Australian National University

Exploring merged means test options

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Key assumption

- Australia will not ever agree to and sustain a means-test-free age pension
  - Notwithstanding the advantages of simplicity and coordination with superannuation and the tax system
    - Even the 1984 Gruen Report that led to reintroduction of an assets test argued for the *eventual* move to a universal pension
  - Partly because of the cost, but also because of over a century of history and the path dependency this has clearly imposed
- But successive inquiries have advocated a move to a simpler, income-based test with tapers that allow rewards for work and saving
  - Henderson 1976, Income Security Review 1977, Henry 2010
  - The means test was progressively liberalised between 1908 and 1983

Problems of current separate income and assets tests

- Inconsistencies between the tests
  - Illustrated by differences in equivalent cut-out points (for a couple, $81,172 under income test, around $50,000 actuarial value (depending on price assumption) of assets test cut-out)
- Distortions of assets test taper
  - Incentives for those within taper range to shift assets away from superannuation-funded income streams, limit additional super savings
  - Moral issue where people compelled to contribute when not in their financial interests
- Complexity
  - ‘Deeming’ arrangements, special arrangements for annuities etc
- More broadly, detracts from focus on retirement income streams

Basis of original 1960s merged means test (Kewley 1973)

- Assessable assets converted into equivalent (potential) income stream over retirement years
  - Based on CPI-indexed annuity for man aged 65 (then price was 10)
  - Single factor (10%), not adjusted for age or for prevailing interest rates
- This equivalent income added to any other income (of individual or couple), the total subject to the tapered means test
  - With ‘free areas’ and no separate threshold for assessable assets
  - 50% taper above free areas
  - Annuities treated directly as income, including return-of-capital component

