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Can we afford old age?

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THE CENTRE FOR INDEPENDENT STUDIES

Australia is getting older. Rising life expectancy brings with it the prospect of not years but decades in retirement. Can we afford the costs of old age? Will superannuation give retirees the standard of living they want? Is pension spending sustainable if it will triple over the next 40 years?

These are the pressing questions that were addressed by Dr Cassandra Goldie (CEO, Australian Council of Social Services), Jeremy Cooper (Chairman, Retirement Income at Challenger Ltd), and Simon Cowan (CIS Research Fellow and Target30 Director) at the Centre for Independent Studies forum: Can We Afford Old Age?

The speakers probed the age pension, superannuation, the family home exemption in the assets tests, and ways to give pensioners a good standard of living without placing a heavier burden on taxpayers.

Dr Cassandra Goldie

I want to thank the Centre for Independent studies for inviting ACOSS to this forum. It's actually been fantastic that Simon and I have been in the same rooms on a number of occasions over time and I think this is a healthy sign that some of us share some frustration about the lack of getting real progress on some common ground for reform in areas where we really need it — and that we are doing our very best to listen to each other to work out where we can find common ground. Because I think it's in all our interests to try and unstick some of what has got stuck in Canberra.

I wanted to briefly give you a bit of a big picture. ACOSS has a particular focus on protecting people in poverty in Australia but with an eye to the common good, and so certainly we do have a strong focus on economic policy, social policy and environmental policy because all of these things work together. We do agree we have a budget challenge and that whilst we're not in a crisis, we've got some serious work to do on making sure that we have the right combination of revenue generation and the right well targeted expenditure.

It is a great story for Australia that we are living longer and health outcomes are fantastic. Yes, we can afford a wonderful future for everybody, including the babies being born today. But we have to make it work, and that is why where we are all here having a serious look at the big picture. It is important for us to acknowledge that over the most recent period of time we've had very strong economic growth but we have had a falloff in our revenue picture. It is often debated whether we are a big taxing country (we could probably have a discussion about that right now) but certainly in terms of the balance over the budget we've had a big falloff in revenue and we have some areas of significant growth in expenditure.

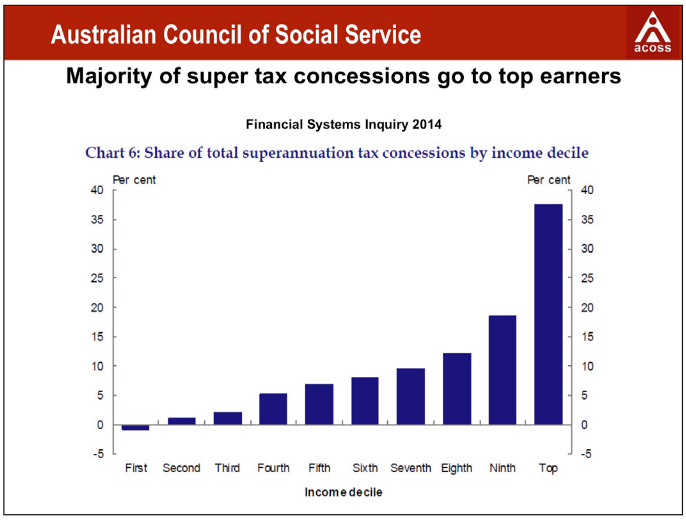
I want to touch on where the real pressure points are there. I think it's very important for us to be as factual as we can about exactly where Australia is at in terms of our expenditure. We are not anywhere near that of the high-spending side of the OECD, we're on the lower side in terms of our transfer or cash payments. You can see where Australia is, we're right down on the bottom end of it. The OECD average is about 13% of GDP and we're tracking at about 8.6% of GDP. When we talk about 'the welfare budget' the public most typically think about a person who is unemployed. But the reality is that in terms of those key payments, like the payment for a person if they're unemployed or have a disability, those working age payments have been declining in terms of the number of people relying on those payments proportionate to the population. So this is not the area of growth in terms of our welfare expenditure.

The area of big pressure for us is absolutely in the areas of the age pension, health and schools. Those are the areas of real growth and that is certainly why we at ACOSS, together with many others, have been having a serious look at what we need to do to make sure that the expenditure we've got going into these important areas is well targeted — and that we're getting the most out of the investment in this kind of expenditure to place us in a strong footing into the future.

