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A Note on the Treatment of Assets in the Australian Age Pension Means Test

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Abstract

This note looks at the treatment of wealth in the income and assets tests that comprise the Age Pension means test. We demonstrate how the tests interact, the extent to which different assets are treated equally and whether the income and assets tests interact effectively across the asset distribution. Policymakers have equalised treatment of some asset classes but have been reluctant to go further. Recent reforms have made the means test more aggressive with respect to assessable assets. This recognises the value of not only asset income but the underlying capital value. We show how a similar outcome can be achieved by implementing a comprehensive income test alongside deemed income rates that increase with assets.

Key words: Population Ageing; Social Policy; Pensions

JEL codes: D63, I38, J1

A NOTE ON THE TREATMENT OF ASSETS IN THE AUSTRALIAN AGE PENSION MEANS TEST

1. *Introduction*

Unlike other countries, Australia relies heavily on means testing in its delivery of publicly funded transfers in retirement. Also unlike other countries, Australia assesses not only income but considers wealth when determining pensions levels. This is done via the separate income and assets tests, where payment is based on the lower of the rates determined by the two tests. This note looks specifically at the treatment of wealth in each test, how the assets and incomes tests interact, and the implications of existing and proposed designs.[1]

2. *Treatment of different assets classes*

There are various concerns about the current treatment of assets in the means test. The exclusion of the family home from the assets test introduces ‘horizontal’ inequity (between those who invested in their home and those who hold non-home assets of the same value), distorts incentives to hold wealth in housing assets, and makes the age pension more expensive. Changing this status quo is often assumed to be politically infeasible. Still, various government and other reports have recommended that the value of the family home be taken into account in means testing above some, usually high, threshold. For example, the Henry (2010) tax review recommended a $1.2 million threshold.[2,3]

Horizontal equity issues arise not only in regard to the family home, however. The means test results in people with different non-home assets of the same value having different pension entitlements. Take financial assets (e.g. superannuation, shares, bank savings etc.) and non-financial assets (e.g. investment real estate or businesses). Financial assets are counted in the assets test according to their value and in the income test according to a *deemed* level of income. That is, a specific investment return is assumed.[4] Non-financial assets, on the other hand, are counted in the assets test according to their value and in the income test according to their *actual* income. So while both enter the assets test equally, in the income test (which is more likely to be binding), $1,000 of shares is assessed to yield $17.50 and (given a 50%

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[1] For more detail on the operation and administration of pension means testing in Australia see Chomik and Piggott (2014); International comparisons and economic impacts of means testing are summarised in Chomik et al. (2015)

[2] Such a measure would be complemented by an existing reverse mortgage structure known as the Pension Loans Scheme, allowing people to receive the pension, draw down on home equity, and remaining living in their home.

[3] Note that non-home owners can hold more assessable assets than home owners before seeing their pension decline. Recent reforms accentuate this, allowing them to hold more non-home assets, which take a step toward redressing the imbalance in overall treatment between home-owners and others.

[4] Deeming rates are changed according to broad market conditions and currently stand at 1.75% for assets valued up to around $50,000, reflecting the likely lower returns for people with fewer assets, and 3.25% for higher value assets. Changes, however, are made by the relevant minister/s rather than against a transparent benchmark. Since January 2015 Superannuation assets join other financial assets in being deemed in the income test.

withdrawal in the income test) can reduce the pension by $8.25, yet $1,000 of non-income-producing land has no effect.

3. The comprehensive income test

The Henry Review recommended that the two tests be combined into a comprehensive means test, extending deeming to real estate and other asset classes, whether income-producing or not.[5] Where deemed income would be difficult to determine other arrangements were suggested. For example, for Superannuation income streams, the Review suggested that gross income be used minus an actuarially fair deduction for capital.

In reflecting on the comprehensive test there are two points worth making. First, if it were implemented, consistent deeming of assets would naturally aid horizontal equity. But this could also be achieved by retaining separate tests and applying each more consistently across all asset classes. Second, the comprehensive test as recommended by Henry would ignore the capacity of individuals to spend down capital to finance their consumption.[6] This would relinquish a very useful feature of the current assets test. Deeming rates within a comprehensive test *could* be set to take account of capital as a retirement resource by increasing with assets (see section 6, below).[7]

Considering how the underlying capital is treated is particularly important in light of evidence that has emerged since the Henry Review, that pensioner households tend not to spend down their financial assets in retirement.[8] In fact, a majority see their nominal wealth grow through their retirement; the left over bequests are therefore effectively subsidised by the Age Pension.[9]

4. Treatment of different asset levels

So how do the current tests interact as the value of assets increases? Each has different thresholds (or 'free areas') beyond which asset income or assets are assessed and different rates of withdrawal of the Age Pension per unit of additional resources. The overall effect is that

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[5] See section F2, pages 533-553.

