COMMITTEE FOR SUSTAINABLE RETIREMENT INCOMES

# Clarifying the Purpose of the Retirement Income System

CSRI Position Paper

9 February 2016

# Background

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

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

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

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

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

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

# The CSRI's Preferred Articulation

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

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

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

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

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

**Table 1: Proposed Retirement Income Policy Objectives**

| **Overarching Objective** |
| --- |
| • Provides adequate income through all the years of retirement for all Australians |
| **Supporting Objectives:** |
| • Is fair and equitable |
| • Helps individuals manage financial risks |
| • Provides certainty with necessary safeguards |
| • Contributes to the sustainability of government expenditures |

***Provide adequate income through all the years of retirement for all Australians***

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

> "to provide adequate income through all the years of retirement for all Australians".

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

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

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

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

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

***Is fair and equitable***

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

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

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

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

***Helps individuals manage financial risks***

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

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

***Provides certainty with necessary safeguards***

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

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

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

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

***Contributes to the sustainability of government expenditures***

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

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

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

# References

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# ATTACHMENT A

OTHER SUGGESTIONS FOR SYSTEM OBJECTIVES

# Other Suggestions for System Objectives

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

*Adequate and sustainable pensions by ensuring:*

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

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

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

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

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

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

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

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

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

- *broad and adequate, in that it protects those unable to save against poverty in their old-age and provides the means by which individuals must or can save for their retirement;*
- *acceptable to individuals, in that it considers the income needs of individuals both before and after retirement, is equitable and does not bias inappropriately other saving decisions;*
- *robust, in that it deals appropriately with investment, inflation and longevity risk;*

- *simple and approachable, in that it allows individuals to make decisions which are in their best interests; and*
- *sustainable, in that it is financially sound and detracts as little as possible from economic growth.*

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

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

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

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

An evaluation of the merit of each proposed objective is provided in Table 1.

| Table 1: Evaluation of Proposed Superannuation System Objectives | | | |
|---|---|---|---|
| | **Objective** | | **CSRI Comment** |
| | **Financial System Report (Murray Inquiry)** | | |
| | *Primary objective* | *Why the objective is important (according to FSI)* | |
| **1** | To provide income in retirement…. | | Places the focus squarely, as it should, on "income in retirement" implicitly to the exclusion of wealth accummulation. However it is silent on the level, stability or security of retirement income. Some guidance may be inferred from the sub objectives. |
| **2** | …. to substitute or supplement the Age Pension | | The focus on the age pension costs to the exclusion of the fiscal cost of superannuation tax concesssions runs counter to equity principles. While the FSI includes "to alleviate fiscal pressures" as a sub objective, we believe this should be a main objective. |
| **3** | *Subsidiary objective* | | |
| **4** | Facilitate consumption smoothing over the course of an individual's life | Superannuation is a vehicle for individuals to fund consumption in retirement largely from working life income. The system should facilitate consumption smoothing while providing choice and flexibility to meet individual needs and preferences. | Opponents of consumption smoothing as a stated objective argue that it implies the need for higher government support for higher income earners that would be contrary to principles of equity and fiscal sustainability. The counterargument is that the question of government support is a separate issue and that this objective would call forth measures of super coverage rather than target replacement rates that would encourage more equitable and sustainable outcomes. |

| Table 1: Evaluation of Proposed Superannuation System Objectives | | | |
|---|---|---|---|
| **5** | Help people manage financial risks in retirement | Risk management is important as retirees generally have limited opportunities to replenish losses. The retirement income system should help individuals manage longevity risk, investment risk and inflation risk. Products with risk pooling would help people to manage longevity risk efficiently. | Draws attention to the range of financial risks (including longevity, inflation and sequencing risks) faced in post retirement, that have to date received less policy attention than the accumulation phase. (E.g. these risks are not included in the range of risks that superannuation funds must have regard for in managing superannuation fund investments - see section 52(6) of the SIS Act.) Many retirees are self managing longevity risk when there is scope for financial intermediaries to assist in this regard without transferring more of this burden back to government. |
| **6** | Be fully funded from savings | A fully funded system, as opposed to an unfunded system, is important for sustainability and stability. The system is designed to be predominantly funded by savings from working life income and investment earnings, where superannuation fund members in general have claims on all assets in the fund. | This is a design strength of the superannuation system rather than a system objective in need of monitoring. One deviation from this principle is the ability of self managed superannuation funds to use borrowings to invest in super. Setting this as a sub-objective could serve to highlight SMSF leverage issue. On the other hand the SMSF leverage could also be picked up as a prudential issue or an equity and fairness issue. |
| **7** | Be invested in the best interests of superannuation fund members | Superannuation funds are managed for the sole benefit of members, which means the investment focus should be on maximising risk-adjusted returns, net of fees and taxes, over the lifetime of a member. This results in auxiliary benefits to the economy by creating a pool of savings to fund long-term investment. | The overarching objective is to provide income in retirement rather than wealth accumulation or for bequest purposes. The SIS Act requires that trustees undertake their duties in the best interests of beneficiaries which includes members. A focus on members rather than beneficiaries would arguably be more consistent with a retirement income rather than accumulation/bequest focus. This sub objective might also help to rule out the use of super for other purposes (e.g. nation building or home purchases). However the FSI's description of this sub-objective (on the left) which focuses on maximising risk adjusted returns runs counter to the overarching retirement income aim by ignoring the significance of sequencing risk and longevity risk on retirement incomes (as mentioned earlier). |