This is one of the reasons we carefully looked at the reforms that were needed in the age pension. We agree that the age pension is not a universal payment, it is a safety net payment — so to that extent it is appropriate for it to be income and assets tested. We certainly didn't support the proposal by the federal government to reduce the value of the base rate of the age pension, reducing it from index wages down to CPI. We felt that was the wrong way for us to look at where we should be appropriately targeting the age pension. Our view, which we have advocated for a number of years, was that what we should be doing in the short term is restoring the assets test back to essentially where it was at the 2007 period, and that is essentially where we've got the reform to at this point in time.

In our view the much bigger, structural changes that we need to be looking at is the overall retirement income system and particularly superannuation. Jeremy talked about David Murray's important piece of work on the financial services enquiry. I think Mr Murray made a very important intervention where he said it is time for us to settle the core purpose of our retirement income system. It is time for us to be very clear about what we try to achieve out of it. I think all of us, including probably yourselves in the room, want to get to a point where we can have some stability and some certainty. He acknowledged that it had become a multipurpose system and we really had become unclear about what we should be trying to do in any kind of structural reform that we might need to do at this point in time.

What he's highlighted is something ACOSS does highlight, that in the same way our direct expenditure on the age pension is in the order of $40 billion, in terms of the value of the concessionary arrangements on superannuation that is tracking around about the same kind of value.



It is significant and growing. And in our view what Graph 1 shows you is that, of the $40-odd billion in the concessionary arrangements and associated with superannuation, the bulk of those are going to minimise the tax liability of people on higher incomes and more wealthy people — many of whom will not be needing to rely on the age pension into the future. And that what we're not getting is a better targeting of those concessionary arrangements to try and assist more and more people on low and modest incomes to be securing the kind of superannuation balances that you will need to ideally be independent, or at least only partially reliant on the age pension into the future.

There are a few points that I want to highlight for this evening's discussion. I do think that whilst we certainly supported the particular reform over the assets test on the age pension, one of the big structural problems we've got right now is that we don't have any appropriate way to set what is an adequate level of a pension. We have some big changing factors going on. Jeremy highlighted the changing picture in terms of homeownership and the extent to which you have a debt at the point of your post working age life.

We know that increasingly as populations come through at the moment, unless we do something on housing affordability we are going to have fewer and fewer people who will be fully owning their home — so that the age pension level is adequate for them because it's their income and they don't have major housing costs which will be coming out of that. I certainly welcome the contribution from the Centre for Independent Studies in flagging up rent assistance, which is a welfare payment that you can have access to in certain circumstances to help you to cover your rental cost — but it's a big cost.

So how do we factor in housing costs in changes to resetting the level of the age pension over time? Do we just wait for the politics of the day? We got some politics going on in 2009 when we were successful in achieving that one-off increase in the base rate of the pension, about $30. We've come through the risk of potentially moving indexation away from wages down to CPI on the age pension. But in ACOSS's view this is a very important benchmark for us to provide some certainty about the way — over the decades to come — what is the right formula, the approach, for us to be resetting the level of pensions and other welfare payments to make sure they are adequate and responsive to the changing pressures of costs in a person's life. Because the costs are real.

We've recommended that we should be putting in place a stable four or five-yearly analysis about the question of adequacy and advice to government; to say this is what we need to do on these really critical payments like the age pension to reset its level. We don't know what it will say… whether it goes up or down depends on where we are at any point in time. But that we have some kind of stable evidence-based approach to the setting of the level of this key payment. We also think this kind of stable review would be very useful for us in ongoing analysis of the retirement income system overall because we'd have a level of an age pension. We currently have different views from different parts of the sectors about what is an adequate retirement income. What should you be trying to get behind you in terms of superannuation savings in order for you to have an adequate standard of living in your post working age life? But the goal posts are not agreed in public policy and that's a big problem for us. What are we trying to achieve out of this?

I've talked a little bit about our position on the assets test and I know that Simon will talk about the question of the treatment of the principal home. Certainly in our view we think that it is important for these next questions to be dealt with in the context of a more wide-ranging retirement income review. I think many of us acknowledge that if you change one part of the system in a major way it will have flow-through effects into other parts of the system and so I think it's healthy for us to be running our models, trying to predict what behaviour might be. This is very difficult work to do, so as at this point from ACOSS's point of view we should settle what would be done with the assets test and invest our time now in scoping out a proper overarching review of the retirement income system — and see where we might get to on some of these difficult questions.

