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Retirement incomes: Australia v the Rest of the World

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Retirement incomes: Australia v the Rest of the World

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Executive Summary

This paper compares several features of Australia's retirement system with those in ten other developed economies and finds that

- The level of the full age pension is reasonable
- The net replacement rate for an individual with a full career on average earnings is comparatively low
- The shape of Australia's net replacement rates across different income levels is somewhat perverse with an increasing replacement rate for higher income earners
- The income-tested pension or supplement available in many countries is structured so that it provides no benefit to those with incomes above 40 per cent of the average wage; hence it does not affect most average income workers. This is not the Australian experience
- Australia is the only country with the complexity of both an assets test and an income test
- Many countries are increasing their pension entitlement age with the increases in life expectancies. An automatic adjustment to this age linked to life expectancies is a more objective approach than one-off political decisions
- The labour force participation rate at ages 55-64 has increased from 57.2% to 64.5% over 8 years but Australia still lags some countries, including New Zealand
- Although Australia has considerable assets set aside to pay future retirement benefits, there are some countries that are in a stronger position
- The net real investment return achieved by the overall system has been credible, particularly when one recognises that investment returns are subject to tax
- The Australian Government expenditure on pensions for the aged is relatively low and is not expected to increase, when expressed as a percentage of GDP
- Unlike some European countries and Singapore, Australia has no requirements relating to the form in which retirement benefits are to be taken

In summary, the Australian system has many positive features but the outcomes for the average income worker should be improved. This would not only improve adequacy but would provide a fairer system overall. The question is: *How can this be done in a simple and sustainable manner?*

The paper suggests that one way forward is to follow the Danish approach where part of the public age pension is paid to everyone as taxable income with the balance paid on an income-tested basis. For example, the current age pension could be divided into two components:

- A universal pension equal to 10 per cent of the average wage
- An income-tested pension equal to the balance, namely 17.6 per cent of the average wage

Several advantages of this approach are then discussed.

Background

How does Australia fare globally when it comes to retirement incomes? Our compulsory Superannuation Guarantee system is often highlighted within Australia as a long term success of decisions made in the 1980s and early 1990s. These decisions have certainly increased superannuation coverage; broadened the application of group life insurance and have led to more than \$2.6 trillion of assets, or more than 130% of our GDP. Our system is also often mentioned in discussions that occur in North America, the UK and Europe. Indeed the 2017 Melbourne Mercer Global Pension Index (MMGPI) ranked the Australian pension system third out of 30 countries. But are we really that good?

This paper will not focus on all aspects of our retirement income system; rather it is going to focus on the delivery of incomes during the retirement years which should be the primary purpose of our multi pillar system that comprises the means-tested age pension, compulsory SG contributions by employers and voluntary contributions by employees and the self-employed.

Of course, we need to be careful in the countries we select for this global comparison by limiting it to a manageable number of countries whilst not omitting countries who are doing it well and from whom lessons can be learned.

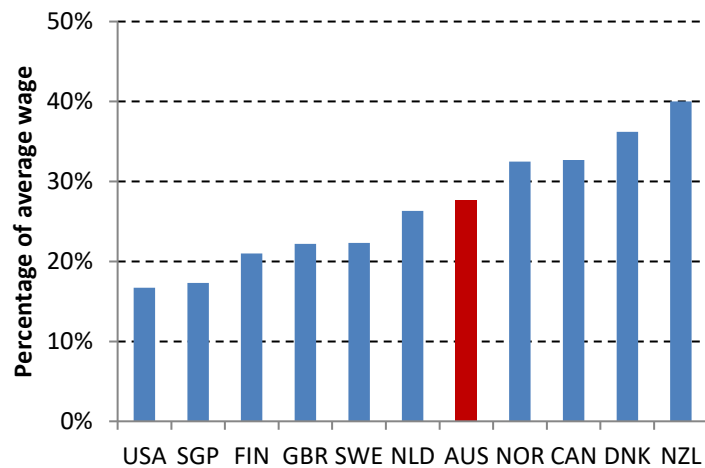
Ten countries have been chosen, namely

- Denmark, the Netherlands, Norway, Finland, Sweden and Singapore who were the top six countries in the 2017 MMGPI, after excluding Australia, and
- New Zealand, Canada, the United Kingdom and the USA who are countries with similar historical, cultural and economic backgrounds to Australia. These countries finished 9th, 11th, 15th and 17th respectively in the 2017 MMGPI.

Income levels in retirement

Let's begin with the level of retirement income provided to the aged who have very limited income or assets. In Australia, this represents the means-tested age pension whereas in other countries it may represent a universal pension and/or some means-tested support. Figure 1 shows the minimum level of income paid to a single aged person expressed as a percentage of the average wage in each country.

Figure 1: The minimum pension¹



The average is 26.8% of the average wage, slightly below the Australian figure of 27.6%. Hence, the level of the Australian age pension provided to the poor aged is reasonable based on this international comparison.

Now let us consider an income earner who is assumed to have a full-time career earning the average wage, entering the workforce at age 20 and retiring at the normal pension age in each country. The real investment return on the funded defined contribution arrangements is assumed to be 3% pa with earnings growing at a real rate of 1.25% pa. Other assumptions are available in OECD (2017).

The retirement income is expressed as a net replacement rate as it reflects the disposable income available in retirement compared to the net income available at retirement. This income includes income from both compulsory pension arrangements (whether they are in the private or public sectors) as well as any means-tested pension arrangements. Figure 2 shows the net replacement rates² for an average income earner in each country.

The stronger assets test in Australia from January 2017 has had a significant impact on this result and is the major cause in reducing the net replacement rate for the average income earner in Australia from 55.7%³ to 40.7%⁴.

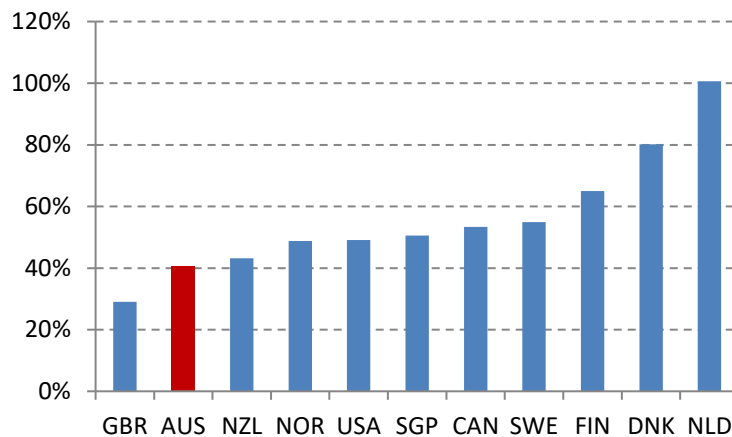
¹ Source: OECD (2017) p89, Author's calculations for Singapore

² These net replacement rates represent a price-indexed annuity calculated at an actuarial fair price.