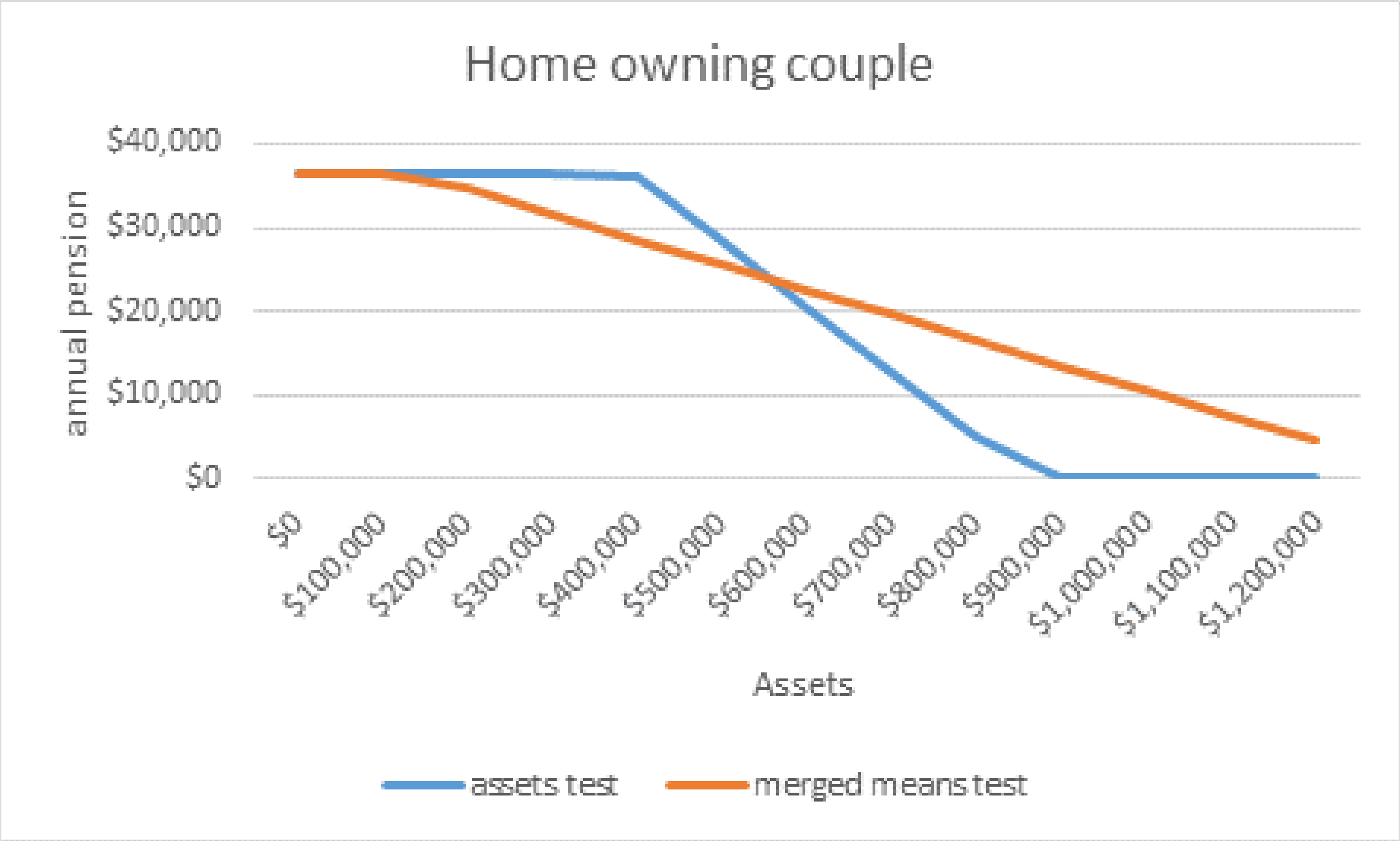
Applying original model today

- Conversion factor of assessable assets into equivalent income
  - CPI-indexed annuity for man aged 67 (or couple with survivor benefits) today would be under 5% of the purchase price (i.e. price over 20)
  - Case for applying different standard
    - No profit margin
    - No adjustment for possible selection bias
    - No residual benefit
    - Presumption of real interest rates higher than right now (say, 2-3%)
  - Suggests factor of around 6% (price around 16), with no adjustment for prevailing interest rates (6.3% without reversion; 5.5% with reversion)
- Annuities actually purchased to be treated as income
- No separate assets test threshold, just income test free areas

Impact of original merged means test model today

- Assets threshold (if no other income)
  - $133,467 for couple (when income test threshold is reached)
  - Compared to $394,500 for home-owning couple at present
- Effective taper above threshold
  - 3% (6% conversion factor halved by 50% income test taper)
  - Compared to 7.8% currently (3.9% previously)
- Cut-out points
  - $1,352,867 when income test cut-out reached by couple (when annuity would be $81,172, equal to the income test cut-out)
  - Compared to $863,500 for home-owning couple at present

Impact of original merged means test model today



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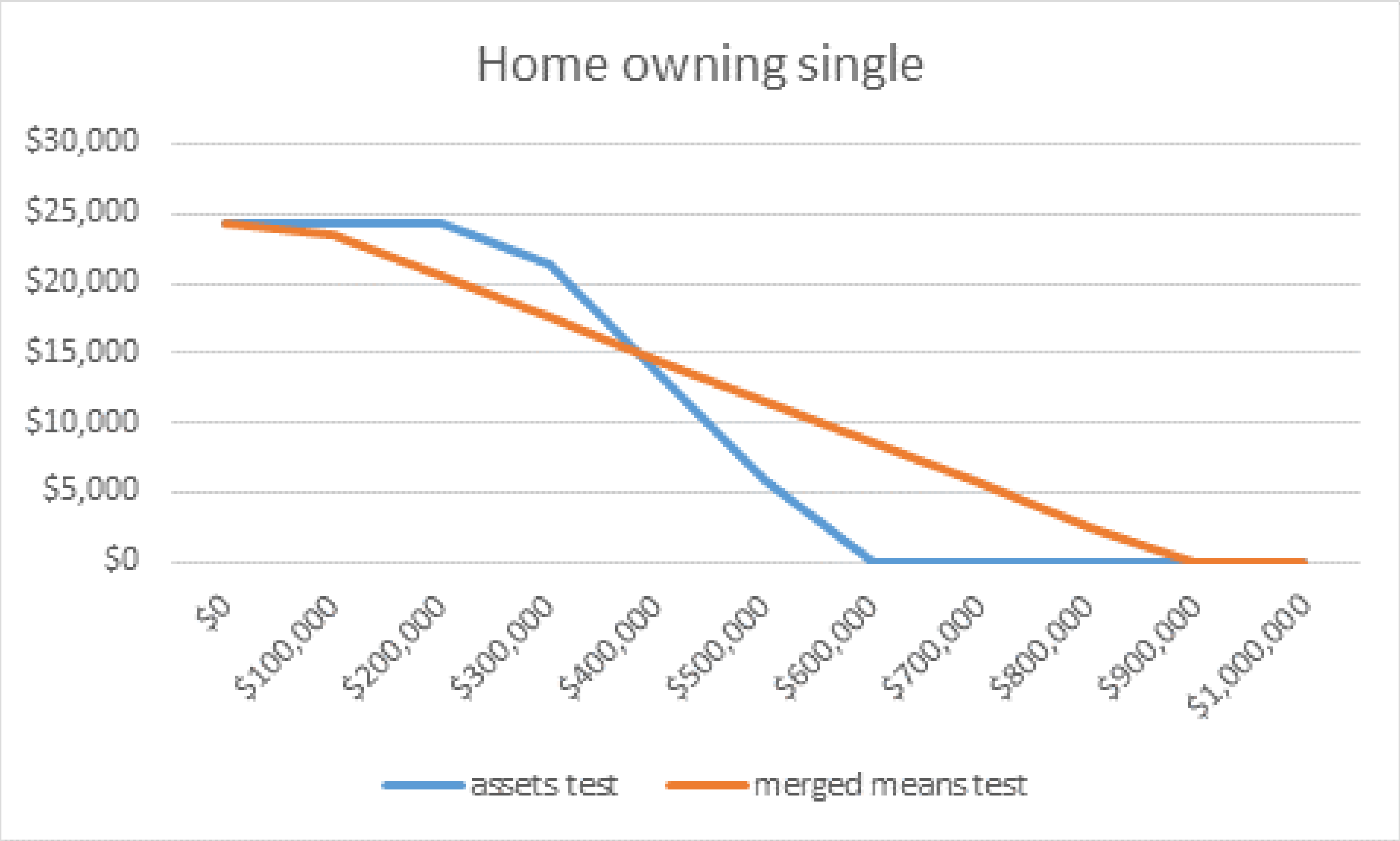