In terms of superannuation reform, I know this is an area of policy that flares up debates. As I said at the beginning, our view is that we are not distributing our concessionary arrangements in an equitable way and we do think there is need for some major structural reform there. We think the work the Henry tax panel did in looking at how you would recalibrate the benefits of concessionary arrangements is an important place to start. We certainly think we need to be re-looking at this transition phase, the phase in which — if you are in a position to do so — you're putting more contributions into your super fund; and you are also able to take the tax benefit of drawing down through the transition phase.

So we do have people who are in a position to seriously minimise their tax bill at a time when they're not actually contributing to accumulating more savings. I think this throws up for us the debate that the Productivity Commission has helped us to progress somewhat, in terms of the merits of lifting the preservation age. ACOSS, in our last federal Budget submission, also flagged that this is something that should be considered.

However, we are very conscious that there are many worlds — and we've all got our own story about when we get to that time of life, when we are looking at where did we get to and how do we make this work best for us. But there are essentially two significantly different experiences. We also have a group of people for whom retirement is not a choice: either you become unwell, you secure a disability or you experience the ravages of mature age worker discrimination and you've hit a certain age where nobody appears to be interested in helping you to retrain, and you go onto the unemployment payment and you are one of the people who are facing a long future living on an unemployment payment — which is now just $37 a day — for a long time before you get to the point of being able to access the higher rate of the age pension.

This is a big challenge for us in Australia and I was saying to Jeremy earlier that there have been many policy thinkers putting efforts on the table trying to get programs in place to lift up participation rates of older workers. Yet there seems to be something deeply cultural for Australia about why it becomes so hard at a certain age, and I think the debate will be forced on us. It's coming in terms of the availability of workers in proportion to the overall population, but I think we need to make this a very specific debate that pushes us hard to understand why — with our often common comparator, New Zealand — we're so far behind on that front. I do think that if we are to move toward the lifting the preservation age, we need to make sure we have a very carefully structured early access system in place to make sure that we are protecting people, alleviating people from poverty, who are in that category where they are not able — for one reason or another — to continue to participate in paid work.

I want to acknowledge Jeremy's work. As I first came into this role I had a good look over the work Jeremy was doing when he was in the driving seat trying to generate common ground on reforming the retirement income area. I think that, in some respects, we can — across groups like ACOSS, like The Centre for Independent Studies, like representatives from the superannuation industry — agree that it's about first principles first. Let us settle the core purpose of this system. In our view it is about protecting people from poverty and also facilitating people to secure an adequate income in your post working age life that means you can be independent.

There are a few other issues I'll flag. Obviously, when it comes to those questions of adequacy, we also have some big changes going on in the way in which we are delivering key services. We are having a hot debate in Australia about whether we should be moving away from universal healthcare to user pays. We are debating things like infrastructure investment, where on the one hand some want government to seriously invest so that as much as possible you are not being hit with a fee every time you move around the place, or we will be going further down a user pays path. These are some of the other parts of the environment in which we will live in the future, which will absolutely bear on the question of whether or not as an older person you are able to live with dignity, fully participating and ideally enjoying your health for a very long time.

Dr Cassandra Goldie – CEO, Australian Council of Social Services.

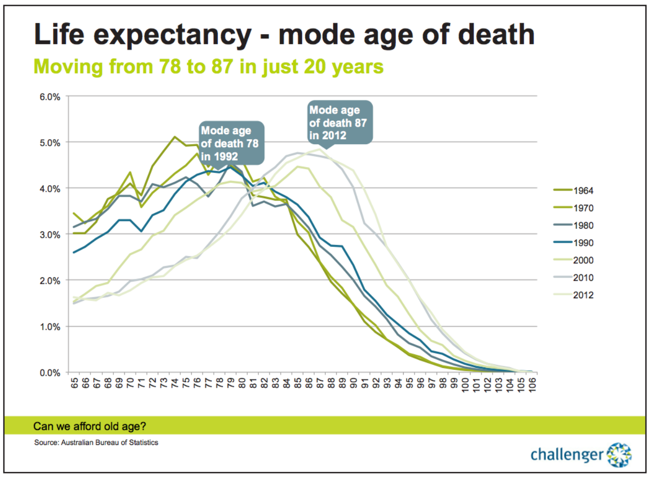
Jeremy Cooper

I unashamedly come at this from the second pillar, the superannuation or retirement income part. I look at it from a retirement income perspective because — let's face it — an efficient and well operating retirement income system can do a lot of heavy lifting in relation to the cost of growing old.

