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for Post-Retirement

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The Productivity Commission

The Productivity Commission is the Australian Government's independent research and advisory body on a range of economic, social and environmental issues affecting the welfare of Australians. Its role, expressed most simply, is to help governments make better policies, in the long term interest of the Australian community.

The Commission's independence is underpinned by an Act of Parliament. Its processes and outputs are open to public scrutiny and are driven by concern for the wellbeing of the community as a whole.

Further information on the Productivity Commission can be obtained from the Commission's website (www.pc.gov.au).

Foreword

This research paper is consciously designed to complement the Commission's 2013 flagship research paper *An Ageing Australia: Preparing for the Future*. That paper dealt with demographic change and the pressures on the Commonwealth and the states and territories, with particular interest in incentives to remain in work for a longer-lived and healthier population.

As a number of commentators pointed out at the time, access to superannuation has potentially similar disincentives to continuing employment as Age Pension access arrangements. This paper reviews that general area. It offers a unique insight into how individuals are likely to respond to a change in the age at which they can access their superannuation, including the implications for Age Pension outlays and taxation revenues. The participation rate of older Australians — an important consideration in a coming era of lower participation generally — is also examined. The report also considers whether the way people draw down their superannuation (and in particular the use of lump sums) is problematic.

Read together, and with work now commencing into the housing decisions of older Australians, these reports should assist policy-makers to actively consider options to address national welfare improvement in an ageing Australia.

This paper was produced by a team led by Dominique Lowe, and included Anderson Cheung, Elina Gilbourd, Pragya Giri, Suzana Hardy, Philip Harslett, Alan Raine, Leo Soames and Vernon Topp. This paper was overseen by Commissioners Karen Chester and Angela MacRae.

Peter Harris

Chair

July 2015

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The Commission's report is in two volumes. This volume contains the overview and chapters. Volume 2 contains the supplementary papers, detail around the conduct of the project, and references. The modelling papers referred to in the report are available from the Commission's website (www.pc.gov.au).

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These modelling papers are available from the Commission's website (www.pc.gov.au)

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The Commission is grateful to everyone who has taken their time to discuss the issues canvassed in this research project. Particular thanks are extended to those who participated in the Commission's modelling workshop held in Canberra on 8 April 2015.

The Commission would also like to thank officers of the Australian Taxation Office, the Parliamentary Budget Office, the Department of Social Services, and the Department of the Treasury for their assistance.

Use of HILDA data

This paper uses unit record data from the Household, Income and Labour Dynamics in Australia (HILDA) Survey. The HILDA Project was initiated and is funded by the Australian Government Department of Social Services (DSS), and is managed by the Melbourne Institute of Applied Economic and Social Research (Melbourne Institute). The findings and views reported in this paper, however, are those of the author and should not be attributed to either DSS or the Melbourne Institute.

Abbreviations and explanations

Abbreviations

ABS	Australian Bureau of Statistics
APRA	Australian Prudential Regulatory Authority
ASFA	Association of Superannuation Funds of Australia
ASIC	Australian Securities & Investment Commission
ATO	Australian Taxation Office
CEPAR	ARC Centre of Excellence in Population Ageing Research
CIPR	Comprehensive Income Product for Retirement
CPI	Consumer Price Index
FSI	Financial System Inquiry
FUM	Funds under management
HILDA	Household, Income and Labour Dynamics in Australia Survey
IGR	Intergenerational Report
NATSEM	National Centre for Social and Economic Modelling
OECD	Organisation for Economic Co-operation and Development
PBO	Parliamentary Budget Office
PC	Productivity Commission
PCRM	Productivity Commission Retirement Model
SG	Superannuation Guarantee
SIH	ABS Survey of Income and Housing
SMSF	Self-managed Superannuation Fund
TTR	Transition to Retirement

Explanations

Billion The convention used for a billion is a thousand million (10⁹).

OVERVIEW

Key points

Australia's ageing population will increase demands on the retirement income system. With this in mind, this report seeks to improve understanding of two elements of the retirement income puzzle — when and how individuals access their superannuation.

The preservation age — the age at which people can access their superannuation savings — is considered by some to be an important policy lever in managing the transition to an older Australia. The Commission has found that, consistent with expectations, raising the preservation age encourages some people to work longer and accumulate more superannuation.

Modelling undertaken by the Commission in order to better understand the response of individuals to a gradual increase in the preservation age to 65 suggests that:

- there will be a modest increase in the participation rate of older workers (of around 2 percentage points in 2055) — mainly among those with higher wealth at or near retirement
- households that delay their retirement are likely to do so by around two years and will have superannuation balances around 10 per cent larger in real terms when they retire
- there will be an indicative annual fiscal improvement of around \$7 billion (in 2015 prices) in 2055 — mainly due to tax revenue increases from wealthier households
- changing the preservation age will have little, if any, impact on the workforce participation of individuals who retire involuntarily — almost one half of men and over one-third of women who retire between the ages of 60 and 64.

Once they have access to their superannuation savings, individuals are afforded much flexibility in drawing them down. Some consider that this discretion is desirable given the diverse circumstances of retirees. Others are concerned that it encourages individuals to exhaust their superannuation too quickly by taking lump sums and leads to more reliance on the Age Pension.

The evidence suggests that most retirees are prudent in their drawdown behaviour. Less than 30 per cent of superannuation benefits are taken as lump sums. When retirees do take lump sums, they are most frequently used to pay down debt, invest in income stream products, and purchase durable goods that are used throughout retirement.

Lump sum use is not uniform, and is most prevalent among those with low superannuation balances (less than \$10 000). These households tend to take between half and all of their superannuation assets as a lump sum. The evidence suggests that this behaviour has little impact on Age Pension reliance.

In undertaking its analysis, the Commission has identified a range of policy areas that warrant further and collective attention. These include:

- how involuntary retirement impacts policy outcomes
- the way in which incentives inherent in the retirement income system affect individuals' savings and retirement decisions
- how the retirement income system can better cater for the diverse circumstances and needs of retirees, particularly in the drawdown stage where 'one-size' never fits all.
- how to best manage longevity risk given the demographic transition underway.

The retirement income system has seen ongoing change to its components, albeit with less focus on the drawdown phase. But its overarching objectives remain poorly defined. Ideally, future changes to the system would be guided by a common set of objectives, informed by the principles of sustainability and efficacy, and considered as part of a holistic review involving considered and extensive community consultation.

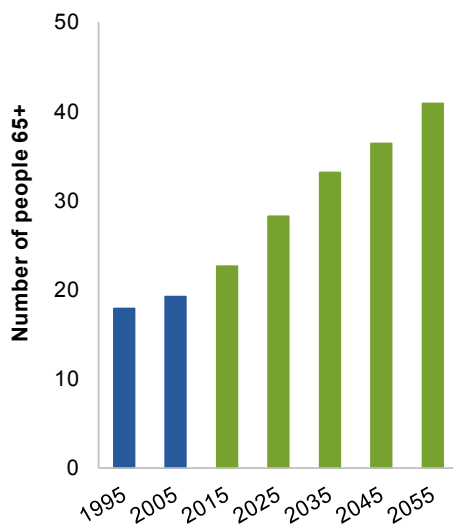
Overview

Ageing will increase demands on the retirement income system

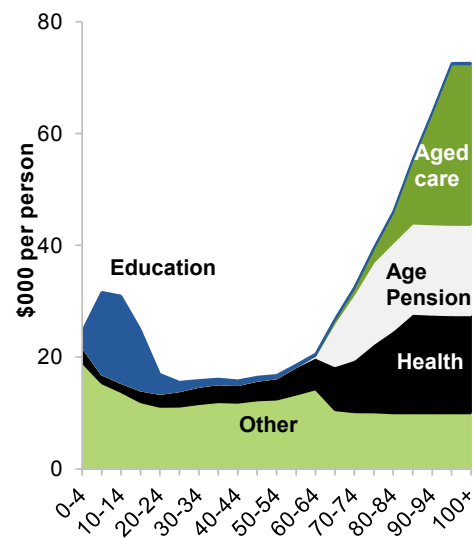
Australia’s population is changing — people are living longer and the share of the elderly is increasing. Coming decades will see this trend continue, with the proportion of the population aged 65 or over expected to increase from one in seven today to around one in four by 2055. By 2055, there will be less than three individuals of working age for each older Australian (figure 1(i)).

Figure 1 **Demographic change will impact government expenditure**

(i) Number of people aged over 65 per hundred people aged 15-64



(ii) Age-related government expenditure



The demographic transition underway will give rise to major social and economic change as more Australians make calls on the Age Pension and the health and aged care systems (figure 1(ii)). The fiscal implications of an ageing population have been explored extensively by the Commission and others. What has not been examined in detail is how well the retirement income system is placed to deal with these changes, and how its reform might ease these pressures while delivering sustainable retirement incomes for older Australians.

The Commission has sought to advance understanding of these issues by addressing two questions.

- What might happen if the age that individuals can access their superannuation (the ‘preservation age’) were raised?
- Is the way people draw down their superannuation, and in particular, the use of lump sums, problematic?

Notwithstanding this focused approach, the Commission has considered the broader retirement income landscape and the interplay between its parts.

How well placed is the retirement income system?

Australia’s retirement income system comprises ‘three pillars’ — the Age Pension, compulsory saving through the Superannuation Guarantee and voluntary savings.

The Age Pension had its genesis at the turn of the last century and its provisions reflect those origins. At that time, a man aged 65 years could expect to live around 14 more years, whereas a man born today who reaches the age of 65, can expect to more than double this time in retirement. A number of policy changes over recent years have sought to better align the Age Pension with Australia’s demographic future. The Age Pension age for women has been gradually increased from 60 to 65 years. And the eligibility age for both men and women is scheduled to increase to 67 years between 2017 and 2023.¹

Relative to the Age Pension, Australia’s compulsory superannuation contribution scheme is a policy newcomer. It was designed to increase individual lifetime savings and act as a supplement to improve post-retirement living standards above what can be afforded by the Age Pension. Since 1992, employers have been required to contribute a share of their employees’ ordinary time earnings into superannuation. That share is currently 9.5 per cent and is scheduled to increase to 12 per cent by 2026. The majority of people retiring today have only made compulsory superannuation contributions for part of their working lives, and only then at comparatively low rates.

People have always been able to save privately for their own retirement and governments have long encouraged this behaviour, including by providing incentives such as superannuation co-contributions and tax concessions. While much focus is placed on voluntary superannuation savings, people also save for their retirement outside of the superannuation system, including through real estate, shares and bonds.

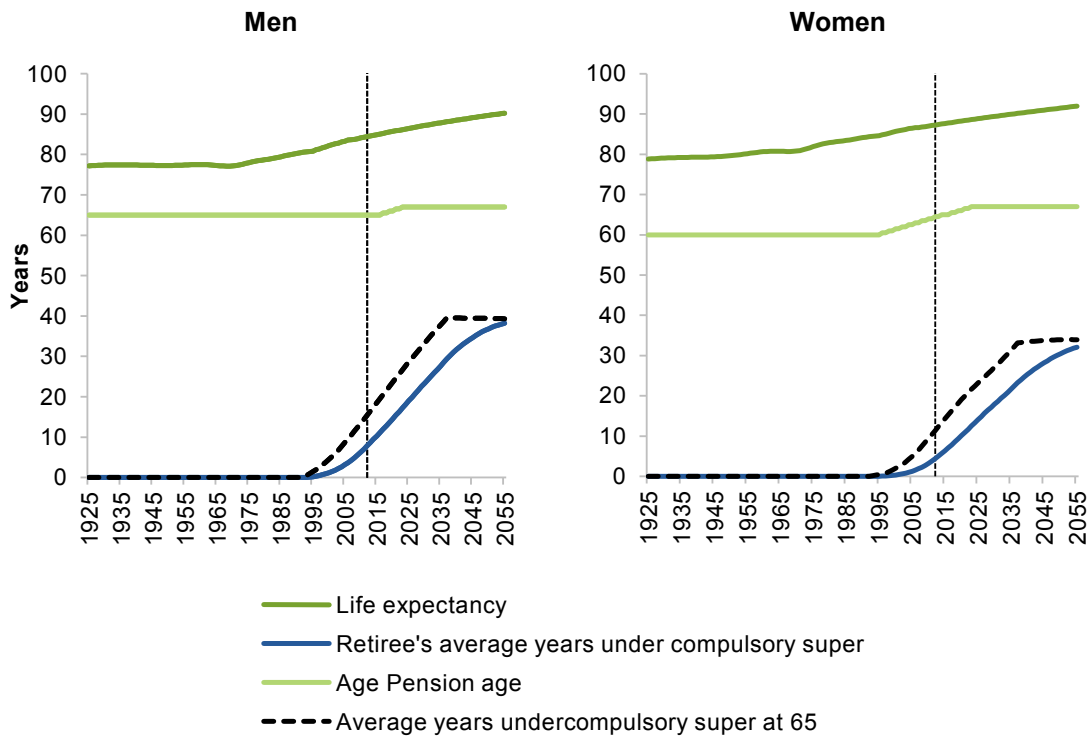
The three pillars have been subject to ongoing and piecemeal changes, many of which have focused on the accumulation of retirement savings. The disparate and slow-moving pace of

¹ The 2014-15 Budget announced a further increase in the Age Pension age to 70 years, which remains subject to legislative passage.

these changes, combined with long lead times, has meant that policy settings have tended to lag improvements in life expectancy (figure 2).

Figure 2 Ageing quickly, changing slowly — the relevant policy settings

Life expectancies, the Age Pension age, and average time spent under compulsory superannuation^a



^a Period life expectancies (the life expectancy at 65) are presented. Projections from 2012 onwards.

Retirees will continue to rely heavily on the Age Pension

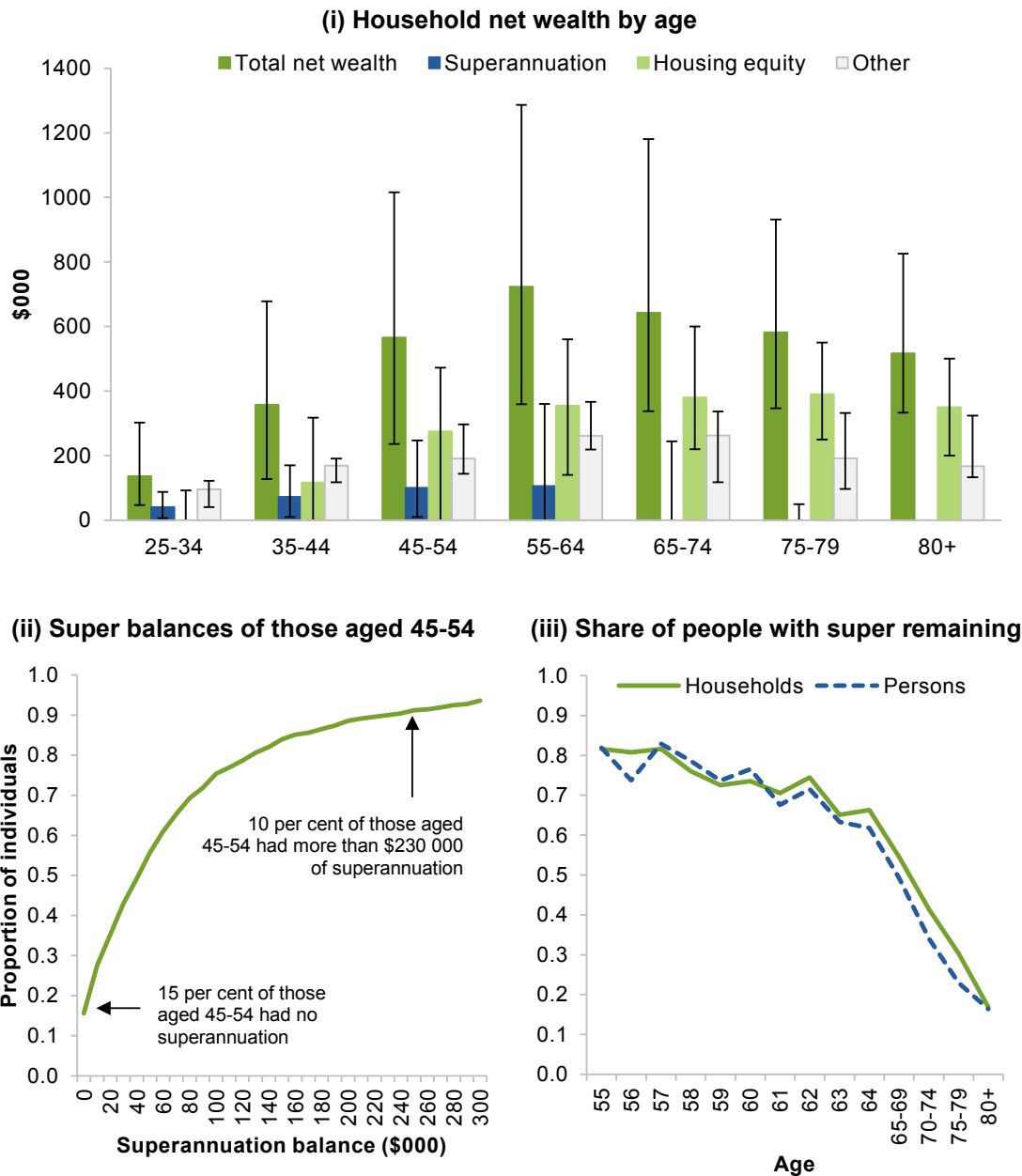
With the compulsory superannuation system decades away from maturity, superannuation savings are still relatively modest, both in terms of how long individuals might spend in retirement and relative to their other wealth holdings.

Median superannuation balances for those aged 55-64 years in 2011-12 were just over \$100 000, making up less than 15 per cent of their total net wealth. In comparison, the family home accounted for around half of household wealth, though it is not typically used to fund retirement (figure 3(i)).

Other private savings comprise the residual of net wealth, including the equity in rental properties and unincorporated businesses; the value of shares, bonds and debentures; and

amounts held in financial accounts. These other savings generally comprise a minority share of total net wealth.

Figure 3 Superannuation and net wealth in context^a
2011-12



^a Total net wealth comprises superannuation, equity in the family home, and other gross assets less debt. Median values are presented, whiskers denote the interquartile range (the values of the first quartile and third quartile for each series).

Headline figures mask the significant diversity in superannuation balances across individuals. For example, of those aged 45-54 in 2011-12, 15 per cent had no superannuation, while 10 per cent had more than \$230 000 (figure 3(ii)). Those with self-managed superannuation funds (SMSFs) (around one million Australians) are more likely to have higher than average balances and hold around 30 per cent of superannuation assets. Variations in balances across the broader population reflect a range of factors, including the linkage of compulsory contributions to an individual's earnings; absences from the workforce; and disparities in voluntary superannuation contributions.

The relatively modest superannuation savings of the current cohort of retirees do not last long in retirement (figure 3(iii)). Around 20 per cent of those who reached the preservation age in 2011-12 had no superannuation, and by the age of 64 — just prior to the current Age Pension age — this increased to around 40 per cent. The share of retirees who have exhausted their superannuation climbs steadily thereafter, with only 17 per cent of individuals aged 80 years or more having any superannuation savings remaining.

Reflecting this often early exhaustion of superannuation savings, for most Australians, the Age Pension remains an integral part of their retirement income. Around 70 per cent receive a pension at some point after the age of 65 (that share is closer to 80 per cent if Service Pensions are taken into account). Many access pension support quite early — in 2013-14, 60 per cent of new recipients started to receive benefits within a year of reaching eligibility age. And even though around 40 per cent of Age Pension recipients only receive a part pension, for most of those, that pension is their primary source of income.

In coming decades as the superannuation system matures, Australians will almost certainly have greater savings, on average, to support themselves in retirement. They will have made compulsory superannuation contributions for most or all of their working lives. Contrast this with 65 year olds retiring today, who will have made compulsory contributions for only around half of their working lives and for much of that time at a lower contribution rate than now applies.

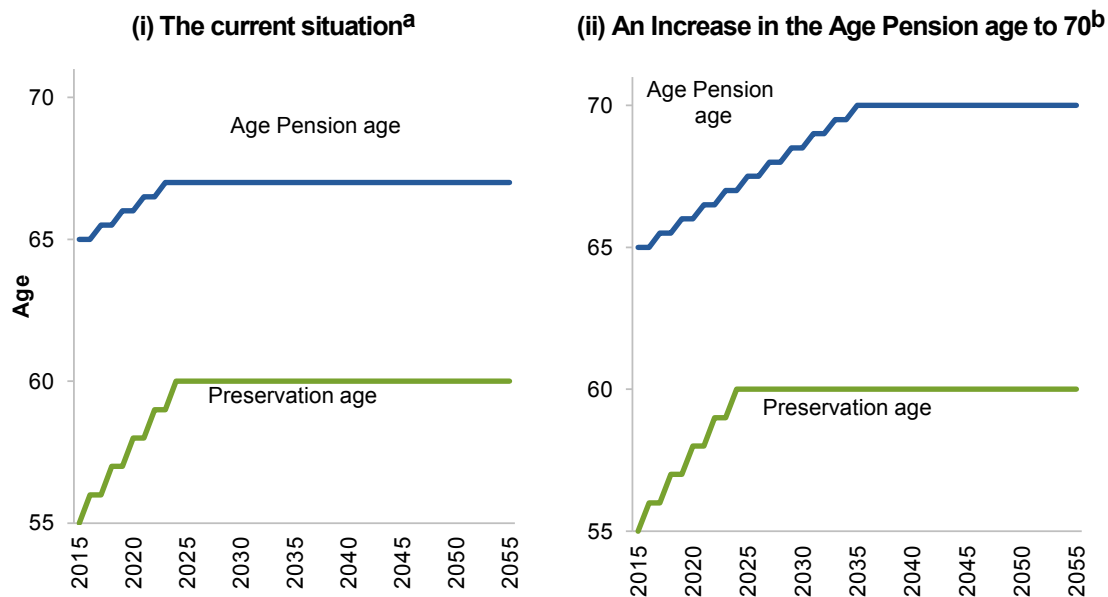
For many, the growth in private retirement savings will delay the time at which they access the Age Pension and/or be used to supplement Age Pension payments. It is generally accepted that a greater proportion of Age Pension recipients will rely on a part (as opposed to full) pension, although the most recent *Intergenerational Report* did not indicate the magnitude of this shift. The report did, however, suggest that the proportion of Australians above retirement age receiving any pension will only decline by three percentage points — from 70 per cent in 2012-13 to around 67 per cent in 2055. Put simply, even under a 'mature' superannuation system, a fully self-funded retirement is likely to remain the province of those who were relatively well off during their working years.

What might happen if the preservation age were raised?

Along with the Age Pension age, the preservation age is considered by some to be an important policy lever in managing the transition to an older Australia. The preservation age provides both a financial incentive and a signal to retire.

The preservation age is legislated to gradually increase from 55 to 60 years in 2025 (figure 4(i)). However, with policy measures in place to raise the Age Pension age to 67 years, and a stated policy goal to increase it further to 70 (figure 4(ii)), debate has once again been prompted about where the preservation age should be set. All else being equal, the larger the gap between the preservation age and the Age Pension age, the greater the opportunities that individuals have to run down their superannuation before reaching Age Pension age.

Figure 4 **Minding the gap — the period between the preservation age and the Age Pension age**



^a The gap between the Age Pension age and the preservation age falls from 10 years to 7 years by 2024, and then remains constant. ^b An increase in the Age Pension to age 70 as announced in the 2014-15 Budget, but not currently legislated, would see the preservation age gap widen.

The Commission, in its report, *An Ageing Australia: Preparing for the Future* pointed to the importance of revisiting the preservation age, noting that:

In principle, the preservation age should consider life expectancy and the Age Pension eligibility age as relevant factors. A preservation age linked to life expectancy would provide a financial incentive to stay in work for longer, and as noted earlier for the Age Pension, provide a shift in expectations about the age to retire ... In theory, changes to such age thresholds

would be likely to increase superannuation account balances, reduce age pension outlays and stimulate labour supply. (PC 2013, p. 201)

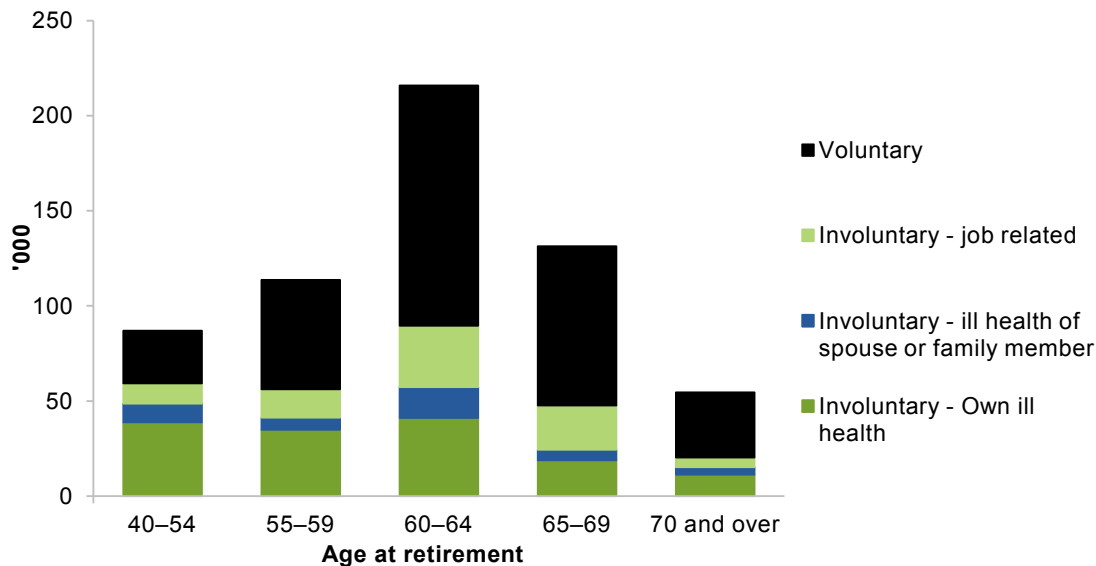
There are a diverse range of stakeholders that support raising the preservation age further. The Henry Tax Review recommended that it be gradually increased until it aligned with the Age Pension age. An increase in the preservation age (albeit to different levels) has also been supported by the Actuaries Institute, the Australian Council of Social Service, the Grattan Institute, the Centre of Excellence in Population Ageing Research and a number of academics.

On their face, the arguments in support of raising the preservation age are relatively straightforward. The expectation is that individuals will delay their retirement if they are unable to access their superannuation. The longer individuals remain in the workforce, the larger their superannuation balances will be when they do retire, reducing calls on the Age Pension.

But in practice, there are a number of reasons why these expectations may not be fully realised. More years of work also mean fewer years of retirement. Those with a strong preference for leisure are unlikely to delay their retirement if they have the financial means to retire when they choose.

Some individuals who retire do not do so of their own choosing, but do so because of caring responsibilities or poor health (figure 5). Data suggest that around 28 per cent of men and 25 per cent of women aged 60-64 who retire do so for these reasons. Others have their employment terminated, and/or have difficulty finding new work (this represents a further 20 per cent of men and 11 per cent of women). Raising the preservation age is unlikely to fundamentally alter the retirement behaviour of these individuals.

Figure 5 Number of people retiring, by age group and reason for retirement, 2011



Further, the preservation age is only one of a range of factors that influence the timing of individuals' retirement. Other factors, such as an increase in the Age Pension age will also encourage people to retire later. The impacts of changing the preservation age, when considered against this backdrop, are likely to be more subdued.

The Commission's approach

Assessing how a change in the preservation age works in concert with other factors that influence retirement decisions is a complicated task. In order to better understand how retirement behaviour might be affected by an increase in the preservation age, the Commission developed a behavioural model, which provides a stylised representation of the retirement decision making process.

Like other retirement models, the Commission's model is not designed to make precise predictions about behavioural changes. Indeed it is not feasible to do so, given the difficulty in modelling household behaviour over a lifetime and the long time horizon considered. Rather, the Commission's modelling is intended to be indicative and highlight the avenues through which behavioural change occurs. The Commission has also undertaken analyses to test the sensitivity of its modelling results to changes in the underlying assumptions. Varying some assumptions — such as around investment returns and discount rates — has a material impact on the modelling results.

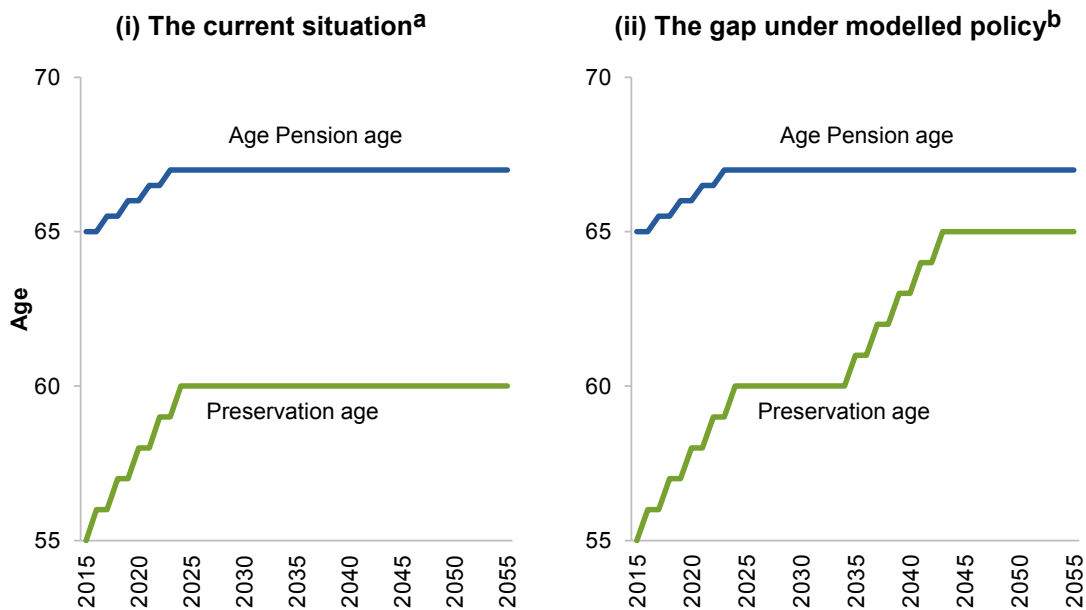
While there have been calls to increase the preservation age there is no common view on the extent to which it should be increased and the appropriate phasing period. Some have

called for the gap between the preservation and Age Pension ages to be narrowed, while others have proposed closing it entirely. There have also been calls to link both the preservation age and Age Pension age to life expectancy.

In order to illustrate the possible effect of raising the preservation age, the Commission has assessed the impacts of a gradual increase in the preservation age to 65 years (figure 6(ii)). Such an option represents a middle ground and is consistent with past approaches, which have provided affected individuals with sufficient lead times to adjust their behaviour given the lag between savings decisions during working years and eventual retirement incomes.

The impacts associated with alternative transition pathways and sensitivity analyses are detailed in the body of this report.

Figure 6 Narrowing the gap — modelling a closer preservation age and Age Pension age



^a The gap between the Age Pension age and the preservation age falls from 10 years to 7 years by 2024, and then remains constant. ^b The policy modelled is the same as the current situation, until 2035, when the gap begins to narrow with an increasing preservation age — falling to a 2 year gap by 2043.

Raising the preservation age encourages some people to work longer and save more

Consistent with expectations, raising the preservation age encourages some individuals to retire later and accrue more superannuation savings. However, the Commission’s modelling results suggest that these impacts are likely to be concentrated among a small

share of the population. Increasing the preservation age to 65 is likely to increase the participation rate of older workers (those aged 50-64 years) by around 2 percentage points in 2055. Households that delay their retirement do so by around two years and are likely to have superannuation balances that are around 10 per cent larger on average in real terms when they retire.

The impacts of an increase in the preservation age vary across cohorts. Under the policy scenario explored by the Commission, the first cohort to be affected by a change in the preservation age are those who were 30-34 years old in 2012. Around 14 per cent of this group respond by delaying their retirement.

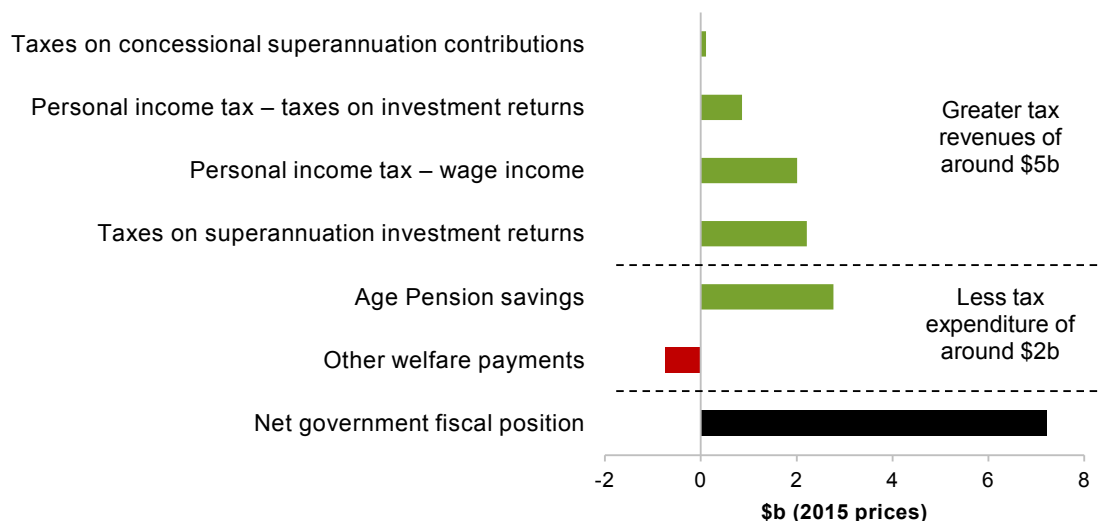
Modelling results suggest that the impacts on successive cohorts are slightly more pronounced. For example, of the cohort of individuals who were 20-24 years old in 2012, around 17 per cent delay their retirement. This is because they are likely to have accrued more superannuation savings than previous cohorts (both due to real wage growth and having made contributions for longer and at a higher rate) such that a change in the preservation age is more likely to influence their behaviour.