³ OECD (2015), p 145

⁴ OECD (2017), p 107

Figure 2: The net replacement rate for an average income earner⁵



These net replacement rates range from 29% for the UK to above 100% for the Netherlands with an average of 56 per cent, which is similar to Australia’s pre-2017 result. Australia is now the second lowest of the eleven countries. A figure above 100 per cent, as occurs in the Netherlands, may be considered to be too high as a generally accepted target for net replacement rates is in the 60 to 70 per cent range. However the Australian figure, based on the current SG legislation and the revised means tests is delivering a relatively low level of retirement income for workers on average incomes.

It is interesting to note that this net replacement for an average income earner in Australia provides an income that is approximately halfway between the Modest and Comfortable lifestyles produced by the ASFA Retirement Standard for a single person.

The above net replacement rates are based on public and mandatory private schemes. Some countries in this comparison (namely Canada, the UK and the USA) have significant coverage (i.e. above 40 per cent of the working age population) in voluntary occupational or personal pension arrangements. Naturally such arrangements would increase the net replacement rate for individuals who are covered by such schemes.

Another limitation of the above set of figures, based on the average income earner only, means that it does not provide a complete picture as most workers have income below or above the average. Figures 3 and 4 show the net replacement rates for a worker earning 50 per cent or 150 per cent of the average income throughout their career respectively.

⁵ Source for Figures 2, 3 and 4: OECD (2017), p107; OECD, unpublished data for Singapore

Figure 3: The net replacement rate for a below average income earner

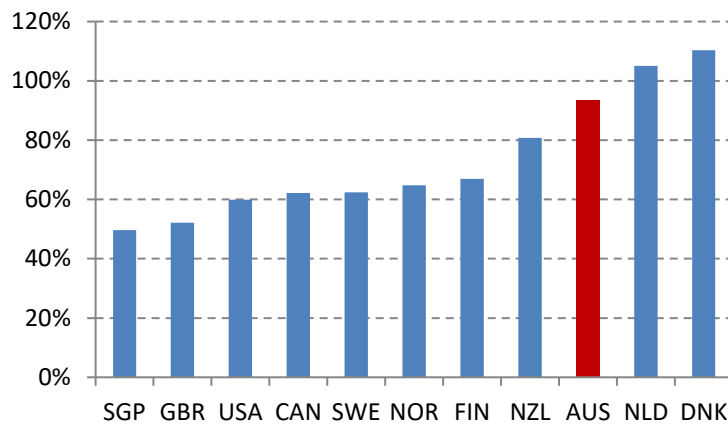
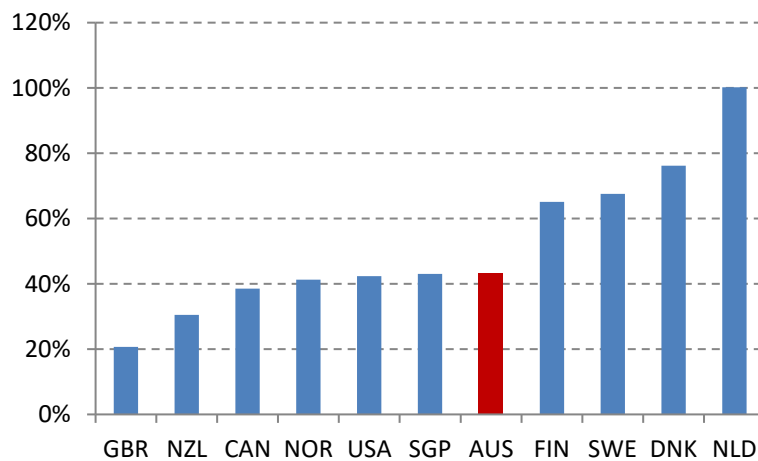


Figure 4: The net replacement rate for an above average income earner



It is interesting to note that although Australia was second last for the average earner, we are in third place and fifth place for the low and high income earners respectively. The impact of the asset test on the average income earner is clear. Notwithstanding the variations in Australia’s rankings for different incomes, Denmark and the Netherlands provide very generous benefits at all income levels whilst the UK performs poorly at all income levels.

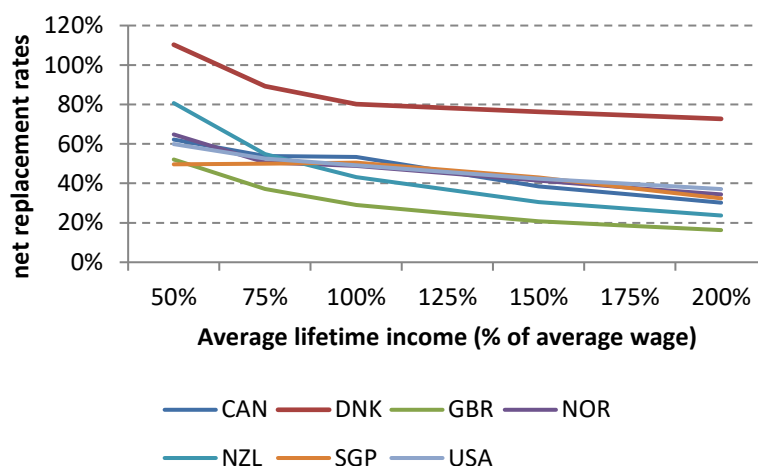
The shape of net replacement rates across income levels

When considering replacement rates across different income levels, it would normally be expected that the net replacement rates would decrease as incomes rise. That is, lower income earners need a higher replacement rate whereas a lower replacement rate (but not a lower income) is normally the target for higher income earners. Holzmann and Hinz (2005) of the World Bank noted that “Lower income workers require higher rates (of replacement), while higher income workers require lower rates”⁶ from a mandatory system.

Seven of the eleven countries in this study exhibit this pattern as shown in Figure 5.

⁶ Holzmann and Hinz (2005), p56.