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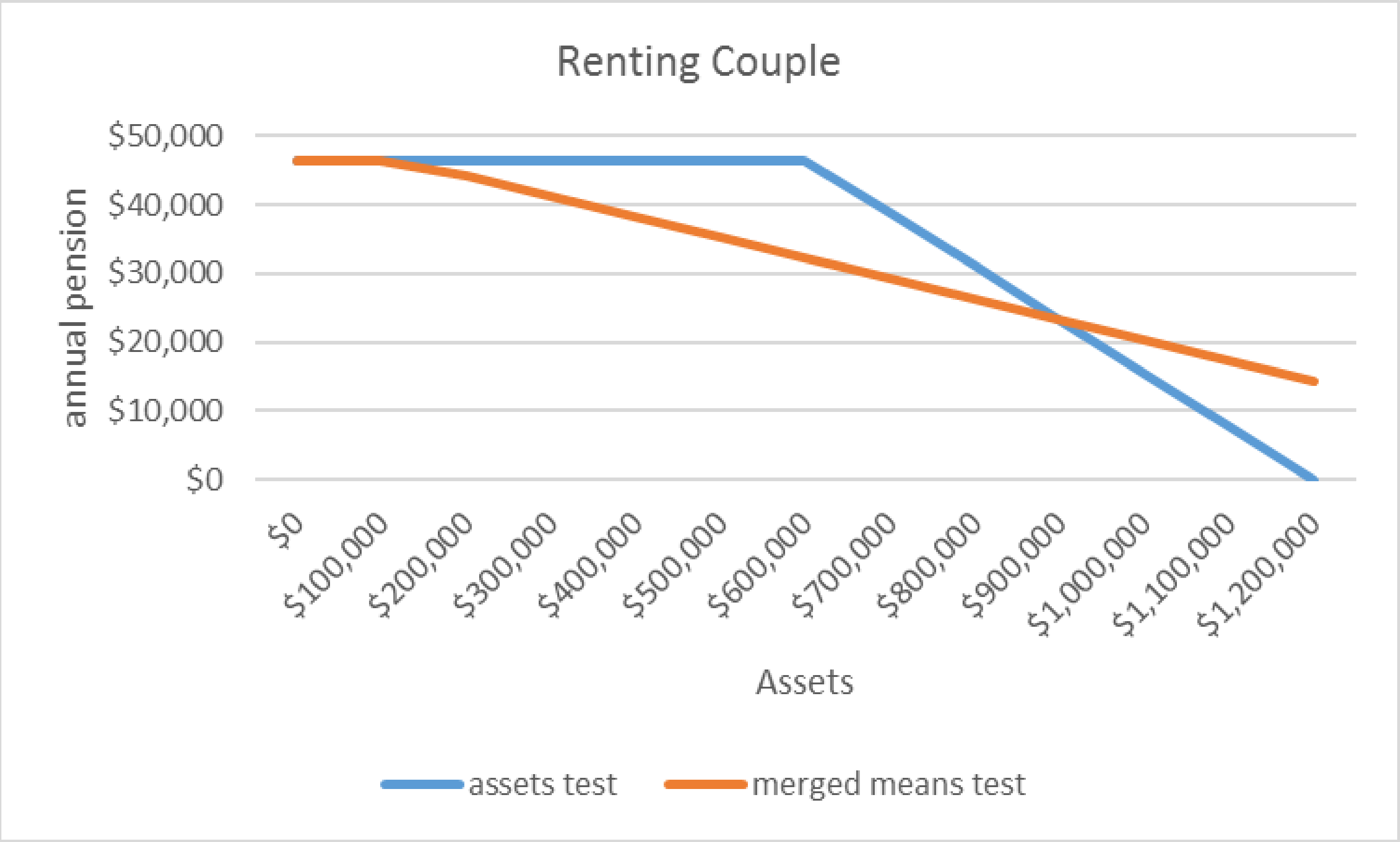