Flow on fiscal effects mainly increase tax receipts but also reduce Age Pension outlays

Calls for an increase in the preservation age are mainly motivated by concerns about the impacts of an ageing population on Age Pension outlays and on the government's fiscal position more broadly.

The Commission's modelling results suggest that raising the preservation age to 65 would likely result in an annual fiscal improvement of around \$7 billion in 2055. Age Pension outlays would fall by around \$3 billion in 2055 (figure 7). However, some people would retire involuntarily and (in the absence of changes to early access rules) might not be able to call on their superannuation savings to support them until they reach 65 years. The Commission has sought to explicitly account for the impacts on this group and where individuals meet the relevant means tests, has assumed that they receive some form of income support payment until they reach Age Pension age. In 2055, Age Pension savings would be offset, in part, by expenditure of around \$750 million on these other welfare payments.

Figure 7 **Fiscal effects in 2055 of increasing the preservation age^a**



^a In the main, the base case that underpins these modelling results incorporates legislated changes in retirement income policy, but does not include changes that have been proposed and are subject to the passage of legislation. The increase in the Age Pension age to 67 is incorporated in the base case, whereas a further increase in the Age Pension age to 70 and recently passed (22 June 2015) changes to the Age Pension assets test have not been incorporated.

The majority of the fiscal improvement — around \$5 billion in 2055 — arises due to an increase in tax receipts. Households that delay their retirement pay personal income tax on the additional wage income that they earn and on the earnings of the additional superannuation contributions that they make. In deferring their retirement, households also postpone drawing down on their assets (both superannuation and other assets), and so returns on these assets would also be taxed for additional years.

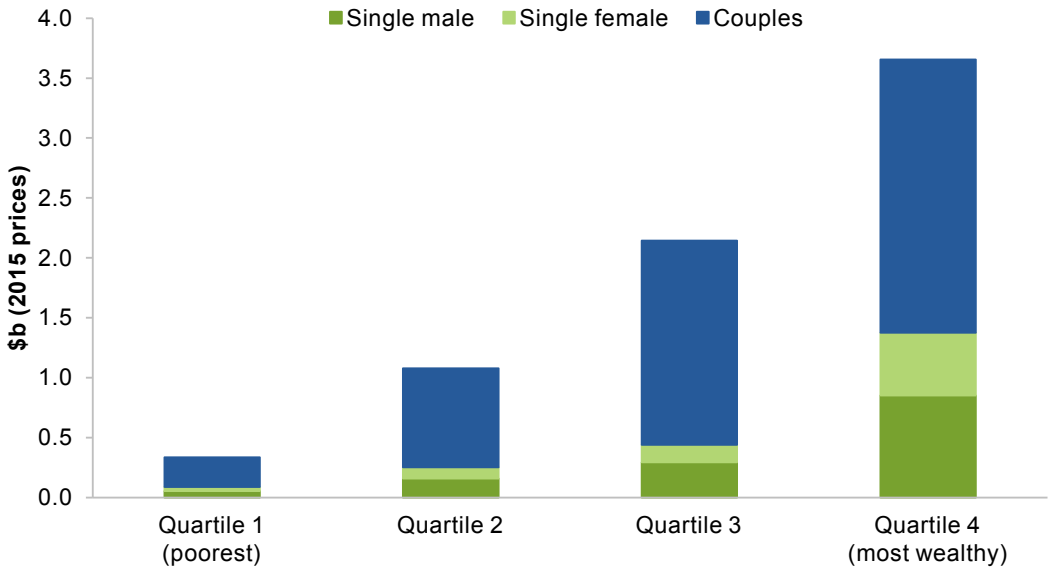
Impacts vary by household type

One factor that has contributed to broad-based support for an increase in the preservation age is the belief that it will encourage wealthier individuals to remain in the workforce for longer.

The Commission’s modelling results largely support this view. Wealthier individuals are, on average, more likely to delay their retirement. They also have higher superannuation savings (and so pay more tax on superannuation earnings) and receive fewer welfare payments in later years. These factors combined mean that the bulk of the fiscal gains associated with an increase in the preservation age can be attributed to wealthier households (figure 8).

In contrast, poorer individuals tend not to delay their retirement in response to a change in the preservation age — their limited superannuation savings mean that the Age Pension age is far more important in determining when they might retire. Even so, poorer individuals will still be affected by an increase in the preservation age. They have a greater likelihood of becoming involuntarily retired and so may need to wait up to an additional five years before they can access their superannuation savings. The modest fiscal savings attributed to lower wealth households arise, in part, because their superannuation earnings are taxed during this time. Some stakeholders have proposed that any increase in the preservation age be accompanied by a relaxation of early access arrangements for the involuntarily retired. Doing so would have two (opposing) fiscal effects — reducing calls on government payments and reducing tax revenues on superannuation earnings relative to the counterfactual.

Figure 8 Most of the fiscal gains associated with an increase in the preservation age come from wealthier households^a
 Fiscal impact in 2055 by household type



^a Note that in assessing the fiscal impacts by wealth, the ‘cut-offs’ for each quartile are determined separately for single male, single female and couple households and vary across age groups and time. The impacts on those with SMSFs is not modelled explicitly, rather population-wide data on superannuation savings were used to inform the model.

The implications for preservation age policy are not clear cut

Raising the preservation age is likely to increase the superannuation savings of some, and improve the capacity of the government to manage the transition to an older Australia. While the analysis contained in this report gives a sense of the impact of changes to the

preservation age on retirement decisions, superannuation balances and fiscal outlays, it cannot, on its own, determine if a change in the preservation age is warranted.

As noted in the Commission's report, *An Ageing Australia: Preparing for the Future*, the government has a number of means at its disposal to manage the fiscal pressures associated with an ageing population. Ideally, policy makers would weigh up the merits of these options before deciding on any given response.

More fundamentally, any assessment of the desirability of raising the preservation age should take into account the objectives of the superannuation system and the broader retirement income system of which it is a part. Such an exercise is hampered by the absence of clear and prioritised objectives. It is difficult to assess and design effective policy when there is no consensus on what the policy objectives should be.

While this report has assessed the likely magnitude of the impacts from raising the preservation age, the Commission has not turned its attention to implementation issues. The capacity of individuals who become involuntarily retired to access their superannuation savings prior to reaching the preservation age is one obvious issue that would need to be considered. Currently, early access provisions only apply in a very limited set of circumstances, and in most cases, only provide for the release of comparatively small amounts. Consideration needs to be given to some form of safety net, which would need to be in place to protect the wellbeing of these individuals, who may spend a significant amount of time out of the workforce.

Is the way people draw down their superannuation a concern?

The way that individuals can draw down their superannuation is subject to few limits once they reach the preservation age. Individuals can take their superannuation as a lump sum, an income stream or a combination of the two.

The degree of discretion that people have in drawing down their superannuation assets has advantages and limitations. Having the opportunity to take a lump sum can assist retirees in making significant purchases or meeting unexpected costs. A flexible system may also be appropriate given the diversity of needs and circumstances people face in retirement.

However, this flexibility may add to the risk that people will outlive their savings, and potentially allow some to structure their affairs to maximise access to welfare and taxation benefits. The consequences of this flexibility have been the subject of much recent debate, with some stakeholders arguing that access to lump sums should be restricted.

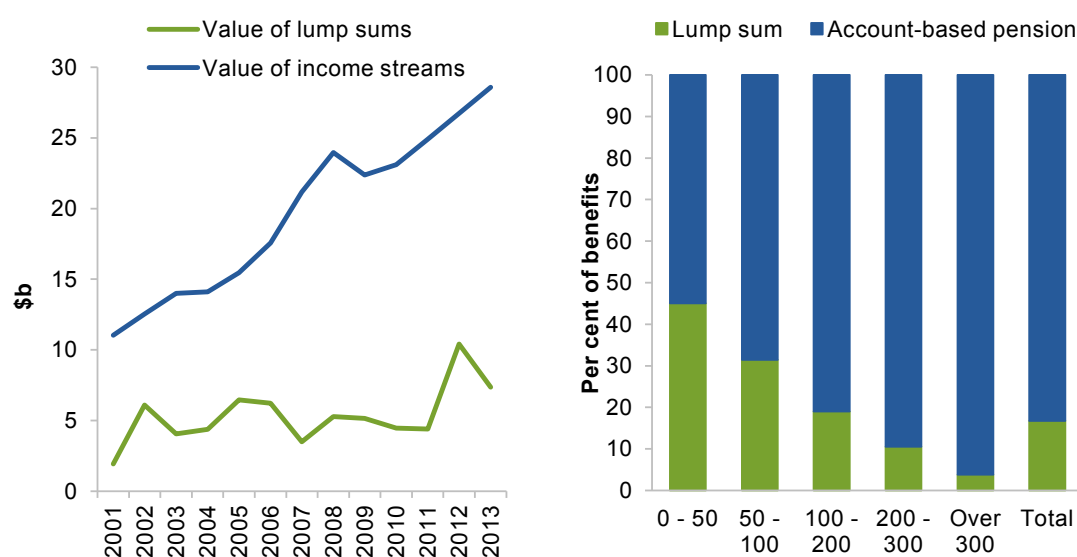
There is little evidence that lump sum behaviour is problematic for individuals ...

While concerns are focused on the prevalence and use of lump sums, the large bulk of superannuation assets are taken as income stream rollovers at the time of retirement (figure 9(i)). Analysing longer term trends in drawdown behaviour is frustrated by a lack of consistent data. Even so, most measures suggest that both the absolute value and proportion of superannuation benefits taken as an income stream is increasing over time (figure 9(ii)).

Further, many of those who use income stream rollovers withdraw the minimum amount required by legislation — drawing down on their superannuation savings as conservatively as the rules allow.

Figure 9 Superannuation benefit withdrawals

(i) Total superannuation benefits over time (ii) Benefits by size of super balance (\$000)



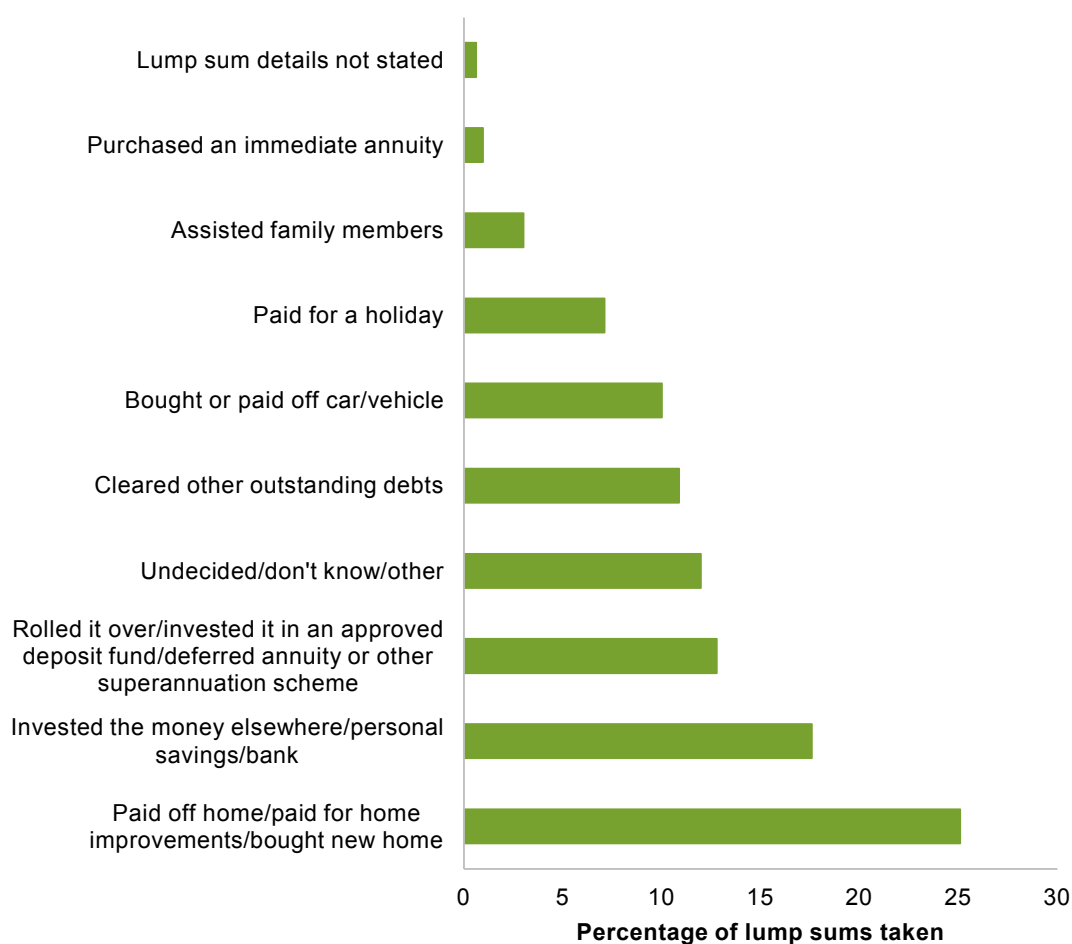
In contrast, only around 16 per cent of benefits are taken as lump sums (figure 9(ii)). The bulk of individuals who take lump sums are aged between 55 and 70 years — the median value they take is around \$20 000. Lump sums are more likely to be taken by people with relatively small superannuation balances — more than 90 per cent of people with up to \$10 000 in superannuation assets take their benefits as a lump sum at retirement compared to around 30 per cent of people with assets between \$100 000 and \$200 000. When individuals with low balances take a lump sum, they typically exhaust all of their superannuation savings. As the *Financial System Inquiry* noted in its interim report:

For people with small superannuation balances, taking the entirety of their benefits as a lump sum may be an optimal strategy because the income stream generated from a small balance is

negligible and has relatively high costs and no tax advantages. (Australian Government 2014c, p. 4-12)

Where lump sums are being taken, there is little evidence to suggest that they are being squandered. Individuals can set themselves up for retirement in many ways. In addition to retiring debt (particularly housing debt) many individuals use their lump sums to modify their primary residence and/or invest in consumer durables to see them through their retirement years (figure 10). For those who have had an interrupted work history or were relatively low-income earners, their lump sums (while relatively meagre) provide an opportunity to self-finance ‘lumpy’ consumption.

Figure 10 **Main uses of superannuation lump sums^{a,b}**
2012-13



^a Main uses have not changed significantly since 2004-05. ^b The category of ‘Other’ was added to ‘Undecided/don’t know’ because it appears in past releases of the *Retirement and Retirement Intentions* survey. ‘Other’ typically accounts for around 10 per cent of lump sums taken.

... or for the community as a whole

Taking lump sums may be in an individual's interest, but doing so can also potentially have impacts on the broader community. To the extent that lump sums affect the receipt of the Age Pension, their use is of policy relevance to the community and potentially of concern for government.

Concerns that lump sums allow individuals to restructure their wealth holdings to maximise access to the Age Pension are understandable, indeed financial advisors offer guidance on how best to do so. But not all individuals have scope to structure their affairs in order to increase their access to the Age Pension — those with very little savings are likely to receive the Age Pension anyway, while those with considerable asset holdings at retirement would be ineligible. Concerns are most relevant for those retirees with superannuation savings (and other assets) close to the Age Pension means test thresholds.

The question of whether lump sums encourage Age Pension take up (either by design or default) has already been examined extensively by a number of researchers. The Association of Superannuation Funds of Australia examined the use of lump sums to determine how it might affect future Age Pension usage. They concluded:

A number of commentators have asserted that there is a 'lump sum' mentality in Australia and that many (or at least a significant number) of retirees take a lump sum superannuation benefit, spend it on consumption goods or a holiday, and then fall back on the Age Pension. Individuals taking lump sums generally take an amount that is not material to the amount of Age Pension they will receive. (2014a, p. 24)

Other researchers have also examined whether individuals alter their draw down well in advance of the Age Pension age in order to gain access to the payment. They too found little evidence that individuals were acting strategically, concluding that other factors, such as experiencing the onset of disability were more important in explaining early draw down and exhaustion of superannuation savings.

Moreover, rather than finding evidence of widespread restructuring, researchers found evidence that individuals continue to accumulate assets as they approach retirement. These results are broadly consistent with the Commission's own analysis of wealth accumulation patterns.

The current body of research suggests that the practice of restructuring assets in order to gain access to the Age Pension is not widespread. To the extent that it occurs, such behaviour reflects incentives embodied in the means tests for the Age Pension itself, rather than the flexibility of draw down afforded by superannuation arrangements. These incentives are not specific to superannuation, rather, they apply equally to shares and other financial assets. To the extent that strategic exhaustion of assets is a problem, its solution does not lie solely in restricting draw downs from superannuation.

Lump sums will become proportionally smaller over time

Drawdown behaviour will likely be affected by the maturing of the superannuation system. On average, superannuation balances are expected to grow and, in turn, income streams will become even more prevalent.

Even so, lump sums will still play a role in improving the welfare of retirees. For most people, lump sums will represent a small share of their superannuation under a mature system and, as is currently the case, are likely to be used to retire debt and otherwise prepare for retirement. Lump sums are likely to remain particularly important for those with relatively small balances at retirement. Even in a mature system, there will be people who have had an interrupted work history, worked part-time, or have experienced ill-health.

The super to-do list

While there has been substantial public debate about retirement income policy, in-depth analysis, especially around the drawdown phase, has been more limited. This report has advanced understanding of two important elements — the likely impacts of increasing the preservation age and the implications of flexible superannuation drawdown rules. Notwithstanding this focused approach, the Commission has had regard to the broader retirement income landscape and, in doing so, has identified a number of features of retirement income policy that warrant more detailed and collective analysis.

Retirement decisions are not always voluntary

Often, policy proposals that affect income in retirement are based on assumptions that people leave the workforce at a time of their choosing. In practice, the degree of involuntary retirement — for job, family and health-related reasons — is substantial and could be expected to increase as the Age Pension and preservation ages are raised over time. The Commission has sought to explicitly account for this by incorporating involuntary retirement into its assessment of the impacts of increasing the preservation age. Such an approach reveals that involuntary retirement limits potential policy impacts.

Involuntary retirement needs to be better understood and taken into consideration when contemplating changes to retirement income policy. Policies designed to lessen the impacts of involuntary retirement — including income support, assistance finding new work, and early access to superannuation benefits — also need to be assessed to determine whether they are well targeted and working effectively.

Incentives need to be fine-tuned

As noted earlier, governments have long encouraged individuals to save for their retirement, including by providing incentives such as co-contributions and tax concessions. It is unclear whether the current concessional tax rates applied to superannuation are designed and targeted as effectively as they could be, and whether they provide an incentive to make additional savings for retirement, or merely distort the way that people store their wealth.

Likewise, the tax concessions embodied in transition to retirement pensions — designed to ease workers to part-time work prior to retirement — appear to be used almost exclusively by people working full-time and as a means to reduce tax liabilities among wealthier Australians. A better understanding of how these incentives are being used and by whom could potentially improve the efficacy and sustainability of the retirement income system.

The family home accounts for around one half of household wealth. It was made exempt from the assets test for the Age Pension in 1912 and remains so today. Its role in supporting living standards in retirement is a complex one. The family home makes an important contribution to quality of life — with home ownership substantially reducing the need for income in retirement and providing security of tenure — but represents a largely untapped store of wealth. Increasingly, the family home is seen by retirees as a way to manage unexpected costs, such as those associated with aged care. The treatment of the family home in the Age Pension assets test has important ramifications for individuals' savings decisions and so for the retirement income and aged care systems more broadly.

The superannuation system needs to better account for diversity

The circumstances of retirees are diverse. The way in which they hold their savings, the amount of retirement savings they have, and their expectations for retirement all differ. But often, in formulating superannuation policy, too much focus is placed on the 'average' retiree. This can lead to inequitable and unintended outcomes because one 'policy size' does not fit all.

Given this diversity, existing rules which require individuals to draw down specified amounts and recent suggestions that retirees should be encouraged to take their superannuation in particular forms warrant closer examination. Designing appropriate minimum draw downs and 'defaults' necessitates a thorough understanding of people's superannuation balances, other assets, debts, as well as their personal needs in retirement, which may be affected by their health, marital status and expected lifespan. Absent careful design, such prescriptive approaches, even in the form of relatively flexible soft defaults, might be ineffective or make some retirees worse off. Given the varied circumstances of retirees and their preference for flexibility, consideration of prescriptive options, including soft defaults, needs to be based on strong evidence that retirees are unable to make sound financial decisions.

‘One-size’ policies necessarily do not take account of the individual circumstances of groups within the community. For example, some Aboriginal and Torres Strait Islander Australians have difficulty understanding and interacting with the complexities of the superannuation system, and may benefit less from broad policy settings aimed at preparing for an ageing Australia. More needs to be done to understand how the impacts of retirement income policies vary for different groups.

Just as stocks of wealth vary between individuals, so do levels of financial literacy. While survey evidence suggests that most Australians have a reasonable standard of financial literacy for simpler matters, it also indicates that they find it hard to understand the complexities of the retirement income system. This lack of financial literacy manifests itself in many ways, including leaving decisions about retirement savings until it is too late; failing to recognise the risks associated with involuntary retirement; and underestimating the amount of private savings needed in retirement. These outcomes in and of themselves are concerning, but are even more so in the face of an ageing population.

There has been a proliferation of measures aimed at improving financial literacy. But there has been little evaluation of whether such approaches work in isolation or in concert, and a lack of financial literacy continues to hinder how effectively retirees build and make use of their retirement savings.

Managing longevity risk will become more important

Life expectancies have increased steadily in the last 20 years. But perceptions of life expectancy have not kept pace. Surveys reveal that individuals tend to be pessimistic about their life expectancy — on average, females underestimate their life expectancy by around five years, and males by around three years.

As life expectancies continue to improve, longevity risk — the risk that retirees outlive their savings — will become increasingly relevant. Understanding who is best placed to bear this risk will be a key policy question.

Addressing the concern around longevity risk would also need to consider the role of the Age Pension. This includes determining whether the Age Pension should serve as a safety net, or a supplement to other retirement income, and whether the incentives created by the means tests are consistent with policy objectives relating to managing longevity risk.

Investments need to be made in building the evidence base

Answering these policy questions will be challenging within the confines of existing data on the superannuation system and the circumstances of retirees. At present, different sources use inconsistent definitions, differing scopes and irregular collection periods. With the value of superannuation expected to increase to trillions of dollars by 2050, it is time to invest in a robust and enduring evidence base to better inform policy. The decisions that

affect the living standards of retirees need to be based on strong evidence rather than weak anecdotes.

Reforms are best considered within the context of a holistic review

In practice, the retirement income system is a puzzle that policymakers have often sought to solve in a piecemeal fashion — tackling different policy pieces at different times. But the three pillars that make up the system are inextricably linked — changes in each can, and often do, affect the others. Indeed, some of the concerns raised by stakeholders about the retirement income system have arisen due to failures to account for the way that incentives inherent in each pillar combine — and conflict — with one another:

In practice, the ‘3 Pillars’ have each developed independently. Rather than being the basis for a consistent and integrated retirement incomes policy, they make for an incoherent and dysfunctional whole. (Dunsford and Wickham 2009, p. 13)

While it is possible to consider each piece of the system separately, there is merit in a holistic review that examines reform of retirement income policies collectively. Not only would such a review be able to address some of the policy questions from the ‘to-do’ list above in the detail they deserve, it could also serve to explore other broader issues, such as the adequacy of retirement incomes and the sustainability of the system under demographic change. Ultimately, such a review could determine what the future role of the retirement income system should be — a question that is best informed by considered and extensive community consultation.

1 Setting the scene

Key points

Australia's retirement income system comprises three pillars: the Age Pension, compulsory superannuation saving and voluntary saving (through superannuation or otherwise). Despite the important interplays between the three pillars, reviews and reforms have occurred at different times and moved at different paces.

As Australia's population ages, the proportion of people retired relative to those of working age will increase, and greater demands will be placed on the retirement income system. Accordingly, any shortcomings in the superannuation system will take on greater prominence.

While the superannuation system has seen many changes, limited analysis and policy attention has been devoted to the post-retirement (or 'drawdown') phase.

The overarching policy architecture and the incentives inherent in the retirement income system have not been reviewed to assess how well the system is placed to deal with demographic change, and how its reform might ease demographic pressures while delivering sustainable retirement incomes for older Australians.

This report seeks to begin addressing these gaps through detailed analysis of two aspects of superannuation policy affecting the drawdown phase:

- What might happen if the age that individuals can access their superannuation (the 'preservation age') were raised?
- Is the way people draw down their superannuation, and in particular, the use of lump sums, problematic?

1.1 The role of superannuation in Australia's retirement income system

Australia's retirement income system comprises 'three pillars' — the Age Pension, compulsory saving via the Superannuation Guarantee, and voluntary saving (box 1.1). Together, they form a system in which both governments and individuals play a role in promoting standards of living in retirement. Governments set the rules, such as compulsory saving rates (the Superannuation Guarantee rate) and superannuation taxation rates, as well as funding the Age Pension and other age-related expenditure, including aged care and health care. Individuals save for their own retirement (both in and out of superannuation) and also bear some of the cost of the broader system as taxpayers. Overall, the retirement income system seeks to strike a balance across two dimensions:

- for individuals — between pre-retirement and post-retirement incomes

-
- for the economy — between post-retirement standards of living and fiscal sustainability (reflecting intergenerational equity).

Box 1.1 **The three pillars of Australia’s retirement income system**

Pillar 1: the Age Pension

The Age Pension is a means-tested government payment for older Australians, which dates back to 1909. It serves three key purposes as:

- a safety net that ensures a minimum standard of living for the aged
- a form of social insurance against risk (including market, longevity and myopia risks)
- an ‘intergenerational compact’ whereby each generation of workers contributes to funding the retirement of the preceding generation (PC 2013).

While it is generally described as a safety net, the majority of people aged over 65 receive at least a part Age Pension at some point (chapter 2).

Pillar 2: compulsory saving via the Superannuation Guarantee

Introduced in 1992, the Superannuation Guarantee is a compulsory employer contribution to an employee’s superannuation account. Currently the contribution rate is set at 9.5 per cent of employee (ordinary time) earnings, and will gradually increase to 12 per cent by 2025. While the legal incidence falls on the employer who makes the contribution, the economic incidence likely falls on employees through lower real wages (Treasury 2009c).

The Superannuation Guarantee was designed to increase individual lifetime savings so that each generation would make a greater contribution to its own retirement income; and to provide a supplement that would improve post-retirement living standards above what can be afforded by the Age Pension (FaHCSIA 2009). The *FitzGerald Report on National Saving* envisaged a more ambitious role for the Superannuation Guarantee in the future:

In the long term it will change the role, and community perceptions of the role, of the age pension — away from being the major source of retirement income to an even more targeted ‘safety net’ or poverty alleviation role than now. But for many years to come, the age pension and the Superannuation Guarantee will operate *in conjunction* to provide the retirement incomes of most people in the community. (1993, p. 51)

Currently, retirees have only contributed compulsorily to their own retirement for part of their working lives. As the superannuation system ‘matures’ over coming decades, people will retire after having contributed superannuation for longer.

Pillar 3: other voluntary saving

People have always been able to save privately for their own retirement and governments have long encouraged this behaviour, including by providing incentives such as co-contributions and tax concessions for additional superannuation savings.

While much focus is placed on superannuation, the third pillar includes all forms of retirement savings by individuals. For example, financial accounts, shares, bonds and rental properties are also drawn on to fund retirement (chapter 2). Home equity is another form of saving that is so significant that some researchers have suggested it be considered a ‘fourth pillar’ of the system (Brownfield 2014). And more broadly still, investment in education and health can also be important forms of ‘life cycle provisioning’ which lead to better living standards in retirement.

One system, three moving parts

The three pillars that make up the retirement income system are inextricably linked — changes in each can, and often do, affect the others. Ideally incentives embedded in the system would align with stated policy objectives. But this is not always the case — the roles of the pillars are not always clear and incentives are not always compatible or well understood. A point noted by several commentators:

In practice, the ‘3 Pillars’ have each developed independently. Rather than being the basis for a consistent and integrated retirement incomes policy, they make for an incoherent and dysfunctional whole. (Dunsford and Wickham 2009, p. 13)

... Australia’s successful basic retirement provision paradigm is bedevilled by design flaws that have been ignored or made worse by successive governments. (Chomik and Piggott 2012b, p. 351)

Reform to each of the pillars has occurred at different times and moved at different paces.

Age Pension arrangements have remained relatively static since they were established in the early 1900s. The eligibility age for men has remained at 65 years for over a century², though it is legislated to gradually increase to 67 years between 2017 and 2023. Similarly, the family home was made exempt from the assets test in 1912 and remains exempt today.

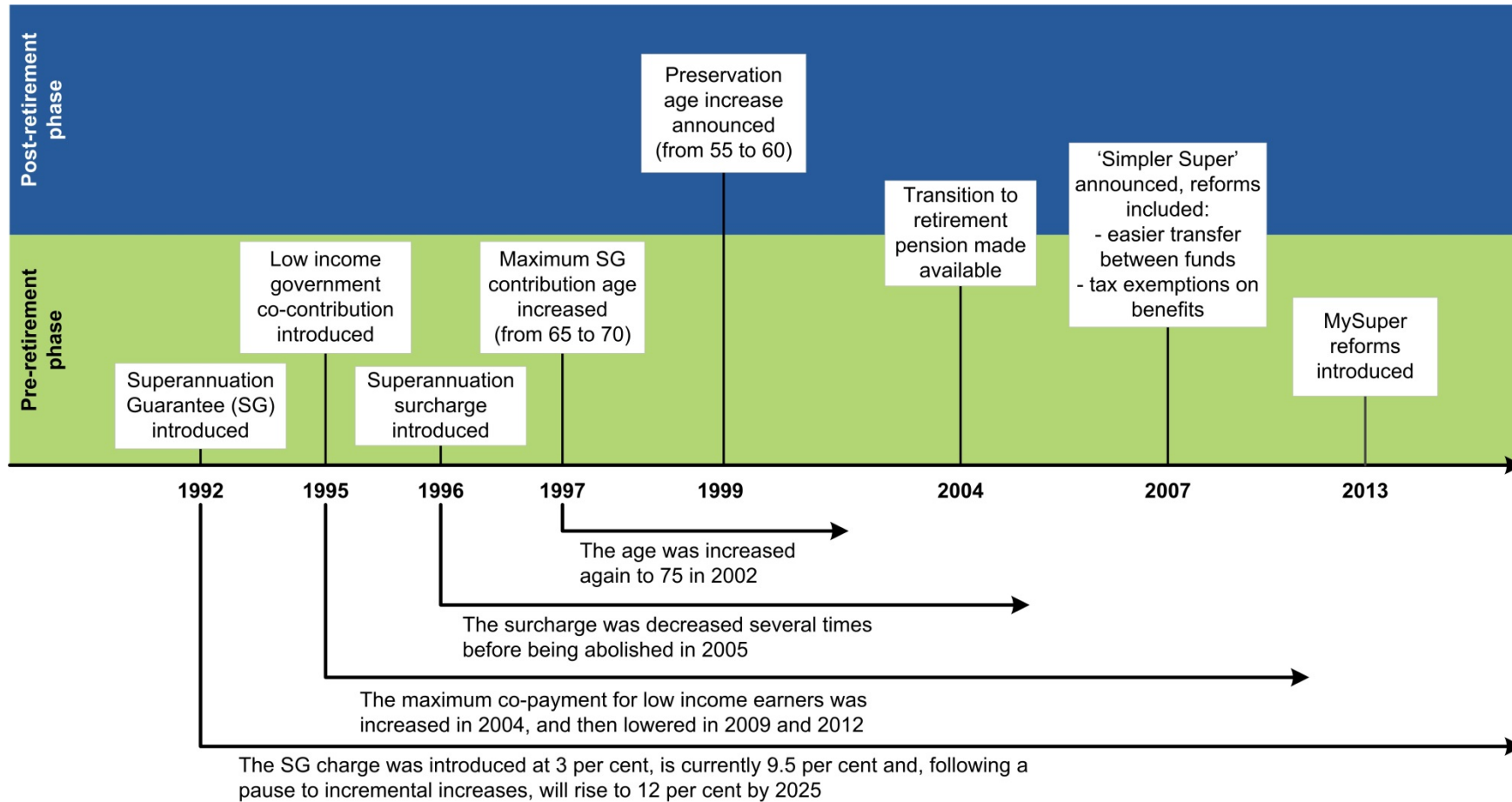
By contrast, the relatively new superannuation system has been subject to ongoing amendment, with a recent chronology of superannuation system changes compiled by the Parliamentary Library stretching to more than 30 pages (Swoboda 2014). Changes have included incremental increases to the Superannuation Guarantee rate, increases in the maximum contribution age, changes to the tax treatment of superannuation assets and the MySuper reforms (figure 1.1). Viewed collectively, these changes suggest that the post-retirement phase of superannuation has been relatively neglected from a policy perspective. Superannuation arrangements are outlined in more detail in supplementary paper 1.