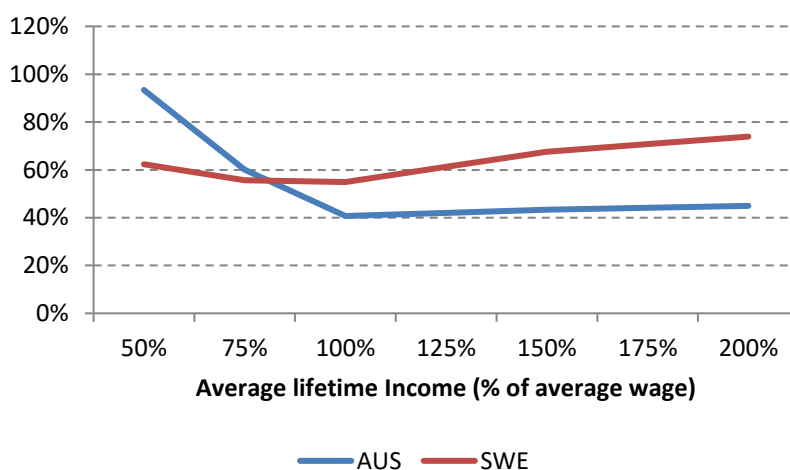
Figure 5: The downward slope exhibited by seven countries⁷



Two countries, namely Finland and the Netherlands, have virtually constant net replacement rates across all income levels. The net replacement rates for Finland are between 65 per cent and 67 per cent at all income levels between half and twice the average wage. The Dutch replacement rates are much higher with the results ranging between 100 per cent and 105 per cent at all these income levels.

The remaining two countries, namely Australia and Sweden, have a modified U shape with the lowest replacement at or near the average wage as illustrated by Figure 6.

Figure 6: Net replacement rates for Australia and Sweden



The causes of these two results are very different. For Australia, it is primarily the impact of the assets test at incomes below the average wage and the effective removal of income taxation after retirement so the net replacement rates rise with higher incomes. However, in Sweden the primary cause is that the contribution rate into the funded DC plan increases significantly for incomes above a prescribed level, which is slightly above the average wage.

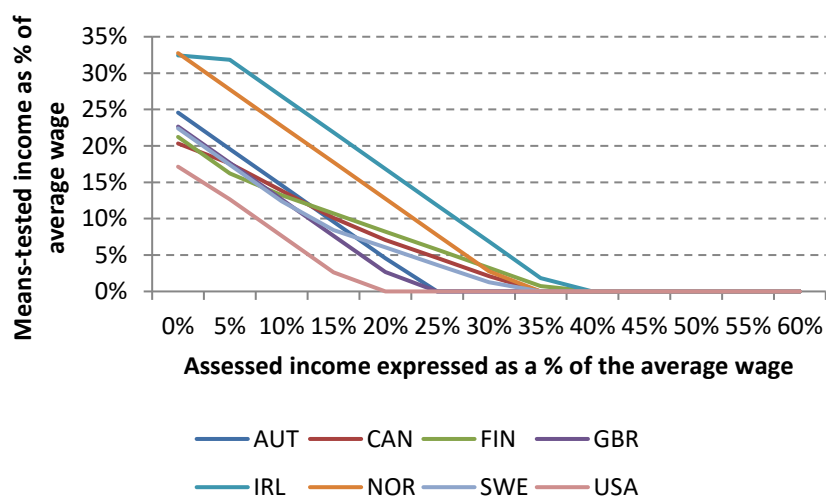
⁷ Figures 5 and 6 are developed from data in the individual country reports in OECD (2017).

The impact of means testing

As noted above, the net replacement rates in many countries decrease with income. This outcome is often delivered through the provision of some means-tested pension or supplement for those with lower incomes. Of the eleven countries discussed above, two countries, namely the Netherlands and New Zealand have a flat rate universal (or basic) pension with no means testing. Hence, they are excluded from this section. Singapore has also been excluded as they have a variety of mechanisms to support the poor which are not straightforward. This leaves eight countries. Austria and Ireland have been added to expand this comparison to ten countries.

Figure 7 shows the impact on the level of this means-tested income provided to single aged persons as other income increases for eight of these ten countries, excluding Australia and Denmark. Most of this data has been collected from Mercer colleagues supported by OECD (2017).

Figure 7: The means-tested pensions available to the aged poor

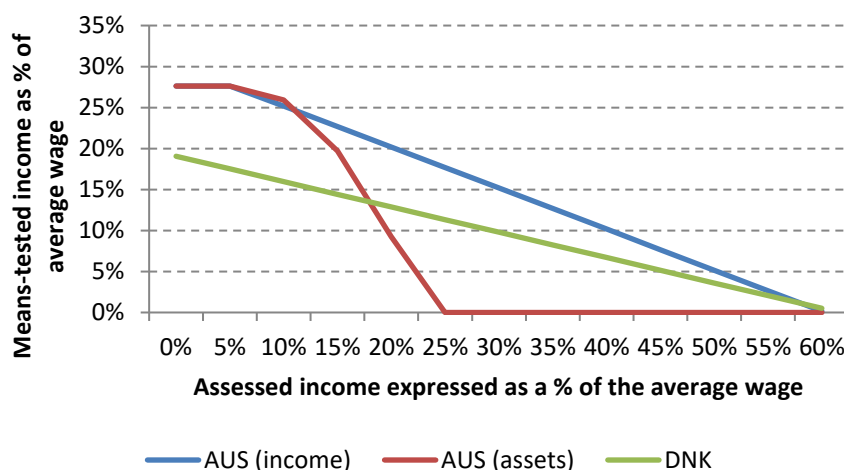


There is considerable common ground between these eight approaches, including:

- With the exception of Ireland, the means-tested pension reduces with all means-tested income above (or very close to) zero. That is, there is no (or a very limited) means test free zone.
- In most cases, the taper rate is 80 or 100 percent. That is, for every dollar of income, the means-tested pension is reduced by the full amount (or at least 80 per cent thereof). The exceptions are Canada and Finland where the taper rate is at least 50 per cent.
- The steeper taper rates and/or lower pension (expressed as a percentage of the average wage) mean that no retiree with an income above 40 per cent of the average wage receives any means-tested pension. That is, this income is focussed on the poor.
- These countries have no assets test; they are income tests only. In some cases, it is all income whereas in other cases only other pension income is counted.

Now let us turn to Australia and Denmark. Figure 8 shows the result for Denmark as well as two results for Australia assuming that only the assets test or the income test applies. In practice, it is often a combination starting with the assets test and then moving to the income test.

Figure 8: The means tested pensions available in Australia and Denmark



The Danish system has the relatively low taper rate of 31 per cent which means that a small means-tested supplement is payable when a retiree has income above 60 per cent of the average wage. However, it should be noted that as well as this means tested pension supplement, Denmark also provides a universal pension equal to about 18 per cent of the average wage.

The two Australia graphs stand in contrast to one another. First, if the income test only was applied with its 50 per cent taper and means test free zone, the pension would not cease until the income was above 60 per cent of the average wage. On the other hand, the current assets test taper is particularly steep such that the means-tested pension is, in effect, lost at a rate that is more than 100 per cent for every dollar of extra income.