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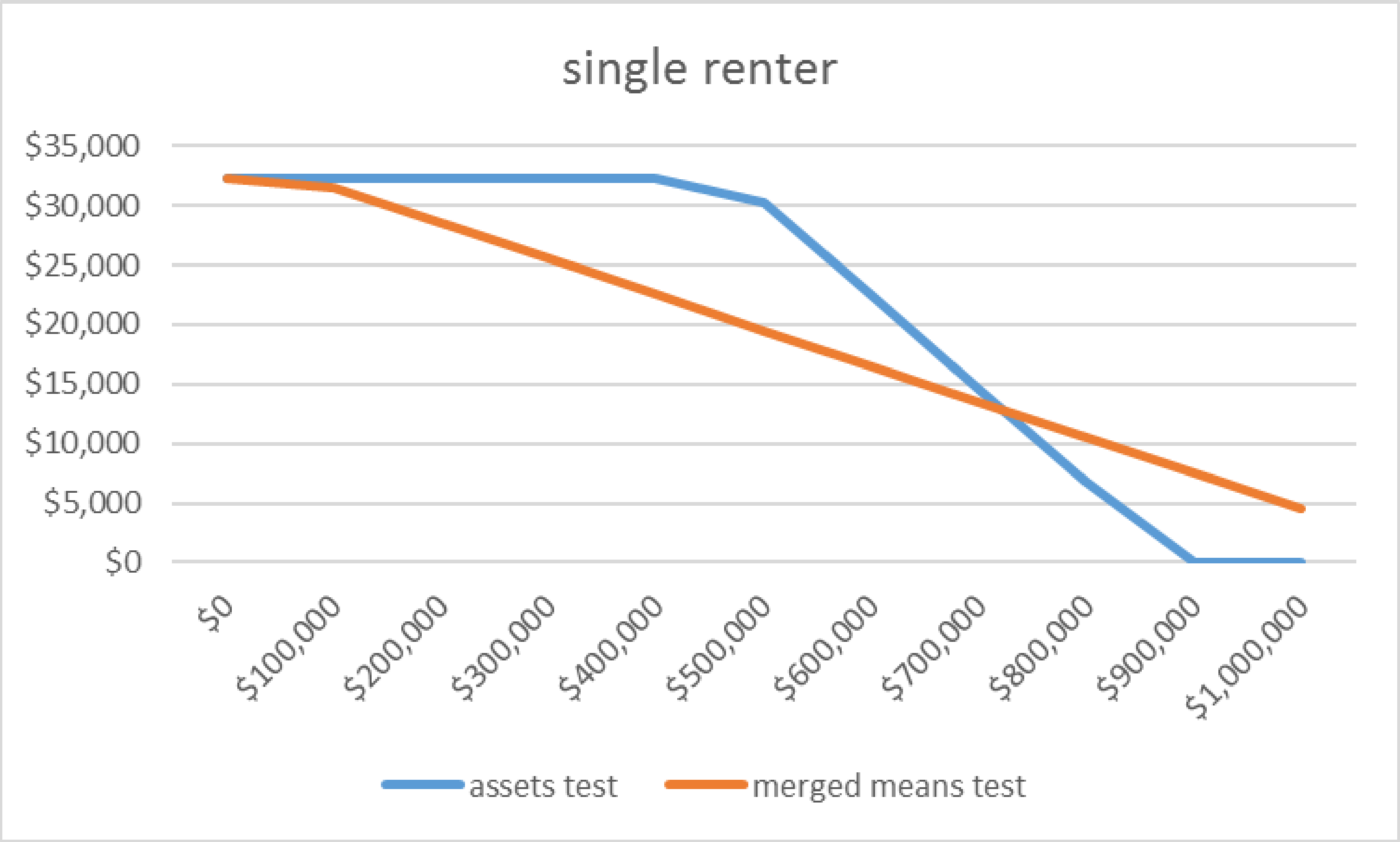
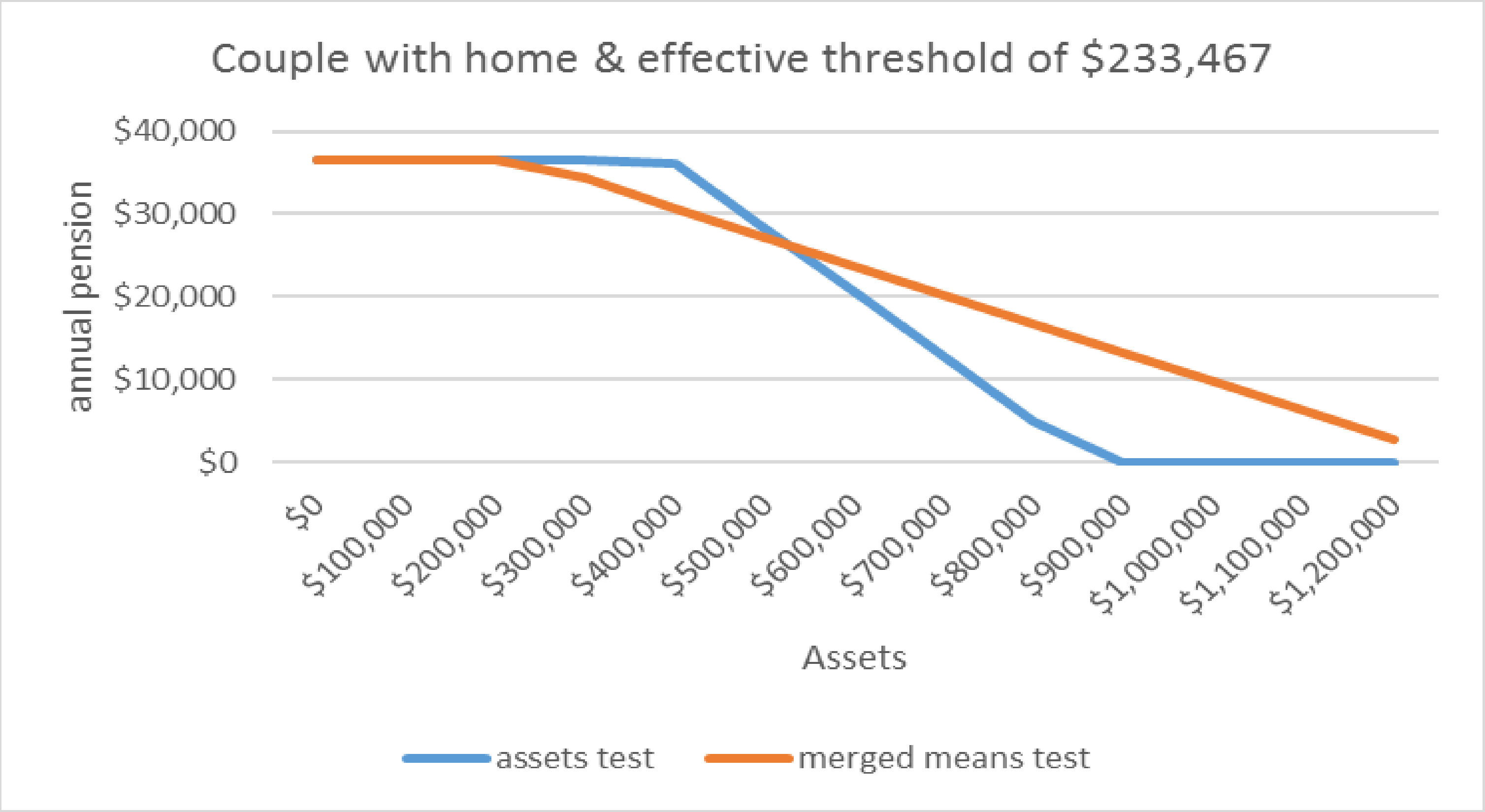


