Australian Government

Department of Social Services

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Senator Zed Seselja
Chairperson
Senate Standing Committee on Community Affairs
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Dear Senator Seselja

REQUEST FOR A RESPONSE FROM THE DEPARTMENT TO SUBMISSIONS TO THE SENATE COMMUNITY AFFAIRS LEGISLATION COMMITTEE

Thank you for your Committee's email of 17 June 2015, requesting a response from the Department of Social Services to concerns that have been raised in the submissions to the Senate Community Affairs Legislation Committee Inquiry into the *Social Services Legislation Amendment (Fair and Sustainable Pensions) Bill 2015.*

The Committee requested a response on schedules 1, 3 and 4, in particular a response to modelling outlined in Industry Australia's submission.

Thank you for providing the Department with an opportunity to provide this response.

Yours sincerely

Serena Wilson

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SOCIAL SERVICES LEGISLATION AMENDMENT (FAIR AND SUSTAINABLE PENSIONS) BILL 2015.

Schedule 1 – Defined benefit income streams

The original DSS submission addresses many of the concerns raised in the submissions. However, there are two issues raised in submissions that the Department wishes to respond to and provide further information.

As background, this measure will increase the proportion of their defined benefit income stream that is assessed under the social security income test, for some income support recipients. It does this by capping the proportion of income that is excluded from assessment (the deductible amount) at ten per cent from 1 January 2016.

<u>Components of the Deductible Amount</u>
Some submissions have stated that the deductible amount for their defined benefit income stream represents their personal after-tax contributions as well as employer contributions and salary sacrificed amounts. However, for social security income test purposes the deductible amount should only reflect the return of personal after-tax contributions, if any, made by the employee to their defined benefit income stream.

As stated in the original DSS submission, the change in the calculation of the deductible amount resulted in people with service prior to 30 June 1983 having a significant amount of upfront employer contributions treated as personal after-tax contributions. This resulted in a higher deductible amount, and consequently higher income support payments, even though nothing had changed for the defined benefit recipient in terms of their contributions or the amount of income they receive each year from their income stream provider.

This was a change introduced in 2007 as part of the Simpler Super taxation changes, which were designed to simplify a complicated system of taxation for superannuation benefits. However, this created an unintended outcome whereby the deductible amount used by the social security income test exceeded a person's own after-tax contributions for some defined benefits income streams.

Taxable income and income assessed for social security support are assessed differently because the two systems have different purposes. The Australian Taxation Office measures a person's capacity to pay taxes and contribute to Australia's general revenue through the Australian tax system. In contrast, Centrelink makes an income assessment to measure a person's current need for income support and their capacity to contribute towards their own support.

In general, the income test assesses the gross ordinary income of people and measures income from all sources. Under social security law, all income earned, derived or received for a person’s own use or benefit is counted under the income test. The only exceptions are those items specifically exempted under social security law. This ensures social security income support payments are targeted to those who need them most.

Grandfathering

The measure provides a fairer assessment of an individual’s personal contributions to their defined benefit income stream. The Simpler Super taxation changes in 2007 created an unintended change which increased the deductible amount in the income test treatment for some defined benefits income streams. The measure addresses this anomaly. Given this, it is not appropriate to grandfather the deductible amount for existing income support recipients who may have benefited from the anomaly.

Schedule 3 – Assets Test and concession cards

In terms of retirement income policy, the Rebalance the Assets Tests Parameters measure protects or improves outcomes for those only able to save moderate amounts to supplement their Age Pension, while limiting access to the pension for those with sufficient means to support a significantly higher standard of living than the Age Pension.

1. Response to Industry Super Australia submission

Effect of the changes on retirement incomes

As flagged in the Department's submission, much of the critical comment about the changes has focused on the effect of the change in pure income terms.

The submission from Industry Super Australia also takes this approach. Their predictions about future retirement incomes are based purely on income and ignore the improved capacity of future retirees to draw down their savings to meet their retirement needs.