So what are some lessons for Australia?

- All other countries use an income test only.
- Most countries have an income test taper that is harsher than 50 per cent but not as harsh as the current assets test
- Most countries do not have an income test free zone.

These approaches mean that with the exception of Denmark, none of these countries provide any means-tested supplement or pension where the assessed income available for a single aged person is more than 40 per cent of the average wage. The consequence is that most retirees who were previously average income earners (and therefore have a net replacement income of say 50% of the average wage) are not affected by the means test as they receive no means-tested supplement or pension.

The different tax structures for pensions

In light of the impact of taxation on net replacement rates, it is worth comparing the taxation structure of funded occupational pension systems in these eleven countries. Taxation on pension schemes can be applied at three stages; namely on contributions, investment income or benefits. Traditionally, taxation has not been applied on contributions or investment income but full income tax has been payable on pension benefits. However this norm no longer exists in all countries. Table 1 summarises the current taxation position in each country.

Table 1: The taxation of occupational pensions⁸

Country	Contributions	Investment Income	Benefits
Australia	taxed at low rate	taxed at low rate ¹	Exempt
Canada	Exempt	Exempt	Taxed as income
Denmark	Exempt	taxed at low rate	Taxed as income
Finland	Exempt	Exempt	Taxed as earned income
Great Britain	Exempt	Exempt	Taxed as income ²
Netherlands	Exempt	Exempt	Taxed as income
Norway	Exempt	Exempt	Taxed as income
New Zealand	Taxed as income	Taxed	Exempt
Singapore	Exempt	Exempt ³	Exempt
Sweden	Exempt	taxed at low rate	Taxed as earned income
USA	Exempt	Exempt	Taxed as income

Notes

- 1 The tax on investment income is in the accumulation stage only for most individuals.
- 2 25% of the benefit can be taken as a tax free lump sum.
- 3 The Central Provident Fund is predominantly invested in special Treasury bonds which could be considered to be a form of indirect taxation.

As can be seen, most countries still adopt the traditional EET approach where the majority of contributions and investment income are exempt from taxation with the subsequent benefits being subject to full taxation. This approach means that retirees with higher benefits pay a higher proportion of their benefit in taxation due to progressive income taxation.

The two major exceptions to this approach are Australia and New Zealand. In each case, contributions and investment income are subject to tax but the resulting benefits are tax exempt. New Zealand could be considered to adopt a TTE approach as both contributions and investment are taxed at broadly full rates whereas Australia has a tE system where 't' represents taxation at concessional rates.

Many economists and commentators believe that an EET approach is preferred as the taxation is paid when the benefits are received (as normally occurs with personal taxation) and the compounding rate is not reduced by taxation thereby providing larger benefits. However, as much as we might like to adopt an EET approach in Australia, I do not believe it is practical or financially feasible from the Government's perspective to move from our current tE to an EET approach.

⁸ This table represents a summary only and does not allow for special circumstances or various limits.

Is net replacement rate the complete picture?

The above discussion concentrated on net replacement rates as calculated by the OECD. However, is this calculation the best measure to determine the adequacy of an individual's financial position in retirement?

It is clear there are many factors that influence the financial security of individual retirees. These include the actual (not assumed) returns of their investments, their health and the associated longevity, the costs of health and aged care, their home ownership position, the financial resources of their partner (if they have one) and the seemingly 'free' provision of any benefits and services by the Government. As we consider these possible variations and the diversity of the provision of services around the world and even within the same country, it is clearly impossible to objectively compare the full financial security of average retirees across the eleven countries.

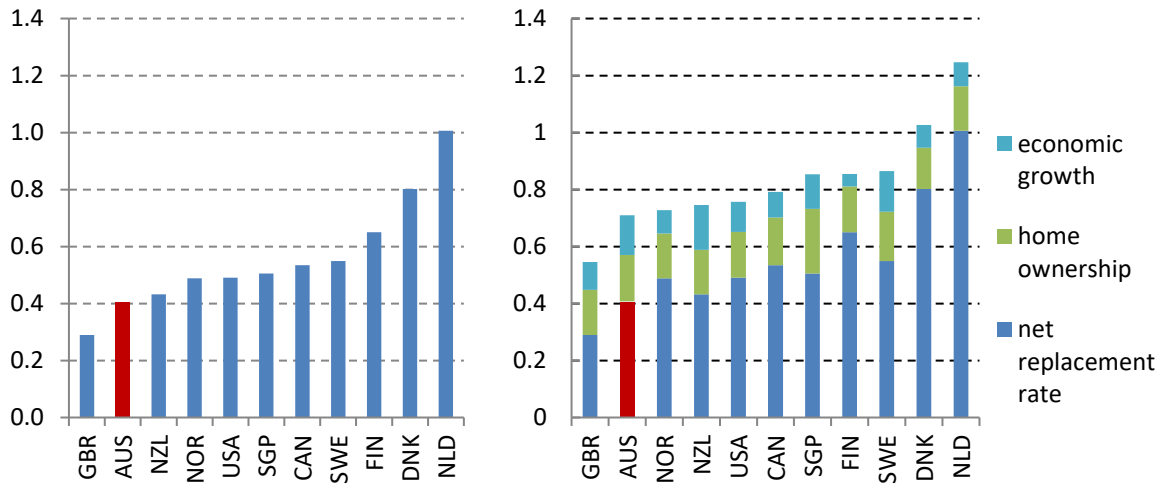
Nevertheless it is possible to improve on the simple measure of net replacement rate. In this exercise, we shall add two components:

- Home ownership, which recognises that a higher level of home ownership removes the need for retirees to pay rent
- Real economic growth, which leads to higher incomes, reduced government borrowing and improved investment returns thereby improving long term retirement incomes.

Figure 9 reproduces Figure 2 showing the net replacement rate for the average income earner and compares this graph with a measure including an allowance for home ownership and real economic growth. Home ownership varies between 57.7 per cent in Denmark to 90.8 per cent in Singapore with the average being 66.4 per cent⁹. Australia's figure is 65.5 per cent. For real economic growth we have averaged the last three years and the projected figures for the next three years as produced by the World Bank (2017). The average real growth rates range from 0.87 per cent pa in Finland to 3.15 per cent pa in New Zealand. Of course, the weighting of these two additional variables can be debated and there is no 'correct' answer. Nevertheless the right hand graph in Figure 9 shows the relative importance between countries and the fact that a more complete perspective can change the relative rankings.

⁹ These figures were sourced from Mercer consultants and used in the 2017 MMGPI.