Possible modifications to this original model

- Introduce assessable assets thresholds
  - Limit losers amongst those with modest assets
  - Keep higher threshold for renters than home-owners (difference perhaps linked to value of modest home – say, at first or second decile)
- Adjust income test thresholds
  - Alternative way to limit losers
- Apply slightly higher conversion factor (say, 7%)
  - Rewarding those who actually purchase annuities, limiting gains for rich
- Phase in inclusion of home value
  - Limit gains to high asset holders, more equal treatment of different assets
  - Perhaps with high threshold (say, at 8th or 9th decile) and phased in
  - May require option to purchase pension by borrowing from estate

Impact of modified version plus assets thresholds

$100,000 (home-owner), $350,000 (non-home-owner), as well as income test thresholds



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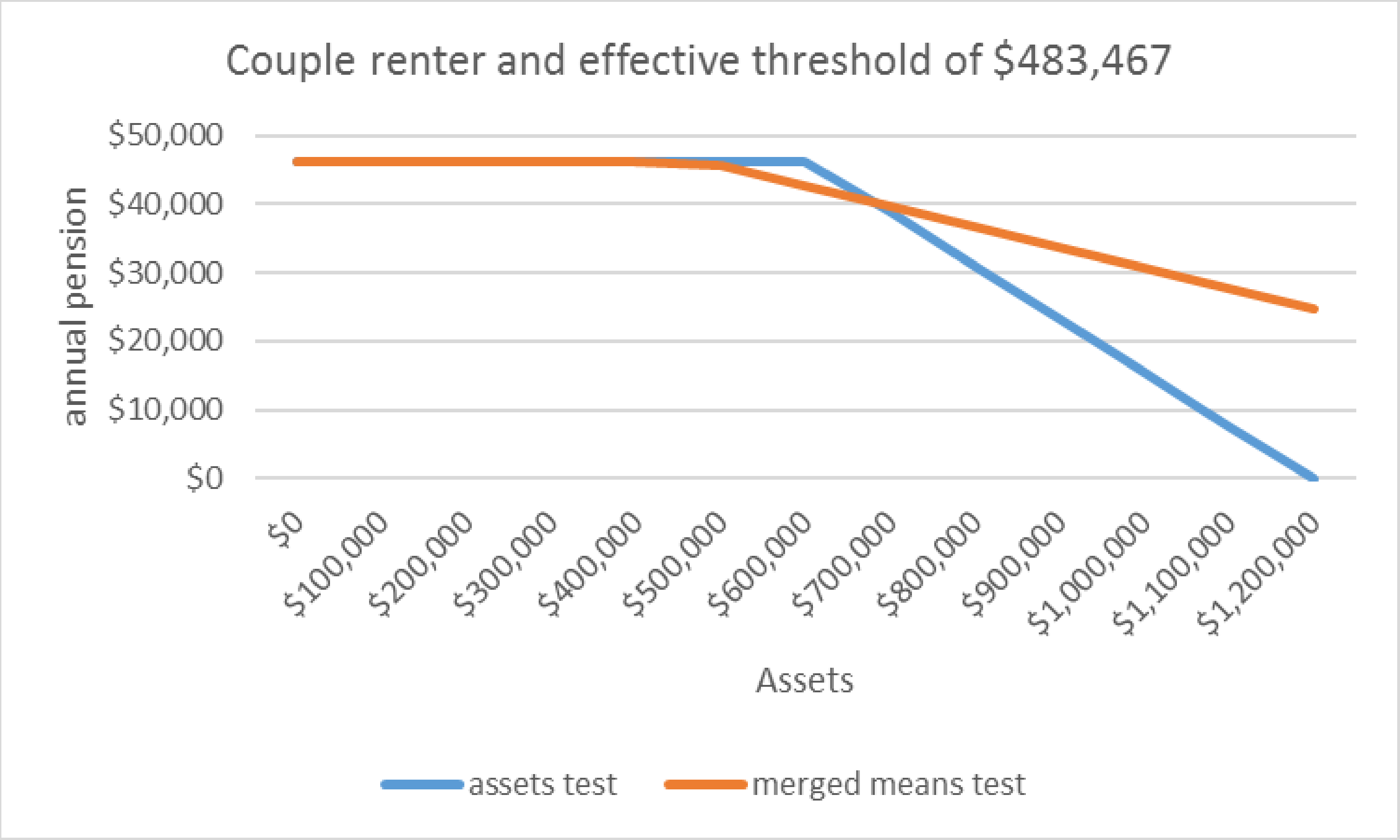