The Department considers that analysis based purely on income is fundamentally flawed as it does not recognise the capacity of people to draw down on their assets to support themselves in retirement. The point of providing taxpayer funded incentives through the tax system for superannuation is that people draw down on those savings to ensure a good standard of living in retirement. The Age Pension should not be expected to operate as a top–up that allows retirees to retain their capital base intact.

It is worth restating that only people with significant levels of assets other than their home will have their payments affected and that they have the capacity to draw down their savings to meet their retirement needs. For the groups most affected by the changes (partnered homeowner couples who have $825,000 in assessable assets and single homeowners with $550,000 in assessable assets):

- the level of assets held (not including their home) equates to almost 24 years of the full rate of partnered or single pension.
- they would only have to draw down a maximum of around 1.8 per cent of their assets a year to make up for the loss of their part pension.

- they could support a significantly higher standard of living in retirement than the maximum rate of pension through a combination of investment earnings, capital drawdowns and eventual pension entitlements. Assuming the drawdown of investment returns and capital over a 35 year period, and long term investment returns averaging five per cent, the partnered couple could generate a total income (including investment returns, capital drawdowns and eventual pension entitlements) of over $58,000 year in real terms, which is approximately $25,000 a year higher than the partnered full pension, and the single person could generate a total income of over $38,000 year in real terms, which is approximately $16,000 a year higher than the single full pension.

The ASFA “Comfortable Lifestyle” retirement income benchmark.
Government retirement income policy does not set any particular goals for the level of income people should be able to achieve in retirement. Australia’s retirement income system does not set any desired income replacement rate or other retirement income target that it sets out to achieve. The Superannuation Guarantee and taxation incentives are designed so that people reaching retirement will be less reliant on the Age Pension and have improved retirement incomes than the Age Pension alone.

Most of the analysis by Industry Super Australia uses the Association of Superannuation Funds of Australia (ASFA) “Comfortable Lifestyle” retirement benchmark.[1]

Given the ISA analysis focuses on people reaching a designated “comfortable lifestyle” income benchmark, it raises broader issues around the purpose and design of superannuation that should be considered separately to the appropriate design of a means test for a social security safety net payment.

The Age Pension role in the retirement income system is a safety net payment that is designed to support a basic, acceptable standard of living, particularly for those with few other resources. Age Pension is funded from general revenue, in other words by current taxpayers, and targeted through the means test to those who need it most. As a non-contributory social security payment, eligibility for the Age Pension is not based on past income or contributions, or taxes paid during a person’s working life.

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1 The ASFA standard for a modest lifestyle for a single person or couple aged around 65 is currently $23,438 and $33,799 a year respectively. For a comfortable lifestyle, it is $42,569 and $58,444 respectively. For a single person or couple aged around 85 the modest lifestyle benchmarks are currently $22,798 and $33,915 a year respectively. For a comfortable lifestyle, the benchmarks are $38,075 and $53,424 respectively. More information about the ASFA Retirement Standard can be found at: https://www.superannuation.asn.au/resources/retirement-standard

The Age Pension is paid at the highest rate of income support payments in the Australian social security system. The current (20 March 2015) maximum pension rates are:

- $22,365.20 a year for singles; and
- $33,716.80 a year for pensioner couples combined.

The level of Age Pension is broadly similar to the ASFA modest lifestyle retirement income benchmark. The capacity of retirees to support a higher standard of living than the Age Pension will depend on their level of savings.

As indicated in our submission, those affected by the assets test change could support a significantly higher standard of living in retirement than the maximum rate of pension through a combination of investment earnings, capital drawdowns and eventual pension entitlements. At the proposed assets test cut-outs, this higher standard of living is broadly in line with the ASFA comfortable lifestyle retirement income benchmark.