[6] The route taken by Henry owes to the three stated principles that a means test should follow, that it be: (1) horizontally equitable; (2) balance incentives to work and save against targeting of public expenditure; and (3) have a broader assessment of means than the tax system, taking account of "the ability of a person to generate an income from their assets" (p.536). The argument in this note is that with respect to the Age Pension assets, the assessment must take account of the ability of a person to use assets to fund *consumption*, not simply generate income.

[7] Major restructuring of the means test appears to come in cycles. In 1961, the separate income and property tests gave way to a merged means test, where property income was deemed to earn 10%. It was temporarily abolished for older pensioners in the 1970s, and operated as an income test (with no asset components) between 1976 and 1985.

[8] See Chomik and Thorp (2015) for a summary.

[9] The extent to which the Age Pension or Superannuation tax 'concessions' subsidise bequests is complicated by the fact that inherited Superannuation may be subject to tax depending on the age of the beneficiary and their dependency status with respect to the deceased.

the income test, with more gradual levels of withdrawal, is binding at the lower end of the asset distribution while the assets test, which features a relatively more aggressive taper, is binding for higher amounts of financial assets. Those with higher assets are therefore compelled to make use of these assets before they can claim greater amounts of the pension.

Reforms announced in the 2015 budget accentuate this mechanism further, though the ostensible intention behind the reforms has been to limit increases in Age Pension expenditure precipitated by an ageing population in a way that does not affect adversely the poorest pensioners.[10] From 2017 the assets test will see an increased free area that extends the threshold at which withdrawal starts, particularly for non-home owners, but the taper rate will be more aggressive (from $1.5 withdrawn per $1000 over the threshold per fortnight to $3).

Current and future arrangements are demonstrated with respect to financial assets in the figure below for a single pensioner who doesn't own a home, showing the effect of both tests across the asset distribution (in 2017 dollars). Before and after reforms, the free areas for both tests mean that the pensioner could have up to about $150,000 financial assets before the pension begins to be withdrawn. Up to this point, the pensioner is assumed to have an increasing total income as assets increase: she receives her full pension and the imputed asset income (including a barely visible upturn at about $50,000, when the deemed income changes from 1.75% to 3.25%).

Between about $150,000 and $500,000 of assets, the higher deemed income reduces pension payments via the income test and total income increases at half the rate it did previously. This is in line with the 50% income taper; the marginal withdrawal for every $1,000 of assets is now 1.625% (half of 3.25%).

Beyond this point, the assets test takes over, reducing the pension and total income more dramatically and increasing the withdrawal rate (even more so post-reform). This is in line with a reduction of $1.5 and $3 for every $1,000 for 26 periods. In the post-reform scenario, the more aggressive taper means that the financial asset level at which a single person receives no pension is reduced by some $200,000 (to about $750,000).

5. Means test as a tax

The means test is effectively an age-based tax on capital income. The rate of withdrawal is high (see middle panel of charts in the below figure). A withdrawal rate of 7.8% on a 3.25% return implies a capital income tax of 240%. The high effective tax rate has attracted criticism from some commentators (e.g., Ingles and Stewart 2015). But the theoretical literature suggests that a higher tax on capital should apply at later ages (see for example Kumru and Piggott 2010). Taxing capital via inheritance-type taxes, seen in many countries, often incurs an effective capital income tax well above 100%.

[10] Note that the projected increases in spending are in fact relatively low (e.g., see Chomik 2015)

Another way in which the means test operates differently to a tax is in its definition of the tax/transfer unit. In Australia, as in most other countries, income taxes define the individual as the taxable unit; but the Age Pension focuses on the spending unit, and importantly takes account of spousal circumstances. As with spending down of capital, this is consistent with the needs-based nature of the means test design.

