gap based on these targets. While 65 per cent of 'take-home pay' may be an appropriate target, it is likely to be excessive when expressed as a percentage of remuneration packages — as it is likely to be understood in today's labour market. It is an anachronism: the last 20 years have seen a step change in the relative cost of housing, in particular. Houses have risen by some 50 per cent relative to wages since the early 1990s.[4] At six times the average wage, the capital to purchase the average house will absorb 15 per cent of a lifetime's labour if spread over 40 years (6/40 = 15%).

For higher income individuals, target replacement rates should be much lower than 65 per cent of the remuneration package. The table below provides an illustration for a family that may earn $6 million over a working lifetime. The illustrated superannuation contributions are likely — under reasonable assumptions — to provide for the maintenance of the pre-retirement standard of living.

Table 2: Illustrative lifetime spend

	$
Lifetime income	6,000,000
Tax	1,000,000
House	900,000
House interest	360,000
School fees	480,000
Other children	480,000
Super contributions	540,000
Balance available for other living expenses	2,240,000
Target ratio	37%

Source: Own calculations.

Retirement Spending Patterns Inadequately Understood

The Henry Review argues that Australian retirees are sensibly using their accumulated assets and therefore do not need to be guided (or compelled) into more suitable retirement income streams. They report that:

> Analysis on the draw-down of assets by Age pensioners has found that over the period 2000–01 to 2003–04, 30 per cent of Age pensioners retained 80 to 100 per cent of their assets, with 30 per cent increasing their assets. Only 1 in 13 Age Pensioners had drawn down more than half of their assets from the time of claiming the pension (Lim-Applegate et al. 2005). (AFTS 2010, Part 2, Vol. 1: 107)

This interpretation of the research by Lim-Applegate et al. appears, however, to be mistaken. Calculations instead show that pensioners in their mid-60s who wish to retain their buying power over their remaining lifetime should have retained in excess of 80 per cent of their initial capital over the period considered — the more so if they are more reliant on the Age Pension, as are most in the sample concerned. With this interpretation, 40 per cent of the pensioners in the Lim-Applegate et al. sample appear to be dissaving too rapidly. Of the rest of those in the data who had maintained their superannuation assets, 40 per cent appear to have been working and so not drawing down assets much and 20 per cent appear to have benefitted from higher house prices, while 10 per cent seem to have sold property and another 12 per cent appear to have inherited money from a spouse.

There appears to be no Australian evidence — but it would be surprising if we did not find significant financial stress among elderly widows and divorcees, as reported by Auerbach and Kotlikoff (1991). The Australian system certainly makes it easier for husbands to spend most of their retirement benefits on themselves, and Harmer recognises the problem of 'widows living in older homes who had traditionally relied on their partners for household maintenance' (Harmer 2009: 53).

The need to protect the interests of elderly widows provides a strong argument to assert their rights to a fair share of the family's superannuation — and for it to

be retained until they need it — through compulsory annuitisation. A number of commentators have raised the inequality between the superannuation balances of men and women, and concluded that greater workforce participation and more equal wages for women are required. These may be desirable but, in their absence, the family law on divorce has no difficulty in recognising women's rights to a share of their husbands' superannuation balances. Superannuation arrangements should do so too.

It is possible for the private sector to provide lifetime annuities that meet this need, although international experience is that it normally needs encouragement in the form of significant tax concessions or compulsion. Lifetime annuities are expensive if guaranteed to maintain real living standards, but in combination with the guaranteed public pension they can enhance welfare by smoothing consumption and insuring longevity risks — even if they are not guaranteed.

Henry notes that restrictive legislation makes development of appropriate products difficult. This is an understatement: the rules, discussed in more detail in Stringer (2011), are interpreted by the Australian Taxation Office to prohibit registered superannuation funds and life insurers from issuing a variety of with-profit and deferred annuities that would be appropriate. What most countries make compulsory, Australia prohibits!