<u>Industry Super Australia projections</u>

In interpreting the Industry Super Australia submission, it is important to remember that the submission contains projections for periods up to 40 years. Projections over extended periods of time need to be treated with appropriate caution because they are naturally very sensitive to assumptions about things such as inflation, wages growth, and long-term investment returns – and ignore the capacity of government to make adjustments to policy settings over time.

The Industry Super Australia projections include superannuation investment returns of 7.2 per cent and an assumption that Age Pension will increase by 4 per cent every year, as results of wages growth. This percentage is significantly higher than current wages growth and is speculative for future years.

<u>Impact of the change on those earning average incomes, those on higher income and on women</u>

The submission from Industry Super Australia makes the point that more people will be affected by the changes over time. It particularly highlights the impact of the change on those earning average incomes, those on higher incomes, and on women.

- Those on average incomes

The finding that more people, including those on average incomes, will be affected by the changes over time is not surprising. The key driver of the projected lower future age pension coverage is higher superannuation balances. This will occur as the superannuation guarantee further matures and retirees (including those on average incomes) have had a lifetime of superannuation contributions.

Higher retirement savings, and a corresponding lower reliance on the Age Pension, are intended outcomes of the superannuation guarantee system. The finding that the assets test changes will, in the longer term, affect those earning average incomes is a positive outcome. It shows that the superannuation system is working and is helping people on average incomes to achieve higher superannuation balances by their retirement, which will allow them to achieve higher retirement living standards than if they relied solely on the Age Pension.

- Those on higher incomes

The finding that the changes will not affect those on high incomes is also not surprising. It simply reflects the Industry Super Australia projections that at this group will have higher levels of superannuation and other savings at retirement. They are not significantly affected by the changes to Age Pension simply because they get little or no Age Pension under current assets test settings.

- Women

Any commentary on the impact of the changes for women needs to recognise that the same assets test applies to female and male pensioners and that applying a means test to all Age Pensioners allows the system to provide greater support for those who reach retirement with more limited superannuation. It should also recognise that, for women who are part of a couple, analysis based on sex is not relevant as the assets of couples are assessed jointly.

The findings about the impact on women largely reflect that superannuation outcomes for women are improving and that woman retiring in the future will do so with higher levels of superannuation and savings due to improved workforce participation and incomes. Similar to the finding that the changes will affect future retirees who have earned average incomes during their working life, it is a positive outcome that shows the superannuation system is working and is helping women to achieve higher superannuation balances by retirement.

Figure 6 of the Industry Super Australia submission shows the effect of the changes on women. It is worth noting that women in the first four deciles (who have lower superannuation savings) will see no or an almost immaterial change to their pension and overall retirement incomes as a result of the assets test changes. In fact, some of this group will likely have benefitted from the changes to the assets test that increases the level of assets that a person can hold before pension is affected.

Women in deciles 5-8 will see a decrease in pension and overall retirement incomes under the changes. However, taking into account that their total income will still be relatively close to the “comfortable standard” benchmark in the ISA analysis, it is likely that they could achieve the AFSA “comfortable lifestyle” benchmark by prudently drawing down on their superannuation capital over time.

Women in deciles 9-10 will continue to easily achieve the AFSA “comfortable lifestyle” benchmark. They are not significantly affected by the changes to Age Pension simply because they get little or no Age Pension under current assets test settings.

2. Responses to other submissions

High Effective and Marginal Tax Rates may distort pensioner behaviours
Some submissions[2] suggests that the proposed taper rate leads to high and effective marginal tax rates that will lead to risky investment behaviour. One submission[3] cites the low rate of return available in bank deposits or term deposits, of around 3%.

However, as noted in the Department’s submission[4] this is not a typical asset allocation for someone with a large amount of retirement savings. Departmental analysis shows that those with substantial assets are already likely to have substantial funds in superannuation income streams, and less in low yield investments like bank accounts and term deposits.