Figure 9: The position of average income earners going beyond net replacement rates



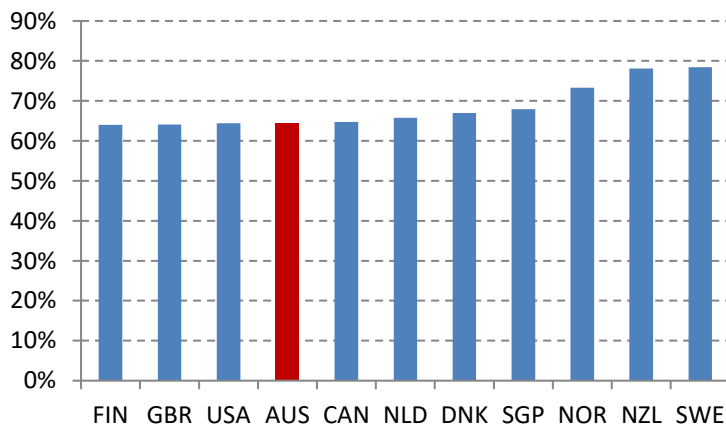
The changes in ranking with these modifications are relatively modest with most countries only changing one position although it is also noticeable that the variation between countries has reduced.

The age of retirement

With life expectancies increasing, an important feature of providing sustainable retirement incomes is the need for longer periods in the workforce and therefore later retirement ages. Let's consider two factors that highlight important differences between countries on this topic.

First, Figure 10 shows the labour force participation rates¹⁰ for 55-64 year olds in each country.

Figure 10: Labour force participation rates for 55-64 year olds



It is apparent that many of these countries have a similar participation rate for this age group with eight of the eleven countries having a rate between 64 per cent and 68 per cent. However three countries (namely Norway, New Zealand and Sweden) have participation rates above 70 per cent

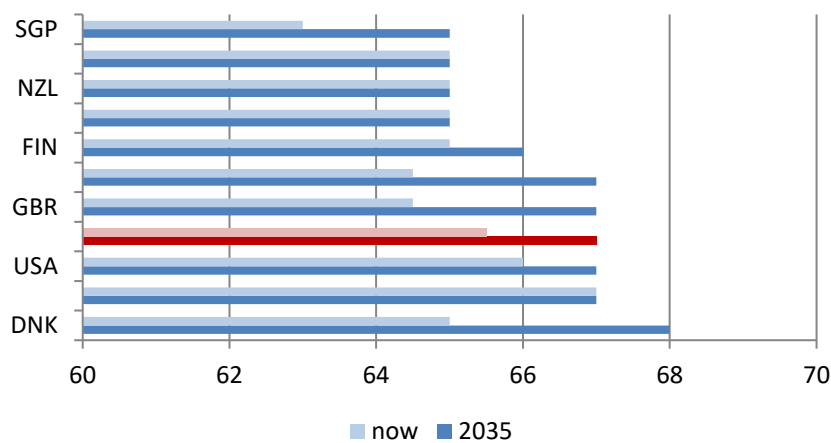
¹⁰ International Labour Organization (2016), www.ilo.org

with Sweden reaching at 78.4 per cent. Both Sweden and New Zealand have participation rates more than 13 percentage points above Australia.

It could be argued that higher participation rates arise from poorer retirement benefits leading to the need to work longer. However the net replacement rates (as shown in Figure 2) for these three countries is similar to some other countries with lower participation rates. Hence, there is not a simple relationship between average retirement benefits and working longer. It is more complex than that.

The second factor that could influence the age of retirement and hence labour force participation rates at older ages is the Social Security age (ie the normal entitlement age for the Government age pension). Figure 11 shows the current pension entitlement age together with the projected age in 2035, based on current legislation.

Figure 11: Current and future pension entitlement ages



Several trends are important, including:

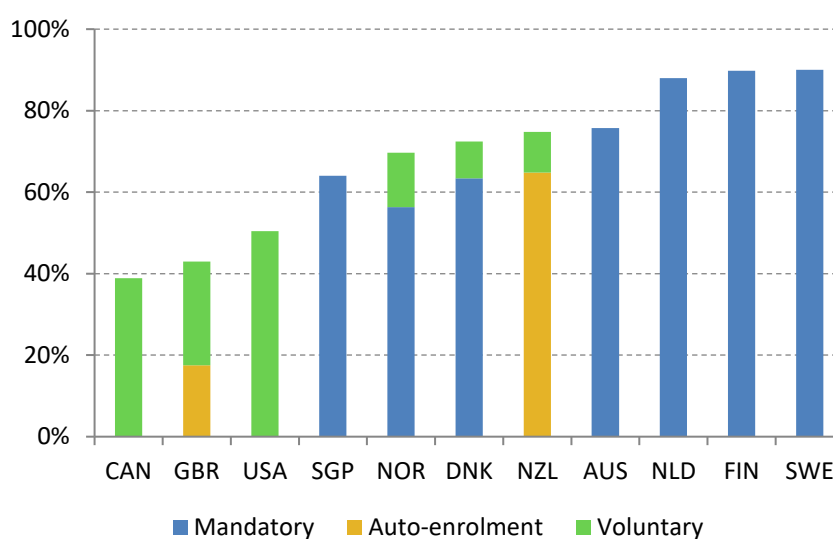
- Eight of the eleven countries are currently increasing their pension age. The exceptions are Canada, New Zealand and Sweden, all of whom remain on 65.
- Five countries, including Australia, are moving to 67 with Denmark moving to 68. No country has legislated the age of 70 which is the Australian Government’s current policy.
- Although Denmark and the Netherlands have the highest net replacement rate, they are both increasing their pension age.
- Although not evident in the graph, the Netherlands and Norway adjust their entitlement age or the level of benefits in line with movements in life expectancy. Such an approach is based on the evidence and should make it more politically acceptable.

Private pension coverage

The previous sections discussed the income provided to retirees across incomes. In most cases the income is a mix of public pensions (means tested or universal), social security (where individuals make contributions throughout their working years) and private sector (or occupational) pensions.

With ageing populations increasing and government budgets under pressure around the world, the role of private pensions is increasing in importance. However coverage (or membership) of private pension plans is not universal in any country. Figure 12 shows the coverage of private pension plans for 15-64 year olds in the eleven countries.

Figure 12: Coverage of 15-64 year olds in private pensions¹¹



Whilst coverage of 100 per cent is clearly impossible, coverage rates above 80 or 85 per cent are feasible. This graph highlights that:

- Not surprisingly, mandatory systems have better coverage than voluntary schemes
- Auto-enrolment is likely to improve coverage but not to the same extent as mandatory schemes
- Coverage in mandatory schemes may still be sub-optimal if it does not cover the self-employed or workers in the “gig” economy.