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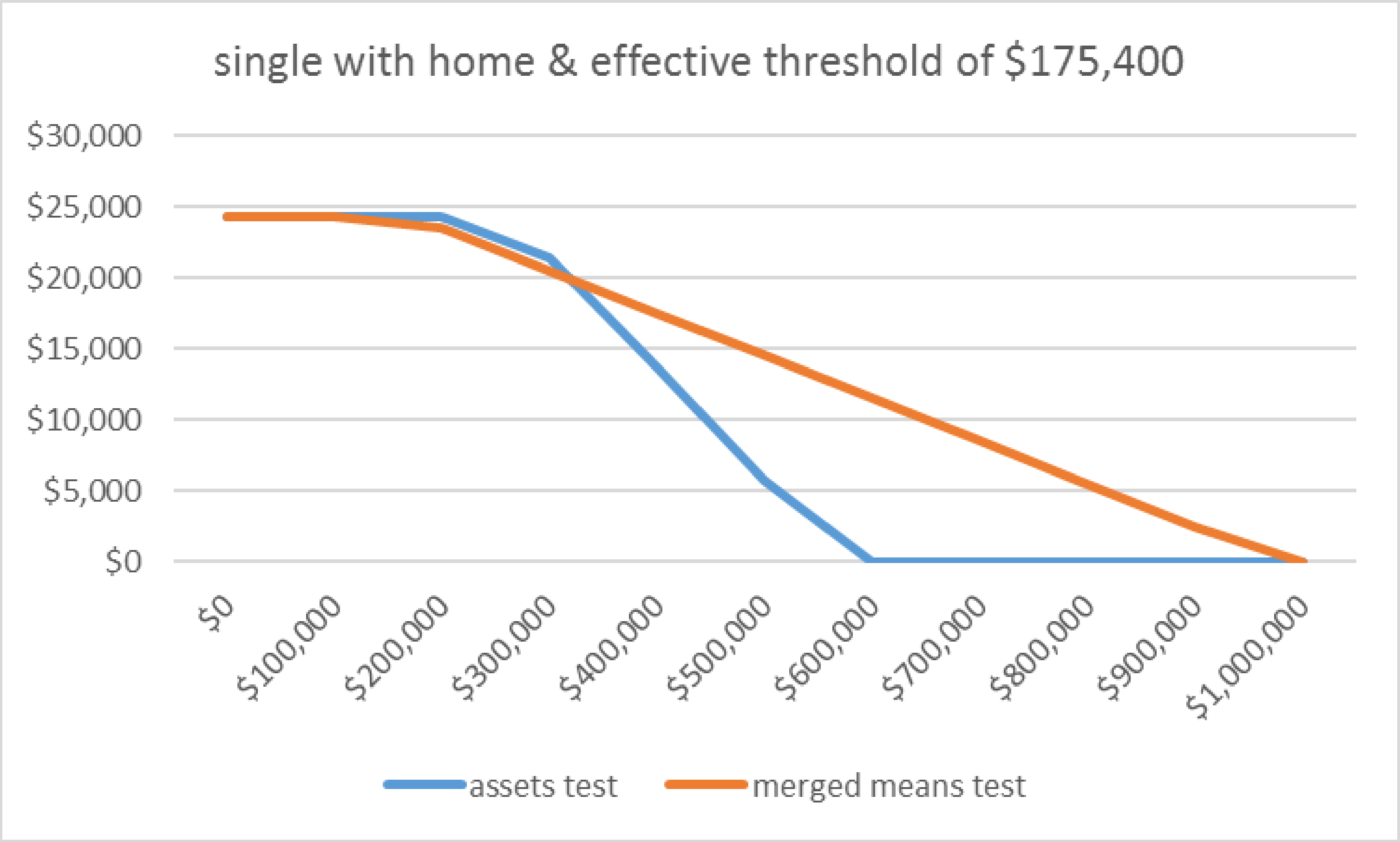