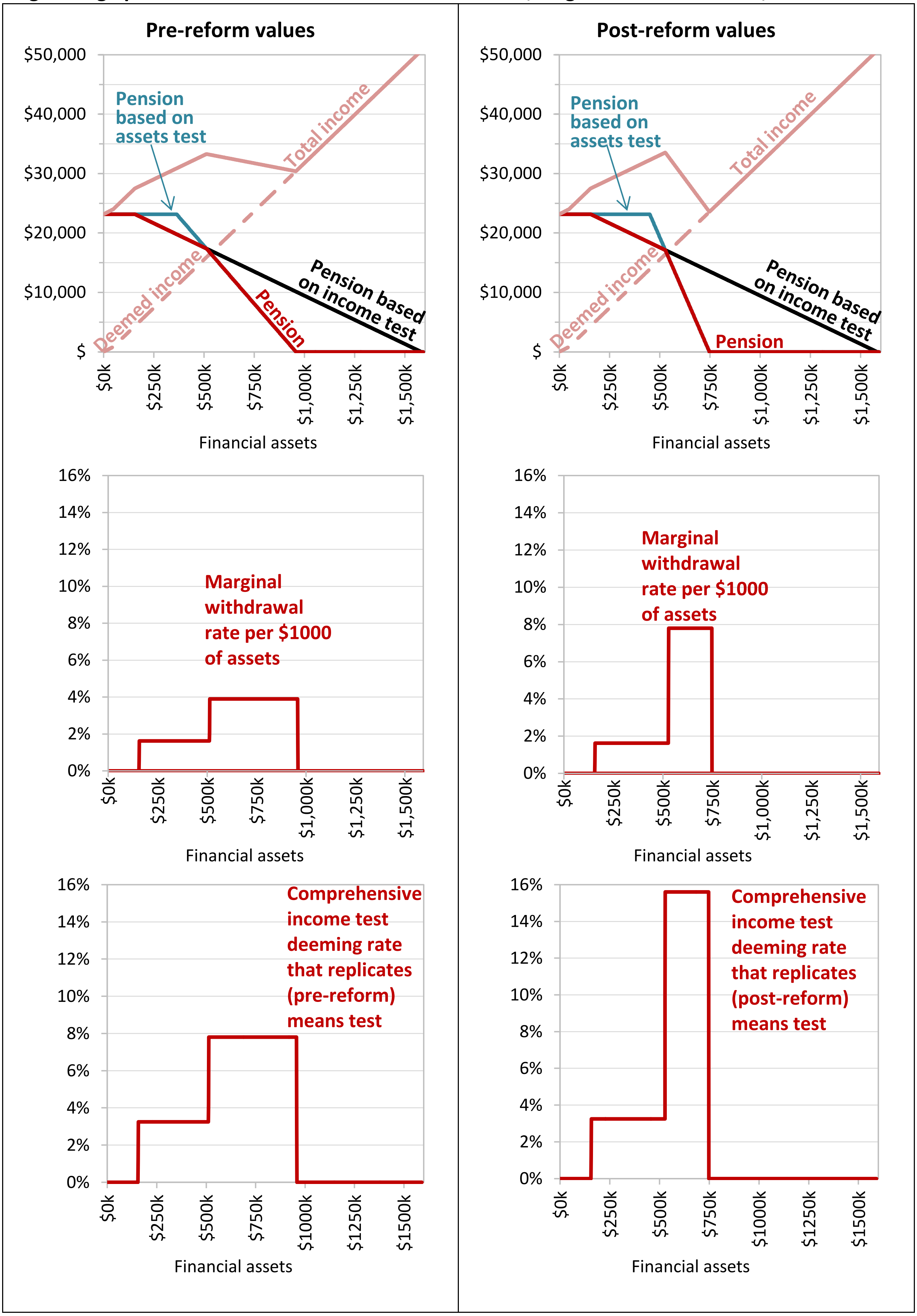
6. Conclusion

Looking at how the income and assets tests interact is instructive for policymakers interested in replacing the current means test with a comprehensive income test. Replicating the current tests within an income test is possible by increasing deeming rates as assets increase (as shown in bottom panel of the figure). In such an arrangement the withdrawal rates seen in middle panels of the figure would also be replicated. For example, in the post-reform scenario a deeming rate of 3.25% and 15.6% combined with a 50% income taper would achieve the same means test and fiscal outcomes as the recently legislated changes to the asset test.[11]

In summary, this note discussed two types of concerns about how the means test assesses wealth: whether different assets are treated equally and whether the income and assets tests interact effectively across the asset distribution. On the first point, policymakers have equalised treatment of some asset classes (e.g., deeming of Superannuation in line with other financial assets) but have been reluctant to include the family home in the assets test. It remains a key area of potential reform of the means test. On the second point, recent reforms have made the means test more aggressive with respect to assessable assets, emphasising that in addition to asset income, the greater the capital value of these assets the lower the need. A similar outcome is achievable by implementing a comprehensive income test for the pension alongside deemed income rates that increase with assets.

[11] The lowest deeming rate of 1.75% could be optionally included. This does not appear in the bottom panel of charts because they show effective deeming rate after interaction with 'free area' is taken into account.

Figure: Age pension income and assets test interaction, single non-home owner, 2017



Note: Figures are annualised. Total income assumes that actual asset income is equivalent to deeming rate. Bottom panel of charts is the effective deeming rate after interaction with 'free area' is taken into account.
Source: Authors' analysis

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