The many changes made to the superannuation system have often been driven by the tensions between the pillars, and considerations of whether superannuation is intended as a complement or substitute to other private savings and the Age Pension. While there has been a general consensus that superannuation is intended to improve standards of living in retirement, its precise role — such as how superannuation should be drawn down — is more contentious. As noted by the *Financial System Inquiry*, a lack of common objectives can have wide ranging effects:

The absence of agreed objectives contributes to short-term ad hoc policy making. It adds complexity, imposes unnecessary costs on superannuation funds and their members, and undermines long-term confidence in the system. (Australian Government 2014b, pp. 96–97)

² The eligibility age for women was initially 60 years and was gradually brought in line with the eligibility age for men (65 years) between 1994 and 2014.

Figure 1.1 Some key changes to the superannuation system



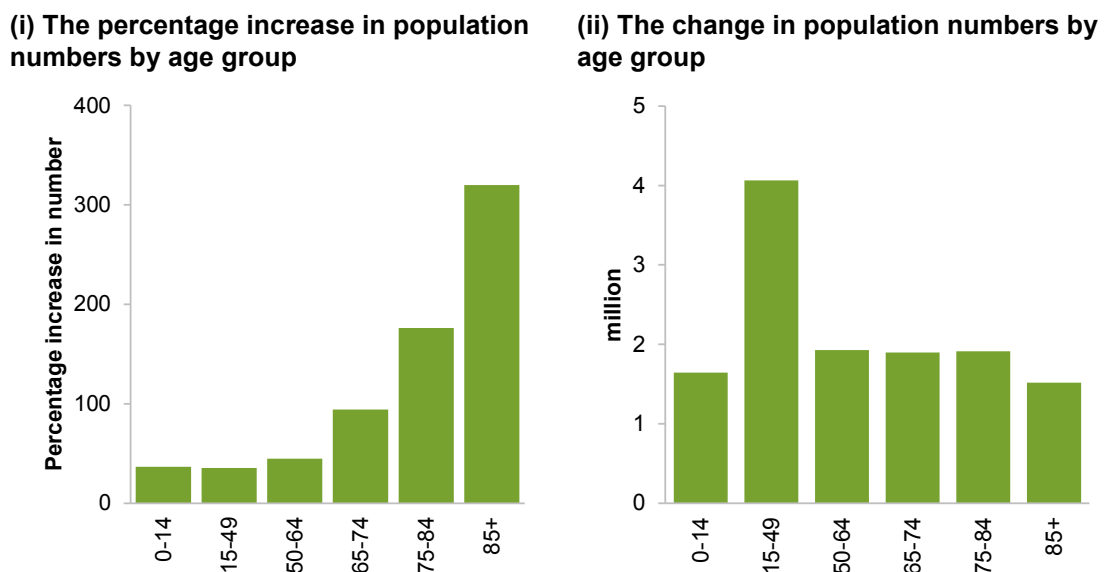
Source: Adapted from Swoboda (2014).

1.2 The growing importance of a well-functioning superannuation system

Any shortcomings of the superannuation system take on greater prominence as the system matures and the Australian population ages. As the system matures, people will have been making superannuation contributions for an increasing portion of their working lives and, as a result, some will have larger superannuation balances at retirement, making their drawdown decisions more important. While people will tend to retire with more superannuation savings, pressure on the system as a whole will increase as a greater proportion of people enter the post-retirement phase (box 1.2).

Australia's ageing population also underscores the importance of a well-functioning superannuation system. The proportion of the Australian population aged 65 years or more will increase from around one in seven today to around one in four by 2055 (figure 1.2).

Figure 1.2 **Growth in the aged far outstrips that of younger people**
2015 to 2055

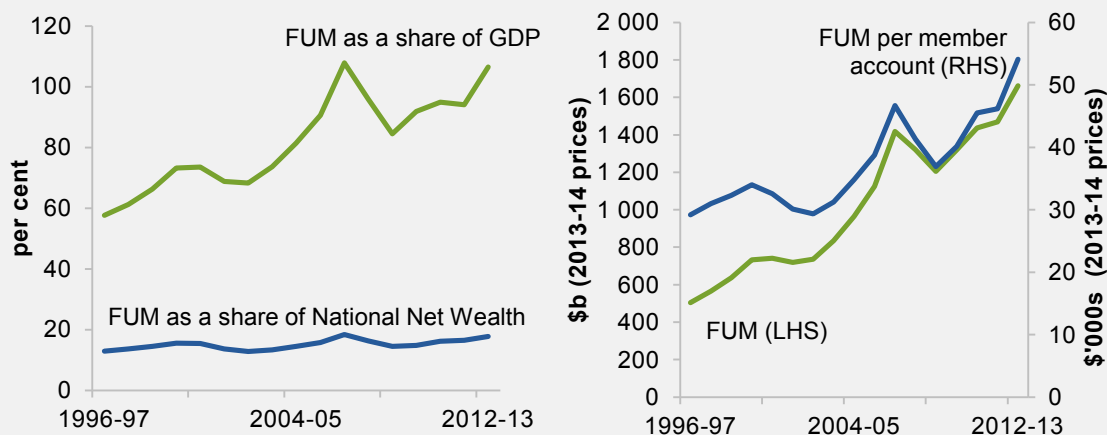


Data source: Commission estimates outlined in PC (2013).

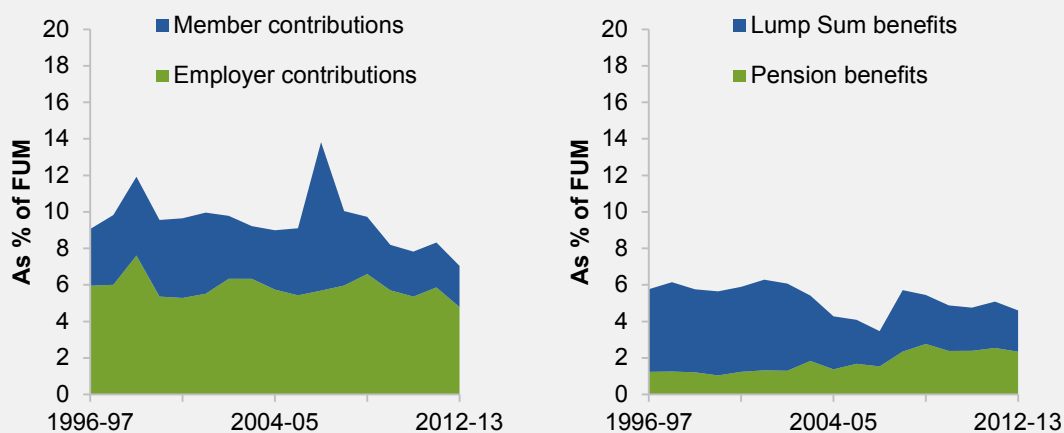
This demographic transition will give rise to major social and economic change as a higher proportion of the population makes calls on the Age Pension, health care and aged care (figure 1.3) while at the same time, relatively fewer people are working and contributing to government revenue through taxes.

Box 1.2 Superannuation funds under management at a glance

Superannuation funds hold a large amount of assets on behalf of their members. These assets are commonly referred to as 'funds under management' (FUM) and have been growing steadily in real terms, rising to around \$1.6 trillion in 2012-13. Accordingly, FUM have grown as a share of GDP, from around 57 per cent in 1996-97 to around 106 per cent in 2012-13. This growth expressed as a share of net national wealth — Australia's total assets less liabilities — has risen from around 12 to 18 per cent over the same period.



FUM can be a useful denominator or base to use when considering the amount of money that is flowing into the superannuation system as contributions, and out as benefits. It helps to provide a sense of how material these flows are, as opposed to simple, large dollar figures. Fluctuations in FUM also reflect equity market shifts and policy changes. For example, in 2006-07 FUM rose due to a temporary increase in the tax-free contribution cap as part of transitional arrangements for the *Simpler Super* reforms. At present, contributions as a share of FUM are larger than the benefits paid, and, generally speaking, the contributions from employers (as part of the Superannuation Guarantee) are greater than member contributions. How much money is flowing out of the system in benefits, and in what form, are areas of contention (chapter 4), but broadly speaking, total benefit payments as a share of FUM have been flat. This is expected to change in the future as an ageing population increasingly draws upon its superannuation savings.



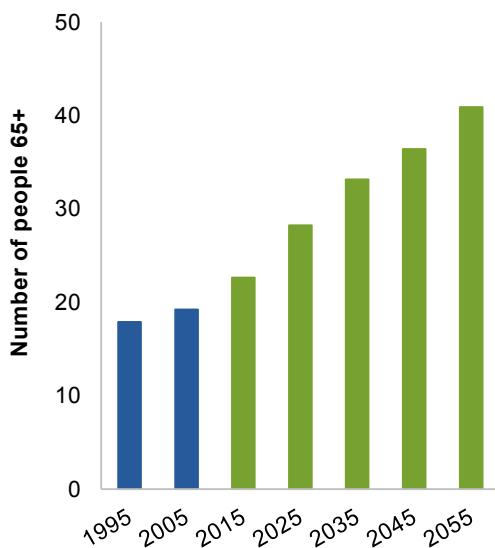
Sources: Commission estimates based on APRA (2014a); ABS (*Consumer Price Index Australia, Mar 2015*, Cat. no. 6401.0; *Australian System of National Accounts, 2013-14*, Cat. no. 5204.0); Deloitte (2013); Australian Government (2006b).

Total government spending is projected to increase from around 27 to 32 per cent of GDP between 2011-12 and 2054-55 (Commission estimates based on PC (2013)). Health care and age-related expenditure are projected to rise, while education and other expenditures are projected to decline as shares of GDP. Health care expenditure — which is spread across all ages, but concentrated among older groups — is expected to comprise the largest share of the increase in expenditure, followed by expenditure on aged care and then the Age Pension.

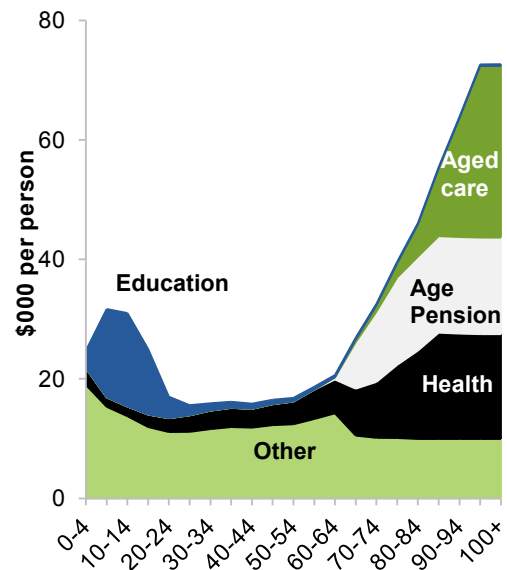
Australia appears better placed than many to manage the demographic changes that are unfolding. Age-related pension expenditure by the Australian Government is low relative to other OECD countries. In 2009, Age Pension expenditure as a share of GDP was 3.5 per cent, less than half the OECD average of 7.8 per cent (OECD 2013). Moreover, from 1990 to 2009 Australia’s expenditure grew modestly, by less than 15 per cent compared to an OECD average 27 per cent. Though, to some extent this reflects that Australia’s old-age dependency ratio³ was below the OECD average.

Figure 1.3 Demographic change will impact government expenditure

(i) Number of people aged over 65 per hundred people aged 15-64^a



(ii) Age-related government expenditure, 2011-12^{b,c}



^a Based on ABS (*Australian Historical Population Statistics*, Cat. no. 3105.0) and PC (2013) for forward projections. ^b Estimates based on the age profiles of expenditure used in PC (2013) projections. Where costs were not available by age, they were equally apportioned to all age groups. Health and education include Australian Government and state and territory government expenditures. ^c The ‘Other’ category includes the Disability Support Pension, Parenting Payment, Family Tax Benefit, Disability Support Services (both Australian Government and state and territory), other social security and welfare payments, Defence and other expenditures (including state and territory) not classified elsewhere.

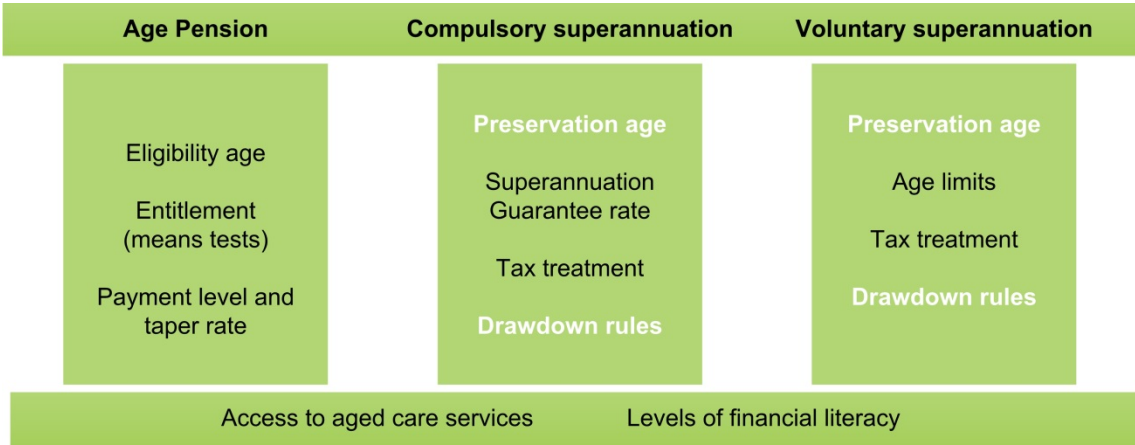
Data source: Commission estimates outlined in PC (2013).

³ Defined in OECD (2013) as the share of over 65 year olds relative to those aged 20 or over.

Nevertheless, these demographic changes have sparked policy discussion about the durability of the superannuation system — including its ability to meet the needs of retirees, and its potential to alleviate fiscal pressures caused by a lower share of working aged people. While the maturing superannuation system is expected to lead to a smaller share of Age Pension recipients calling on the full (as opposed to part) rate pension, the overall share of older Australians receiving any Age Pension is expected to remain relatively stable (chapter 2).

This elevates the imperative for the Government to re-examine the efficacy of policies that can be used to collectively ease pressure on the broader retirement system. In particular, analysis is required to understand the degree to which different policy levers within the superannuation system can be feasibly changed, and the magnitude of the impacts of such changes. Some potential policy levers are depicted in figure 1.4.

Figure 1.4 Policy levers in the retirement income system



1.3 The focus of this report

While the retirement income system has recently been afforded some policy attention, including in the *Financial System Inquiry*, the overarching policy architecture and the incentives inherent in the system have not been fully examined — particularly in relation to the post-retirement phase. More needs to be done to better understand how older Australians will use their superannuation and other savings in retirement; whether there are any structural shortcomings within the system; and how policies such as changes to the rules that govern individuals’ access to superannuation could affect retirement behaviour.

This report seeks to begin addressing these gaps through detailed analysis of two aspects of superannuation policy affecting the post-retirement phase:

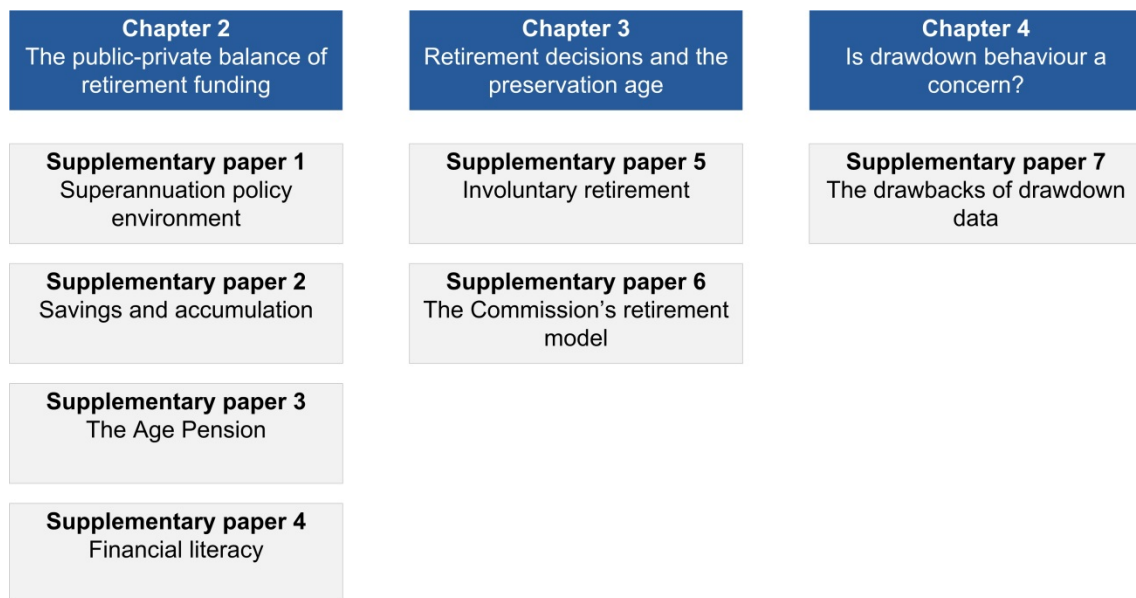
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- What might happen if the age that individuals can access their superannuation (the ‘preservation age’) were raised?
 - Is the way people draw down their superannuation, and in particular, the use of lump sums, problematic?

In examining these issues, the Commission has had regard to the broader retirement income system and the wellbeing of the community as a whole. To that end:

- chapter 2 examines the current (and likely future) balance between private and public retirement funding
- chapter 3 presents information on retirement behaviour and assesses the likely impacts of changes to the preservation age on retirement decisions, and in turn, on retirees’ superannuation balances, Age Pension outlays and the government’s fiscal position more broadly
- chapter 4 examines the way in which individuals draw down their superannuation savings in retirement and assesses what, if any, problems arise from the use of lump sums.

Supporting detail is provided in a number of supplementary papers (figure 1.5).

Figure 1.5 The structure of the report



2 The public-private balance of retirement funding

Key points

Australians save for retirement in two main ways — through compulsory superannuation contributions made on their behalf by employers, and through private voluntary savings inside and outside of superannuation.

Superannuation balances vary widely across individuals and will continue to do so even in a 'mature' superannuation system. Of those aged 45-54 in 2012, 15 per cent had no superannuation at all, whereas 10 per cent had more than \$230 000.

- Such variations reflect a range of factors, including the linkage of compulsory contributions to an individual's wage/salary; absences from the workforce; differences in voluntary superannuation contributions; and differences in the way that balances are invested.

Voluntary contributions — whether via salary sacrifice arrangements or from post-tax income — are tax preferred. The incentives to make voluntary contributions are larger for high income individuals; reinforcing their generally greater capacity to make such contributions. Voluntary contribution rates are also higher for those approaching retirement age.

For many, superannuation and other retirement savings are quickly exhausted. In 2011-12, 40 per cent of retirees who had reached the Age Pension age had no superannuation. However, 16 per cent of retirees aged 80 in that year had some superannuation savings left.

The Age Pension remains an integral part of the retirement income landscape.

- Currently, the majority (around 70 per cent) of Australians above Age Pension age receive at least a part Age Pension. Moreover, in 2013-14 around 60 per cent of recipients started to receive the Age Pension within a year of reaching the eligibility age.
- Survey data suggest that, in 2011-12, the Age Pension comprised over 85 per cent of total income for half of those who received it. Nevertheless, the overall reliance of retirees on income from the Age Pension has been slowly declining.
- The Age Pension still serves as a form of taxpayer-funded 'longevity risk insurance' for those with larger superannuation balances to draw on in retirement.
- In 2013-14 almost 90 per cent of those who took up the Age Pension at age 65 transitioned from another government payment.

As the superannuation system matures, reliance on the Age Pension will continue to decrease as larger superannuation balances mean individuals can self-fund retirement for longer. However, a fully self-funded retirement is likely to remain the province of those who are relatively well off during their working years.

Most of those above Age Pension age are likely to continue to access the pension at some point in the future — over the 40 years to 2054-55 coverage of the combined full and part pension is expected to fall from 70 to 67 per cent (but with a greater share of recipients receiving a part pension than now).

In looking at superannuation policy issues, it is important to understand the context in which those policies operate. To that end, this chapter looks at elements of the landscape that are central to assessing the two policy questions analysed in this report — namely, the likely impacts of changes to the preservation age on people’s retirement decisions; and the implications of allowing individuals to quickly draw down their superannuation savings. Specifically:

- section 2.1 examines how individuals save for their retirement, including how much they have saved in superannuation and how this compares to other sources of wealth such as the family home
- section 2.2 looks at the role the Age Pension plays in supporting retirement incomes
- section 2.3 considers how the balance between private and publicly-funded income sources in retirement might evolve over time as the superannuation system matures.

2.1 How do individuals save for retirement?

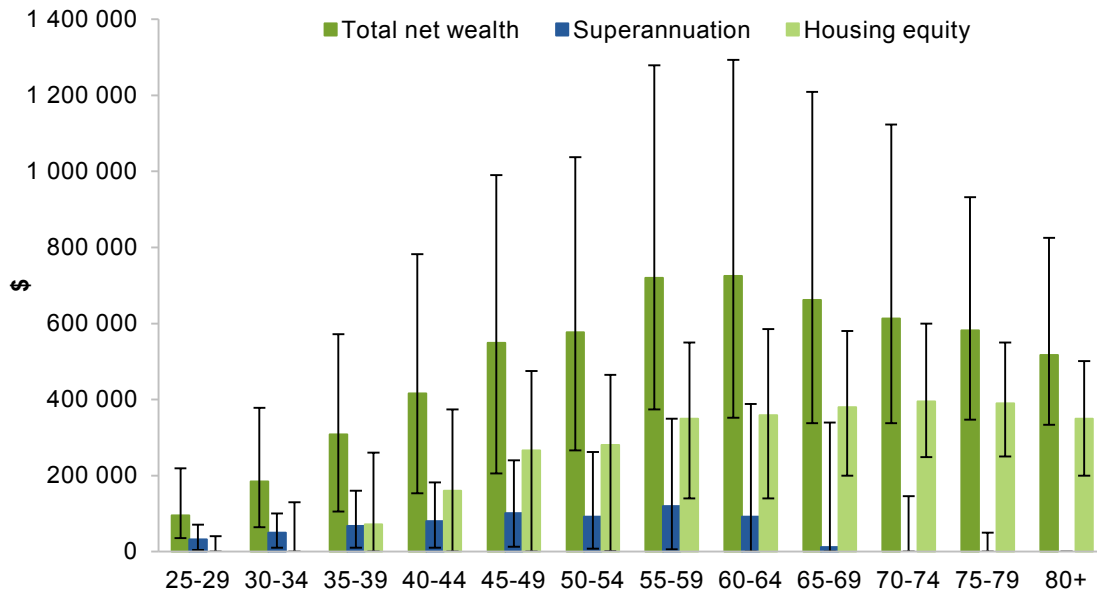
Australians save for retirement in two main ways — through compulsory superannuation contributions made on their behalf by employers (the so-called ‘second pillar’ of retirement incomes), and through additional private savings (the ‘third pillar’). The latter encompasses both personal contributions into superannuation accounts and a variety of investments outside the superannuation system including shares, other financial products and real estate. More detail on how Australians save for retirement is presented in supplementary paper 2.

Generally speaking, the savings and wealth of households increases during their working years, before beginning to decline as savings are drawn upon in retirement (figure 2.1). This pattern is particularly evident for superannuation savings, where:

- individuals can generally only access their superannuation once they reach the preservation age (55 for those born before July 1960, ranging up to 60 for those born after June 1964)
- there are rules providing for a greater rate of draw down from superannuation balances as a superannuant becomes older.

In contrast to superannuation savings, the equity in the family home is not typically drawn upon in retirement. Nonetheless the family home provides an important non-monetary stream of benefits to homeowners, including by providing security of tenure in retirement.

Figure 2.1 Median values for superannuation balances and net household wealth^a
2011-12



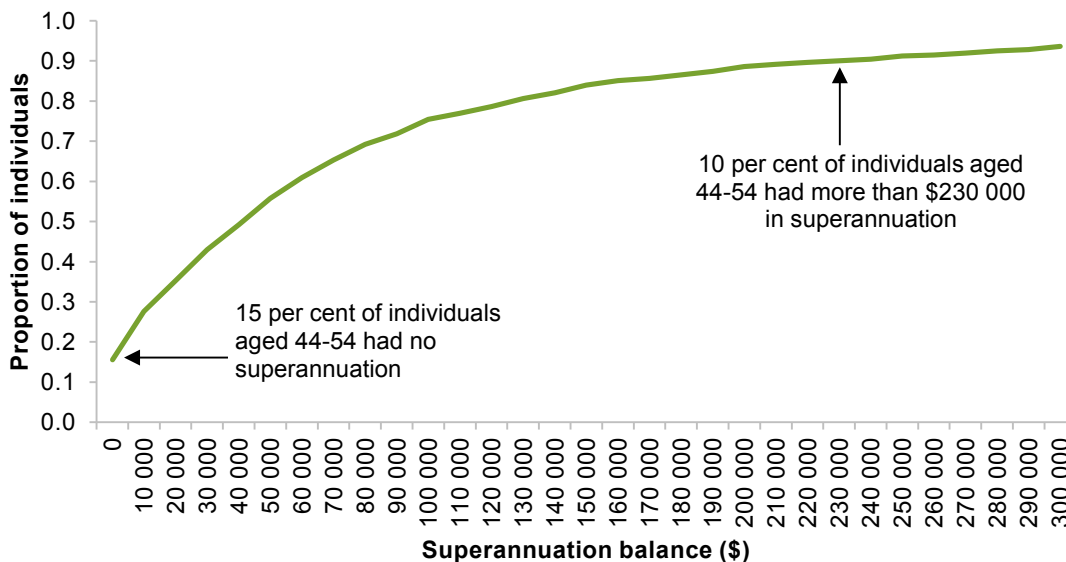
^a Total net wealth comprises of superannuation, equity in the family home, and the remaining gross assets less debt. Whiskers denote the interquartile range (the values of the first quartile and third quartile for each series). Quartiles divide the population into four groups based on some characteristic such as household wealth. The population is divided into the lowest wealth group (quartile 1), second-lowest wealth group (quartile 2), second-highest wealth group (quartile 3) and highest wealth group (quartile 4).

Data source: Commission estimates based on ABS (*Survey of Income and Housing, 2011-12*, Cat. no. 6553.0, basic CURF).

There is much diversity in superannuation savings

The median balance data in figure 2.1 mask considerable diversity in individuals' superannuation savings. Of those aged 45-54 in 2012, around 15 per cent had no superannuation, while 10 per cent had more than \$230 000 (figure 2.2). Those with self-managed superannuation funds (SMSFs) are more likely to have higher than average balances (box 2.1).

Figure 2.2 Cumulative distribution of superannuation balances for those aged 45-54
2011-12



Data source: Commission estimates based on ABS (*Survey of Income and Housing, 2011-12*, Cat. no. 6553.0, basic CURF).

There are several reasons why superannuation balances vary across individuals. For most Australians, the bulk of superannuation savings comes from the compulsory contributions made by employers (on behalf of the employee) as part of the Superannuation Guarantee. The dollar amount of these contributions is linked to an individual’s wage or salary — those who earn more receive more. The level of accumulated contributions is also affected by time spent out of the workforce. Workforce absences due to weak workforce attachment or caring responsibilities can have a significantly detrimental effect on accumulated balances. This is partly reflected in the differences in superannuation balances between men and women, with women having around 10 to 50 per cent less superannuation savings relative to men across different age ranges.

And for both compulsory employer contributions and voluntary contributions, balances are affected by the way they are invested and the investment fees and administrative charges collected by superannuation funds (or involved in managing SMSFs). Indeed, the impact of large differences in administrative charges across funds has been subject to considerable scrutiny of late (most recently in Australian Government 2014b).

Box 2.1 Those with SMSFs typically have high superannuation balances

Population-based data like the *Survey of Income and Housing* (SIH) provide a good overview of the superannuation balances of Australians, but are not designed to specifically examine those with comparatively large balances. This is important when examining the use of self-managed super funds (SMSFs), which typically have larger balances compared to the general population. Around 60 per cent of SMSF users had balances greater than \$200 000 in 2011-12, and SMSF balances today account for nearly a third of all superannuation balances (APRA 2014a; Bambrick 2015).

More detailed data published by the Australian Taxation Office (ATO) shows the distribution of superannuation balances of those with SMSFs. Drawing on this data, the figure below indicates that the most common balance for SMSFs is between \$200 000 and \$500 000; an amount several times larger than the median balance across the population as a whole. In a similar vein, research undertaken by the Association of Superannuation Funds of Australia found that of the 210 000 Australians with more than \$1 million in superannuation savings, around two-thirds had self-managed funds (ASFA 2015b).

The fact that the average superannuation balance of those with SMSFs is considerably higher than the population average reflects that, amongst other things, it may be difficult to justify the set up and compliance costs inherent in an SMSF arrangement unless the user expects to have a significant balance.

Distribution of balances in SMSF compared to the total population, 2011-12^a



^a Compared to those with any positive superannuation balance aged 15 years or older.

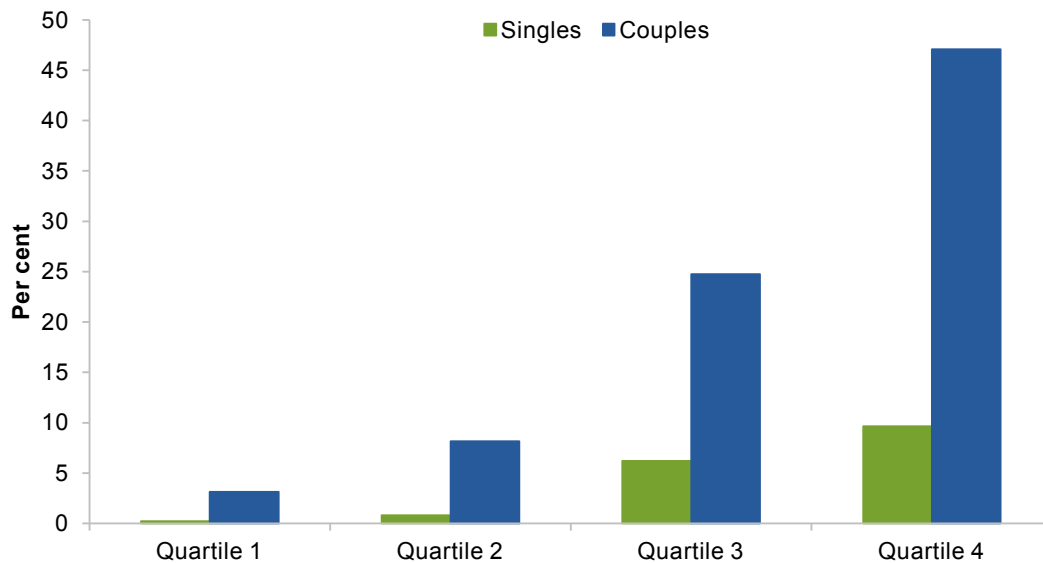
Sources: Commission estimates based on ATO (2014d) and ABS (*Survey of Income and Housing, 2011-12*, Cat. no. 6553.0, basic CURF).

How extensive are voluntary contributions?

Voluntary superannuation contributions made by individuals are another significant contributor to the wide diversity in superannuation balances. Such contributions can take two forms — ‘salary sacrifice’ contributions and contributions made from after tax income. Both forms of contribution are tax-preferred (supplementary paper 1) and most of those who are salary sacrificing are relatively wealthy. More specifically, the available data (discussed in more detail in supplementary paper 2) indicate that:

- around 17 per cent of individuals with superannuation were making voluntary contributions via salary sacrifice in 2011-12
- the wealthiest 50 per cent of couples, which account for around a quarter of the population, made around three-quarters of the total amount that was salary sacrificed into superannuation during 2011-12. (figure 2.3).

Figure 2.3 Share of total salary sacrifice contributions by wealth quartile^a
2011-12



^a Shares of singles is calculated by combining the proportions for the same quartile across single males and single females. The range of the wealth quartiles also differ depending on gender and couple status (for example, the wealthiest couples have more net wealth than the wealthiest singles).

Data source: Commission estimates based on ABS (*Survey of Income and Housing, 2011-12*, Cat. no. 6553.0, basic CURF).

That data also reveal some difference in the incidence of salary sacrificing by gender (19 per cent of men and 13 per cent of women). More significantly, the incidence of salary sacrificing increases sharply as people approach retirement — over 40 per cent of working Australians aged 60 and above made such contributions in 2011-12.

In addition to salary sacrificing, some Australians also make voluntary contributions to superannuation from after-tax income. The number of people making voluntary post-tax contributions is considerably smaller than those salary sacrificing. Estimates of how many make post-tax contributions to superannuation vary (supplementary paper 2), with some data suggesting that around 7 per cent of those with superannuation accounts made such contributions in 2011. Again the incidence of contributions was higher among wealthier households and those approaching retirement.