| Table 1: Evaluation of Proposed Superannuation System Objectives | | | |
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| **8** | Alleviate fiscal pressures on Government from the retirement income system | Government's total contribution to the retirement income system, through both the Age Pension and superannuation tax concessions, needs to be sustainable and targeted. Higher private provisioning for retirement should reduce the burden on public finances. | This sub objective appropriately encapsulates all sources of retirement income fiscal pressure - including superannuation tax concessions and the age pension (unlike row 2 that focussed solely on the cost of the age pension). However, it excludes other significant costs associated with population aging including aged care and healthcare which should arguably be included. |
| **9** | Be simple and efficient, and provide safeguards | The system should achieve its objectives at the minimum cost to individuals and taxpayers. Complexity is less appropriate for a compulsory system, as it tends to add to costs and to favour sophisticated and well-informed investors. Given the compulsory nature of SG contributions, the system needs prudential oversight and should provide good outcomes in both the accumulation and retirement phases for disengaged fund members. | These are important and irrefutable objectives. The main question will be what priority should be placed on simplicity relative to the other objectives given that the system is already very complex and that introducing reform may require grandfathering clauses to make them acceptable to the community. |
| | *Omissions* | | Specific recognition of equity and superannuation coverage considerations. |
| | ***Super Charter Group 2013*** | | |
| **10** | Provide an adequate level of retirement income | | Places the focus squarely as it should on "retirement income" implicitly to the exclusion of wealth accumulation. "Adequacy" would need to be defined. |
| **11** | Relieve pressure on the Age Pension | | The focus on the age pension costs to the exclusion of the fiscal cost of superannuation tax concessions runs counter to equity principles. The objective "to alleviate fiscal pressures" would address this limitation. |
| **12** | Increase national saving… | | While this was an important motivation for establishment of the system, there is some question as to whether this should continue to receive prominence as an objective given the size and the projected growth of the superannuation system. Also, the extent to which the superannuation system actually increases national savings rather than substitutes for other forms of savings is questionable. |

| Table 1: Evaluation of Proposed Superannuation System Objectives | | | |
|---|---|---|---|
| **13** | ….creating a pool of patient capital… | | Superannuation capital may become less patient as the focus of the system changes from accumulation/lump sums to decumulation/income streams and more outflows may need to be accommodated. Questionable whether this should be an objective of the retirement income system rather than simply a bi-product of the system. Creating a sovereign wealth fund would be more effective in creating a pool of patient capital. |
| **14** | …. to be invested as decided by fiduciary trustees. | | This seemingly runs counter to members deciding how to invest their superannuation. Increasing member engagement in superannuation would improve retirement outcomes and therefore the need to reduce system complexity and improve financial literacy so that individuals are better able to ensure they are getting the most out of their superannuation should not be lost sight of. |
| | *Omissions* | | Specific recognition of equity and superannuation coverage considerations, managing financial risks, fiscal sustainability (beyond the cost of the pension) and managing financial risks. |
| | ***Australian Future Tax System 2008 (Henry Review)*** | | |
| | ***Principles*** | | Taken together, these principles recognise the importance of both equity and economic growth towards the achievement of future prosperity. It might be argued that they are specified too broadly, however, this can be addressed through the development of key performance indicators for each. |
| **1** | Broad and Adequate | Protects those unable to save against poverty in their old-age and provides the means by which individuals must or can save for their retirement; | This principle is strongly supported but can otherwise be covered by reference to "adequacy" and "for all Australians" |
| **2** | Acceptable | Considers the income needs of individuals both before and after retirement, is equitable and does not bias inappropriately other saving decisions; | Recognises the subjectivity of the term "equity" and the need for outcomes to be defensible to the broader community. |
| **3** | Robust | Deals appropriately with investment, inflation and longevity risk; | Strongly support the objective although question whether the term is sufficiently transparent to communicate the range of risks purportedly covered. |

| Table 1: Evaluation of Proposed Superannuation System Objectives | | | |
|---|---|---|---|
| **4** | Simple and approachable | Allows individuals to make decisions which are in their best interests; | The system should achieve its objectives at the minimum cost to individuals and taxpayers. Complexity is less appropriate for a compulsory system, as it tends to add to costs and to favour sophisticated and well-informed investors. Given the compulsory nature of SG contributions, the system needs prudential oversight and should provide good outcomes in both the accumulation and retirement phases for disengaged fund members. |
| **5** | Sustainable | Financially sound and detracts as little as possible from economic growth. | This recognises the cost of the system has a bearing on fiscal pressures and that improving the effectiveness of the superannuation system has important consequences for productivity and economic growth. |
| | *Omissions* | | An overarching retirement income objective. |

# About CSRI

The Committee for Sustainable Retirement Incomes (CSRI) is an independent, non-partisan, non-profit organisation committed to improving the adequacy and sustainability of retirement incomes.

It pursues its mission by acting as a catalyst for the development of evidence-based policy and consulting widely with stakeholder groups to reach common ground on policy positions.

The Committee adopts a highly consultative approach, actively seeking contributions from all stakeholder groups and encouraging all competing viewpoints to be heard.

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