So why would we do this now, why would we tinker with the retirement income system at this moment? The recent Intergenerational Report tells us very clearly that age-related expenditures in the budget are an ever increasing problem going out to 2055.

We've had baby boomers retiring at the rate of about 700 a day since 2011 when the post-war baby boom started retiring. We now have larger retirement balances. The superannuation system is sufficiently old that the median male is retiring with something like $225,000. Unfortunately, his female counterpart is retiring with about half that. These amounts are not amounts to go off and buy a sheep station with, but they are amounts that you can do something sensible with in the retirement years and something that can also ameliorate age pension costs.

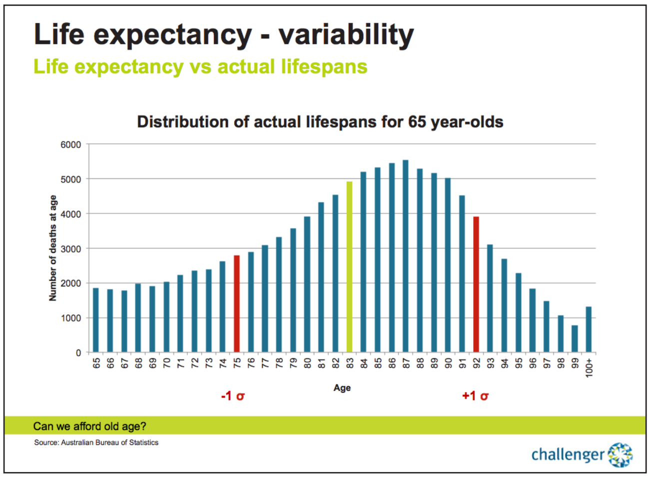
We've got increasing life expectancy with averages of 88 for males and 90 for females for today's 65-year-olds — and that's ever increasing.



I'm going to show you some charts that demonstrate how quickly those numbers have shot up to those levels, and please remember they're only averages, since the peak of a bell curve goes just as much in the right direction as it does the left.

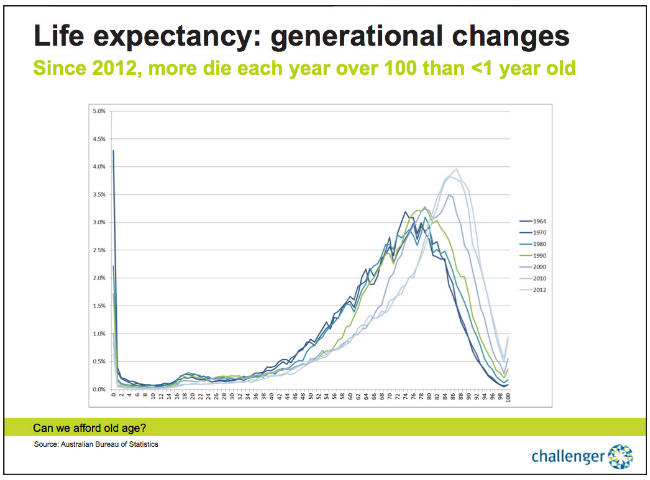
We know that as people age they become less able to deal with the complex issues that surround retirement. And we've got a large Financial System Inquiry report still on the table that's recommending, for the very first time, that we really quite sharply define what the principal and secondary objectives of the superannuation system are.

I have to say that after talking about these sorts of issues for a number of years now, I think the industry is actually ready to get a much sharper product going in retirement and to look after retirees a little bit better than is being done at the moment.



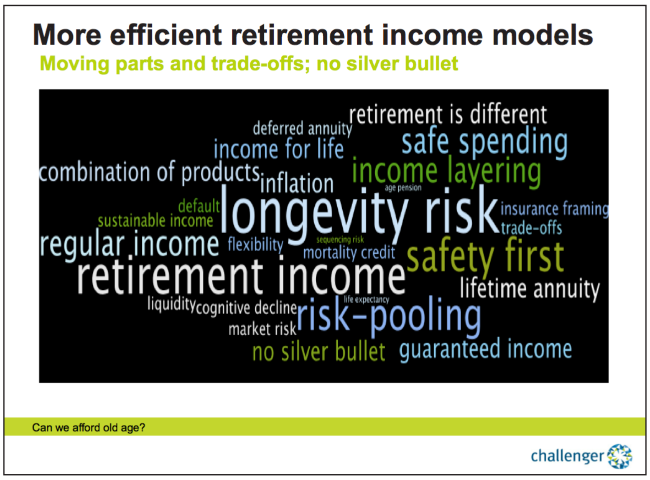
Let's quickly look at how dramatically people's lifespans have been increasing. What Graph 2 is showing us is that in 1992 the most common age of death for older Australians was 78. 20 years forward in 2012, that number has gone up by nine years to 87 … So, roughly every two years over that 20 years, the most common age of death of Australians went up by a year. That gives you an idea of the pace of change and its little wonder that this life expectancy, extra longevity, problem has felt like it snuck up on us very quickly because in actual fact it has.