Transition to retirement pension arrangements

Assessment of the extent of superannuation savings available to help fund retirement savings is further complicated by the ability of those aged 55 to 65 to access some of their superannuation savings while still in the workforce. As discussed in supplementary paper 2, though intended to encourage a gradual shift from full-time work to full-time retirement, the transition to retirement arrangements can be used to reduce a worker's tax liability. In essence, wage income is salary sacrificed into a superannuation account to not only reduce the tax paid on that income, but also to allow the earnings on those contributions to be taxed in the concessional superannuation environment, even though the account can be accessed immediately.⁴

At present, it is difficult to ascertain precisely the purpose for which individuals are using the transition to retirement provision — and, in particular, the extent to which it is encouraging people to retain some connection with the workforce, as distinct from simply operating as a device to minimise tax. That said, of the estimated 5 per cent of eligible Australians (workers between the ages of 55 to 65) who received transition to retirement pensions in 2011-12, the majority were working full-time and were relatively wealthy. This is borne out, too, in SMSF data, which show that around half of eligible SMSF users were using transition to retirement pensions at some point in 2013. This suggests that incentives relating to taxation may have been a more relevant consideration than reducing working hours in the lead-up to retirement.

What discourages voluntary contributions?

The ABS has surveyed individuals to determine why many do *not* make additional personal contributions to their superannuation. The most common reasons nominated by non-contributors were not being able to afford additional contributions, not being eligible to make additional contributions, and a lack of awareness or interest. Women were more likely to nominate cost as a barrier (ABS 2009b). Analysis by Feng (2014) used a variety of data sources and came to similar conclusions, also finding that housing debt was a strong predictor of non-participation in voluntary superannuation contributions.

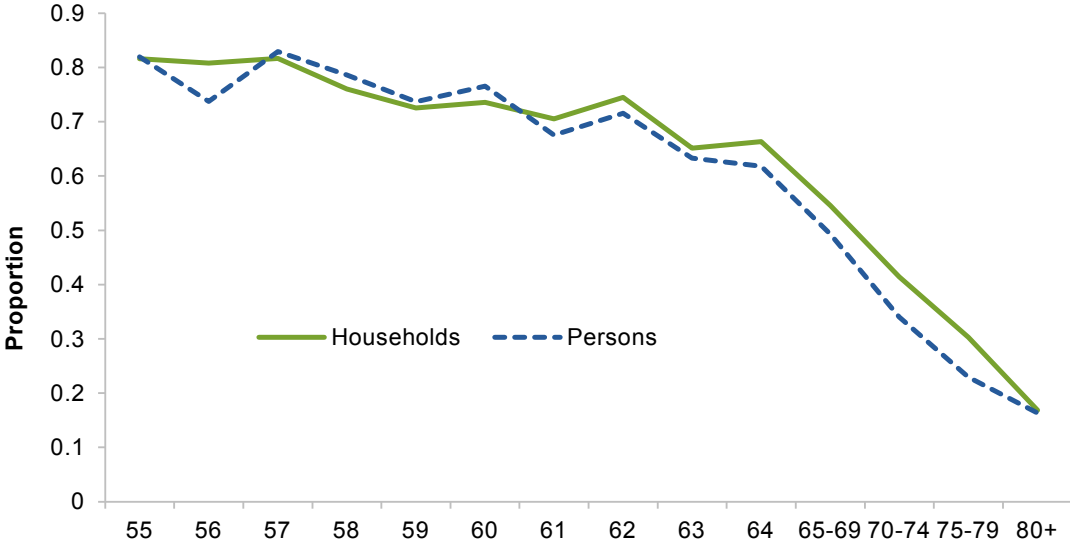
⁴ Taxing earnings in the concessional superannuation environment also makes voluntary, after-tax contributions to a transition to retirement pension fund up to the relevant caps tax effective. More details on the taxation of superannuation savings are provided in supplementary paper 1.

Overall, such responses are to be expected. As indicated above, current tax preferences for voluntary contributions favour higher income earners. Also, for younger people, the opportunity cost of contributions that cannot be accessed for many years may be very high. Alternatives such as paying down a mortgage, or investing in non-superannuation vehicles, may be perceived as delivering a better return on any spare funds available for investment. Viewed in this light, voluntary contributions will almost inevitably be concentrated within a wealthy, older, population cohort.

When are savings exhausted?

Around 80 per cent of Australians who reached their preservation age of 55 in 2011-12 had some amount of superannuation savings. By the age of 64 — just prior to the current Age Pension age — the proportion of those with superannuation savings decreased to around 60 per cent. Thereafter, the rate of exhaustion of superannuation savings continues to increase with age — only 16 per cent of those individuals aged 80 years or more had any superannuation savings remaining in 2011-12. This pattern is similar when superannuation savings are considered at a household level (figure 2.4).

Figure 2.4 Proportion of those with superannuation by age^a
2011-12



^a The data are only available in aggregated age categories from the age of 65 onwards.

Data source: Commission estimates based on ABS (*Survey of Income and Housing, 2011-12*, Cat. no. 6553.0, basic CURF).

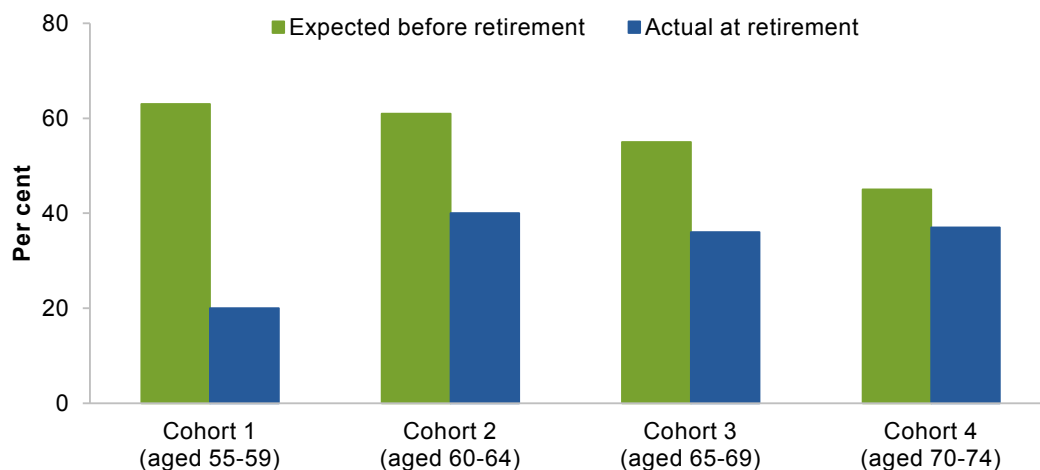
A recent examination of how households accumulated and drew down their financial wealth (including any superannuation) suggests that some have very few savings to sustain themselves through retirement. By comparing the amount of savings they hold relative to a ‘modest budget standard’ determined by the Association of Superannuation Funds of Australia — which for homeowners is around \$23 000 a year for a single and \$42 000 for a couple (ASFA 2015a) — analysis of Australian data by Thorp (2013) found that:

- Around 7 per cent [of retired households] have savings to provide less than 3 weeks of ASFA’s modest budget
- Around 10 per cent have less than 12 weeks
- Around 18 per cent have less than 24 weeks
- Around 28 per cent have less than 48 weeks

Interestingly, in this area, there is a significant disjunct between reality and people’s perceptions, with many recent retirees wrongly believing that they would principally self-fund their retirement (figure 2.5). Such a disconnect in turn serves to focus attention on the more general issue of ‘longevity risk’ (box 2.2) — the risk that someone’s personal savings are exhausted before retirement — and how it should be approached from a policy perspective.

Figure 2.5 The perception gap – expected vs actual self-funding in retirement^{a,b}

Share of individuals expecting to be self-funded, prior and following retirement



^a The period covered by these surveys includes the GFC, where there was a considerable erosion of savings among some prospective retirees. This may have played a role in altering expectations in the lead-up to retirement. ^b Expectation and actual refer to being mainly self-funded in retirement, which is defined as having a main source of income being superannuation, annuity, dividends, interest, rental property income or own unincorporated business income. See data source for more details.

Data source: ABS (*Retirement and Retirement Intentions, Australia, July 2012 to June 2013*, Cat. no. 6238.0).

Box 2.2 Who pays for longevity risk?

The life expectancy of Australians has increased materially over the last few decades, with a child born today expected to live around an additional 10 years, on average, compared to a child born 40 years ago. To date, however, these increases in longevity have not been accompanied by commensurate increases in typical retiring ages; or by increases in retirement savings sufficient to support a longer retirement. Accordingly, the risk of outliving savings in retirement — often referred to as ‘longevity risk’ — has been growing.

How longevity risk is managed can be analysed in the context of the three pillars of the retirement income system. The risk attached to the second and third pillars — compulsory superannuation contributions and voluntary savings, respectively — are primarily borne by the individuals concerned. That is, individuals decide how quickly to draw down their superannuation and other savings. Indeed, more Australians will have to bear a greater proportion of longevity risk in the future due to the transition in recent decades from defined benefit to defined contribution superannuation schemes:

While the evolution towards [defined contribution] pension plans can be beneficial for both employees and employers, it nevertheless reallocates risk within the financial system. In [defined benefit] pension plans, responsibility for funding and investment management rests with the firm sponsoring the plan. In a [defined contribution] plan these tasks and the associated risks are typically assumed by the employee. This shift of responsibilities and risks from the corporate sector to the household sector has potential implications for financial stability. (Broadbent, Palumbo and Woodman 2006, p. 2)

The first pillar, the Age Pension, is also affected by longevity risk. In the first instance, the Age Pension works as both a supplement to improve the standard of living of some retirees, and as a safety net for those who do not have other savings or means. But in performing both of these functions it is serving as a form of government-funded insurance for longevity risk. That is, where individuals exhaust or significantly run-down their private savings in retirement — including circumstances where they manage their longevity risk poorly by design or accident — they can ‘fall back’ on the Age Pension. This may diminish the incentives for some retirees to effectively manage longevity risk in relation to their own savings.

Although there is little evidence that these incentives affect most retirees’ behaviour at present, various reviews have pointed to a need to improve the way that retirees manage their longevity risk, including through restrictions on the way that superannuation benefits can be taken. Such an approach has pros and cons (chapter 4).

More generally, achieving an appropriate overall balance in policies that aim to allocate longevity risk most efficiently, while taking into account the varied circumstances of retirees and the other important risks that they may face, raises a multitude of complex issues. It is contingent upon having a well-defined role for the superannuation system and is thus a matter best analysed in the context of a broader review of retirement incomes.

Source: Commission estimates based on ABS (*Australian Historical Population Statistics, 2014*, Cat. no. 3105.0.65.001).

Equity in the family home is generally retained

While superannuation and other retirement savings are exhausted relatively quickly for many, the family home often remains a largely untapped asset that is not typically drawn down in retirement — such as through reverse mortgages or ‘downsizing’. This occurs for

a number of reasons. For example, concerns about securing an aged care bond contribute to the reluctance of some to unlock equity in the family home as they age (PC 2011). There is also a range of policy settings that may also discourage or otherwise reduce the need for such draw down — including the treatment of the family home in the assets test for the Age Pension (supplementary paper 3), and often sizeable stamp duties on property transactions.

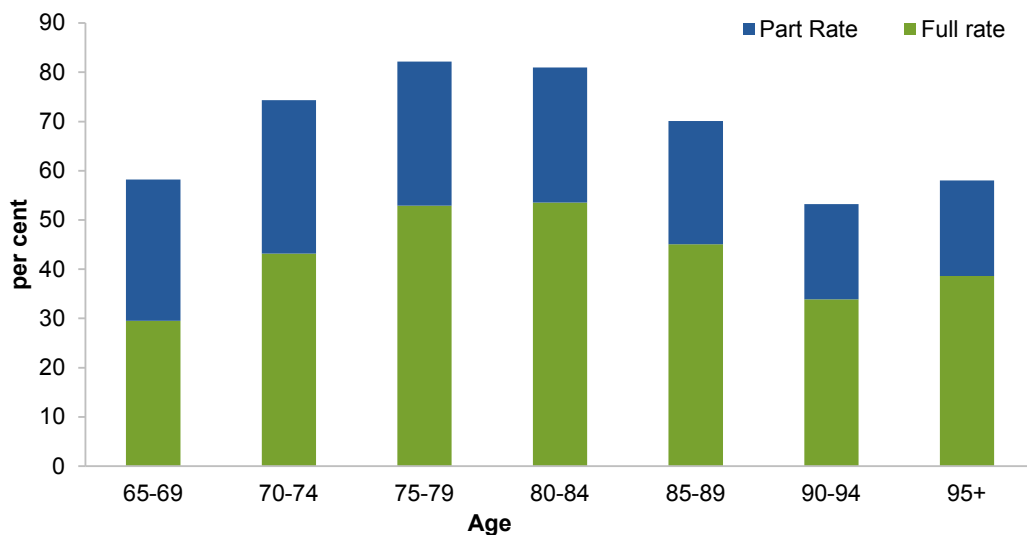
2.2 How does the Age Pension support retirement incomes?

The Age Pension is a government support payment for older Australians, targeted through age, residency and means tests (supplementary paper 3).

Who transitions to the Age Pension and when do they do so?

While the Age Pension is considered a ‘safety net’ and superannuation coverage and assets have been increasing, the majority of older Australians (around 70 per cent) receive at least a part pension at some point after the eligibility age of 65 (figure 2.6).

Figure 2.6 **Age Pension coverage by full or part rate**
Share of population, September 2014



Data sources: Department of Social Services Payment Demographic data and population modelling from PC (2013).

Access typically occurs sooner rather than later — in 2013-14 around 60 per cent of Age Pension recipients started receiving payments within one year of reaching the eligibility age (with an average of 64 per cent over the previous 10 years). And, while accumulated superannuation and other savings explains why some individuals do not get immediate access to the pension, for others it is because they are still working and supporting themselves.

Many of those who transition to the Age Pension at the earliest possible opportunity also transition from another government payment. In 2013-14, almost 90 per cent of those who took up the Age Pension at the qualifying age transitioned from another payment such as the Disability Support Payment, Mature Age Allowance and Widow Pensions. Of these, around three quarters went on to the full rate and the remainder onto the part rate.⁵

Once on the pension, recipients tend to stay on it for long periods, with around half of current recipients having received the Age Pension for more than 10 years.

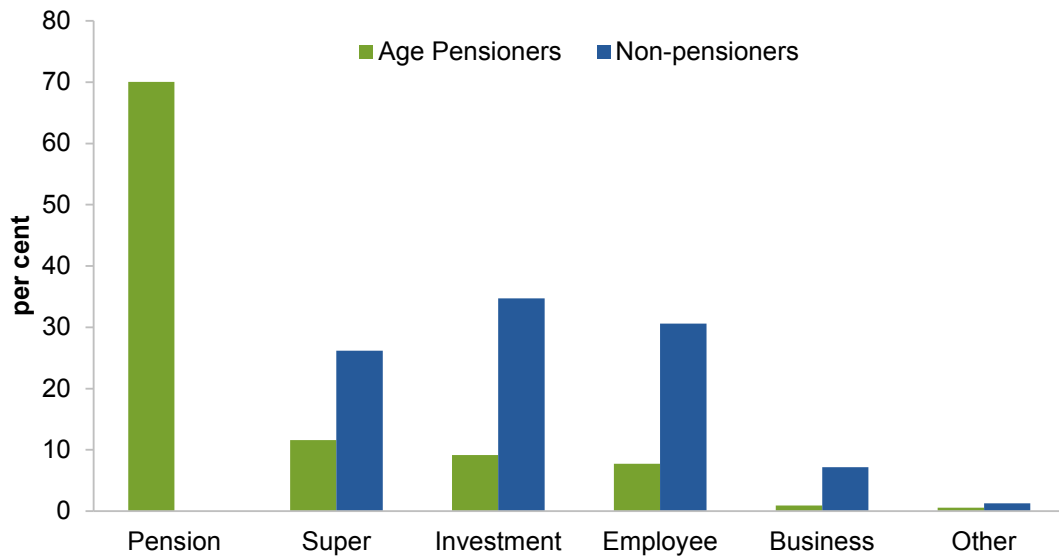
How important is the Age Pension to retirement incomes?

For Age Pension recipients, the income and assets tests mean that pension payments will comprise the bulk of their incomes by design. Based on the 2011-12 *Survey of Income and Housing*, the pension comprised around 70 per cent of total income on average for recipients (figure 2.7). Moreover, pensions comprised over 85 per cent of total income for more than half of recipients. For Age Pensioners, superannuation and other income streams form the most important secondary source of income, while for those not receiving the Age Pension, investment and employment income are more important on average.

However, due in part to the evolution of the superannuation system, the overall reliance of retirees on income from the Age Pension has been slowly declining. For instance, ASFA (2014b) found that in 2013 around 32 per cent of 65 year old retirees were self-funded, compared to 22 per cent in 2000. Similarly, based on analysis of several HILDA waves, pension income as a share of recipients' total income has trended steadily down — with the proportion of recipients relying on the pension for at least half or the vast majority (over 90 per cent) of their income both dropping by around 10 percentage points between 2001 and 2011 (figure 2.8).

⁵ Based on DSS Payment Demographic data.

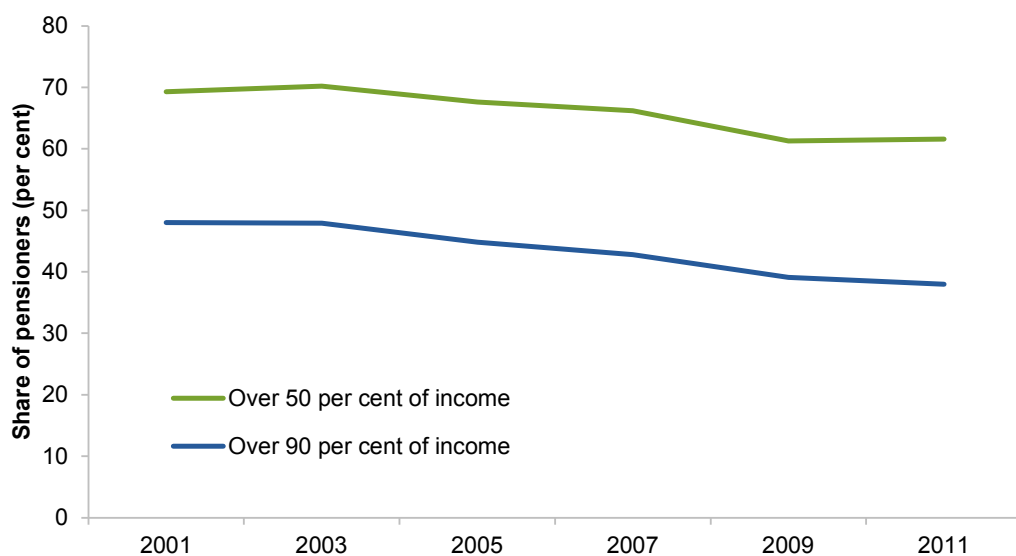
Figure 2.7 Average share of income of older Australians from different sources^a
2011-12



^a Includes all singles and couples over 65, 'Age Pension' refers to any government pension, including both Age and Service Pensions.

Data source: Commission estimates based on ABS (*Survey of Income and Housing, 2011-12*, Cat. no. 6553.0, basic CURF).

Figure 2.8 Pension share of total income for Age Pensioners



Data source: Table 5.5 in Wilkins (2014b), based on various waves of HILDA Survey data.

Also notable is the fact that older Australians are less reliant on government transfers compared to their counterparts in other countries, many of which have directed less policy attention towards encouraging self-funded retirement. The OECD (2013) reported that government transfers accounted for 40 per cent of gross household income of over 65 year olds in Australia, compared with an OECD average of 59 per cent.

2.3 The balance between private and public funding in a mature system

In coming decades, Australians will almost certainly have greater savings, on average, to support themselves in retirement. Among other things, they are likely to have worked for longer and will have had the opportunity to receive more superannuation contributions for large parts of those working lives. Contrast this with 65 year olds retiring today, who will have been subject to compulsory contributions for only around half of their working lives and for much of that period at a lower rate than now applies.

How have private savings changed in the recent past?

One way to examine how important superannuation might be in the future is to see how its importance, relative to other savings, has changed in the recent past. A comparison of wealth and debt from the *Survey of Income and Housing* in 2003-04 and 2011-12 for different age ranges can illustrate how superannuation has evolved in concert with other savings (and are discussed in greater detail in supplementary paper 2). Generally speaking, amongst those aged 45-64:

- gross assets have increased substantially over the 8 year period, with about one third of the growth coming from superannuation, one third from the family home and the rest from other assets including rental properties
- gross debt has increased too, but at a much slower pace than asset growth — much of the growth in debt is associated with housing (both the family home and rental properties).

This increase in housing debt among older households has been of concern among some policymakers and stakeholders. Indeed, the proportion of homeowners that still have a mortgage at ages 60-64 has increased from about 15 to 28 per cent between 2003-04 and 2011-12. However, this group has not experienced a markedly significant change in the debt-to-value being incurred. Put another way, it does not appear that older households are incurring levels of debt where they will need to use their superannuation savings to ‘bail themselves out’.⁶ However, what is less clear is whether retirees will be more willing in the future to draw down on their housing equity in order to finance their retirement.

⁶ How Australians use their superannuation in relation to paying down debt is discussed in detail in chapter 4.

What will superannuation balances look like in future?

As input to the 2012-13 Budget, Treasury provided forecasts of the total amount of superannuation assets out to 2040, as well as estimating what an individual's superannuation balance would be if they earned the full-time median wage over their working life (figure 2.9). In broad terms, these forecasts indicated that both superannuation assets in total and the 'representative' worker's superannuation balance would more than quadruple by 2040 (from less than \$2 trillion to \$8 trillion dollars, and from around \$100 000 to around \$440 000, respectively). While all such estimates are sensitive to assumptions about both future policy settings and changes to general economic conditions — and especially investment returns⁷ — they still provide an 'order of magnitude' as to what might be expected, on average, in the future.⁸

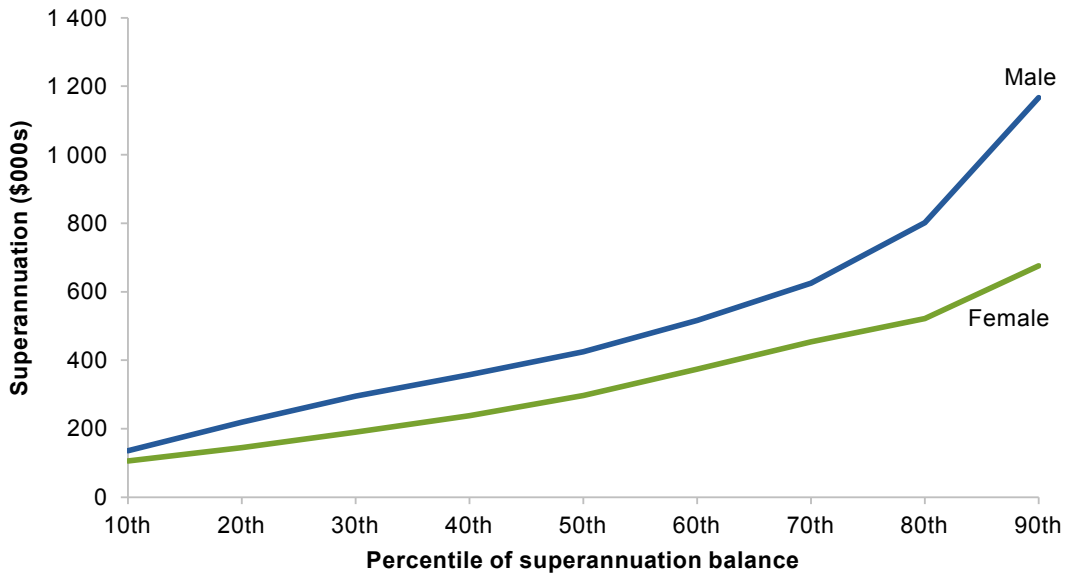
However, averages or outcomes for 'representative' individuals can hide considerable variation in outcomes across individuals. As discussed in more detail in supplementary paper 2, it seems unlikely that greater system maturity will of itself reduce the current significant disparities in superannuation balances across the population. Indeed, there is evidence that, over the last decade, the disparity in balances has increased because of differential wages growth that has widened divergence in superannuation contributions (ACOSS 2015; Greenville, Pobke and Rogers 2013). And projections by NATSEM of superannuation balances of those who will be aged 64-66 in 2051 suggest that factors such as differences in attachment to the labour force will contribute to a continuing and large variation in balances across individuals (figure 2.9).

⁷ One example of how small changes in assumptions can lead to large differences in superannuation projections is contained in the Rice Warner Actuaries submission to the *Financial System Inquiry*. The base projection calculated superannuation assets to be \$3353 billion (in 2013 dollars) by 2028, but the sensitivity analysis of the assumptions revealed that different assumptions could yield a figure between \$2931 billion and \$3791 billion, with assumptions around contribution levels, wage inflation and investment returns all making a material difference to the final result (Rice Warner 2014).

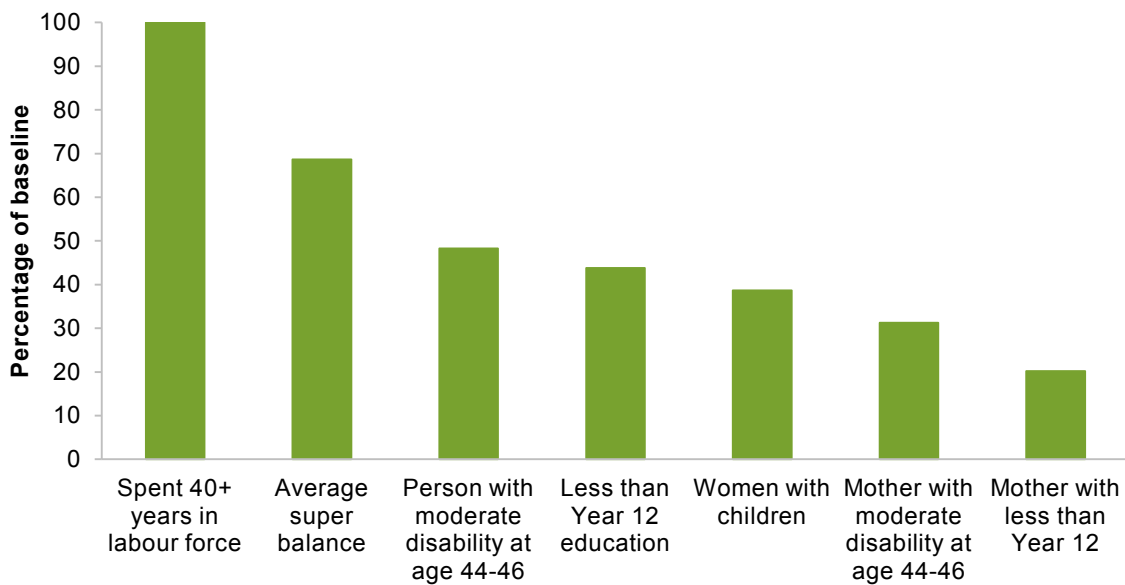
⁸ Importantly, the purpose-built models that have been used to look at this matter are different from the model built by the Commission to examine the effects of raising the preservation age on retirement behaviour (chapter 3).

Figure 2.9 NATSEM analysis of the distribution of superannuation under a more mature system^a

Estimated distribution of superannuation at age 64-66 by gender in 2051^a



Estimated mean superannuation at age 64-66 as a percentage of baseline in 2051



^a In 2006 dollars.

Data source: Keegan, Harding and Kelly (2010).

For example, women who care for children, those with moderate disabilities and those with poor educational attainment are all projected to have less than half the superannuation of someone who has been in full-time employment for 40 years or more. The greater capacity of (and tax-related incentives for) higher income earners to make voluntary contributions may add further to these disparities.

How important will the Age Pension be in supporting retirement incomes in the future?

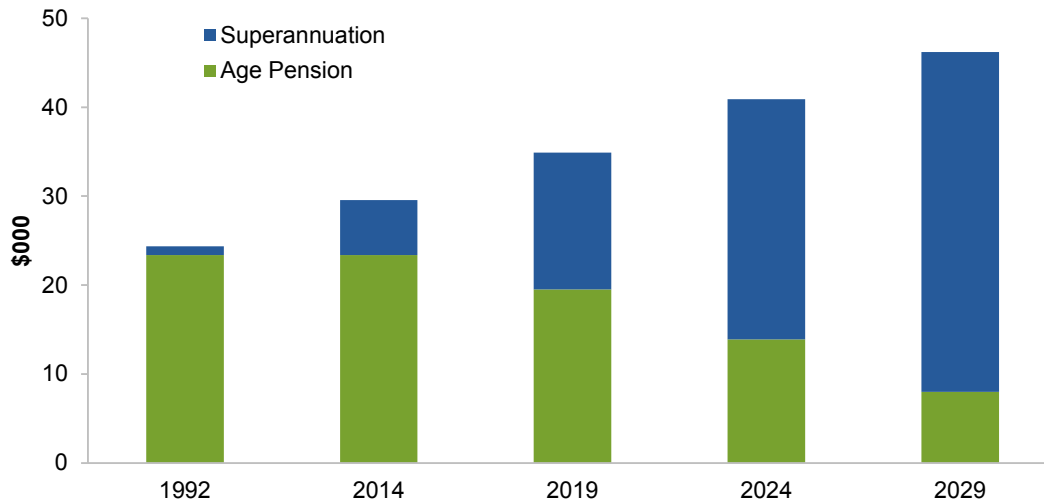
Even as the superannuation system continues to mature, a fully self-funded retirement is likely to remain the province of those who were relatively well off during their working years. As is the case today, for those with an interrupted work history, any retirement savings they manage to accrue are likely to be exhausted quickly and the Age Pension will remain their primary source of retirement income.

While the maturing of the superannuation system may not fundamentally affect those at either end of the wealth spectrum, it is likely to affect those in the middle. This group will, on average, have more in superannuation and will have the means to self-fund for longer before qualifying for and transitioning to a part (as opposed to full) Age Pension.

This effect will filter through to older cohorts gradually — ASFA (2014b) revealed that, although the proportion of self-funded retirees increased for 65 year olds, it remained stable (at around 15 per cent) for 75 year olds over the period 2001–11. This means the impact of the gradual maturing of the superannuation system will be slow in increasing the capacity for self-funded retirement in older age cohorts. Nonetheless, ASFA has projected that, on average, the share of income people derive from the Age Pension will decrease over time (figure 2.10).

While Age Pension coverage rates are expected to remain relatively stable over time — with the 2015 *Intergenerational Report* projecting that coverage would fall from 70 per cent to 67 per cent over the 40 years to 2054-55 — the share of recipients being paid the part rate is expected to rise, though the exact magnitude of this shift was not estimated (Australian Government 2015a). It is not clear how this trend — in combination with an ageing population and other changes such as those to the means tests — might impact on pension outlays in the long run. These issues are discussed in supplementary paper 3.

Figure 2.10 **Average retirement income at Age Pension qualifying age^{a,b}**
In 2014 dollars



^a Average balance for all single individuals above Age Pension age. ^b Age Pension entitlement calculation is based on superannuation assets only, it does not include any other assets.

Data source: ASFA pers. comm., 20 May 2015 (updated values from ASFA (2014b)).

3 Preservation age and retirement decisions

Key points

Spikes in retirement occur at the three 'milestone ages' — the preservation age, the tax-free superannuation age and the Age Pension eligibility age. Of the three ages, the Age Pension age provides the strongest financial and social signal to retire.

Mature age labour force participation is likely to continue to increase over the next two decades. Even so, current and impending retirees are living longer and so are likely to spend more time in retirement — perhaps 5 to 7 years more — than their parents' or grandparents' generation.

With people spending longer in retirement and older Australians representing a growing share of the population, there have been calls to revisit superannuation policy settings, including the preservation age.

The preservation age is already scheduled to gradually increase from 55 to 60 years by 2025. Modelling undertaken by the Commission in order to better understand the response of individuals to a further increase in the preservation age to 65 by 2043 suggests that:

- there will be a modest increase in the participation rate of older workers of around 2 percentage points in 2055.
- households that delay their retirement are likely to do so by around 2 years and will have superannuation balances around 10 per cent larger in real terms when they retire.
- there will be an indicative annual fiscal improvement of around \$7 billion (in 2015 prices) in 2055. Around \$5 billion of this fiscal improvement is attributable to higher tax receipts. A net reduction in welfare payments is projected to contribute a further \$2 billion.
- the bulk of the fiscal gains associated with an increase in the preservation age can be attributed to wealthier households. These households are on average, more likely to delay their retirement. They also have higher superannuation savings (and so pay more tax on superannuation earnings) and receive lower welfare payments in later years.
- changing the preservation age will have little, if any, impact on the workforce participation of individuals who retire involuntarily — almost one half of men and over one third of women who currently retire between the ages of 60 and 64. There is however, still a fiscal impact on this group.
 - As people who retire involuntarily may not be able to access their superannuation benefits for longer, they continue to pay tax on their superannuation earnings. This additional tax revenue is offset, in part, by additional government outlays, as some individuals with little in the way of non-superannuation savings may need to rely on income support payments.

The ageing of Australia’s population has prompted calls to reform the retirement income system. The principle role of this chapter is to examine whether and how a change in the preservation age — the age at which individuals can access their superannuation — might ease pressure on the retirement income system, while at the same time, deliver sustainable retirement incomes for older Australians.