It is also suggested that the proposed taper rate will create the incentive for people shifted part of their assets into non- assessable assets such as their home.[5]

As noted in the Department’s submission, a pensioner who reduced their assets by say $50,000 to qualify for a higher pension payment would take more than 35 years to break even, assuming a long term investment return averaging 5%. Retirees who over-invest in housing reduce their financial capacity to enjoy a higher standard of living in retirement. There is no evidence that pensioners systemically over-invest in housing to gain a pension advantage.

Is the drawdown implicit in the proposed tightening of the assets test reasonable?
Some submissions question the rate that retirees will be required to draw down on their assets to maintain their standard of living.[6]

The DSS submission states that DSS analysis shows that the majority of pensioners are conservative with their savings and there was no evidence that when the assets test taper was previously $3.00 that pensioners dissipated their assets more than they currently do. Therefore it is not clear how much pensioners will draw down from their assets under the assets test changes.

[2] Submission from the Committee for Sustainable and Retirement Incomes, page 7, Tax Transfer Policy Institute submission , page 7.
[3] Submission from the Committee for Sustainable and Retirement Incomes, page 7.
[4] Department of Social Services Submission, page 10.
[5] Submission from the Committee for Sustainable and Retirement Incomes, page 7.
[6] Submissions from the Committee for Sustainable and Retirement Incomes and Tax Transfer Policy Institute.

The timing and level of drawdown, and the standard of living that retirees choose to achieve with their savings, is a matter for individuals. However, as the Department noted in its submission,[7] retirees affected by the assets test changes could support a significantly higher standard of living in retirement than the maximum rate of pension through a combination of investment earnings, capital drawdowns and eventual pension entitlements.

The Department's submission provided the example that, assuming the drawdown of investment returns and capital over a 35 year period and long term investment returns averaging five per cent, a partnered couple who own their home and have $825,000 in assessable assets (just above the estimated assets test cut off amount of $823,000 that would apply from 1 January 2017 under the proposed changes) could generate a total income (including investment returns, capital drawdowns and eventual pension entitlements) of over $58,000 year in real terms. This is approximately $25,000 a year higher than the full pension.

<u>Won't people who draw down their assets end up back on the pension? Will the Government end up paying more over the longer term?</u>

One submission[8] suggests that if people are forced to run down their savings, and become eligible for part pension, some of the budgetary savings from the measure will be lost.

It is correct that retirees who are initially excluded from the Age Pension due to high assets may, over time, become eligible to receive a part-rate of Age Pension. This is a normal feature of the operation of the pension means test as retirees drawdown on their savings to meet their needs in retirement, and a demonstration of how the Age Pension operates as a safety net for retirees.

The resulting pattern of Age Pension receipt is lower pension coverage and average payment rates in the early years of retirement, with increasing coverage and higher average rates at older ages. This pattern of receipt is anticipated in modelling of the proposed assets test changes. This is illustrated in the Charts at Attachment B of the Department's original submission. However, it is not correct that the Government will end up paying more Age Pension in the longer term.

The DSS submission[9] refers to modelling that shows that the Government will not end up paying more over the longer term. It shows, for example, that the cumulative cost of the pension for the couple would be lower under the assets test changes for the first 30 years from their commencement on pension.

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[7] Page 11.
[8] Submission from the Committee for Sustainable and Retirement Incomes, page 8.
[9] Department of Social Services Submission, page 13.

Merged means test

Some submissions[10] suggest an alternative to tightening the assets test is to extend deeming to all assets. This approach would remove the existing pension assets test and expand the pension income test by extending deeming provisions to affect most assets, not just financial investment assets. The proposal is similar to an example in the final report of the “Australia’s Future Tax System” review.