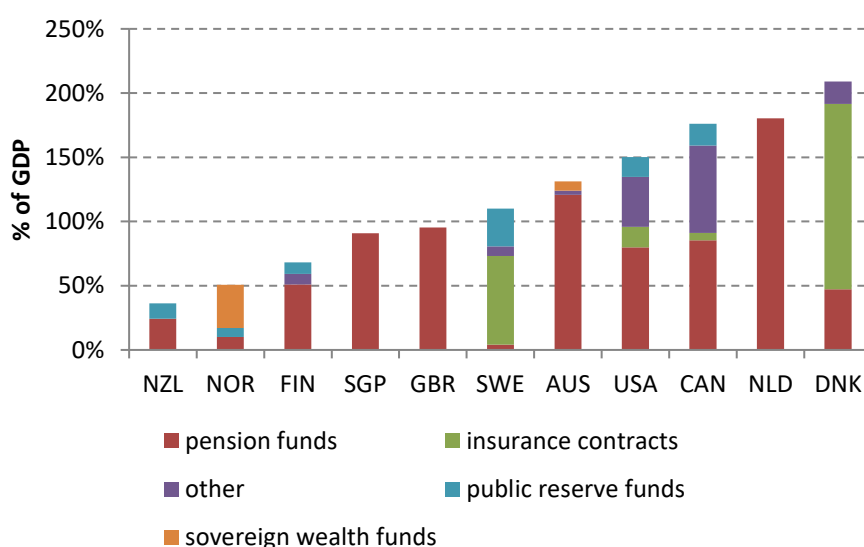
All these countries have a relatively formalised labour market so that it is feasible for a mandatory system to cover most, if not all, workers. However, for countries with a less developed economy and a more significant informal labour market, mandatory systems are likely to have less penetration with the subsequent lower coverage. This result may also occur in developed economies if the mandatory system does not cover the growing number of “gig” employees. Clearly membership of private pension plans (and hence coverage) is an important pre-requisite to providing many people with adequate retirement incomes.

¹¹ Author’s calculations based on OECD (2017), p151.

The available assets

An important part of a sustainable pension system that delivers incomes during retirement is to ensure that assets are available to fund these pensions and to not overly rely on future Governments, particularly given the ageing populations. Figure 13 shows the levels of assets, expressed as a percentage of GDP, for the selected countries.

Figure 13: The available assets to fund future pension payments¹²



The total assets available to pay pensions range from 36 per cent of GDP in New Zealand to more than 200 per cent of GDP in Denmark. Although we often consider that the \$2.6 trillion in Australian superannuation funds represents a very significant level of assets, it needs to be recognised that the Australian figure of 131 per cent of GDP is only slightly higher than the average for these eleven countries.

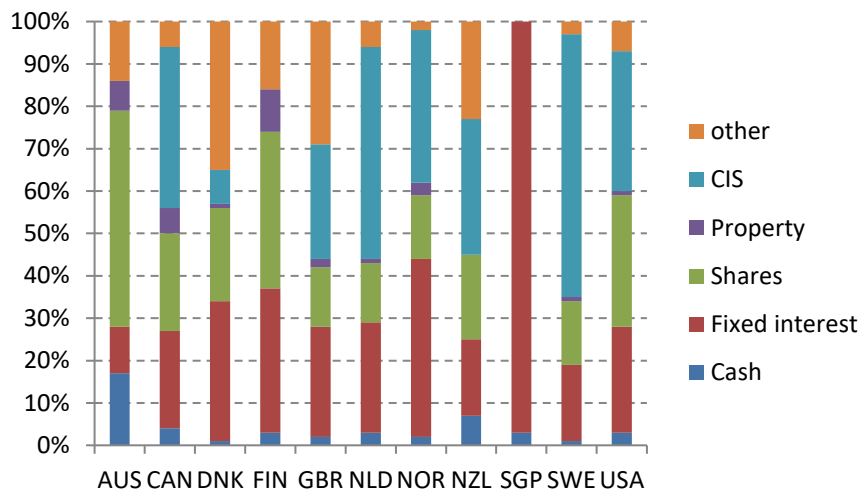
Whilst most of these assets are in autonomous pension funds, there are considerable assets in insurance contracts, personal retirement accounts (shown as 'other' for some countries), sovereign wealth funds (including Australia's Future Fund) and public reserve funds which support social security arrangements.

It is also worth noting that the use of these funds for non-retirement purposes varies between countries but can be prevalent where the preservation requirements are not as strong as in Australia. Such leakage from the system clearly affects the adequacy of future retirement incomes.

The allocation of these funds to different asset classes also affects adequacy. Figure 14 shows the variety of asset allocation across the eleven countries.

¹² Based on OECD (2017), p155 and other available OECD data

Figure 14: Asset allocation of funded private pension arrangements¹³



Note: CIS = Collective Investment Schemes

This graph highlights the following:

- Pension schemes in most countries have a diversified asset portfolio
- Australia seems to have the highest exposure to shares, although the asset exposure of the mutual funds (or collective investment schemes) is unknown
- The exposure to fixed interest assets is lower in Australia than any other country
- The high exposure to cash in the Australian figure is influenced by self-managed superannuation funds
- The Central Provident Fund in Singapore has less asset diversification than any other country

Having considered the asset allocation, it is also worth considering whether any country's system provides a better long term return. Figure 15 shows the annual real net rate of investment returns for ten countries from 2007 to 2016. Note that the New Zealand and Australian figures are for the year ending in March and June respectively and not December.

The impact of the global financial crisis is clear with negative real returns in 2008 in every country. Australia and New Zealand also show as negative for 2009 as their figures do not allow for the whole calendar year. However since 2010, most countries have had annual real returns between 0% and 10%. Only Denmark, Sweden and the Netherlands exceed 10% in 2014 as interest rates fell. Interestingly only the USA have recorded any years of real negative returns since 2010 and these occurred in 2011 and 2015.

Not surprisingly, there is considerable variation between countries within the bands of 0% and 10% depending on the actual asset allocation. However, the interesting question is whether any country has outperformed other countries during this period.