The chapter begins by detailing the factors that influence the retirement decisions of mature age workers, before exploring how retirement behaviour has changed over time and how it might change in the future (sections 3.1 and 3.2). The chapter then examines how retirement behaviour might respond to an increase in the preservation age (section 3.3). This section includes an assessment of the impacts of changing the preservation age on workforce participation, superannuation balances, Age Pension outlays, and the government’s fiscal position more broadly.

3.1 What influences the retirement decisions of mature age workers?

At an individual level, the decision to retire is often a complex one that reflects the evaluation of a range of factors. The relative weight ascribed to these factors can differ from individual to individual, and from couple to couple. Nevertheless, some factors are more important than others, and can help to explain broader trends observed in retirement behaviour across the community as a whole.

The factors that drive the retirement decisions of individuals can be characterised in a number of ways (supplementary paper 5). In assessing whether individuals are likely to change the timing of their retirement in response to a given policy — in this case, a change in the preservation age — it is helpful to distinguish between those who retire involuntarily and those who retire voluntarily.

Involuntary retirement occurs where individuals do not get to exercise choice about whether or not to continue to participate in the workforce (this might be due to factors such as ill health or redundancy). In contrast, individuals who retire voluntarily elect to do so (and it is assumed that they time their retirement to maximise their own utility). Distinguishing between the two is important — those who retire involuntarily may have little or no scope to alter the timing of their retirement and empirical evidence suggests that they may be substantial in number.

Voluntary retirement

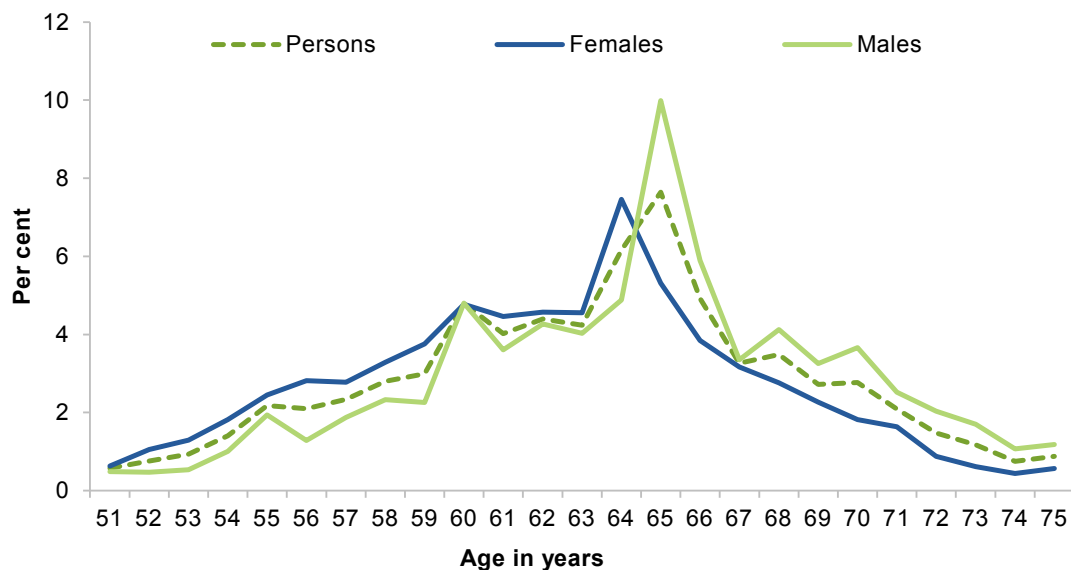
Central to any discussion of the drivers of voluntary retirement are the incentives established by the three pillars of the retirement system and their associated milestone ages. An examination of year on year changes in the proportion of individuals who are retired at each age highlights the importance of the key policy ‘ages’ in explaining

retirement behaviour. Spikes in retirement rates occur at the preservation age, the tax-free superannuation age and most noticeably at the Age Pension eligibility age (figure 3.1).

These patterns are consistent with empirical research into retirement drivers, which find that the financial incentives embedded in the retirement system influence retirement behaviour, particularly for men (Chomik and Piggott 2012a; Headey, Freebairn and Warren 2010; Warren and Oguzoglu 2010). Of the three ages, the Age Pension eligibility age is found to have the largest impact on retirement behaviour.

Apart from their financial dimension, the policy ages also play a role in establishing community norms or expectations regarding the acceptable or appropriate age at which to retire (Headey, Freebairn and Warren 2010; Ingles 2000; PC 2013). The conditioning or signalling role of the ages may be a more important influence on retirement behaviour than the financial role, particularly given the complex financial incentives characterising the current system (Headey, Freebairn and Warren 2010; Warren and Oguzoglu 2010).

Figure 3.1 **Change in annual retirement rate at each year of age in 2011^a**



^a In 2011, the preservation age was 55 years, the tax free superannuation age was 60 years, and the Age Pension age was 64 years for women and 65 years for men.

Data source: ABS (*Census of Population and Housing, 2011*).

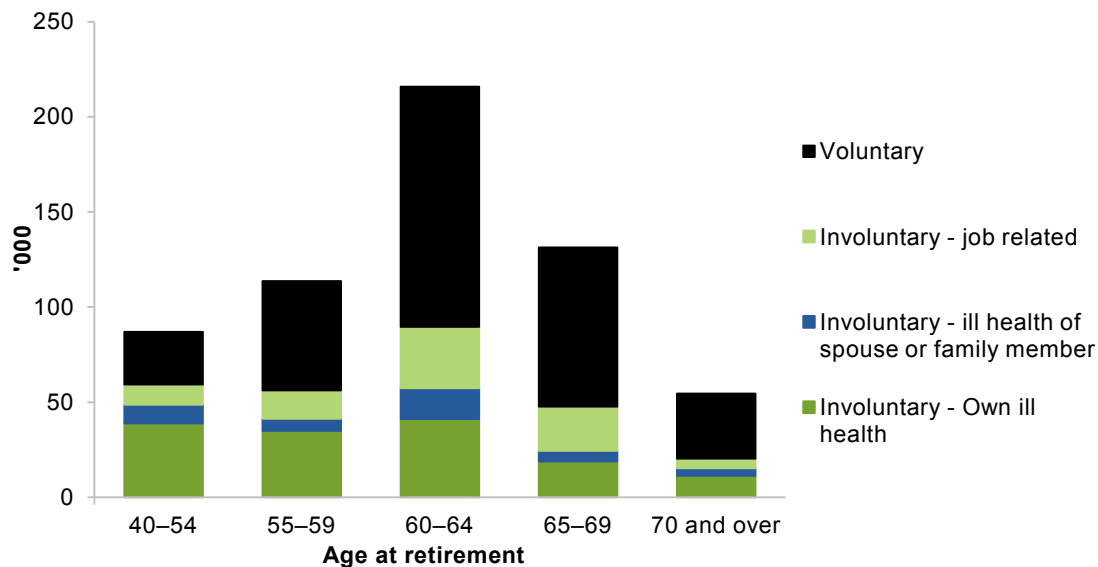
The financial incentives associated with the three milestone ages form part of a broader set of financial factors that individuals weigh up in making retirement decisions. Other influences include home ownership status (people who own their home outright tend to retire earlier than those that do not), and the number of dependent children living at home (the greater the number, the longer the wait until retirement).

Not all factors that shape voluntary retirement decisions are financial in nature. For example, the retirement decisions of women are strongly influenced by their partner’s employment status. Although men tend to be more responsive to financial factors, other issues, such as the length of time spent in the workforce, also appear to impact on their retirement decisions (Warren and Oguzoglu 2010).⁹

Involuntary retirement

The various financial and non-financial factors above go a long way to explain retirement behaviour. However, many people appear to have much less choice over the timing of their exit from the labour force. Data from the Household, Income and Labour Dynamics in Australia (HILDA) survey and other sources show that a large proportion of mature age Australians retire involuntarily, mostly for health reasons, but also due to an inability to maintain or find a job (figure 3.2).

Figure 3.2 Number of persons retiring, by age and reason^a



^a Number of people aged over 40 who retired in the last five years, taken from 2011 census data. Reasons for retirement within each age group were derived from HILDA data.

Data sources: Commission estimates based on HILDA (2013, release 13, wave 11) and ABS (*Census of Population and Housing, 2011*).

While rates of involuntary retirement decrease with age (and eventually become less important than voluntary retirement among people who retire at older ages), involuntary retirement remains a dominant reason for early exit from the workforce. Although difficult

⁹ While time spent in the workforce may be partly explained by higher earnings, it might also reflect non-pecuniary factors such as enjoyment derived from work.

to measure definitively, it is possible that around one half of all Australians who retire between the ages of 45 and 70 do so involuntarily.

For individuals retiring involuntarily between the ages of 45 and 55, the key driver is ill health — either their own ill health or that of a spouse or family member (figure 3.2). Amongst this age cohort, women are more likely than men to retire involuntarily because of the need to undertake caring responsibilities, whereas men primarily retire because of their own ill health (Borland 2005; Warren 2006).

Involuntary retirement for job-related reasons is more important among 60 to 70 year olds (for example, around 40 per cent of people retiring involuntarily at this age do so because they were unable to find or keep a job). This may be evidence of a broader lack of job opportunities for older workers or workplace bias (Borland 2005). Headey et al. (2007) find evidence that ‘employers generally perceive older people as worth retaining in their current jobs, but not worth hiring as new employees’ (p. 13).

More recently, the Australian Human Rights Commission (2015) found that many Australians over the age of 50 experience some form of age discrimination in the workplace, with the highest rates of discrimination observed in the population aged between 55 and 64.

On balance, the empirical evidence indicates that many Australians *become* retired, rather than enter this state freely at a time of their own choosing. These individuals have less scope to change their behaviour in response to policy changes such as increases in the preservation age or the Age Pension age. The involuntarily retired also have lower levels of accumulated assets than voluntary retirees, raising equity issues. Apart from the importance of this result for the immediate task of modelling the impacts of changes to the key policy ages, a better understanding of the nature and scope of involuntary retirement could help to identify other pathways to encourage higher labour participation among mature age Australians.¹⁰

3.2 How is retirement behaviour changing?

The propensity to retire begins to increase from around the age of 50, with the greatest rates of exit from the workforce typically occurring between the ages of 55 and 70. As discussed above, the single most common age of retirement is the Age Pension age with (lesser pronounced) spikes in retirement occurring around the preservation age, and the tax free superannuation age.

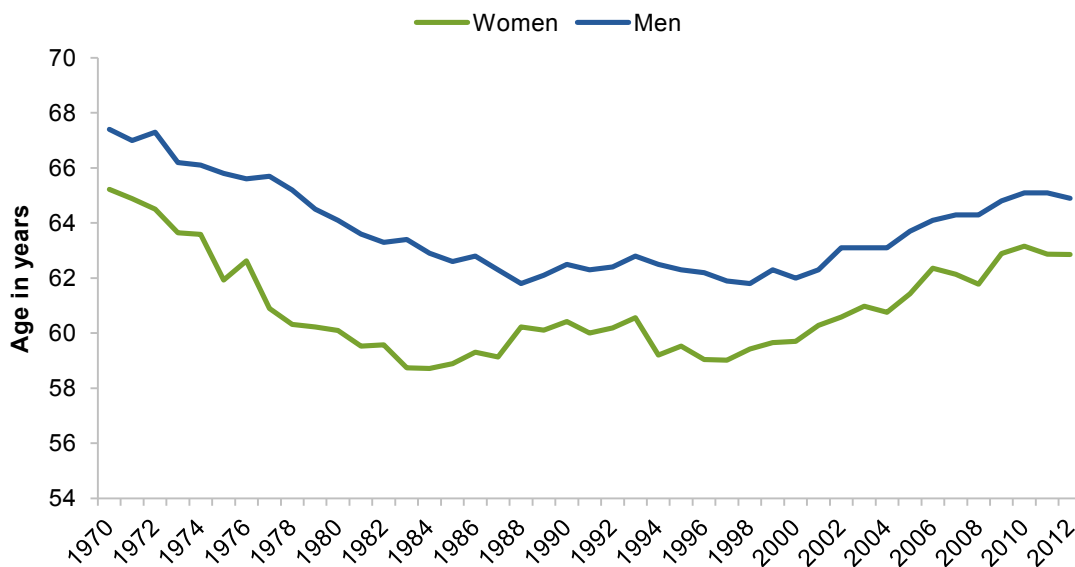
¹⁰ Levels of involuntary retirement in the future are likely to be affected by a mix of factors, including labour market conditions and the health of older Australians. The mix of factors at play makes it difficult to project rates of involuntary retirement. The nature and extent of involuntary retirement is discussed in more detail in supplementary paper 5.

By the age of 75, most people who intend to retire have retired. Just over 2 per cent of those aged over 45 years — mostly farmers and the self-employed — never retire from the labour force, at least according to their responses to surveys of retirement intentions.

While these trends are broadly representative of the current cohort of retirees, the average age at which people retire is not fixed — rather it changes over time in response to a wide range of conditions and influences. For example, in the 1970s and 1980s there was a trend towards earlier retirement in Australia (figure 3.3). This trend was attributed to a number of factors, including more people having the means to retire early, which itself is a function of the increased incidence of second income earners in families, and the rising spread of occupational superannuation (Ingles 2000).¹¹

The increase in early retirement was also attributed to adverse labour market developments, including discrimination against older workers (due to perceived skill and training deficiencies), and a decline in blue-collar jobs brought on by mechanisation and other structural changes in the economy (Ingles 2000; PC 1998).

Figure 3.3 Average effective retirement age for those working^a
1970 to 2012



^a The average *effective age of retirement* is an indirect measure of the actual retirement age. It is calculated as a weighted average of (net) withdrawals from the labour market at different ages over a 5-year period for workers initially aged 40 and over.

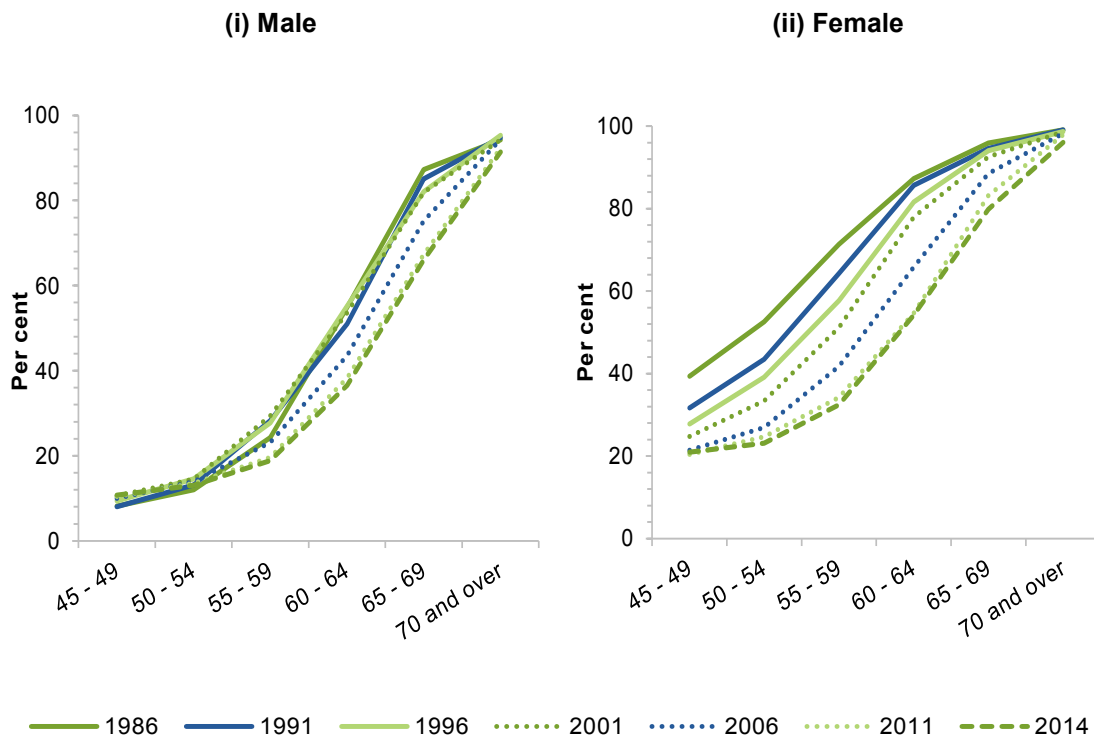
Data source: OECD (2015).

¹¹ Although some have argued that many of these early retirees could only have afforded to do so because they ultimately ended up on the Age Pension (Edey and Simon 1996).

There has been a gradual shift towards later retirement

In contrast to the retirement patterns observed in the 1970s and the early 1980s, over the past 10 to 15 years the average age at which both males and females have been retiring has been increasing (figures 3.3 and 3.4).

Figure 3.4 **Proportion of individuals who are retired, by gender and age cohort ^a**



^a Proportion of individuals in each age cohort classified as being 'Not in the workforce'.

Data source: ABS (*Labour Force, Australia, Detailed – Electronic Delivery, Jan 2015*, Cat. no. 6291.0.55.001).

For females, the change is due to increased labour force participation across all age groups, and reflects a longer-term development that dates back to the 1980s. The increase in female participation rates over this period resulted from increased levels of education, changing social attitudes towards gender roles, declining fertility rates, better access to childcare services and more flexible working arrangements (Australian Government 2015a). For males, the move to later retirement is mostly due to an increase in the labour force participation of older cohorts (particularly those aged between 60 and 70), and has largely occurred in the period since 2001.

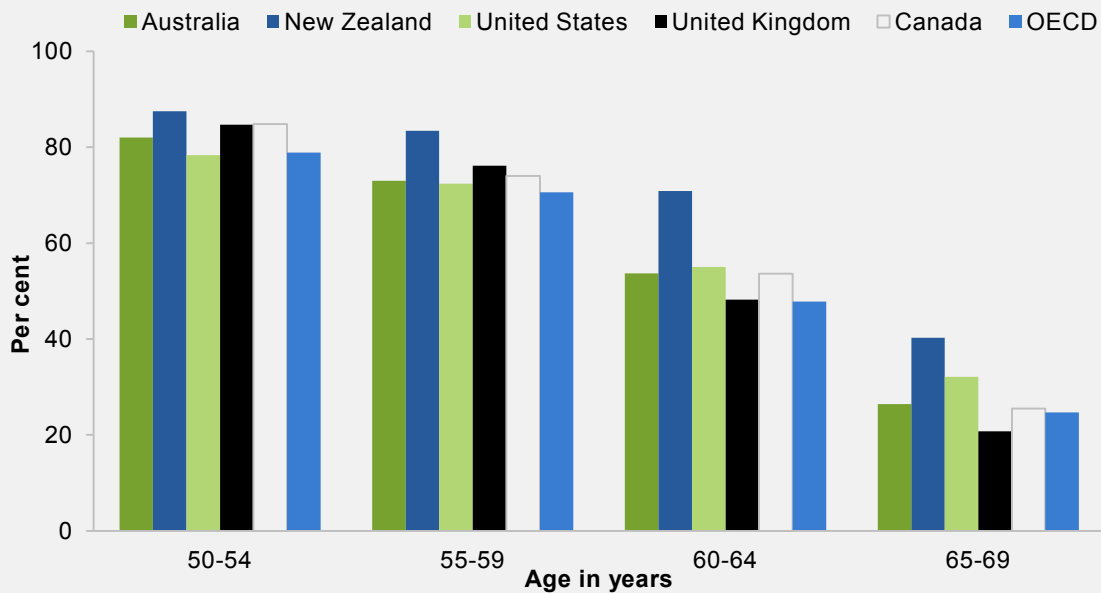
Notwithstanding the move towards later retirement, rates of workforce participation among older Australians are lower than in some other countries (box 3.1). This and other factors,

such as latent demand among mature age workers for greater employment opportunities, have led some to conclude that there is scope to increase average rates of labour force participation among mature age Australians above current levels — assuming that the right incentives and signals are in place.¹²

Box 3.1 How does Australia compare internationally?

Mature age labour force participation rates in Australia are just above the OECD average for most age groups. Participation is higher in Australia compared with the United States for people aged between 50 and 60, but lower for people aged over 60. Australia's participation is lower than New Zealand's at all ages, and significantly so in most cases. This may be due to the latter having a non-means-tested Age Pension scheme, which arguably encourages greater mature age participation. It may also reflect the less generous Age Pension in New Zealand (Guest 2013).

Mature age labour force participation rates (all persons)



Source: OECD (2015).

Individuals are spending longer in retirement

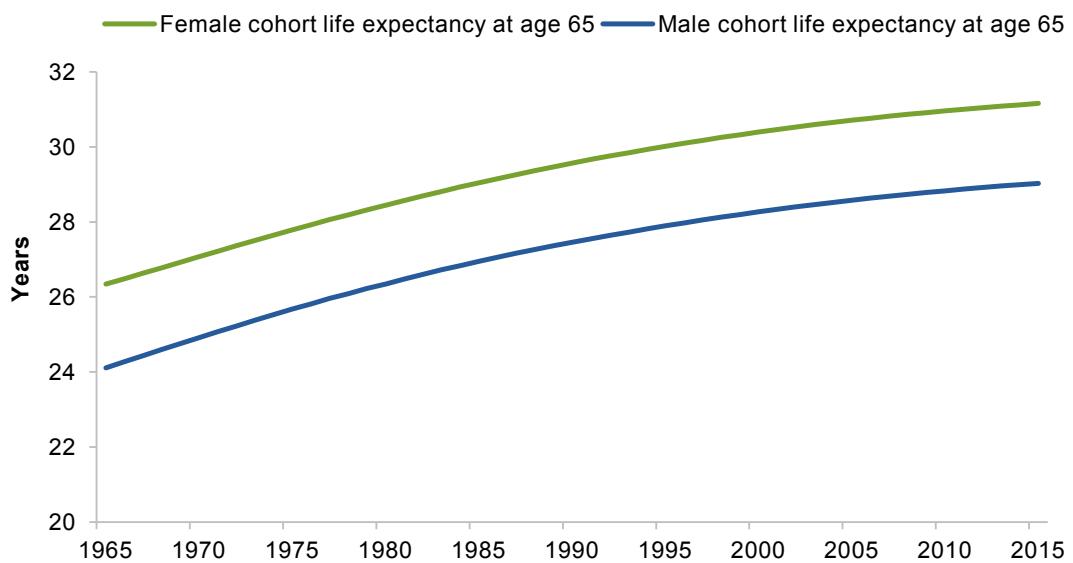
While there has been a gradual shift towards later retirement, life expectancy has also increased substantially over the last 40 years (figure 3.5). For example, a 65 year old woman in 2015 is expected to live for another 31 years (on average), which is around 5 years longer than a 65 year old woman in 1965 could have expected to live (PC 2013).

¹² For example, in 2011 there were over 185 000 people between the ages of 55 and 64 years who were not currently working and wanted a paid job — 1.5 per cent of the current total labour force (PC 2013).

As such, most current and impending retirees can expect to spend longer in retirement — perhaps 5 to 7 years longer — than their parents’ or grandparents’ generation.

At a time when the population is ageing, the prospect that many people may spend longer in retirement raises a sustainability imperative for government budgets. It is also important for individuals trying to determine the quantum of savings they need to accumulate during their working lives in order to fund a particular standard of living in retirement.

Figure 3.5 Life expectancy at age 65 years^a



^a Cohort life expectancy at a given age takes into account known or projected changes in mortality over the remainder of the average person’s lifetime.

Data source: PC (2013).

Pathways to retirement are also changing

Behavioural changes have not been confined to the age at which people retire — the process by which individuals are transitioning to retirement is also evolving. Retirement has traditionally been thought of as an abrupt change from full-time work to not working at all. However, the contemporary view of retirement is more nuanced, with many people believing or expecting that they will transition to retirement through bridging jobs, or by gradually reducing the hours of paid work they do until they are ready to permanently retire.

According to Warren (2015), many Australians claim that they are in transition to retirement, or intend to make a gradual transition in the future. However, the behavioural evidence indicates that gradual transitions to retirement are still comparatively uncommon. Using HILDA data, Warren (2015) finds that only 5 per cent of individuals transition to

retirement by first moving from full-time to part-time work. Where transitions to retirement do occur, they are typically observed among individuals with higher household wealth, longer work experience, and partners who work.

What might the future hold?

Many of the factors that have prompted individuals to retire later — increasing levels of education, changing attitudes, and more flexible working arrangements — will continue to impact retirement decisions in the future. Among women in particular, the strong cohort effect of higher participation at earlier ages that began in the 1980s is expected to underpin further increases in average mature age participation rates over the next two decades.

Some policy changes that are already in train are also likely to encourage individuals to retire later. For example, the already scheduled increase in the preservation age from 55 to 60 years, is expected to induce higher levels of workforce participation in the 55-60 year old cohort. However, the magnitude of the effect is not expected to be particularly large (Headey, Freebairn and Warren 2010). One reason is that not many individuals retire *voluntarily* between the ages of 55 and 60 (or before reaching 55), and hence there is little scope to change the aggregate retirement behaviour of this cohort.

The gradual increase in the Age Pension age from 67 to 70 years (if legislated) is expected to have a more pronounced effect on future retirement behaviour. As noted earlier, of the three ages, the Age Pension age motivates the largest increase in retirement, partly because there is a strong financial incentive to retire after reaching this age, but also because of its power as a social signal to retire (Headey, Freebairn and Warren 2010; Warren and Oguzoglu 2010).

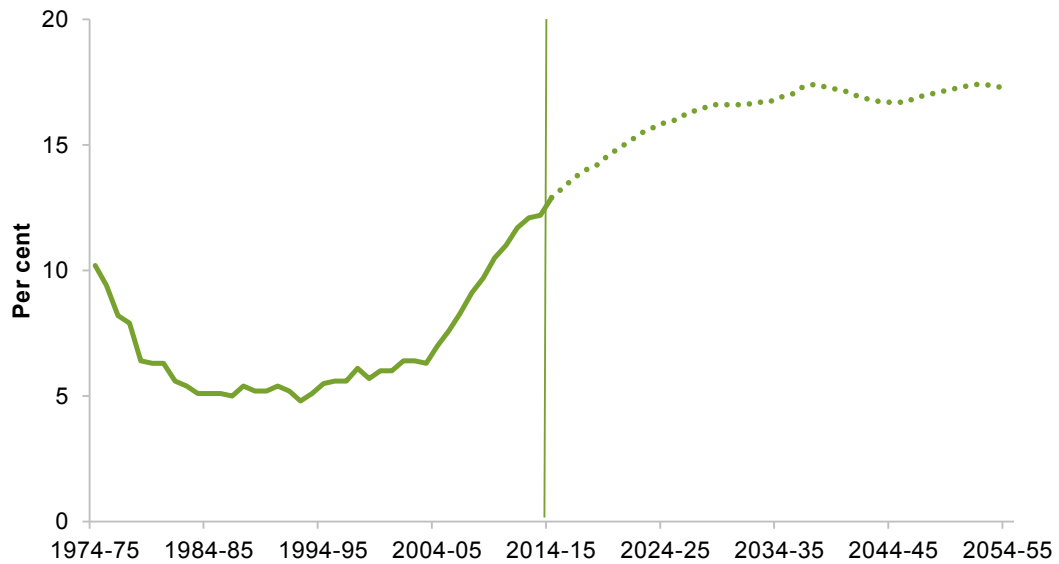
Future rates of mature age participation may also be influenced by changing attitudes and expectations regarding the quality of life in retirement. Some researchers argue that the ‘baby boomer’ generation — those born between 1946 and 1964, and many of whom are now approaching retirement — differs from previous generations in that they anticipate or desire a higher standard of living in retirement (McDonald 2011; National Seniors Productive Ageing Centre 2012). As noted by Warren:

Studies from the United States and Australia have concluded that relatively few baby boomers will retire early and a large minority will continue working past traditional retirement age, mainly due to the fact that they will not have saved enough to retire completely and still maintain their preretirement lifestyle. (2015, p. 146)

Gauging the cumulative impacts of these factors on future rates of mature age workforce participation is challenging. The most recent *Intergenerational Report* (Australian Government 2015a) projects an increase of around 4 percentage points in the average labour participation of people aged over 65 years during the next 40 years (figure 3.6). The increase is attributed to improvements in educational attainment, the cohort effect of greater female participation, and proposed changes in the Age Pension age. Most of the

growth is anticipated over the next decade, with the participation rate expected to stabilise at around 17 per cent after that.

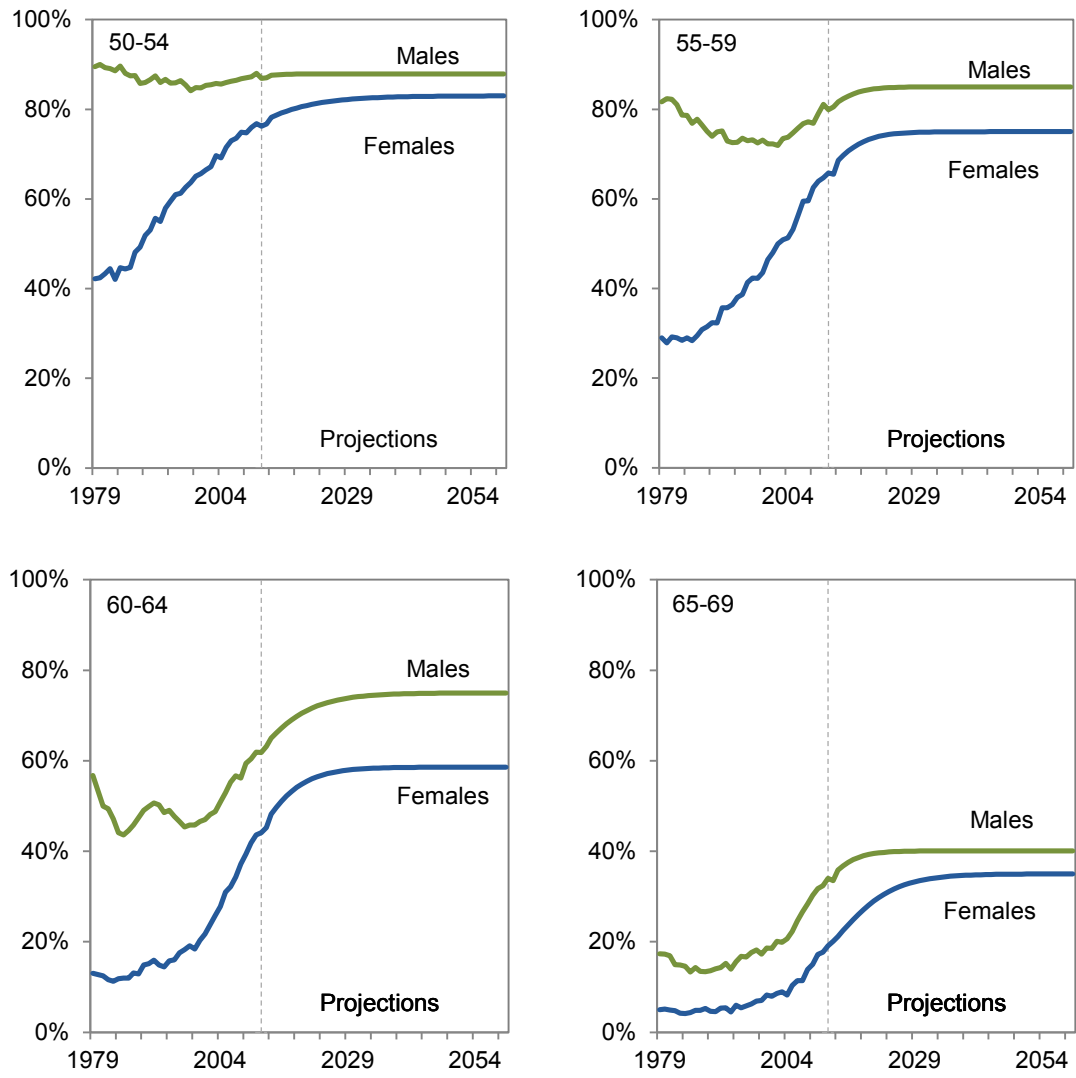
Figure 3.6 Participation rates of people aged 65 years and over



Data source: Australian Government (2015a).

These projections are broadly similar to those reported by the Commission in its most recent evaluation of the longer-term consequences of population ageing. The Commission's study identified the main driver of the increase in aggregate mature age participation as increased participation by women (across all age groups), although the participation rates of older men were also forecast to increase over the next decade or two (figure 3.7). These increases were attributed to growing educational attainment levels, greater lifetime attachment of women to the workforce, and a general pattern of deferred retirement (PC 2013).

Figure 3.7 Historical and projected labour force participation rates
 Percentage rates, average of the year ending June 1979 to June 2060



Data source: PC (2013).