The Henry Review is concerned that compulsory annuitisation will lead to cross-subsidies from those with lower incomes and poorer longevity prospects. This issue can be addressed by providing for differential pricing on a socio-economic basis, with additional allowance for those in poor health. Given the choices available in the industry, it is likely that such products would be forthcoming.

Soft Compulsion: A Better Way Forward

The recent lobbying by the gerontocracy, the industry, and public interest groups focused on the needs of the poor can explain the increase in the compulsory superannuation contribution rate to 12%. Those disadvantaged by this change are disorganised and not so poor that they fall within the ambit of the NGOs. Elderly widows of moderate means are also poorly organised and unrepresented. Their needs apparently do not concern the lobbyists — one or two representations to Harmer aside.

Mandatory contributions and preservation are an intrusion into liberty, but there is an approach that automatically provides advice but leaves people free to make their own decisions. 'Soft compulsion' in the form of default options, which can only be avoided at some personal inconvenience and after obtaining appropriate advice, offers a real alternative. It can address people's expressed need for assistance in saving, while leaving them freedom. This could be achieved by increasing the current 'hardship' provisions in the superannuation legislation so that withdrawals could be made to repay mortgage debt — within appropriate limits. It is suggested that it should apply to both the increase in contributions decided upon by the government — where young families should be permitted to redirect their superannuation savings into repaying mortgage debt — and to the purchase of appropriate income streams.

4. The Means Tests

As Disney (2009: 96) puts it:

> The basic arguments for and against means testing of public pensions are well known and straightforward (e.g. see Knox 1995, in the Australian context). Means testing focuses payment of benefits on the poorest elderly and thus is broadly inequality-reducing over the lifetime distribution of income. Second, when taxes cannot be raised by first-best means, overall deadweight losses are minimised by targeting benefits, so minimising distortions arising from revenue-raising from second-best or indeed in-best tax structures.

Targeting

There is, however, no practical way of targeting benefits precisely at those who need them. The nature of needs is complex and fluctuating; the measurement is inevitably somewhat simplistic, limited to a particular time, and prone to error. Where attempts have been made at triangulation (measuring needs using different methods, including surveys of the views of the poor and their neighbours), significantly different answers are obtained. Meyer and Sullivan (2003) mention some of the difficulties, and conclude that while the relationship with income is not precise, it can, in most cases, suffice.

If it is true that the Age Pension meets all essentials, there is then a strong argument for a pragmatic approach to measuring income and withdrawing or taxing benefits. Getting into too much detail represents a spurious level of care, and is an unwarranted interference in the lives of benefit recipients. The initial presumption should be that income — as defined by the tax collecting agencies — is an adequate measure of lifestyle for most purposes.

Administration

The second of Disney's points concerns whether it is easier to collect taxes or impose means tests.

The challenges of auditing assets and income for means tests are difficult to overstate. Apart from catching those who cheat, one should review records of income from casual jobs and the renting of rooms, interest on formal and informal loans, pensions and transfer payments. This is effectively impossible. Centrelink is the agency responsible for implementing the tests in Australia. Its website lists seven different kinds of income and six different types of assets that must be considered twice each year. In many instances, there is no way in which the answers can be independently confirmed, while the level of complexity makes the assessment difficult even for diligent applicants and competent administrators with goodwill and plenty of time.

The difficulties are illustrated by the audit of Centrelink reported in Pender (2004). It found that the agency made some 250,000 errors a month, with an 'actionable' error in 52 per cent of the cases investigated, and that almost all folders contained administrative errors. This is not to suggest that Centrelink is any

worse than other agencies. Rather, it is to suggest that the proper administration of means tests is not possible.