¹³ OECD (2017), Pension Markets in Focus, based on Table 2

Figure 15: Annual net real return for funded private pension arrangements¹⁴

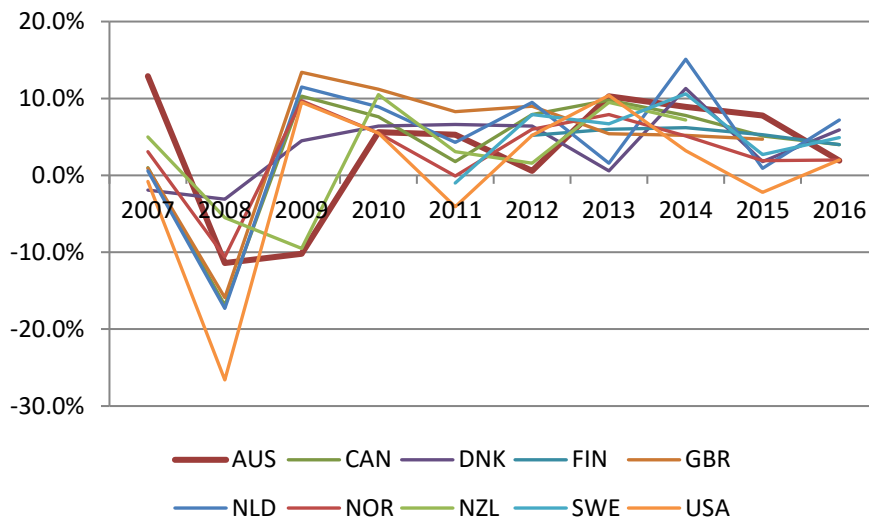


Table 2 shows the geometric average of the net real returns for the 5 and 10 year periods to 2016 for the countries where this data is available for the full periods.

Table 2: Net real returns for 5 and 10 years to 2016¹⁵

Country	5 year period	10 year period
Australia	5.8%	2.9%
Canada	6.9%	3.5%
Denmark	5.1%	3.8%
Finland	5.3%	na
Netherlands	6.7%	3.8%
Norway	4.6%	2.9%
Sweden	6.5%	na
USA	3.7%	-0.3%

With the exception of the USA, which has the lowest real returns for both periods, there is a relatively narrow band for both the 5 and 10 year periods. However it is also worth remembering that the investment returns in Australia, Denmark and Sweden are subject to some form of tax with the respective tax rates being 15% before retirement, 15.3% and 15% on an imputed return based on the government's borrowing rate.

Hence, given the fact that the investment income in Australia is subject to tax prior to retirement, these net real returns are very credible when compared to other leading pension systems.

¹⁴ OECD (2017), Pension Markets in Focus, based on Table A.4

¹⁵ OECD (2017), Pension Markets in Focus, Table 1

Public expenditure

Most retirement income systems are a multi-pillar system representing payments from the public system (ie the Government) as well as private or occupational pensions. Given the ongoing financial pressures faced by many countries relating to the ageing populations and budget deficits, it is worth considering the financial arrangements of the current retirement income systems.

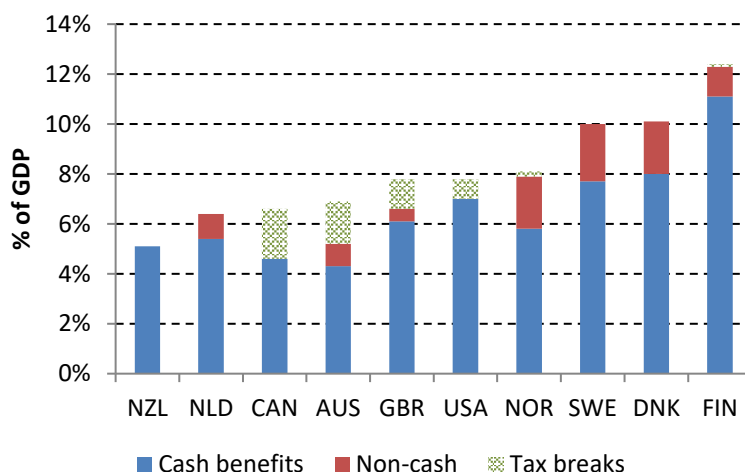
Figure 16 shows the public expenditure (expressed as a % of GDP) on age pensions and non-cash benefits for older people in 2013 for the ten OECD countries discussed earlier. Singapore has been excluded as comparable data is not available.

The graph also shows the level of tax breaks provided for private pensions with the lightly shaded part of the bars. However as the OECD notes:

“Tax expenditure figures come with important caveats: they are not comparable between countries because of differences in the benchmark tax system chosen. Despite their name, they are not equivalent to direct expenditures and so should not be added to numbers for public pension spending.”¹⁶

Hence this component of Figure 16 must be treated with great caution. The tax breaks have been shown here to highlight the fact that Government support for the aged comes in three different components, namely: direct pension payments, non-cash benefits and taxation support for private pension plans.

Figure 16: Government expenditure in 2013 supporting the pensions paid to the aged¹⁷

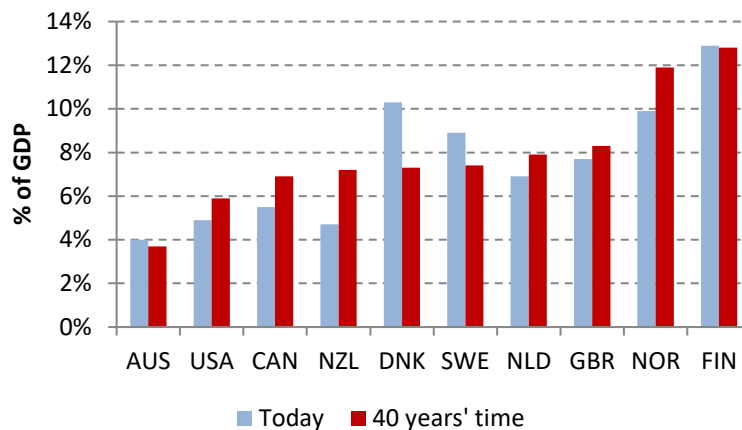


The previous graph considered the current level of Government expenditure. However, given the ageing populations around the world, it is reasonable to expect that these numbers may change over time. Figure 17 compares the current level of public spending on pensions (averaged over 2013-15) and the projected expenditure in 40 years' time expressed as a percentage of GDP.

¹⁶ OECD (2017), p144.

¹⁷ Based on OECD (2017), p143 and p145.

Figure 17: Current and projected expenditure on pensions¹⁸



The average expenditure for these ten countries rises over the four decades from 7.6 per cent to 7.9 per cent of GDP although there is considerable variation between the expected experiences. Australia's public expenditure on pensions is the lowest of the ten countries, both now and in the future.

Requirements for retirement incomes

Thus far, this paper has considered the big picture without looking at any regulations which drive the actual retirement income products in some countries. It is now time to compare the requirements for retirement incomes in each country. Table 3 sets out a summary of the current requirements for the eleven countries previously identified.