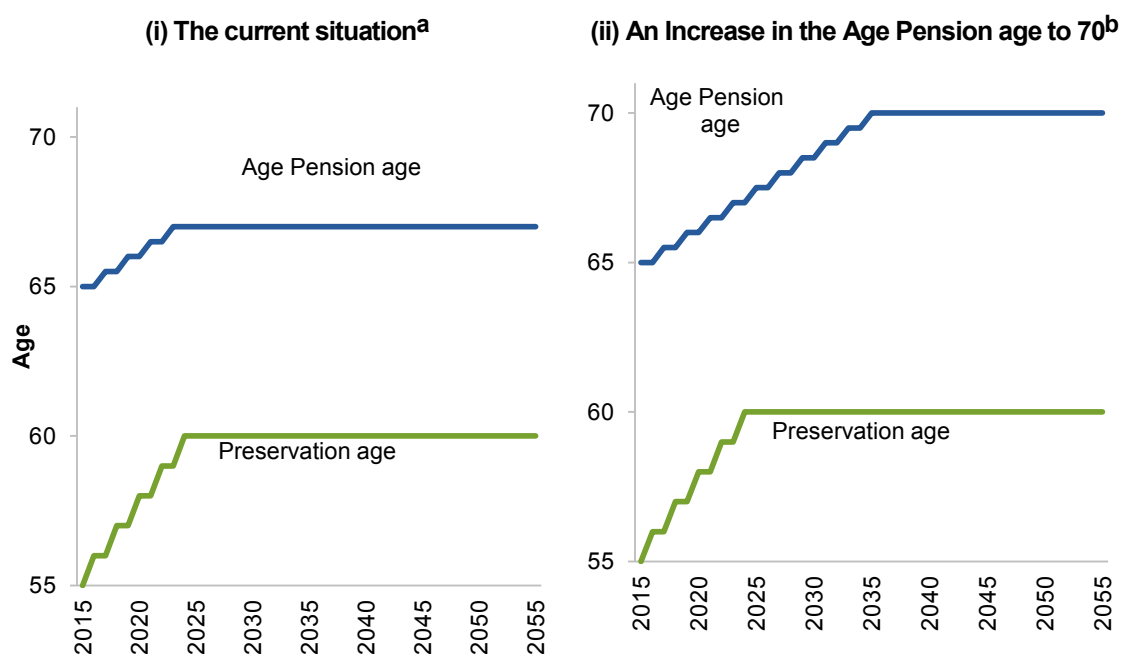
3.3 Will further increasing the preservation age impact retirement decisions?

The preservation age is scheduled to gradually increase from 55 years today to 60 years in 2025 (figure 3.8(i)). However, with policy measures in place to raise the Age Pension age to 67 years, and a stated policy goal to increase it to 70, debate has once again been prompted about where the preservation age should be set. The larger the gap between the two, the greater the opportunity available to individuals to run down their superannuation before reaching Age Pension age (figure 3.8(ii)). The Commission, in its report *An Ageing*

Australia: Preparing for the Future, pointed to the importance of revisiting the preservation age:

In principle, the preservation age should consider life expectancy and the Age Pension eligibility age as relevant factors. A preservation age linked to life expectancy would provide a financial incentive to stay in work for longer, and as noted earlier for the Age Pension, provide a shift in expectations about the age to retire ... In theory, changes to such age thresholds would be likely to increase superannuation account balances, reduce Age Pension outlays and stimulate labour supply. (2013, p. 201)

Figure 3.8 **Minding the gap — the period between the preservation age and the Age Pension age**



^a The gap between the Age Pension age and the preservation age falls from 10 years to 7 years by 2024, and then remains constant. ^b An increase in the Age Pension to age 70 as announced in the 2014-15 Budget, but not currently legislated, would see the preservation age gap widen.

A diverse range of stakeholders support (further) raising the preservation age. The Henry Tax Review recommended that the preservation age be gradually increased until it aligned with the Age Pension age. An increase in the preservation age (albeit to different levels) has also been supported by the Actuaries Institute (2014), Australian Council of Social Service (2009), the Grattan Institute (2013), and academics (Chomik and Piggott 2012a; Headey et al. 2007).

The arguments made by those in favour of raising the preservation age are relatively straight-forward. The expectation is that individuals will delay their retirement if they are unable to access their superannuation. The longer individuals remain in the workforce, the

larger their superannuation balances will be when they do retire, reducing calls on the Age Pension.

But there are a number of reasons why these expectations may not be fully realised. First, more years of work also mean fewer years of retirement. If the increase in (utility derived from additional) retirement income due to the postponement of retirement is not large enough to offset the shorter period of leisure, those who have the ability to draw on other (non-superannuation) savings or to take out a loan to finance an earlier retirement, will exit the labour force.

Second, raising the preservation age is unlikely to fundamentally alter the retirement behaviour of those who retire involuntarily. If these individuals are unable to access their superannuation, and do not have other savings on which to draw, they may transition onto income support payments, such as the Disability Support Pension, Carer Payment or Newstart Allowance.

A number of stakeholders pointed to these two effects as being reasons why raising the preservation age might only have modest impacts, with the latter raising equity issues for the less wealthy, who tend to face a higher rate of involuntarily retirement.

Using modelling to better understand the likely impacts

Assessing how a change in the preservation age works in concert with other factors that influence retirement decisions is a complicated task. In order to better understand how retirement behaviour might be affected by an increase in the preservation age, the Commission has developed a behavioural model, which provides a stylised representation of the retirement decision making process (box 3.2, figure 3.9).

Like other retirement models, the Commission's model is not designed to make precise projections of future behavioural changes. Indeed, it is not feasible to do so, given the difficulty in modelling household behaviour over a lifetime and, in the case of superannuation policies, the long time horizons considered. Rather, the Commission's modelling is intended to be indicative and highlight the avenues through which behavioural change is likely to occur.

Box 3.2 **Unpacking the Productivity Commission Retirement Model**

The decision makers — A change in the preservation age will not affect all households in the same way. To account for differences in the retirement decisions of households, the Productivity Commission Retirement Model (PCRM) groups households of a given age cohort into 12 different household types according to their couple status (single or couple), their gender (for single households), and their wealth relative to other households of the same type. Each of the 12 household types are further differentiated by 10 different preferences for non-paid work activities.

The nature of the decision — Given the fundamental differences between voluntary and involuntary retirement, the PCRM varies the nature of the retirement decision individuals face. Individuals that make voluntary retirement decisions are assumed to choose the retirement age that maximises their wellbeing across all the future years of their lives. These individuals are assumed to derive utility from three sources.

- Non-paid work activities. Setting aside the fact that working provides individuals with an income, individuals are assumed to prefer not working to working.
- Consumption, which is equal to wage income earned less savings for those who are still working; and asset draw downs plus any Age Pension payments for those who have retired.
- Bequests, which proxy a range of factors that lead to (mainly) wealthier households accumulating more savings, and after they retire, drawing down on their savings more slowly than would be expected if they intended to consume all of their savings before they die.

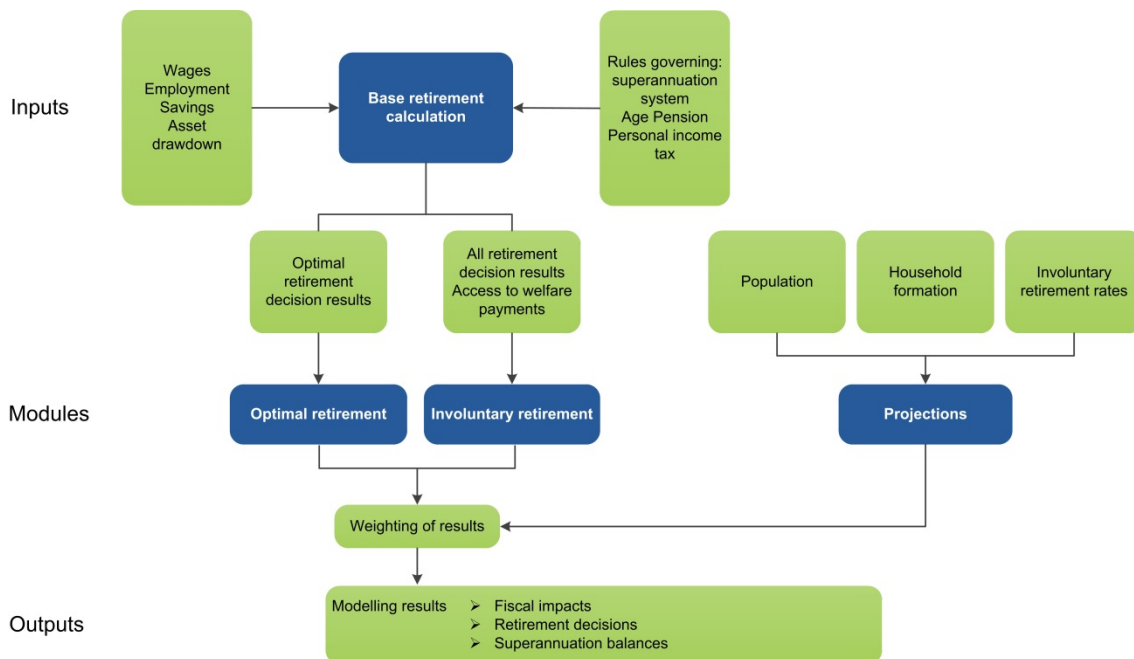
Some aspects of the retirement decision have been simplified. For example, it is assumed that: retirement is permanent; there is no explicit 'phasing to retirement'; and couple households retire at the same time and are of the same age. Not all of the factors that influence voluntary retirement — such as education levels and homeownership — have been explicitly included. That said, some factors have been indirectly included because they are highly correlated with factors that have been explicitly included (for example, the effect of education levels on retirement are likely to be proxied by wage earnings and wealth, which are included in the model). Other factors are implicitly included because the parameters in the utility model are calibrated such that the model reproduces current retirement behaviour.

While all households intend to retire voluntarily in the model, some **involuntarily retire** before they reach their desired retirement age. Data on involuntary retirement are used to determine how many households retire involuntarily. The likelihood of retiring involuntarily increases with age and is higher for low-wealth households.

The nature of the retirement decision embodied in PCRM relates only to the **timing of retirement**. However, in reality, households make more choices that affect their retirement than just choosing their retirement age. For example, individuals choose their level of voluntary contributions to superannuation and non-superannuation savings and the rate at which they draw down their assets in retirement. In the PCRM, individuals do not get to explicitly make these decisions, rather their behaviour is based on financial and other data. This means that within the model, individuals cannot divert superannuation contributions towards non-superannuation assets if investing in superannuation becomes less desirable. That said, the policy changes considered here are unlikely to significantly affect the desirability of superannuation as a savings device when the preferential tax treatment of superannuation is considered.

A detailed description of the PCRM is contained in supplementary paper 6.

Figure 3.9 The Productivity Commission Retirement Model



What does the model tell us about how retirement age might change over time?

Given that any change in the preservation age is unlikely to apply immediately, it is retirement behaviour in the *future* that will determine the effects of policy changes. The model's *base case* projects one view of how retirement behaviour might change going forward. It incorporates a number of factors that are likely to change the distribution of retirement ages over time, including:

- *the maturing of the superannuation system.* With larger superannuation balances, more households will have the option of retiring earlier. At the same time, some households with greater wealth may decide to work for longer (due to the bequest motive).¹³
- *increases in real wages.* On the one hand, this will decrease the incentive to retire for individuals as they will have to forgo a higher income. On the other hand, if individuals have higher incomes over their working lives, they will also have larger savings balances, which could encourage them to retire earlier.
- *legislated changes in government policy,* such as the gradual increase in the Superannuation Guarantee to 12 per cent, the increase in the preservation age from 55 to 60 years by 2025 and the increase in the Age Pension age from 65 to 67 years

¹³ As savings balances increase, the marginal benefit of delaying retirement for bequeathing purposes increases because the absolute returns to savings are higher.

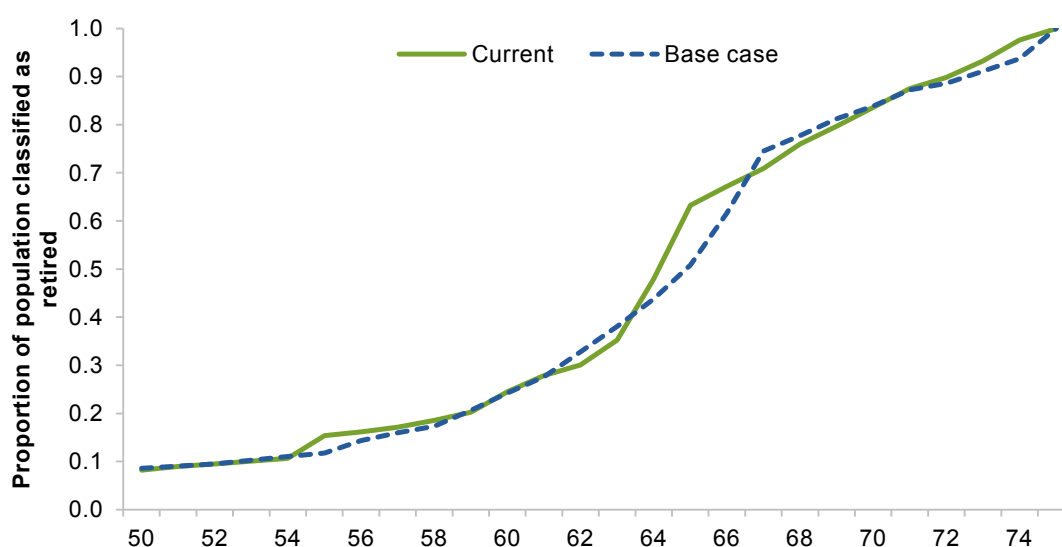
by 2023. As already discussed, these latter two changes are likely to delay the retirement of individuals.

The retirement age distribution under the base case for the period 2012 through 2055 is depicted in figure 3.10. There are three noticeable features:

- A delay in retirement for individuals who retire before age 60. This is due to an increase in the preservation age from 55 to 60.
- A shift in the spike in retirement at age 65 to age 67. This is due to the increase in the Age Pension age from 65 to 67.
- A modest increase in the proportion of individuals who retire at the ages of 62 and 63. This is because the incentive to retire earlier (due to the fact that households have larger savings balances) is stronger than the factors that delay retirement (such as an increase in real wages and hence foregone income).

It is against this base case that the impacts of increasing the preservation age are assessed.

Figure 3.10 **Model retirement behaviour (today and projected)^a**



^a Current retirement behaviour is calibrated to behaviour of 50 year olds in 2012 assuming no policy changes (whether legislated or not). Base case retirement behaviour is for 30-34 year olds in 2012 assuming legislated policy changes.

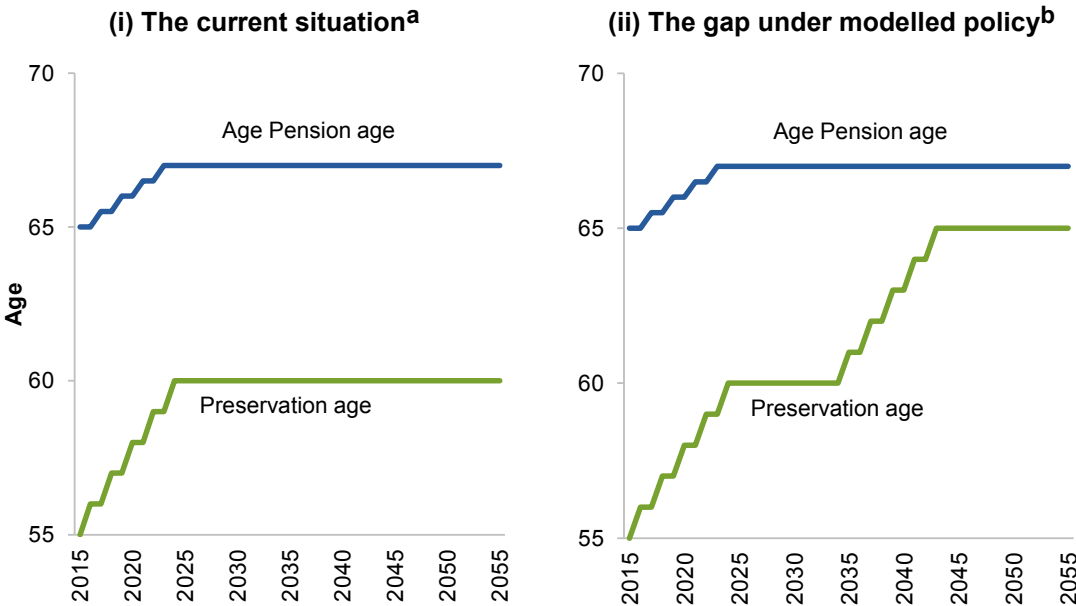
Data source: Commission estimates.

What are the impacts of raising the preservation age to 65?

The Commission has assessed the impacts of a gradual increase in the preservation age to 65 years (figure 3.11). Such an option represents a middle-ground and is consistent with

past approaches, which have provided affected individuals with sufficient lead times to adjust their behaviour given the lag between savings decisions during working years and eventual retirement incomes. The impacts associated with alternative transition pathways and sensitivity analyses are detailed later in this paper and in supplementary paper 6.

Figure 3.11 Narrowing the gap — modelling a closer preservation age and Age Pension age



^a The gap between the Age Pension age and the preservation age falls from 10 years to 7 years by 2024, and then remains constant. ^b The policy modelled is the same as the current situation, until 2035, when the gap begins to narrow with an increasing preservation age — falling to a 2 year gap by 2043.

Consistent with expectations, raising the preservation age encourages some individuals to retire later and accrue more superannuation savings. However, the Commission’s modelling results suggest that these impacts are likely to be concentrated among a relatively small share of the population. Increasing the preservation age to 65 is likely to increase the participation rate of older workers, such that by 2055, the average participation rate among 50 to 64 year olds is around 2 percentage points higher. Households that delay their retirement do so by around two years, and are likely to have superannuation balances that are around 10 per cent larger in real terms when they retire.

The impacts of an increase in preservation age vary across cohorts. Under the policy scenario explored by the Commission, the first cohort to be affected by a change in the preservation age are those who were 30-34 years old in 2012.¹⁴ Around 14 per cent of this group are projected to delay their retirement under this scenario, and will accumulate superannuation balances that are around 9 per cent larger in real terms when they retire.

¹⁴ This cohort of individuals would be 73-77 years of age in 2055.

The modelling results also suggest that the impacts on successive cohorts are slightly more pronounced. For example, of the cohort of individuals who were 20-24 in 2012, around 17 per cent delay their retirement. This is because they are likely to have accrued more superannuation savings than previous cohorts (both due to real wage growth and having made contributions for longer and at a higher rate) such that a change in the preservation age is more likely to influence their behaviour.

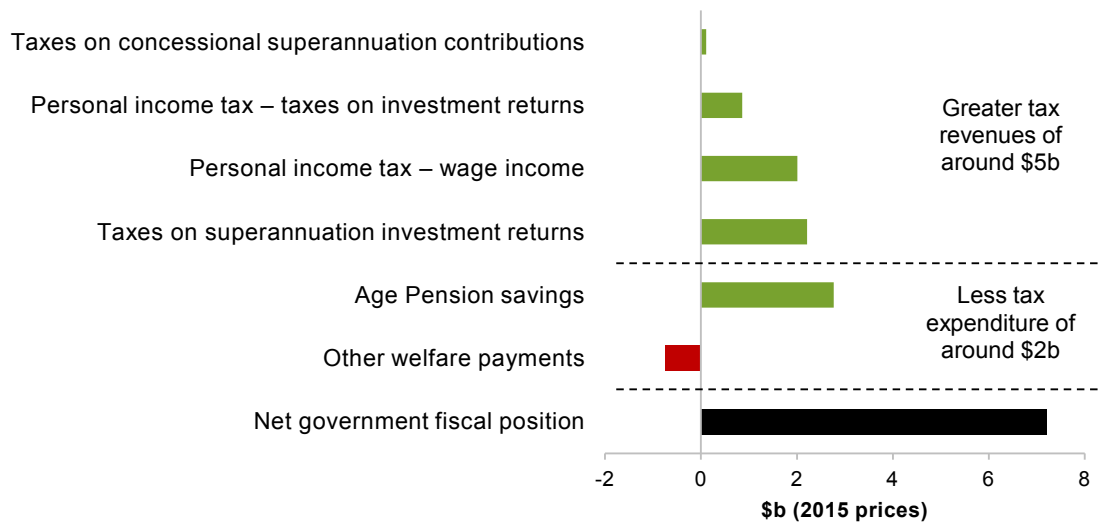
What about government (and taxpayers)?

A change in the preservation age would also have implications for government expenses and tax receipts. This occurs through a number of different mechanisms, almost all of which contribute to an improvement in the government's fiscal position.

- Households that delay their retirement would pay personal income tax on the additional wage income that they earn. They would also make additional superannuation contributions (both compulsory and voluntary), which would also be taxed.
- The superannuation returns of those who delay their retirement would be taxed for additional years (superannuation returns are not taxed when they are in the 'pension phase'). Extra taxes would also be collected on the superannuation returns of those who have involuntarily retired because these individuals may have to wait additional years to access their superannuation savings.
- Taxes on returns to non-superannuation assets would be paid for additional years. This is because non-superannuation assets are only assumed to be consumed in retirement.
- Some households that delay their retirement would access the Age Pension at a later age because they would have larger superannuation balances at retirement.
- Some households that involuntarily retired under the base case may need to rely on welfare payments for up to five additional years before they can access their superannuation savings. However, these additional payments might be offset by reduced Age Pension payments in later years.
- Some households that previously retired voluntarily, might retire involuntarily if they cannot delay their retirement. These households might be eligible for some kind of welfare payment (for example, Disability Support Pension, Newstart Allowance or Carer Payment).

Results from the PCRMM indicate that the annual cumulative fiscal impact could be in the order of \$7 billion (in 2015 prices) by 2055, with around \$5 billion arising due to an increase in tax receipts (especially taxes on superannuation returns). A net reduction in outlays contributes around a further \$2 billion (figure 3.12).

Figure 3.12 Fiscal effects in 2055 of increasing the preservation age^a



^a In the main, the base case that underpins these modelling results incorporates legislated changes in retirement income policy, but does not include changes that have been proposed and are subject to the passage of legislation. The increase in the Age Pension age to 67 is incorporated in the base case, whereas a further increase in the Age Pension age to 70 and recently passed (22 June 2015) changes to the Age Pension assets test have not been incorporated.

How do the impacts vary by household?

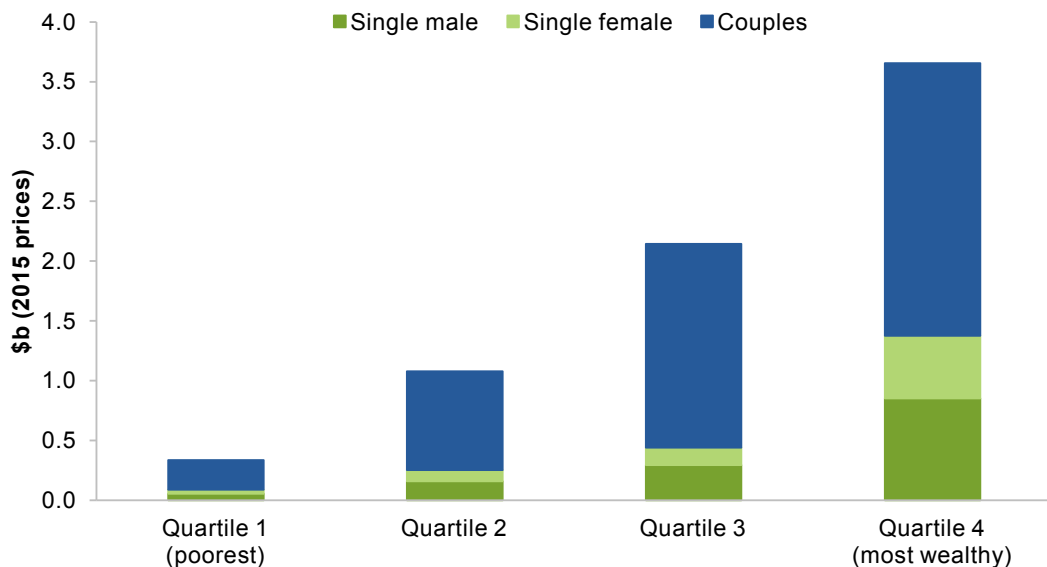
One factor that has contributed to broad-based support for an increase in the preservation age is the belief that it will encourage wealthier individuals to remain in the workforce longer.

The Commission’s modelling results largely support this view. Wealthier individuals are, on average more likely to delay their retirement. They also have higher superannuation savings (and so pay more tax on superannuation earnings) and receive fewer welfare payments in later years. These factors combined mean that the bulk of the fiscal gains associated with an increase in the preservation age can be attributed to wealthier households (figure 3.13).

In contrast, poorer individuals tend not to delay their retirement in response to a change in the preservation age — their limited superannuation savings mean that the Age Pension age is far more important in determining when they might retire. Even so, poorer individuals will still be affected by an increase in the preservation age. They have a greater likelihood of becoming involuntarily retired and so may have to wait up to an additional five years before they can access their superannuation savings. The modest fiscal savings attributed to lower wealth households arise, in part, because their superannuation earnings are taxed during this time. Some stakeholders have proposed that any increase in the preservation age be accompanied by a relaxation of early access arrangements for the

involuntarily retired. Doing so would have two (opposing) fiscal effects — reducing calls on government payments and reducing tax revenues on superannuation earnings relative to the counterfactual.

Figure 3.13 Most of the fiscal gains associated with an increase in the preservation age can be attributed to wealthier households^a
Fiscal impact in 2055 by household type



^a Note that in assessing the fiscal impacts by wealth, the ‘cut-offs’ for each quartile are determined separately for single male, single female and couple households and vary across age groups and time. The impacts on those with SMSFs is not modelled explicitly, rather population-wide data on superannuation savings were used to inform the model.

What about alternative policy options?

What happens if the Age Pension age increases to 70 (as announced)?

The modelling presented thus far has assumed that announced (but yet to be legislated) increases in the Age Pension age from 67 to 70 do not occur. If these changes do occur then the impact of increasing the preservation age will be more muted. This is because an increase in the Age Pension age will delay the retirement age of some households that were originally intending to retire before 65. The Commission’s modelling results suggest that the improvement in the government’s fiscal position from raising the preservation age from 60 to 65 would be about \$2.5 billion (in 2015 prices) lower — \$4.7 billion instead of \$7.2 billion in 2055 — if the Age Pension age were increased to 70.

What happens if the preservation age increase was not delayed?

As mentioned previously, the Commission has initially assumed that any increase in the preservation age would be delayed in its implementation (occurring gradually over the period 2026 to 2032). If the increase in the preservation age were not delayed and occurred immediately after the current increase (i.e. in 2026), the fiscal gains associated with the policy would occur at an earlier point in time. However, according to the Commission's modelling, by 2055 the preservation age change would be fully phased in under either scenario, and so the annual gain *in that year* from an immediate preservation age increase would be fairly similar to the delayed increase scenario (\$7.9 billion compared to \$7.2 billion).

Results are sensitive to key assumptions

The results are heavily dependent on the assumptions that underpin the Commission's model (especially the assumed rate of time preference and investment returns). Box 3.2 highlights some of the key modelling assumptions, and the assumptions are outlined in full in supplementary paper 6. Sensitivity analyses that vary some (but not all) key assumptions suggest that the change in labour force participation of 50-64 year olds from increasing the preservation age could vary from 0.8 to 3.8 percentage points. Similarly, the annual fiscal impacts could range from \$2.9 billion to \$11.6 billion in 2055.

3.4 Where to from here?

The modelling results suggest that raising the preservation age would increase mature age participation rates, and generate higher superannuation savings for those workers delaying their retirement. Raising the preservation age would also ease pressure on the government's budget by around \$7 billion in 2055 and in so doing improve its capacity to manage the transition to an older Australia.

While the analysis contained in this report gives a sense of the impact of changes to the preservation age on retirement decisions, superannuation balances and fiscal outlays, it cannot, on its own, determine if a change in the preservation age is warranted. As noted in the Commission's report, *An Ageing Australia: Preparing for the Future*, the government has a number of means at its disposal to manage the fiscal pressures associated with an ageing population. Ideally, policy makers would weigh up the merits of these options before deciding on any given response.

More fundamentally, any assessment of the relative merit of raising the preservation age should take into account the objectives of the superannuation system and the broader retirement income system in which it resides. Such an assessment is hampered by the absence of clear and prioritised objectives. It is difficult to design effective policy when there is no consensus on what the policy objectives should be. Ideally, consideration of any

changes to the preservation age would be considered within the context of a holistic review, informed by broad and extensive community consultation.

Implementation issues will be important

While this report has assessed the likely form and magnitude of the impacts of raising the preservation age, the Commission has not turned its attention to implementation issues. The capacity of individuals who become involuntarily retired to access their superannuation savings prior to reaching the preservation age is one obvious implementation issue that would need to be considered.

Currently, early access provisions only apply in a very limited set of circumstances, and in most cases, only provide for the release of comparatively small amounts. Individuals have two avenues for gaining early access to their superannuation benefits — they can apply to the Department of Human Services on compassionate grounds, or they can apply to their superannuation fund on a number of grounds including severe financial hardship, terminal illness and disability (supplementary paper 1). In practice, early release on compassionate grounds is relatively uncommon.

Early access to superannuation is particularly important to some groups within the community. Aboriginal and Torres Strait Islander Australians, for example, face shorter life expectancies and higher incidences of chronic illness and poverty relative to the rest of the community. While this group may be more inclined to need to withdraw their superannuation early, the administrative requirements — such as having letters from both a medical practitioner and a specialist where funds are being used to pay for medical treatment — appear to impact disproportionately on this group. This is only one of a range of challenges Aboriginal and Torres Strait Islander Australians face when attempting to engage with the complexities of the superannuation system (box 3.3).

Box 3.3 **Aboriginal and Torres Strait Islander Australians and the superannuation system**

On average, Aboriginal and Torres Strait Islander Australians have lower superannuation coverage and lower balances than the general population. These disparities arise in large part due to differences in paid labour force participation.

In 2010, superannuation coverage for Aboriginal and Torres Strait Islander men was around 70 per cent and coverage for women was around 60 per cent. By comparison, coverage rates for the population more broadly were 85 per cent for men and 80 per cent for women (ASFA 2012). Aboriginal and Torres Strait Islander men had on average just over \$55 000 in superannuation savings, relative to \$110 000 for men in the broader population. For women the respective figures are just under \$40 000 and \$63 000. Median balances for both Aboriginal and Torres Strait Islander men and women are much lower at \$14 000 and \$15 000 (ASFA 2012).

With comparatively less in superannuation, the erosion of superannuation balances through fees has been raised as an issue. For example, a participant in a pilot study into financial literacy and superannuation awareness amongst Aboriginal and Torres Strait Islander Australians, noted:

I don't support the superannuation because of things that happen to me and my husband in the past. We had jobs that paid good wages and they took our money out for super and taxes and did not pay it to their company (fund?). Another problem was my husband was in one Super for a long time – 10 years? – and the company told him that he has no Super with them because it all went in accounting fees. I don't have a lot of faith in Super any more. I find I would be better off if I put money into a bank account and saved it that way, where I can keep an eye on my Super and get interest at the same time. (Gerrans, Clark-Murphy and Truscott 2009, p. 435)

Not only do Aboriginal and Torres Strait Islander Australians have comparatively less in superannuation, the complexity of the superannuation system can make it hard for them to access their savings. For example, naming conventions, combined with lower levels of financial literacy (supplementary paper 4) mean that the incidence of lost superannuation amongst this group is high and it can be difficult for them to prove that lost superannuation is theirs.

The role that the superannuation system is perceived to play may also have an influence on how Aboriginal and Torres Strait Islander Australians engage in understanding the system. If it is perceived as savings to be left as a bequest, rather than for retirement income, then this can reduce the motivation to understand the system better. For example, as Anthony McCarthy — a manager of Catholic Super — noted about a conference held by the National Aboriginal and Torres Strait Islander Catholic Council in 2012:

Most of the questions were about funeral benefits and (provisions) for the beneficiaries. ... Almost none of the questions were actually about retirement or how to access money at an earlier stage during the life span. It was a little bit shocking. They didn't seem to see it as something they could access through their lifetime. (McCarthy in James 2012)

Finally, even if early access provisions were altered, this alone would not necessarily provide an adequate safety net. As noted earlier, less wealthy households are more likely to become involuntarily retired. These same households are also less likely to have significant superannuation savings and may therefore need to rely on income support payments. Some form of safety net would need to be in place to protect the wellbeing of these individuals, who may spend a considerable amount of time out of the workforce.

4 Is drawdown behaviour a concern?

Key points

Individuals are afforded much flexibility in how they draw down their superannuation. Many stakeholders are concerned that people draw down their superannuation assets too quickly by taking large lump sums once they reach retirement. However, less than 30 per cent of superannuation assets are taken as lump sums and when lump sums are taken, they have a median value of around \$20 000.

Lump sums are more prevalent among those who have low superannuation balances (below \$10 000) including women (especially single women), low wealth households, and renters — these sections of the population take between half and all of their superannuation assets as lump sums. Those with comparatively more superannuation savings tend to take lump sums that comprise a relatively small proportion of their superannuation assets.

Evidence indicates that people are generally prudent in their drawdown behaviour. Where lump sums are taken, they are used to retire debt or purchase goods and services that can be used throughout retirement, such as making home improvements and purchasing consumer durables.

Lump sums are likely to decline in importance as the superannuation system matures. But even once maturity is reached, it will still make good financial sense for some retirees to take a lump sum, particularly those with low superannuation balances and those entering retirement with debt.

Income streams are used more frequently by those with comparatively large balances. Account-based pensions provide greater flexibility and are more commonly used to draw an income stream from superannuation than annuities, which prioritise certainty. Some stakeholders have recently raised concerns that retirees draw down their account-based pensions too slowly.

A range of factors has likely contributed to the low demand for annuities, including: the preference for flexibility; the difficulty retirees' face in understanding the risk of outliving their savings and the role of the Age Pension in managing this risk; and the removal of concessional treatment of annuities. Providers have recently offered more tailored products and demand for annuities has started to increase, albeit from a low base.