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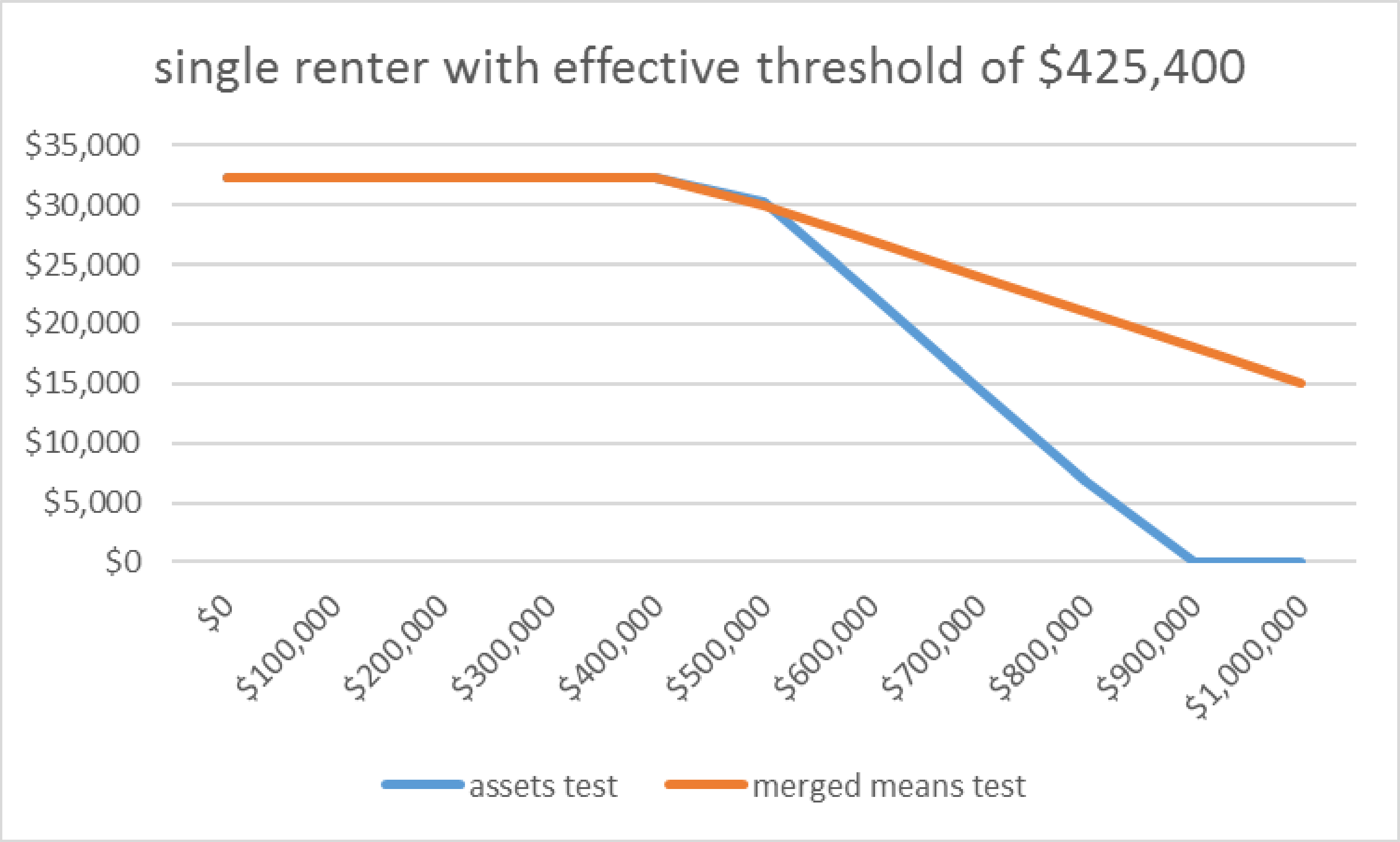
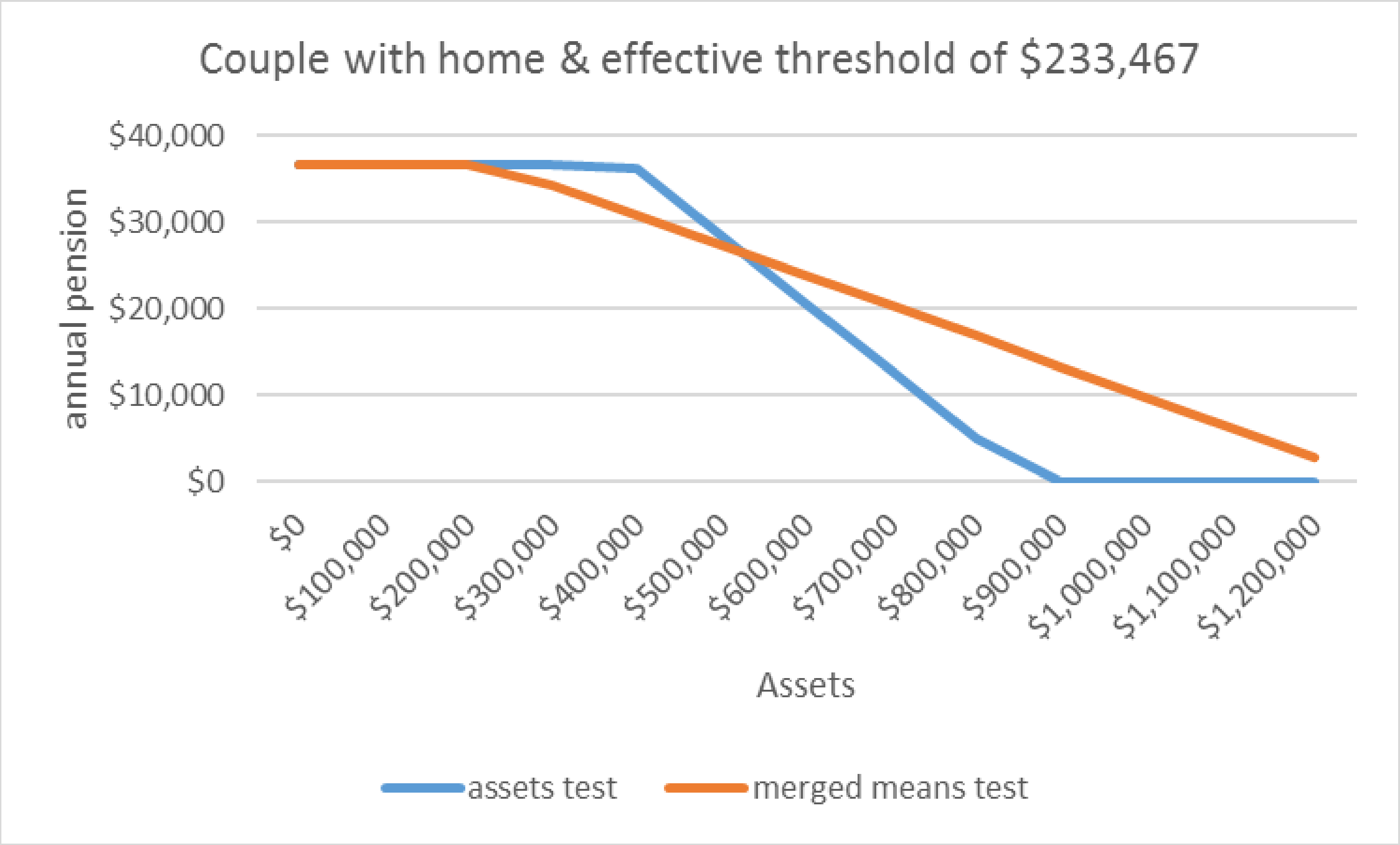