Table 3: A summary of the retirement benefit requirements

Country	Requirements or limitations in respect of the form of retirement benefit
Australia	nil
Canada	Pension plans must provide 100% income whereas for individual RRSPs there are no requirements
Denmark	Occupational pensions - above a minimum, most benefits are life annuities; ATP - deferred annuity
Finland	Income streams are required - fixed term (minimum of 10 years) or lifetime
Great Britain	nil
Netherlands	100% to be taken as income with profit sharing
Norway	100% to be taken as income until at least age 77
New Zealand	nil
Singapore	Life annuity up to a maximum level to provide a basic income
Sweden	100% - life time annuities or variable annuities
USA	nil

¹⁸ OECD (2017), p147.

In broad terms, there are four types of arrangements:

1. No requirements exist in Australia, Canada (for Registered Retirement Savings Plans), Great Britain, New Zealand and the USA, where the individual normally has full discretion as to the form of benefit although some DB schemes may require a lifetime pension.
2. A requirement that all the benefit must be taken as an income (as occurs in Canada for trustee pension plans, Finland, the Netherlands, Norway and Sweden) although there are some variations as to the minimum term that may be required.
3. A requirement that an annuity must be taken once the retirement benefit is above a prescribed minimum as occurs in Denmark.
4. A requirement that an annuity must be taken to provide a basic level of income as occurs in Singapore.

The absence of any requirement in Australia to take part or all of the funded retirement benefit as income or as part of a pooled longevity product limits the efficacy of the Australian superannuation system as was highlighted by the Financial System Inquiry. On the other hand, a requirement to take 100 per cent of the benefit as an annuity or pension reduces the flexibility required by many retirees.

A flexible system that provides regular income as well as some access to capital seems to provide a better outcome for most retirees who often require:

- A regular income for day-to-day living expenses,
- Access to some capital for those unexpected (or indeed expected) major expenses, and
- Some protection from major market downturns and/or longevity risks.

It appears that none of these countries have a system which requires that an income must be taken whilst at the same time providing some access to capital or liquidity during retirement.

Some general conclusions relevant for Australia

Before considering some ideas to improve the efficacy of the current Australian retirement system, here are the relevant findings from these international comparisons:

- The level of the full age pension is reasonable and not out of line with comparable countries, when expressed as a percentage of the average wage.
- The net replacement rate for an individual with a full career on average earnings is comparatively low and has been adversely affected by the 2017 changes to the assets test.
- In contrast to the previous result, the net replacement rate for an individual with earnings that are constantly below average is relatively high.
- The shape of net replacement rates across different income levels is somewhat perverse with an increasing replacement rate for higher income earners.
- The income-tested pension or supplement available in many countries is structured so that it provides no benefit to those with retirement incomes above 40 per cent of the average wage; hence it does not affect most average income workers. This is not the Australian experience.
- Australia is the only country with the complexity of both an assets test and an income test.

- The taxation treatment of superannuation is unusual and currently provides limited flexibility at retirement to create incentives or promote greater equity.
- Many countries are increasing their pension entitlement age with the increases in life expectancies. An automatic adjustment to this age linked to life expectancies is a more objective approach than a one-off political decision.
- The labour force participation rate at ages 55-64 has increased from 57.2% to 64.5% over 8 years but Australia still lags some countries, including New Zealand.
- The compulsory superannuation system has clearly increased coverage which has benefitted many workers. However as the work force changes with the 'gig' economy, a broader approach is now required.
- Although Australia has considerable assets available to pay future retirement benefits, there are some countries that are in a stronger position.
- The net real investment return achieved by the overall system has been credible, particularly when one recognises that investment returns are subject to tax.
- The Australian Government expenditure on pensions for the aged is relatively low and is not expected to increase, when expressed as a percentage of GDP, notwithstanding the ageing population.
- Unlike some European countries and Singapore, Australia has no requirements relating to the form in which retirement benefits are to be taken.

In summary, the Australian system has many positive features but the outcomes for the average income worker in respect of retirement incomes should be improved. This would not only improve adequacy but would provide a fairer system overall. The question is:

How can this be done in a simple and sustainable manner?

A possible way forward

The current and projected Australian Government expenditure on the age pension is the lowest of the ten OECD countries in Figure 17. This situation raises the potential to enable the pension expenditure to be increased slightly, when expressed as a percentage of GDP, without imposing a significant burden on the federal budget.

One way forward is to follow the Danish approach where part of the pension is paid to everyone as taxable income with the balance paid on an income-tested basis. For example, the current age pension could be divided into two components:

- A universal pension equal to 10 per cent of the average wage
- An income-tested pension equal to the balance, namely 17.6 per cent of the average wage

This approach has several advantages including:

- The universal pension would include provision of the health card, thereby removing the current incentive for many retirees to deliberately rearrange their affairs to receive a part pension and therefore the health card. Such an outcome would encourage all retirees to maximise their assets and income.

- The introduction of the universal pension would improve the retirement income for the average income earner but would have a reduced effect at higher incomes as it would represent a fixed payment in dollar terms.
- As the income-tested pension would represent less than 18 per cent of the average wage, the income test would cease to have any effect where other income exceeded about 40 per cent of the average wage. This would provide a much clearer incentive for those with the capacity to save to do so, whereas such behaviour is not always rewarded under the current system due to the assets test.
- As with all other countries in this comparison, a single income test would be applied, including deemed income on all assets. This would remove the need for a dual means test.
- Given the universal part pension, it may be feasible to gradually increase the taper rate on the income test from 50 per cent to say 75 per cent thereby making it closer to the arrangements in many other countries and reducing the overall cost.
- Full pensioners would not be affected.

Of course, there would be an extra expense to the Government budget. That is, there would be an increase in the number of part pensioners. However, this expense would be offset, at least to some extent, by additional income tax from those with higher taxable incomes and possibly, a reduced demand on Government services due to the extra income and the changed behaviour as additional saving would be clearly rewarded.

The universal pension could also be seen as an unnecessary gift to the wealthy. However this extra cost could be offset by some other adjustments in the taxation system affecting high income earners only thereby producing a more efficient retirement system without adversely affecting equity within the overall system.

In terms of superannuation, there would be no need to change the planned increase of the Superannuation Guarantee to 12 per cent, which is already factored into the OECD calculations. However the provision of a limited universal pension means that the designs of the forthcoming CIPRs and any related requirements could be developed in the knowledge that all retirees will be receiving an age pension of at least 10 per cent of the average wage. This should also lead to a stronger focus on incomes which, over time, could lead to a requirement that a certain portion of all superannuation benefits above a certain threshold must be taken as an income for retirement.

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