The important thing about this chart is these are not forward projections as you often get in the life expectancy game. These rates are looking backwards. This is the Bureau of Statistics saying in these years how many Australians died and what age they were. So that's the life expectancy problem illustrated for you in one particular way.



Here is another way, Graph 3 is looking at the variability. We all talk about these averages of life expectancy and the olive green bar in the middle is showing that in 2012 the average life expectancy was 83 and the mode, consistent with what I said before ,the tallest bar there is at age 87. … So that's the most common age at which people died. The red bars are what statisticians call one standard deviation either side of the average. So in two-thirds of cases, you'll be somewhere along that rather wide degree of variations of lifespan.

Though we talk about averages, the actual challenge in retirement is that we have really no idea, within this very broad range of possibilities, how long we are actually going to live for.



This is a dreadfully complicated graph, but it is a very happy story; because in Australia for the first time in 2012, and it's happening every year now, we have more people dying each year who are over 100 than in the first year of life. You'll see that the peak of the very faint line is the most current data and that's showing that more and more people are dying over the age 100 because we now have four or five thousand Australians who are in that happy territory of being over 100. Also, we've really solved infant mortality shown on the left-hand side. A large part of that will be the indigenous population, but nonetheless we now have a very low level of infant mortality. These longevity stories are not all negative.

Let's think about getting better retirement income products, and this goes right to the heart of the Murray Financial System Inquiry that is on the table at the moment. Recommendation 11 went to coming up with a thing called a 'comprehensive income product for retirement' that was meant to solve many different problems in retirement.

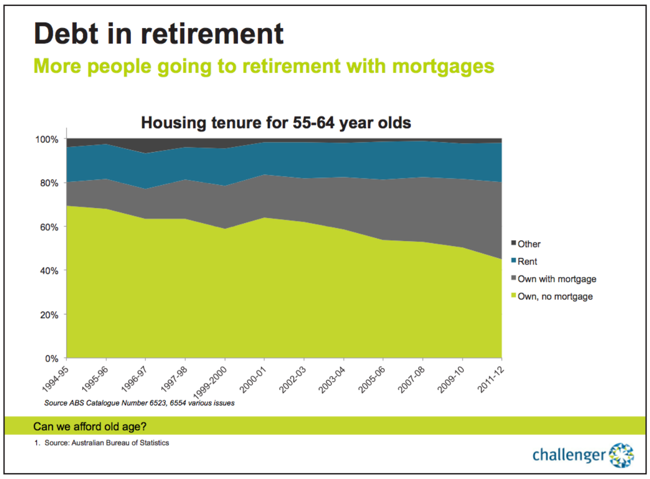
This word cloud illustrates the number of different moving parts that are going on in a product like that, seeking to solve longevity risk, the risk of living too long and running out of money; in other words, the need to be able to spend money safely in retirement rather than taking risks. I've put words in there like 'deferred annuity' which is a product that we're hoping will be available in Australia soon which will enable you to effectively insure against living a very, very long time. The product might provide income to you at the age of 85 and beyond, should you live that long. The idea of the word cloud is really just to show how complex some of the issues are. But if we get them right — and we're hoping that the government will support the recommendation for these products — they certainly will go towards helping people have more efficient retirements economically; and this will indeed reduce the burden of the age pension on the budget.

Another challenge we have at the moment is our ultralow interest rate environment. In April, I wrote an opinion piece for the *Australian Financial Review* that simply pointed out that with the ultralow long-term bond rates we have at the moment (at that point the 10-year bond rate was 2.2%), what this does is effectively increases the future cost burden of retirement.