Personal Effects

The Henry recommendation is for a comprehensive income test that uses a deeming rate 'based on the returns expected from a portfolio of assets held by a prudent investor'. The assets are summarised as including superannuation, real estate, financial and personal, being 'Car, Furniture — with exemption' (AFTS 2010, Consolidated Summary: 63). It is not clear what exemptions are envisaged, but one must ask whether members of the review panel have read the relevant Centrelink forms. The first asset question on the 50-question form[5] is worth reproducing as an egregious example of bureaucratic bullying. It says (p. 3):

> Please read this before answering the following question about the market value of household contents and personal effects.
>
> The *current market value* of an item is what you would get if you sold it. It is not the replacement or insured value.
>
> Include:
> - all furniture (including soft furnishings such as curtains), antiques and works of art
> - electrical appliances such as televisions and fridges
> - jewellery for personal use and hobby collections (e.g. stamps, coins).
>
> Do NOT include:
> - fixtures such as stoves and built-in items.
>
> What is your estimate of the current market value of your (and/or your partner's) household contents and personal effects?
>
> Current market value $
>
> Amount owed $
>
> Your share %
>
> Partner's share %

The best that can be said about this and other similar questions is that they are unlikely to be enforced, and anecdotal evidence is that Centrelink officials helpfully turn their blind eyes. It is suggested, however, that the inclusion of personal effects is utterly unjustifiable.

Vertical Equity

Chart 24 in the Harmer report (2009: 124) demonstrates the complexity and vertical inequities in the means tests as they applied in January 2009. It shows nine different benefits and offsets and an effective marginal rate of tax and claw-back on a single person that rose from 20 per cent to 50 per cent at an annual income of $2600, to 60 per cent at an income of about $25,000, with two spikes

of over 100 per cent at annual incomes of about $40,000 and $50,000. It then declines to under 40 per cent.

Vertical equity is not hard to achieve: smooth increasing marginal rates of tax and clawback. Modelling by Creedy et al (2003) seems to be consistent with that of Ingles (1991). His conclusions would seem to continue to hold:

> [It is] possible and affordable to abolish the age pension means test. However it is not clear if the pension taper should be reduced below, say, 25%. Most of the efficiency gains are achieved by the first tranche of taper reduction. Optimal taxation of superannuation-cum-retirement savings necessarily involves integration of tax and means test provisions. It does appear reasonable to trade-off pension taper reductions for higher end-benefits taxation of superannuation, but there will be substantial transitional issues in moving to any new system. (Ingles 1991: 14)

5. Conclusion

The heated debates about the Australian retirement income system can be explained by the rich tax concessions and profitable business opportunities it presents. Subjected to a framework of evaluating justice, its major failings appear to arise from a failure to minimise its intrusion into the freedom of all stakeholders, and to consider adequately the needs of elderly widows. The system also fails the test of vertical equity with excessive marginal rates at some levels.

The following four suggestions are made.

- Compulsory membership should be extended to cover a default requirement to buy lifetime annuities.
- Members should (within appropriate limits) be entitled to withdraw money to repay mortgage debt.
- Personal effects should be removed from the asset test.
- The taper on the means test should be integrated with the tax system and the two should be increasing with income.

Notes

1. Parliamentary Joint Committee on Corporations and Financial Services, Inquiry into Financial Products and Services in Australia (2009), Commonwealth of Australia, Canberra, available: http://www.aph.gov.au/senate/committee/corporations_ctte/fps/index.htm [accessed 1 November 2011].
2. Review into the Governance, Efficiency, Structure and Operation of Australia's Superannuation System (2010), Commonwealth of Australia, Canberra, available: http://www.supersystemreview.gov.au/content/downloads/final_report/part_one/Final_Report_Part_1_Consolidated.pdf [accessed 1 November 2011].
3. Explanatory Memorandum to the Tax Laws Amendment (Simplified Superannuation) Bill 2006 (Cth).
4. As can be seen by Graph 63 of the Reserve Bank of Australia's *Financial Stability Review — March 2009* (2009).
5. 'Income and Assets', Centrelink form SA369.1005, Australian Government, available: http://www.centrelink.gov.au/internet/internet.nsf/filestores/sa369_1005/$file/sa369_1005en_p.pdf [accessed 1 November 2011].

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