7% conversion rate and assets thresholds



Other means test options

- Actuaries Institute Green Paper presents several other options
- Option 1 is to ‘simplify the age pension’
  - At best these measures might promote everyone receiving at least the maximum rate of pension as an income stream
  - But they do not address the wider problems of retirement incomes and super-age pension relations
- Option 2 focuses mainly on having a merged means test
  - With no details, but a useful suggestion to explore the link between the age pension means test and the means test for aged care
  - This relates in large part to the appropriate treatment of the home, perhaps justifying generous treatment for pension purposes and firmer treatment for residential aged care

- Option 3 is ‘A universal minimum Age Pension’
  - Equal to 10% of the average wage, supplemented by a more strictly means-tested supplement to achieve a safety net equal to the current maximum rate
  - Would ensure far fewer people are subject to the high emtrs (though the emtrs would be higher than now)
  - The main losers would be similar to those who would lose under the merged means test options, with bigger losses
  - There would be more winners amongst high asset owners than under the merged means test options
  - Overall cost may be higher than that of the merged means test only
  - Would such an option be sustained, or be subject to continuing tinkering?

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Re-establishing focus on retirement income streams

- CIPRS agenda important but insufficient
- Need for regular reporting, at least from age 50, of likely income streams from current saving to preservation or age pension age
  - Based on current real earnings, with a standard ‘price’ for indexed annuity
  - Also, capacity to explore likely pension eligibility
- Perhaps expert views of role of annuities still shifting
  - From widespread support, at least in theory, and attractions of defined benefit schemes
  - To suggestions of superiority of allocated pensions plus deferred annuities
  - Now to uncertainty about the practicality of deferred annuities and unease about the risks of excessive reliance on allocated pensions
- Merged means test could be important part of this wider agenda