Merged means test proposals based on achievable deemed rates of return come at a large cost to outlays and have regressive distributional impacts. A proposal previously costed, which was based on the deeming rates at the time of 3-4% and would have extend deeming provisions to affect most assets except for the primary residence and up to $75,000 of personal use assets, would have:

- added over $5 billion a year to outlays and has regressive distributional impacts;
- benefitted about 1.6 million people with very high levels of assets;
- adversely affected 100,000 poorer pensioners, including 25,000 maximum rate pensioners.

The fiscal cost arises due to the abolition of the assets test. For pensioners with higher levels of assets, the assets test currently impacts harder than a merged means test would. As an example, the assets test cut-off for a homeowner couple is currently $1.15 million, in addition to their home. Under the proposal previously costed the amount of assets a homeowner couple could have before losing pension entitlement would have risen to about $2.16 million in assets, in addition to their home, before the deemed income on those assets would cancel their pension. Increases in outlays of this order would substantially increase pressure on the fiscal sustainability of retirement income policy settings (even at significantly higher deeming rates than currently apply).

The merged means test approach advocated in one submission[11] suggest a high 6% deeming rate. The Department has not modelled the distributional impacts, however it would certainly not be fairer:

- a 6% deeming rate is far higher than the current upper deeming rate of 3.25% and as such it would have very severe adverse impacts on the large number of pensioners with lower levels of assets, including many current maximum rate pensioners, and
- a rough calculation based on the 6% deeming rate indicates the assets test cut-off would rise to about $1.25 million for a homeowner couple, meaning that more wealthy pensioners would benefit from the change, including some who would become eligible for pension for the first time.

[10] Committee for Sustainable Retirement Incomes and Tax and Transfer Policy Institute submissions.
[11] Tax Transfer Policy Institute submission, page 8.

It is not clear what policy rationale there would be for reducing assistance for age pensioners with lower levels of savings, including many current maximum rate age pensioners. However, even taking into account these reductions in pension, it is not certain that the approach advocated would achieve savings comparable to the Government's rebalanced assets test measure because of the increase in the assets cut-outs.

3. Impact of the changes on women.

Since making its submission to the Committee, the Department has undertaken some further broad analysis on the impact of the change on single women. (For women who are part of a couple, analysis is not relevant as the assets of couples are assessed jointly).

About 71% of single homeowner age pensioners are women. They are slightly under represented in the group impacted by the changes making up 66% of the cancellations, 67% of the reductions and 65% of those who will receive an increase.

Analysis of single non–homeowners shows that 64% of single non-homeowner age pensioners are women. They make up 63% of the cancellations, 63% of the reductions and 58% of those who will receive an increase under the changes.

The analysis shows that the changes do not impact women proportionally more than men. Rather, as a percentage of the total Age Pension population, men are slightly more impacted. This was anticipated and reflects that the lower average level of assets held by single women is lower than single men. This is despite the fact that, due to longer life expectancies, some women will have higher relative levels of assessable assets following the death of their partner.

Schedule 4 – Energy Supplement replacing seniors supplement

UnitingCare Australia states in their submission that the purpose of the Seniors Supplement is to support low income retirees. The Seniors Supplement is paid to holders of the Commonwealth Seniors Health Card (CSHC), and is not to be confused with the Pension Supplement paid to all pensioners.

Approximately 75 per cent of people over the age of 65 receive a pension. Compared to pensioners, CSHC holders have greater means and are not low income retirees. They have too much income and/or assets to be entitled to receive a taxpayer funded pension. As noted in the Department's submission, providing cash payments to self-funded retirees is inconsistent with a social security system designed to assist those with less capacity for self-support. Assistance through social security should be targeted to those in most need.

The Seniors Supplement was introduced in 2009 to assist with household and other living expenses. It is not consistent with a well-targeted social security system to make payments to retirees with higher means, nor is it financially sustainable while the Government is repairing the Budget.

Holders of the CSHC will continue to have access to a range of concessions including cheaper Pharmaceutical Benefits Scheme items and a lower threshold for the Extended Medicare Safety Net. They will also be entitled to the Energy Supplement.