Proposals to encourage retirees to purchase particular income stream products should have regard to the diverse circumstances of retirees including their superannuation balances, other assets, debts and needs. Such proposals should also have regard to the broader workings of the retirement income system and be subject to communitywide consultation.

The task of analysing drawdown patterns is frustrated by the lack of consistent data. There are large differences in the definition, measurement and collection of data on lump sums and superannuation income streams. This makes it difficult to track lump sums and income streams across time.

When it comes to examining the superannuation system, *how* people access their superannuation is as important as *when* they access it. People have a number of choices in how they draw down their superannuation — once they have met certain criteria.¹⁵ People can take a lump sum (an irregular withdrawal from their superannuation balance), they can draw down their superannuation assets as a regular income stream (box 4.1) or take some combination of the two.

The distinction between lump sums and income streams is not always straightforward. For example, people can use their lump sums to purchase income stream products for retirement. They can also take lump sums from their account-based pensions — currently the most common method used to draw a superannuation income stream.

Box 4.1 **Types of superannuation income streams**

There are various **income stream products** that people can use. Most commonly, people derive income from **account-based pensions**, which are subject to minimum drawdown rates based on age (supplementary paper 1).

Account-based pensions allow people to withdraw lump sums, but do not enable people to make contributions once they have started drawing an income, and do not provide certainty in terms of the period over which the income stream will last. While they can be designed to produce fixed, regular income amounts like an **annuity**, the ability of an account-based pension to continue to pay these amounts will depend on the performance of the underlying investments.

Other forms of income streams include annuities, which generally do not allow lump sums to be withdrawn without a substantial financial penalty, but generate a regular income stream for a determined period.

Some forms of annuities, such as **lifetime annuities**, also manage longevity risk (the risk of outliving superannuation savings) by sustaining an income stream for the life of the recipient.

The degree of flexibility that people have in drawing down their superannuation assets has advantages and limitations. A flexible system may be appropriate given the wide variety of needs and circumstances people face in retirement. For example, having the opportunity to take a lump sum can assist retirees in making significant purchases and meeting unexpected costs.

However, this flexibility may increase the risk that people outlive their superannuation savings (longevity risk), and potentially allow for some to structure their affairs to maximise access to welfare and taxation benefits. The flexibility afforded by the superannuation system has been the subject of much recent debate, with some stakeholders proposing that there should be restrictions on the use of superannuation savings and the form in which benefits can be taken.

¹⁵ Once a person reaches the age of 55 — the preservation age — they can start accessing superannuation if they meet one of the conditions of release, which include being retired or transitioning to retirement. The rules around when and how superannuation can be accessed are discussed in supplementary paper 1.

This chapter examines whether stakeholder concerns about drawdown behaviour, and particularly the use of lump sums, are valid. The chapter begins by outlining the nature of these concerns (section 4.1). Next, the chapter reveals how households draw down their superannuation, which households take lump sums and the nature of spending that occurs when lump sums are taken (sections 4.2 and 4.3). The chapter then considers the financial position of households at retirement, and against this backdrop, examines whether there may be sound reasons for individuals to take a lump sum and whether there is widespread restructuring of drawdown patterns to maximise access to the Age Pension (section 4.4). How drawdown behaviour might change in the future as the superannuation system matures is then considered (section 4.5). The chapter concludes by exploring some of the reasons why particular income stream products have not been frequently used and whether there is a case for policy change (section 4.6).

4.1 What do people say about lump sums?

Many stakeholders consider that Australians prefer lump sums to a guaranteed retirement income stream even though they risk outliving their superannuation savings — sometimes referred to as a ‘lump sum mentality’, ‘culture’ or ‘bias’ (Association of Superannuation Funds of Australia (ASFA) 2014a). It has been suggested that this bias makes individuals worse off in three ways.

First, it is argued that lump sums should be restricted because they reduce the superannuation income that could have otherwise been generated. These arguments assume the role of the superannuation system is to provide an income stream in retirement.

Reflecting a likely objective of providing adequate and sustainable income throughout retirement, the policy framework should include mechanisms that promote benefits being primarily taken as income streams rather than lump sums. A focus on retirement income adequacy and sustainability, rather than wealth accumulation at retirement date, is needed. (APRA 2014b, p. 75)

It is our view that the purpose of the Australian Superannuation system is to provide retirement incomes for Australians. In this sense we support mechanisms that encourage, but not mandate, retirees to take out income stream products, rather than to take lump sums. (AFA 2014, p. 11)

Second, some argue that a preference for lump sums reduces retirees’ living standards by encouraging them to prematurely exhaust their superannuation savings — by allowing excessive consumption at retirement or taking on too much debt during their working years.

Lump sum superannuation benefits are being treated as a windfall and being used to pay for the lifestyle that’s being lived now instead of being put aside to provide income in retirement. ... Serious consideration must be given to limiting the amount of superannuation that can be taken as a lump sum and encouraging income streams in retirement. (CPA Australia 2012, p. 2)

In a society facing population ageing it is important that individuals have access to appropriate retirement income products and make well informed choices. The alternative may be lower

standards of living (e.g., greater reliance on the Age Pension), a misallocation of resources (where lump sums are spent primarily on immediate consumption or housing, which is tax- and means-test-advantaged), and future fiscal costs (via Age Pension, health and aged care). (CEPAR 2014, p. 8)

Third, it is also argued that lump sums, by encouraging superannuation balances to be drawn down too quickly, increase Age Pension outlays as people structure their drawdown patterns to maximise government benefits or inadvertently exhaust their superannuation and end up on the Age Pension prematurely.

For fiscal purposes government should favour a risk management solution that encourages the retiree to take an income stream over a lump sum ... (Actuaries Institute 2015, p. 3)

But views on the shortcomings of lump sums are far from universal, with some stakeholders suggesting that the ‘lump sum mentality’ is exaggerated (Rice Warner 2015), and other research finding that retirement behaviour is not properly understood.

... when you read in the press and when you hear people talking about Australian retirees you get this caricature of people — that Australians generally withdraw a lump sum from their superannuation, they spend it quickly on a 4WD and a caravan and they take a long holiday (become grey nomads for a couple of years) then suddenly realise that they’ve run out of money and spend the remainder of their life on the Age Pension. So we get this cartoon analysis of what people are like in retirement. (Thorp 2013)

And others consider that lump sums may improve retirees’ living standards as the goals of maximising income and enhancing wellbeing may not always align.

A reasonable interpretation of the data is that persons retiring mostly do not spend the money [lump sums] frivolously but on items which will raise their standard of living in retirement. But a part of the longer term benefit is indirect (home improvements, new car) rather than direct investments generating retirement income. (Rothman and Wang 2013, p. 11)

It is clear that the desirability of lump sums is perceived differently by the superannuation industry, its regulators and its researchers. This is not surprising given that the broader question about what role superannuation should play in retirement is contested (chapter 1), and is in practice likely to vary across individuals with different means, preferences and aspirations. Only a closer examination of how superannuation is drawn down can answer questions about whether lump sums can play a useful role in improving welfare in retirement; whether lump sums are spent on ‘frivolous’ consumption or goods and services that supplement the living standards of retirees; and whether the costs to the community in providing the Age Pension are increased by the use of lump sums.

4.2 How is superannuation being drawn down?

Assessing the existence of a bias towards taking superannuation as a lump sum requires an understanding of current drawdown patterns and their likely evolution as superannuation balances grow. Examining trends in the drawdown patterns of the population, and the share

of superannuation benefits that are taken as lump sums can assist in assessing the extent of lump sum behaviour in the future.

Analysis of drawdown patterns and the prevalence of the ‘lump sum mentality’ depends on the availability of high-quality data and evidence. There are many sources of information on drawdown behaviour that could be used to build the evidence base, but little consistency in how data are defined, measured and collected (table 4.1). This frustrates the task of accurately and consistently measuring the incidence and size of lump sums over time and helps explain why stakeholders have formed conflicting views on the propensity of retirees to take lump sums. In drawing together its analysis, the Commission has considered the advantages and limitations of the various data sources and employed the source that it recognised as being most ‘fit for purpose’. The distinctions between, and limitations of, the various data sources are discussed in detail in supplementary paper 7.

More assets are taken as income stream rollovers than lump sums

It is a commonly held view that lump sums are strongly preferred to income streams from superannuation. However, most retirees who have superannuation assets receive some form of income stream — usually in the form of an account-based pension. Income streams are most common among those with relatively higher superannuation balances (those in quartiles 3 and 4, figure 4.1).¹⁶

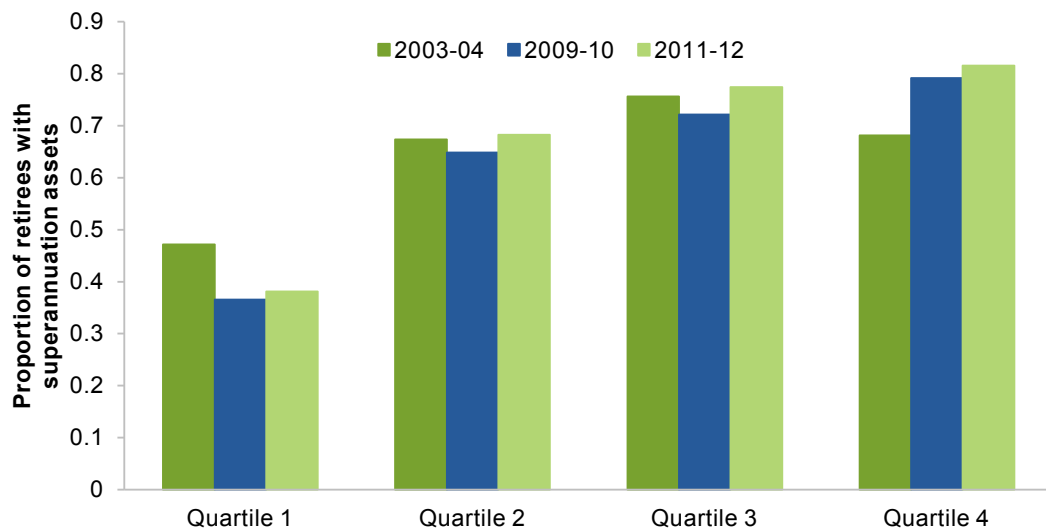
¹⁶ The Commission uses quartiles and quintiles in its analysis to highlight behavioural differences in the population. Quartiles divide the population into four groups based on some characteristic such as household wealth. The population is divided into the lowest wealth group (quartile 1), second-lowest wealth group (quartile 2), second-highest wealth group (quartile 3) and highest wealth group (quartile 4). Quintiles divide the population into five groups and include a ‘middle group’.

Table 4.1 Comparison of drawdown data sources

<i>Collection agency</i>	<i>Value of lump sums (\$b)</i>	<i>Lump sum share of total benefits ^a</i>	<i>Definitions, measurement and collection</i>
APRA (2014a)	36.5	49%	<ul style="list-style-type: none"> • Funds report benefits, which are validated against previous reporting and the Australian Taxation Office (ATO) supplies Self-managed superannuation fund (SMSF) data on total benefits. • Lump sums include those taken for reasons other than retirement, including death benefits and re-contribution strategies. • Lump sums of any value are recorded.
ABS (2013)	11.1	30%	<ul style="list-style-type: none"> • Data are self-reported by individuals. • Lump sums are recorded as ‘irregular payments from superannuation over the last two years’. • Income streams are recorded as ‘weekly income from superannuation and annuities’. • Total benefits are the sum of lump sums taken over the last two years and annual income from superannuation. • Excludes lump sums under \$500.
ATO (2015f)	2.9	28%	<ul style="list-style-type: none"> • Data are self-reported by individuals or tax agents. • Lump sums include those taken for reasons other than retirement, including disability. • Population covers taxable benefits only. Excludes many over the age of 60 years because in most cases they are not required to report their superannuation benefits. ^b • Lump sums under \$200 are not reported. These are mainly due to the closure of low value accounts.
Melbourne Institute of Applied Economic and Social Research (2015)	7.4	21%	<ul style="list-style-type: none"> • Data are self-reported by individuals. • Superannuation benefits are the sum of the total value of lump sums taken in the period of a year and income from superannuation and annuities over the year.
Rice Warner (2015)	9.2	17%	<ul style="list-style-type: none"> • Fund-level data are used.
ATO (2014d)	1.8	7%	<ul style="list-style-type: none"> • Population only covers SMSF accounts. SMSF account-holders are not representative of the general population as they have much larger superannuation balances than other account members. For example, 67 per cent of people with superannuation assets over \$1 million are SMSFs (ASFA 2015b). • Total benefits includes lump sums, income streams and transition to retirement pensions. In previous years combined lump sums and income stream were also reported.

^a Measurement of ‘total benefits’ differs across datasets. ^b Prior to 2007-08 data on the superannuation benefits of those aged 60 years and over were more complete. Reporting requirements have since changed.

Figure 4.1 **Retirees currently with superannuation assets receiving a superannuation income stream^a**



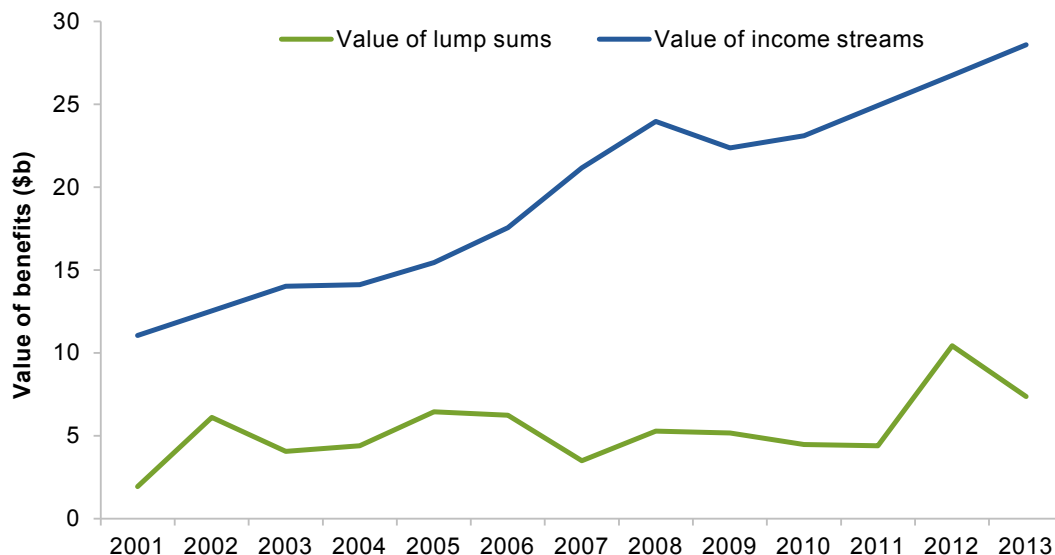
^a Superannuation quartiles are based on the superannuation assets of those people who are aged 55 years and over, are no longer in the workforce and have a positive level of superannuation assets.

Period	Quartile 1 range	Quartile 2 range	Quartile 3 range	Quartile 4 range
2003-04	\$1 - \$22 000	\$22 062 - \$66 000	\$66 190 - \$164 977	\$165 000 and above
2009-10	\$4 - \$31 000	\$31 500 - \$88 243	\$88 435 - \$228 400	\$229 033 and above
2011-12	\$1 - \$38 000	\$38 124 - \$100 000	\$100 011 - \$258 776	\$259 260 and above

Data sources: Commission estimates based on ABS (*Survey of Income and Housing, 2011-12*, Cat. no. 6553.0, basic CURF; *Survey of Income and Housing, 2009-10*, Cat. no. 6503.0, basic CURF; *Household Expenditure Survey, 2003-04*, Cat. no. 6503.0, basic CURF).

The large bulk of superannuation assets are taken as income stream rollovers at the time of retirement (Rice Warner 2015). The Commission estimates, based on Australian Bureau of Statistics (ABS) data, that around 70 per cent of superannuation assets were taken as an income stream in 2011-12. More recent research by Rice Warner for Colonial First State finds that around 83 per cent of benefits are taken as an income stream. This finding is broadly consistent with information from other datasets that show that income streams represent a growing share of superannuation benefits (figure 4.2).

Figure 4.2 Total superannuation benefits over time



Data source: Commission estimates based on HILDA (2013, release 13, waves 1-13).

Many people take a small proportion of their assets as a lump sum ...

One reason some stakeholders are concerned about lump sums is that they fear that retirees who take lump sums exhaust their superannuation savings prematurely, which can then lead to a greater reliance on the Age Pension. Examining the size of lump sums, and the share they comprise of individual superannuation balances, is key to assessing whether these concerns are valid.

The median value of lump sums taken by those aged between 55 and 70 years — the bulk of individuals who take lump sums — is around \$20 000 and while some take more than one lump sum during their retirement, in practice most only take a single lump sum.¹⁷

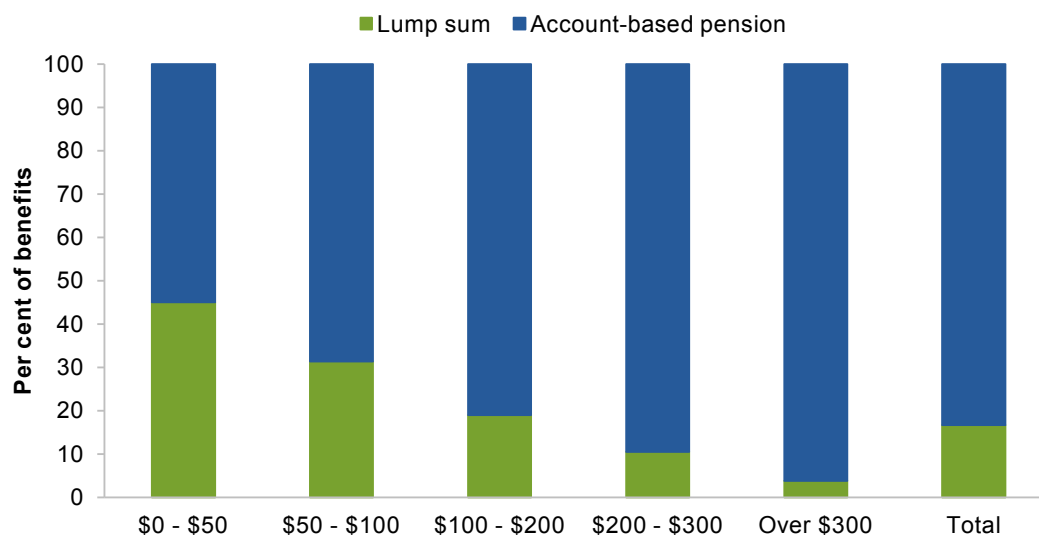
However, given the wide spectrum of superannuation balances, average aggregate measures can conceal important behavioural differences. Analysis of drawdown behaviour of different groups in the population provides a more detailed picture of current behaviour.

The tendency to take lump sums varies markedly by the size of superannuation savings. In general, lump sums are more likely to be taken by people with relatively small superannuation balances. An analysis of fund data reveals that more than 90 per cent of people with up to \$10 000 in superannuation assets take a lump sum at retirement compared to around 30 per cent of people with assets between \$100 000 and \$200 000

¹⁷ This observation is based on a preliminary examination of HILDA (2013, release 13, wave 13).

(ASFA 2013). An update of research previously undertaken for ASFA shows a similar pattern (figure 4.3).

Figure 4.3 **Benefits by size of superannuation balance (\$000), 2013-14^a**

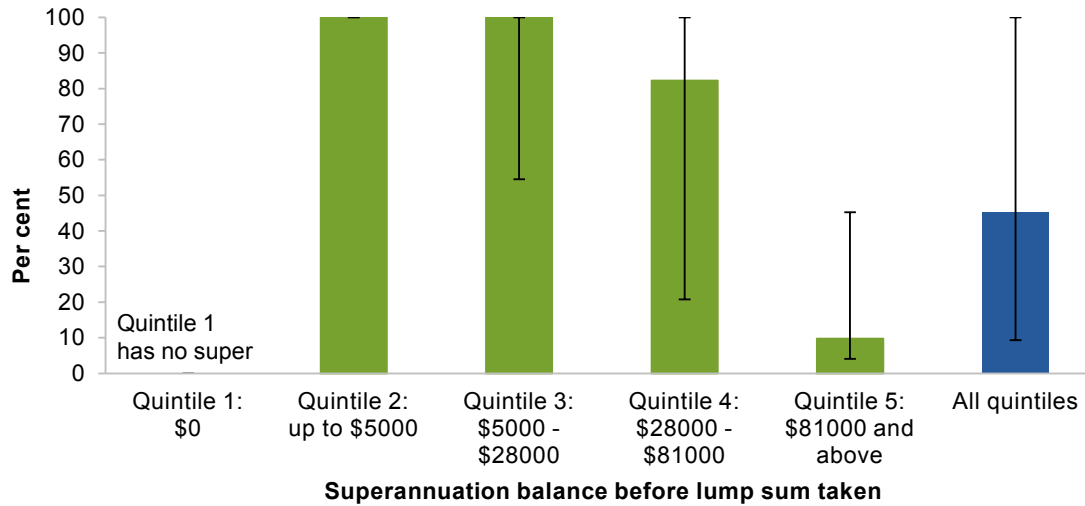


^a Includes SMSFs.

Data source: Rice Warner (2015).

When individuals with low balances take a lump sum, they typically exhaust all of their superannuation savings (figure 4.4). In contrast to those with low balances, individuals with larger superannuation balances withdraw lump sums that are relatively small and in some cases less than 10 per cent of their balance (figure 4.5).

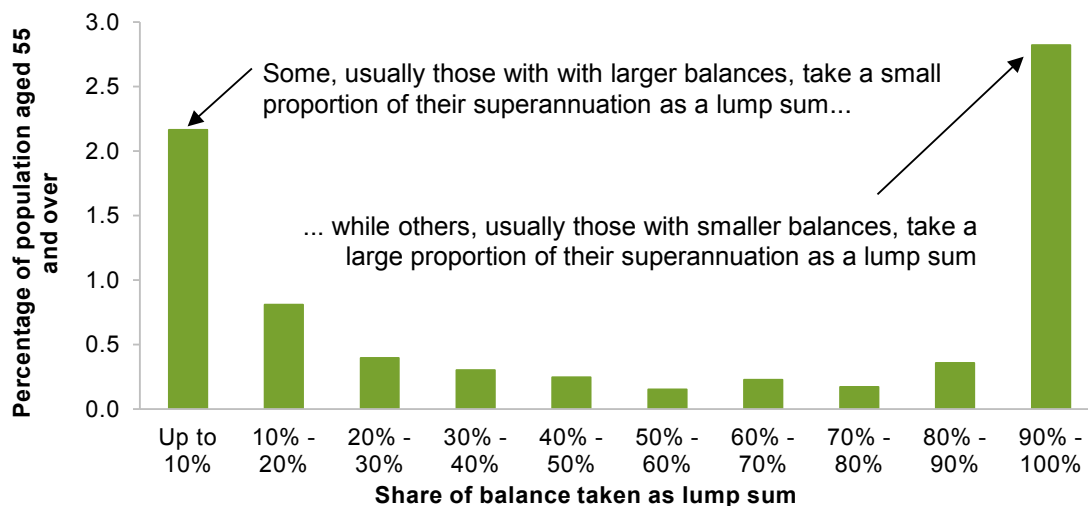
Figure 4.4 Share of superannuation taken as a lump sum^{a,b,c}
by the median individual who has taken a lump sum aged 55 and over



^a Quintiles of superannuation balances are calculated before the lump sum was taken. People who have not taken a lump sum are not included. ^b Whiskers denote the interquartile range. ^c Quintiles were used to highlight that one-fifth of the population aged 55 years and over do not have superannuation balances and have not taken lump sums within the last two years.

Data source: Commission estimates based on ABS (Survey of Income and Housing, 2011-12, Cat. no. 6553.0, basic CURF).

Figure 4.5 Lump sums as a share of superannuation assets, 2011-12^a



^a Share of superannuation balance taken as a lump sum is calculated by dividing an individual's lump sums by their superannuation balance before the lump sums were taken.

Data source: Commission estimates based on ABS (Survey of Income and Housing, 2011-12, Cat. no. 6553.0, basic CURF).

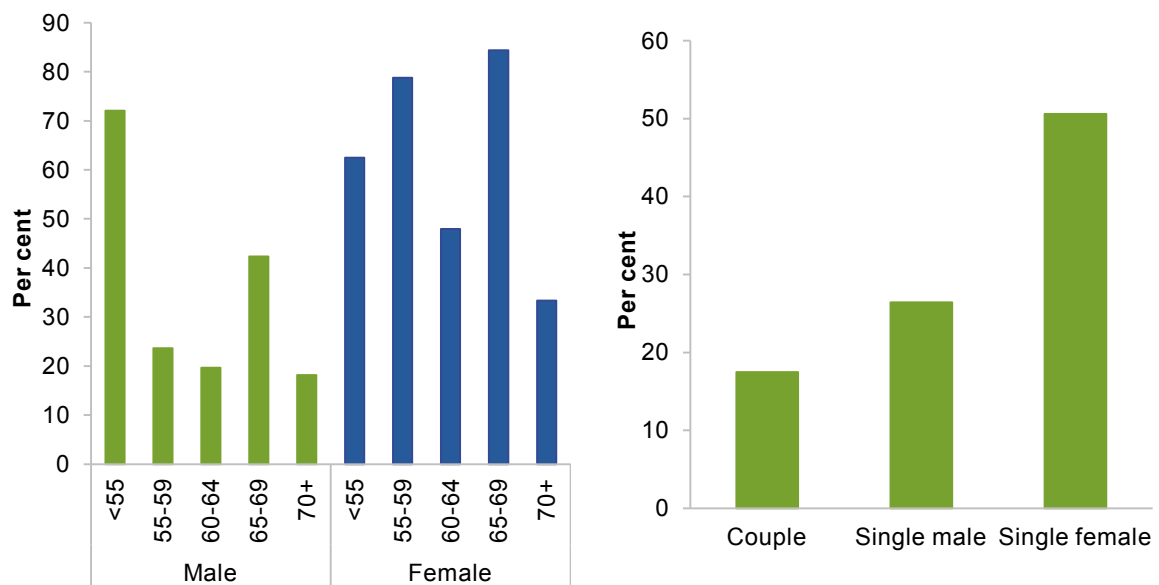
... but some take almost all of their superannuation as a lump sum

Many different types of people take lump sums, but there are some groups of people who are more likely to withdraw a large proportion or the entirety of their superannuation as a lump sum. Those that take the bulk of their superannuation as a lump sum are often those who are:

- women, particularly if they are single (figure 4.6)
- members of low net wealth households (figure 4.7)
- non-home owners (figure 4.8).¹⁸

However, as discussed in more detail in supplementary paper 2, these sections of the population had little superannuation to begin with.

Figure 4.6 **Share of superannuation balance taken as a lump sum, by age and gender, 2011-12^a**
by the median individual in a given household

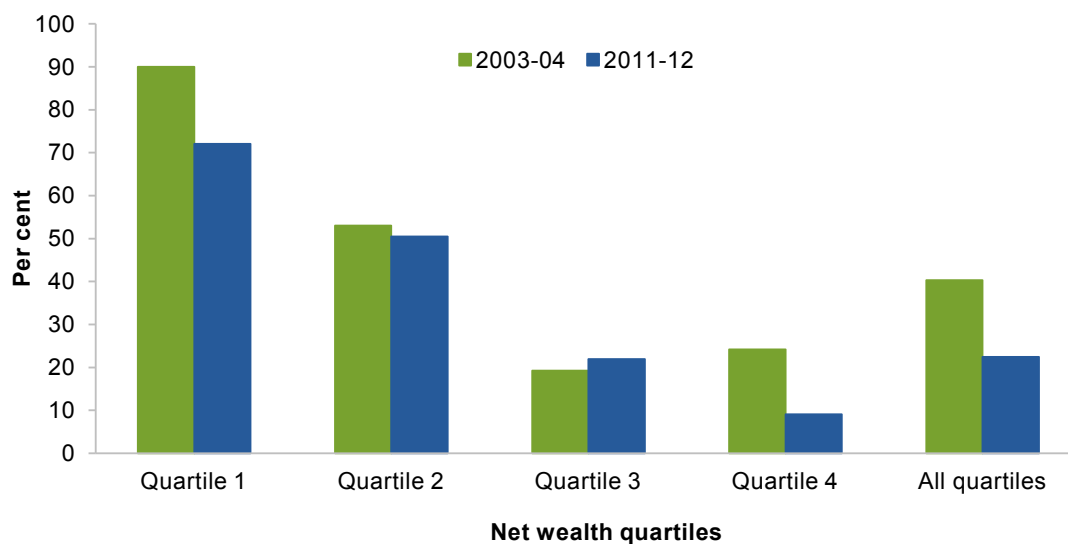


^a Relative lump sums were calculated by dividing an individual's lump sums by their superannuation balance before the lump sums were taken.

Data source: Commission estimates based on ABS (*Survey of Income and Housing, 2011-12*, Cat. no. 6553.0, basic CURF).

¹⁸ The three charts (4.6-4.8) represent the median or 'middle' individual in different groups (be they wealth-, gender-, or home-ownership-based) and depicts what share of their superannuation they take as a lump sum. For example, in figure 4.7, individuals are grouped according to their wealth. In 2003-04, the 'middle' person in the first quartile took around 90 per cent of their superannuation balance as a lump sum.

Figure 4.7 Share of superannuation balance taken as a lump sum, by wealth groups^{a,b}
by the median household in a given wealth quartile



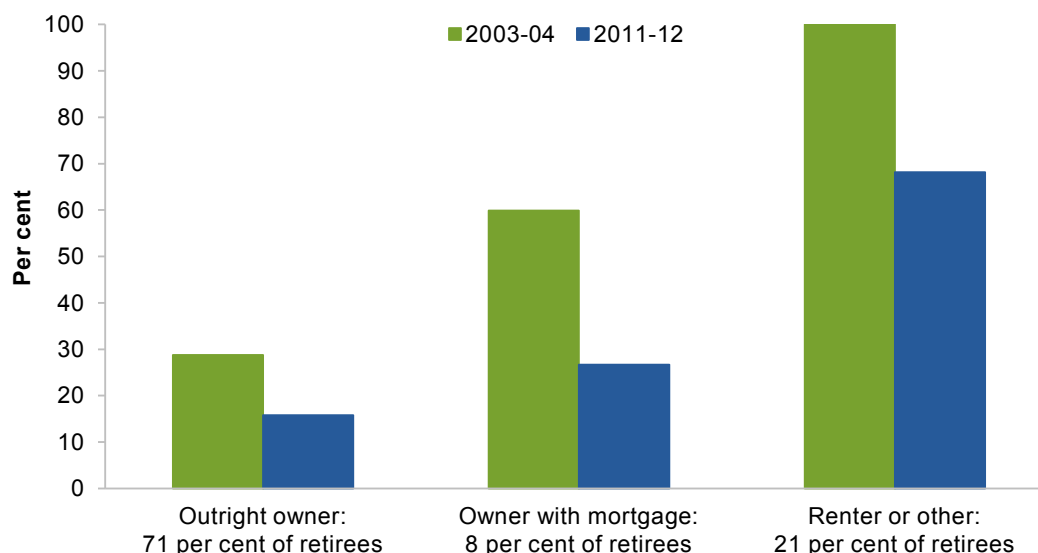
^a Relative lump sums were calculated by dividing a household's lump sums by its superannuation balance before the lump sums were taken. ^b Net wealth quartiles as follows:

Period	Quartile 1	Quartile 2	Quartile 3	Quartile 4
2003-04	Up to \$109336	\$109 446 - \$296500	\$296 670 - \$566793	\$566 943 and above
2011-12	Up to \$133308	\$133 373 - \$426480	\$426 763 - \$845433	\$845 494 and above

Data sources: Commission estimates based on ABS (*Survey of Income and Housing, 2011-12*, Cat. no. 6503.0, basic CURF; *Household Expenditure Survey, 2003-04*, Cat. no. 6503.0, basic CURF).

Figure 4.8 **Share of superannuation balance taken as a lump sum, by housing status^{a,b}**

by the median household with a given home ownership status



^a Relative lump sums were calculated by dividing a household's lump sums by its superannuation balance before the lump sums were taken. ^b The timing of the survey means that it is difficult to observe whether owner occupiers had that status for the entire period or whether they had mortgages and used their lump sum to pay it off completely — thereby becoming outright owners.

Data sources: Commission estimates based on ABS (*Survey of Income and Housing, 2011-12*, Cat. no. 6553.0, basic CURF; *Household Expenditure Survey, 2003-04*, Cat. no. 6503.0, basic CURF).

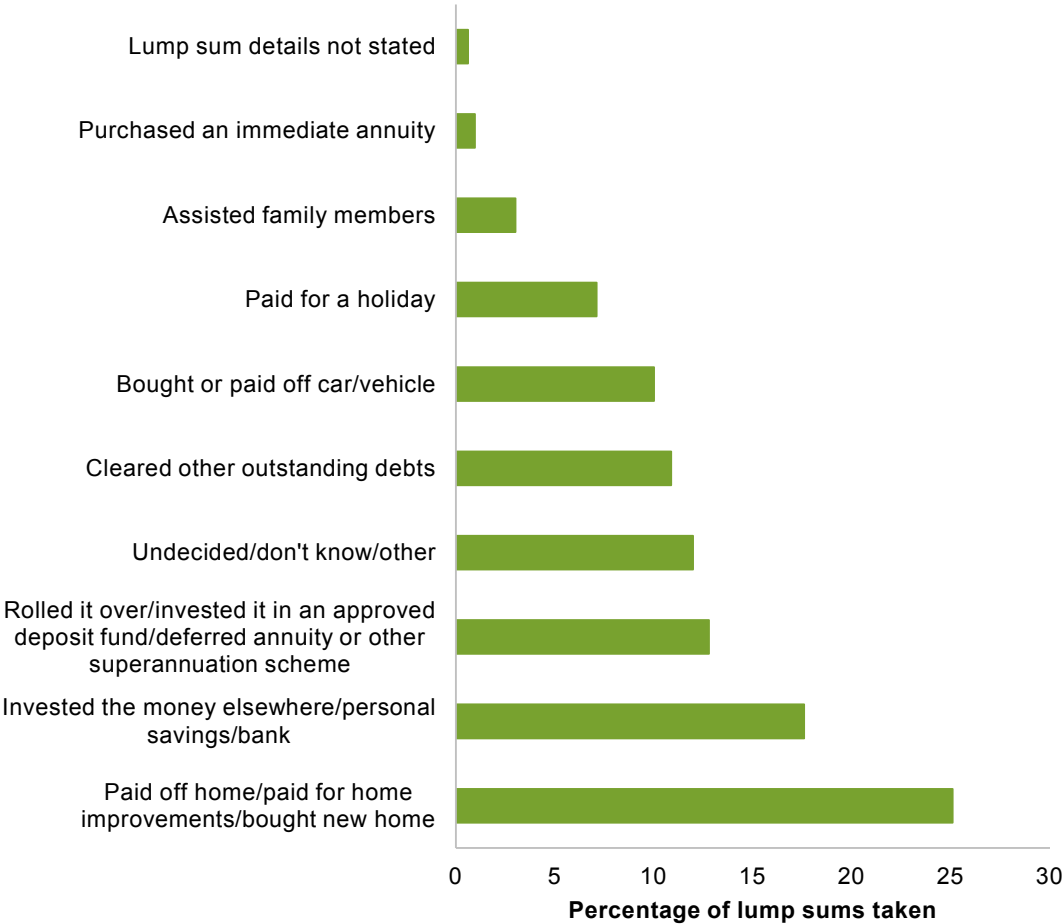
4.3 How are lump sums being used?

Another concern about lump sum behaviour is that individuals use their lump sum to fund 'once-off' recreational activities that provide no long-term benefits. Surveys that ask respondents to list how they spent their lump sums provide some insight into how lump sums are used.

Repeated surveys provide strong evidence to indicate that many retirees are using the flexibility afforded by the superannuation system in a prudent and considered manner. Retirees are largely spending their lump sums on goods and services that will play a role in raising their standard of living over their retirement. Results from the ABS' *Retirement and Retirement Intentions Survey* suggest that around one quarter of lump sums taken are used to repay mortgages, purchase new homes or make home improvements (figure 4.9). In a further 20 per cent of cases, lump sums are used to purchase or pay off a car or to retire debt. Given the characteristics of people who take most of their superannuation savings as a lump sum — single women, renters and those with little wealth — having access to lump

sums may be one of the few opportunities they have to make purchases or payments of this kind.

Figure 4.9 Main uses of superannuation lump sums, 2012-13^{a,b,c}



^a The base is the total number of uses of lump sums rather than the number of people taking lump sums, which is used by Rothman and Wang (2013). These bases differ because a lump sum can have multiple uses and people can take more than one lump sum. ^b Main uses have not changed significantly since 2004-05. ^c The category of 'Other' was added to 'Undecided/don't know' because it appears in past releases of the *Retirement and Retirement Intentions* survey. 'Other' typically accounts for around 10 per cent of lump sums taken.

Data source: ABS (*Retirement and Retirement Intentions, Australia, June 2012 to June 2013*, Cat. no. 6283.0).

Not all lump sums are immediately spent, some are invested. Over 30 per cent of lump sums have been used to purchase financial assets. And in some cases where investments were not made, it was due to individuals perceiving that they had insufficient superannuation savings to make such an investment worthwhile.

Those respondents who did not make an investment in retirement income products were asked what was behind that decision. Of those that answered, the leading answers were not having enough funds to invest (29 per cent), wanting/[needing] money for short term consumption (16 per cent) and preferring to repay debt (10 per cent). (Vidler 2010, p. 14)

Use of lump sums also varies by age. People aged under 60 years who take lump sums are more likely to pay down debt, while those aged over 60 years are more likely to invest their lump sum. The propensity to take a lump sum to go on a holiday remains almost constant across ages (Rice Warner 2015).

Lump sums do not appear to encourage people to take on more debt

It is argued that using lump sums to repay debt is financially sound when the costs of sustaining debt exceed the returns that could be earned if superannuation savings were reinvested.

Repaying loans on retirement is logical as borrowing costs are usually higher than the returns that can be obtained. This means for most retirees they are better off using their savings to reduce their debt rather than continuing to service their loans and investing their savings. (CPA Australia 2012, p. 31)

But some have gone on to ask whether being able to use lump sums in this way encourages households to take on greater debt and more risk, particularly debt relating to the family home and investment properties.

We have already seen that while superannuation has been growing, so has debt, and for homeowners [those with or without a mortgage] the levels of debt can exceed their accumulated superannuation. ... Analysis by type of debt shows that home mortgages and rental property debt are the major areas in which debt is increasing. (CPA Australia 2012, p. 33)

A detailed study of superannuation and housing debt by Bray (2013) found no systemic evidence of lump sums being used to offset mortgages and that Australians who carry mortgages into later stages of life have the means to sustain this debt, including through continued workforce participation.

The Commission has also found evidence of individuals seeking to pay off debt *before* they retire (and draw down their superannuation), with some significantly increasing their debt repayments (including on the family home). While some stakeholders expressed concern about the accumulation of investment property debt, the Commission found that individuals typically tend to draw on the equity in their investment properties prior to retirement (supplementary paper 2).

More broadly, Rothman and Wang (2013) argue that the net impact of debt on retirement living standards is decreasing, even though there is a tendency for lump sums to be used to retire debt:

... in most cases this leaves significant amounts to invest to generate retirement incomes [and] ... the significance of debt as a negative factor in determining adequacy is reducing rather than rising. (2013, p. 22)

Spending patterns differ for those who take lump sums

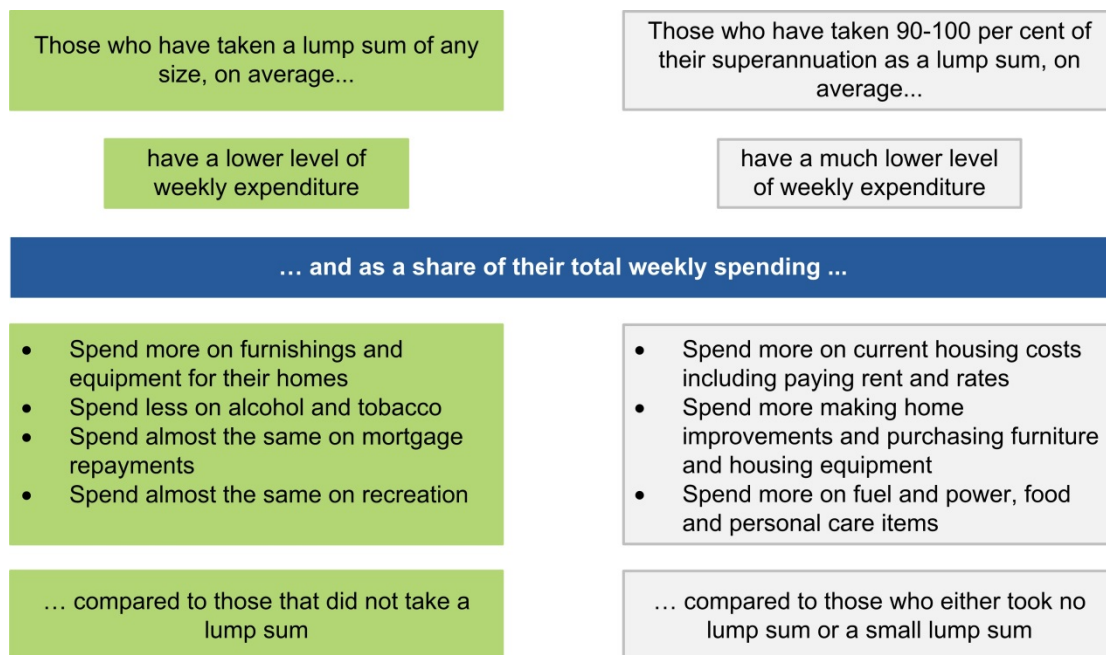
Differences in the expenditure patterns of households that have and have not taken a lump sum can provide a broader perspective on how retirees use their income (including from, but not limited to, lump sums). An analysis of expenditure patterns cannot *directly* show how lump sums were spent, and any differences in expenditure patterns could be explained by other factors including demographic characteristics and the levels of wealth of those that used a lump sum.¹⁹

The Commission compared the expenditure patterns of all people who take a lump sum (which includes people across the wealth spectrum) with those who have not taken a lump sum (figure 4.10). The Commission also examined whether the expenditure patterns of people who take almost (if not) all of their superannuation as a lump sum were different to those who took a small lump sum or did not take a lump sum.

The analysis reveals that people who take lump sums have a lower overall level of spending compared to people who do not take lump sums. Those who take lump sums spend a greater share of their total weekly expenditure on furnishing their homes and around the same proportion on recreational activities when compared to those that did not take a lump sum. Expenditure patterns of those who take most (if not all) of their superannuation as a lump sum — people who tend to be in the lowest net wealth quartile — spend a large share of their weekly budget on ‘the essentials’ such as rent, personal care items and power.

¹⁹ Data from the ABS Household Expenditure Survey (HES) was used to examine the expenditure patterns of those who took lump sums. One issue in using HES to analyse the use of lump sums relates to the timing of the survey. HES measures lump sums that have been taken in the last two years and measures current weekly expenditure. As such, HES cannot show how much debt was paid down by using a lump sum.

Figure 4.10 Expenditure patterns of those taking lump sums, 2009-10^{a,b}



^a A logistic regression approach was used to estimate the probability of taking a lump sum given the shares of expenditure on recreation, alcohol and tobacco products, mortgage payments, health and medical services, clothing, housing costs, food, fuel and power costs, furnishings and equipment, housing services, income tax, miscellaneous expenses, other capital housing costs, personal services, superannuation and life insurance and transport costs. ^b The Commission estimated a second logistic regression, which looked at the probability of taking a large share of superannuation as a lump sum (at least 90 per cent) given the shares of expenditure on recreation, alcohol and tobacco products, mortgage payments, health and medical services, clothing, housing costs, food, fuel and power costs, furnishings and equipment, housing services, income tax, miscellaneous expenses, other capital housing costs, personal services, superannuation and life insurance and transport costs for those aged 55 and over.

Data source: Commission estimates based on ABS (*Household Expenditure Survey, 2009-10*, Cat. no. 6503.0, basic CURF).

4.4 Do lump sums encourage premature access to the Age Pension?

Individuals' decisions to use their superannuation may be in their best interest but their actions may have wider impacts on community wellbeing. To the extent that lump sums affect the receipt of the Age Pension, their use is of policy relevance to the community and of concern for government. Such concerns are not applicable for some individuals — those that have very little savings are likely to receive the Age Pension under any circumstances, while those with considerable asset-holdings at retirement would be ineligible to receive such payments. Indeed, these concerns are most relevant for those retirees with superannuation savings (and other assets) close to the means test cut offs for the Age Pension (supplementary paper 3).

Concerns about the relationship between draw down and Age Pension reliance have already been examined by a number of stakeholders and researchers. For example, ASFA examined fund level data on the amount of superannuation drawn down to determine how lump sums might affect future Age Pension usage:

A number of commentators have asserted that there is a ‘lump sum’ mentality in Australia and that many (or at least a significant number) of retirees take a lump sum superannuation benefit, spend it on consumption goods or a holiday, and then fall back onto the Age Pension. Individuals taking lump sums generally take an amount that is not material to the amount of Age Pension they will receive. (2014a, p. 24)

Other studies have used a longitudinal approach to determine whether individuals restructure their drawdown pattern to gain access to the Age Pension. Bray (2013) analysed wealth and debt trends for those approaching retirement between 2006 and 2010 and found little systemic evidence of people arranging their draw down to maximise their access to the Age Pension. Bray (2013) found that 15 per cent of those with superannuation savings aged 55-64 exhausted their superannuation before reaching Age Pension age. Many of those exhausting their superannuation before Age Pension age:

- had very small balances (relative to those not exhausting their superannuation)
- were female (61 per cent)
- lived with a disability — over half of those who exhausted their superannuation before Age Pension age had a disability or long-term health condition and more than 20 per cent of this group experienced the onset of disability during the period
- were on income support payments (twice as likely relative to the general population)
- were single (38 per cent compared to 22 per cent of the general population).

Studying the incidence of restructuring among those with medium-sized superannuation balances is more complicated. Those with medium-sized balances typically have other assets they could use to restructure their asset-holdings. A number of Australian studies have looked beyond retirees’ superannuation assets in order to examine whether there are observable shifts in behaviour (rapid draw down of superannuation or a shift away from superannuation to other assets) that could be attributed to restructuring.

Cho and Sane (2009) examined patterns of housing and financial wealth accumulation and draw down amongst those aged 61-64 years. The authors do not find statistically significant evidence of individuals immediately drawing down their financial wealth to qualify for the Age Pension. However, Cho and Sane (2009) do find evidence to suggest that Australian individuals invest a greater share of their wealth in the family home because of its exemption in the Age Pension means tests.

Other studies find little evidence to suggest that incentives embedded in the Age Pension means tests are being exploited on a large scale. One example is a study by Cobb-Clark and Hildebrand (2010) which compared the asset allocations and retirement decisions of households headed by a person aged 55-64 years with those aged 65-74 years.

... these results do not provide compelling evidence that on average households respond to the incentives embedded in the asset and income tests used to determine Age Pension eligibility by reallocating their assets. (Cobb-Clark and Hildebrand 2010, p. 32)

Further, the Department of Social Services has argued that retirees draw down their assets slowly (or not at all) because attempting to maximise the receipt of the Age Pension (by way of drawing down assets) can make them worse off.

... people have been saying that pensioners are going to ... give it [their money] all away or spend it all in order to get a maximum rate pension. ... if they did that they would be worse off, ... apart from whatever benefit they got out of spending the money, they will then have less money and they would have a lower standard of living than if they kept the money and drew it down in a considered way to help fund their recurrent consumption needs. ...

Secondly, ... two-thirds of retirees are either not reducing their asset balances over a period of five years or actually increasing their asset balances over a period of five years. When we look more generally at age pension data, the evidence is that pensioners are not profligate or imprudent with their money, they are actually very careful with their money. If anything, they may sometimes be a little bit too careful with their money to their own cost. As a result, they may not necessarily be enjoying the standard of living they could be enjoying if they made more use of it. (Andrew Whitecross at Estimates Hearing for the Senate Community Affairs Legislation Committee 2015, p. 100)

Other studies have also found evidence that some of those of Age Pension age continue to accumulate their non-housing assets as they approach retirement rather than transferring their superannuation to the family home, or undertaking other expenditure to achieve access to the Age Pension:

Overall the analysis identifies that older Australians today have substantially higher assets than in the past and they are continuing to accumulate these assets as they approach Age Pension Age or retirement. (Bray 2013, p. iii)

We conclude that Australian Age Pensioners decumulate at around 5 per cent of non-housing wealth per year during retirement if they are less wealthy, but that more wealthy households continue to accumulate non-housing wealth at around 3 per cent p.a., despite being subject to the incentives of a stricter means-test for pension payments. Portfolio choice appears to have been one driver of wealthy household accumulations. (Hulley et al. 2013, pp. 45–46)

A further consideration when attributing particular drawdown patterns to deliberate attempts to access the Age Pension is that observed behaviour could be driven by motivations and circumstances other than the desire to maximise access to government benefits. For example, what may be perceived as a deliberate restructuring of drawdown patterns may actually be a response to an unexpected financial or health shock. Alternatively, perceived drawing down of assets may instead be the result of cyclical changes in asset values (Bray 2013).

Most recently, the question was examined as part of the 2014 *Financial System Inquiry*, which found little empirical evidence of Australians using their superannuation in a way to

gain access to the Age Pension in its interim report, and did not discuss the issue in the final report:

Stakeholders have suggested that some individuals with small- and medium-sized asset balances tend to structure their affairs around the Age Pension means-test. Indeed, maximising access to the Age Pension is (understandably) a central feature of financial advice for retirees. ... There is no empirical evidence of this behaviour on a large scale. (Australian Government 2014c, p. 4-14)

At present, it appears that the practice of restructuring asset-holdings in order to gain access to the Age Pension is not widespread. Even if evidence of widespread restructuring were found, such behaviour would likely reflect the incentives embodied in the means tests of the Age Pension itself, rather than the flexibility of draw down provided by the superannuation system.

The current asset test for the age pension encourages the spending of retirement savings. ... We should point out this is not a problem restricted to superannuation assets. The same result would have resulted if ... assets were invested in shares or other financial investments. It is not a problem which would be fixed by restricting drawdowns from super. Rather the rate of reduction in the age pension is too high for each additional dollar of asset. (Mercer 2014, p. 55)

4.5 How might drawdown behaviour change as the system matures?

The size of an individual's superannuation balance affects the way in which they draw down their superannuation. Those with larger superannuation balances are more likely to rollover their savings into an income stream product. As such, it is expected that income streams will become even more common as the superannuation system matures and balances grow.

As the Australian system matures, a greater percentage of Australians will take an income stream option at the time of retirement as more Australians will have an account balance for which there are clear advantages in taking an income stream. (ASFA 2014a, p. 25)

Even so, lump sums will still play a role in improving the welfare of retirees. For most people, lump sums will represent a small share of their superannuation under a mature system, and (as is currently the case) are likely to be used to retire debt and otherwise prepare for retirement. Lump sums are likely to remain particularly important for those with relatively small balances at retirement. Even in a mature system, there will be people who have had an interrupted work history or have not worked full-time (supplementary paper 5). For these individuals, lump sums might constitute most of their superannuation assets. As the *Financial System Inquiry* observed in its interim report:

For people with small superannuation balances, taking the entirety of their benefits as a lump sum may be an optimal strategy because the income stream generated from a small balance is negligible and has relatively high costs and no tax advantages. (Australian Government 2014c, p. 4-12)

4.6 Are income streams working well for retirees?

Some retirees draw down their account-based pension slowly

Most calls to restrict access to lump sums are driven by concerns that people are made worse off by the rapid drawdown of their superannuation (which may result in a greater reliance on the Age Pension). However, there are also concerns that individuals who take their superannuation as an account-based pension draw down their superannuation ‘too slowly’ or ‘conservatively’, which in turn lowers their living standards.

Evidence suggests that the major worry among retirees and pre-retirees is exhausting their assets in retirement. An individual with an account-based pension can reduce the risk of outliving their wealth by living more frugally in retirement and drawing down benefits at the minimum allowable rates. This is what the majority of retirees with account-based pensions do, which reduces their standard of living. (Australian Government 2014b, p. 120)

It has also been argued that conservative draw down results in Australians leaving large bequests from their superannuation — sometimes an unintentional consequence of overestimating life expectancy or planning for unrealised events, but in other cases by design.

As people live longer, there is a growing risk that individuals will exhaust their assets before they die. So far, however, the greater problem seems to be that high levels of self-insurance result in retirees living overly frugally, or unintentionally leaving large superannuation savings to their estates. It also appears that in some cases superannuation balances are deliberately accumulated so that they can be left as a tax sheltered bequest by the superannuant. (CSRI 2015, p. 12)

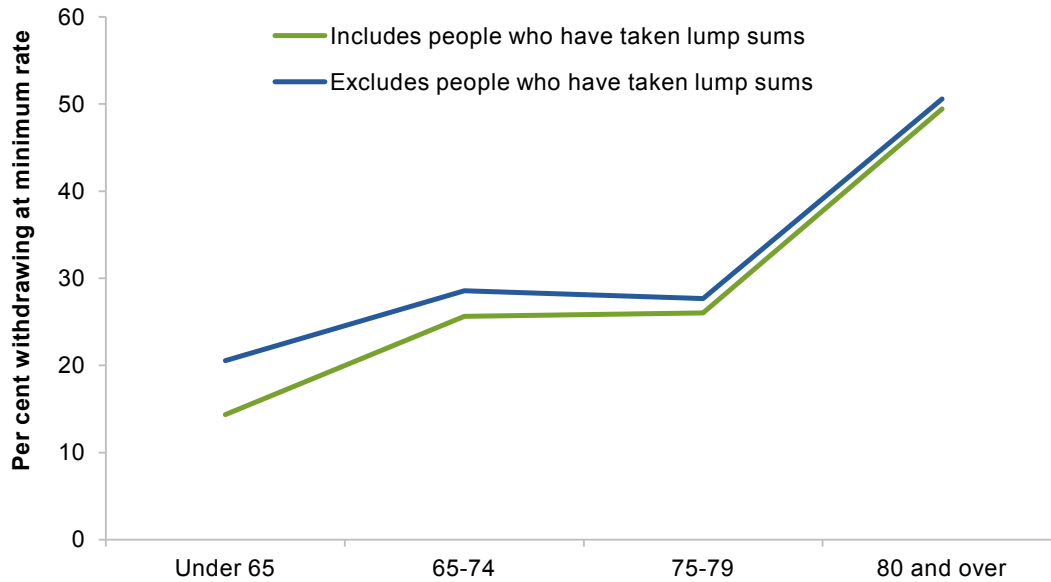
There is some empirical evidence to suggest that retirees draw down their account-based pensions slowly. Rothman and Wang (2013) find that many retirees withdraw the lowest amount of superannuation possible. The authors show that around 50 per cent of people under 79 years, nearly 60 per cent of people aged 80-84 years and around 70 per cent of people aged 85-89 who have account-based pensions draw down at the minimum rate.

However, Rothman and Wang (2013) exclude people who have withdrawn more than 20 per cent of their account-based pension in a year from their calculations. In essence, they are excluding people who have taken lump sums from their analysis of drawdown patterns. The Commission considers that people who take lump sums should be included for a more complete understanding of drawdown behaviour.

Once lump sums are included in the calculation of draw down, Commission estimates based on the *Survey of Income and Housing* (SIH) data suggest that a smaller proportion of retirees withdraw at the minimum rate, particularly at younger ages (figure 4.11). For example about 15 per cent of those aged under 65 years appear to be drawing down at the minimum rate, and this increases to around 50 per cent of people aged over 80 years. This result may indicate that people are less conservative than suggested by Rothman and Wang

(2013). However, several differences in the data used and approach taken could also account for part of the discrepancy.²⁰

Figure 4.11 Percentage of retirees drawing down their superannuation at the age-specific minimum rate, 2011-12^{a,b}



^a The percentage of people who draw down the minimum (excluding lump sums) is calculated by dividing annualised income from superannuation by an individual's superannuation balance at the beginning of the period. The drawdown rate, which includes lump sums, is calculated by summing annualised income from superannuation and the total value of lump sums (total superannuation benefits) and dividing this by the value of superannuation balances before superannuation benefits were taken. ^b SIH does not separate out ages above 80 years. The Commission has taken an average of the proportion of people who draw down between 7 and 14 per cent — the minimum drawdown rates for those aged 80-84 years to those aged over 95 years.

Data source: Commission estimates based on ABS (*Survey of Income and Housing, 2011-12*, Cat. no. 6553.0, basic CURF).

Other research by Susan Thorp (2013) suggests that the minimum drawdown rates may be too high and should be lowered to allow retirees to draw down lower amounts of their superannuation than is currently permissible. This research is not driven by a concern about the conservatism of retirees' draw down — but rather that the rules governing draw down of account-based pensions need to be more flexible in assisting retirees to manage market risk and take account of changes in expenditure patterns as retirees get older. Thorp's research indicates that giving retirees the option to draw down less than the minimum would not necessarily make them worse off (2013).

²⁰ Differences between the Commission's analysis and work undertaken by Rothman and Wang (2013) could be driven by the data sources used. The Commission used SIH data, while Rothman and Wang (2013) used data from the ATO and Department of Social Services. Another difference is that the Commission examined the drawdown patterns of all those with superannuation rather than just those with account-based pensions withdrawing less than 20 per cent a year.

There are many reasons why individuals might draw down their superannuation in a particular way. It is possible that people draw down at the minimum rate so they can leave large bequests. Alternatively, conservatism may be a way of managing the multitude of risks faced in retirement, including longevity risk, market risk (especially in a low interest rate environment) and other unexpected costs associated with ageing such as those relating to aged and health care. As such, arguments about the minimum drawdown rates need to look beyond observed drawdown patterns and consider the variety of circumstances and motivations of retirees.

Is there an aversion to annuities?

With the bulk of superannuation assets already being taken as an income stream, and with balances set to grow over time, more attention is being given to the types of income streams that retirees are taking.

As noted earlier, there are two main types of retirement income products: account-based pensions and annuities. Account-based pensions, which provide retirees with the flexibility to vary the level of income they wish to withdraw, are by far the most popular.

Allocated [or account-based] pensions have become the retirement income product of choice for superannuants who choose to convert their retirement savings into an income stream. Several factors explain this preference: one may be the psychological factor of having an asset, the pension account, clearly identified as belonging to the individual. Another is the flexibility (subject to government imposed limits) provided in terms of size of the annual amounts to be withdrawn from the account. Particularly important is the bequest factor – that the amount remaining in the account at death becomes part of the estate available for distribution to heirs. (Australian Centre for Financial Studies 2010, p. 41)

In contrast, few Australians purchase annuity products — lifetime or fixed term — to provide a retirement income. Unlike account-based pensions, annuities can provide longevity protection and some commentators refer to their lack of take up as the ‘annuity puzzle’.

From an economic standpoint, what is striking about retirement benefits in Australia ... is that almost no privately chosen Superannuation benefits are longevity insured, no matter what the policy in place. The increasingly popular account-based pensions, while ensuring more provident use of accumulations than a lump sum payout, only offer limited self-insurance against outliving one’s resources. (Bateman and Piggott 2011, p. 97)

While annuities provide certainty, there may be a number of reasons why they are not more commonly used. Annuities are far less flexible than account-based pension products, and prevent users from taking additional lump sum withdrawals (or if they do, can be subject to a substantial penalty). As touched on earlier, the flexibility to cover unexpected costs — such as those arising from disability or requiring formal aged or health care — is important to retirees, particularly so for those on low incomes.

Individuals might also perceive annuities to be poor value for money as they do not appreciate the longevity risk that these instruments mitigate (Hu and Scott 2007). Alternatively, the presence of the Age Pension may be seen as providing sufficient insurance against a ‘safety net’ longevity risk (Knox 2000).

Further, both life and term annuities have been characterised by particularly low returns since the global financial crisis. These low returns may be another reason why many choose not to use them as a retirement income product (Actuaries Institute 2015). And according to Glenn Stevens, low returns on annuities are a crucial issue for the current cohort entering retirement:

The key question is: how will an adequate flow of income be generated for the retired community in the future, in a world in which long-term nominal returns on low-risk assets are so low? This is a global question. Just about everywhere in the world the price of buying a given annual flow of future income has gone up a lot. Those seeking to make that purchase now – that is, those on the brink of leaving the workforce – are in a much worse position than those who made it a decade ago. They have to accept a lot more risk to generate the expected flow of future income they want. (2015)

While not an inherent weakness of the product itself, annuities are not as concessionally treated (under tax rules and Age Pension means tests) as they were in the past. The life annuities market in Australia has always been small, but it grew more quickly after 1998 when annuity products were exempted from both the Age Pension asset and income tests. In 2004, this exemption was cut to 50 per cent, and tax concessions for the purchase of annuities were removed for those retirees over the age of 60 in 2007. As a result, the size of the annuities market declined by 90 per cent between 2007 and 2008 (Bateman and Piggott 2011).

More recently, superannuation funds and annuity providers have attempted to provide more tailored post-retirement asset allocation options and flexible income stream products (including some that allow for bequests and/or the preservation of capital) and sales of these products have grown.

... with some formative steps towards a revitalised market for longevity insurance products. The Australian wealth management industry is actively developing new longevity products, while government, in response to recent reviews of the superannuation industry, is looking at ways to both increase consumer demand and reduce supply-side constraints. With appropriate policy settings, better policy coordination, and private-public collaboration, it may be possible to resurrect the longevity insurance market without a need for compulsory annuitization. (Bateman and Piggott 2011, p. 82)

The possibility of removing regulatory inhibitors to further develop the retirement income product market is currently being reviewed.²¹ But some argue that removing regulatory restrictions is not sufficient to improve take-up of particular income products. As such, there have also been calls to encourage retirees to purchase particular types of retirement income streams (Australian Government 2014b).

Encouraging the take up of annuities needs to be carefully considered

As stakeholders become concerned about how individuals manage longevity risk, some have advocated a shift towards particular forms of annuities. Annuities are seen to be an attractive product for retirees as they can manage both longevity risk, and under certain conditions, provide a greater retirement income than some superannuation pension products. The *Financial System Inquiry* recommended that some or all of the benefits to be paid from superannuation be pre-selected by trustees to products that included income products that manage or pool longevity risk. Jeremy Cooper — who chaired the *Super System Review* in 2010 — described the recommendation as a ‘soft default’ (White and Main 2014).²² Specifically, the *Financial System Inquiry* recommended:²³

Government should require superannuation fund trustees to pre-select an option for members to receive their superannuation benefits in retirement. Details of the pre-selected option would be communicated to the member during their working life. At retirement, the member would either give their authority to commence the pre-selected option or elect to take their benefits in another way. ... The pre-selected option should be a comprehensive income product for retirement (CIPR) that has minimum features determined by Government. These features should include a regular and stable income stream, longevity risk management and flexibility.²⁴ (Australian Government 2014b, p. 117)

²¹ The Australian Treasury is currently reviewing supply-side factors that may have contributed to the underdevelopment of the annuities market in Australia, and whether minimum draw down rates of account-based pensions are appropriately flexible. In particular, the Australian Treasury is assessing regulatory barriers to the development of annuity products that mitigate longevity risk, including deferred lifetime annuities and group self-annuitisation schemes. This chapter examines the demand-side of the market.

²² Soft defaults being the default choice made by superannuation trustees, with it being incumbent on users to make contact and change the way that they elect to receive their superannuation.

²³ The *Financial System Inquiry* (Australian Government 2014b) noted that there should be neutrality in how retirement income products (including those that manage longevity risk) are treated under tax and social security rules. As such, the *Financial System Inquiry* (Australian Government 2014b) excluded Age Pension payments from its comparison of income levels derived from different types of retirement income products. Under current policy settings it is likely that the inclusion of Age Pension payments in these calculations would lead to differences in the relative attractiveness of retirement income products. For instance, total income produced by account-based pensions is much closer to income from annuity products when Age Pension payments are included (Australian Government Actuary 2014).

²⁴ In practice, maintaining flexibility and providing regular, stable income streams would be complex and would likely require a proportion of superannuation savings to be preserved in an account-based pension, which could then be flexibly drawn down. The *Financial System Inquiry* (Australian Government 2014b) notes that some flexibility would be forfeited as a result of moving towards comprehensive income products for retirement.

Given the varied circumstances of retirees and their preference for flexibility, consideration of soft defaults needs to be based on strong evidence that retirees are unable to make sound financial decisions.

Policies requiring a person to invest their superannuation in a particular product, or restricting access to lump sums, should only be adopted where there is strong evidence that people are unable to make decisions that are in their best interests. ...

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 during their retirement. Some people may prefer a higher standard of living at the beginning of their retirement, with high drawdowns from their superannuation during this time, before relying on the Age Pension later in their life. Other people may prefer a stable and secure income over their entire retirement. (Treasury 2009b, pp. 117, 121–122)

Preparing soft defaults for implementation would be a significant undertaking. Designing appropriate defaults when there is such diversity necessitates a thorough understanding of people's superannuation balances, other assets, debts, as well as their personal needs in retirement (which may be affected by their health, marital status and exposure to longevity risk). Absent careful design, defaults might be ineffective or make some retirees worse off (supplementary paper 4).

Defaults work best where people are homogenous in their preferences and circumstances, and have relatively limited decision-making expertise. ... In such cases if an optimal option can be identified it would make a good default. If people are more heterogeneous, any default is likely to be sub-optimal for a greater proportion of them, in which case it may be better to prompt people to make their own decisions ... (Reeson and Dunstall 2009, p. 15)

Further, any move towards soft defaults would also need to take into account the broader workings of the retirement income system and the impacts of an ageing population. Interaction with the Age Pension means tests will be critical. The system-wide consequences of low yields on retirement income products (including annuities) would also need to be considered. Under current policy settings (supplementary paper 1) encouraging individuals to take a lifetime annuity could result in lower lifetime income once Age Pension payments and low yields are taken into account (Australian Government Actuary 2014; Stevens 2015).

Finally, in assessing the fiscal impacts of a soft default, any possible reductions in Age Pension outlays need to be weighed up against the consequent reduction in the capacity of retirees to meet other costs associated with their old age, such as aged care and some health costs, through private savings. If soft defaults are to be pursued, their implementation would be best considered within the context of a broader review of the retirement income system and would benefit from communitywide consultation.