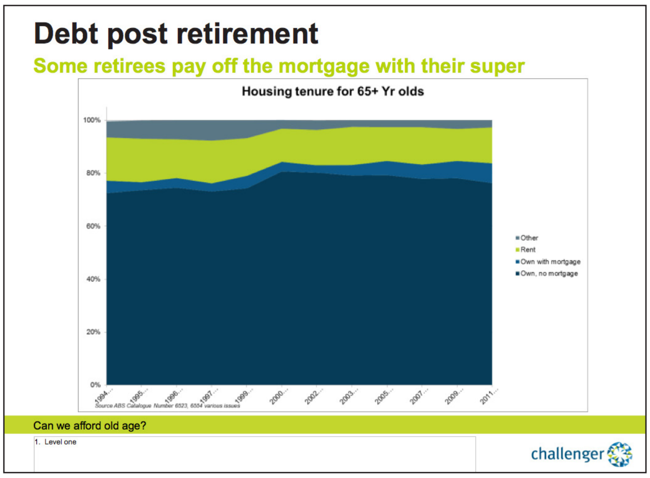
If the government was sitting down thinking how much the age pension is going to cost over the next 30 or 35 years using a very low discount rate like we currently have at the moment, what that does is it just keeps pushing those liabilities up. I pointed out if you wanted to buy the age pension from the government — which of course you can't do but just hypothetically — if you wanted to buy a guaranteed stream of income for the rest of your life as a couple from the government, it would cost you more than a million dollars at today's interest rates.

I was trying to stimulate some discussion about the effect of ultralow interest rates on retirement, which essentially put the cost of retirement up.

Anyway, there was a firestorm of commentary and people were very surprised at just how little $1 million could buy. But the trick was that it was all about the interest rate. At a normal bond rate, of say 6%, that cost would come down to four or five hundred thousand dollars, which we're all relatively comfortable with. So that's just another variable I suppose that makes retirement more complex. And indeed, if people are exhausting their retirement savings because they can't get sufficient returns, that's going to put additional pressure on the age pension.



Another issue is the extent to which people are carrying debt into retirement. In Graph 6, the top of the brown section is effectively showing that, over a 20-year period, it's been fairly constant that about 80% of people in the 55 to 64-year-old age group own their homes. The brown section (between the blue and green sections) is the proportion of those homeowners who still have a mortgage in that age group. 20-odd years ago in 1994-95 it was only 10% of the cohort who owned a home and actually had a mortgage. Now over on the right-hand side, in 2010 and 2012 — which is the latest data that we've been able to get on this — we see that 35% of the people in that age bracket are carrying mortgages at that point.



That's a significant increase and what we think is happening, which Graph 7 demonstrates, is that they are effectively pre-consuming some of their retirement savings and pouring it into the house. This graph is 65-year-olds plus and what we see is that the mortgage is effectively being extinguished by the super balance. The lighter blue section in the middle of Graph 7 is showing the number of people who owned a home over 65 and still had a mortgage was 4.7% 20-odd years ago and is only 7.5% now. So what people are doing in greater number now than 20 years ago is using their superannuation to pay off their mortgages quite late in life. There are some quite strong incentives for them to do this, which I'm sure we'll touch on later in the discussion.

The Productivity Commission has just put out a very useful report on superannuation policy post-retirement and they were looking at two things: Are people still taking lump sums out of superannuation and buying a caravan and using it for things that don't really relate to retirement; or are they tending towards investing the money in income streams and so on?

They found a very strong trend towards people keeping the money in superannuation, putting it into income streams and not taking out lump sums. Then they asked what would happen if we were to increase the age at which you can access super — what is called the 'superannuation preservation age' — from the current levels (lock-stepping upwards from 56 to 60 over a 5-year period) up even further to 65. What that would do is lock off superannuation to people until much closer to the increased ages at which you can access the age pension, which is being increased to 67. In the budget, it was announced that in 2035 the age pension access age would be increased to 70.

So you can see the need to keep those ages much in alignment. Because of the way that the preservation age works, this change would take some time to have an impact. The Productivity Commission says that if this were implemented it would save about $7 billion annually in the budget because people would be in the workforce longer, paying tax and building up their super. This would mean higher super balances going into retirement, which would tend once again to take pressure off the age pension.

Another interesting lever in terms of the cost of old age is how many older people stay in the workforce. And it's interesting that the OECD very recently put out a study looking at the 33 or 34 countries in the OECD and ranking them in terms of mature age workforce participation — and sadly New Zealand is ranked second and Australia is ranked 15th. PricewaterhouseCoopers pointed out what it would look like if we could get Australia to where New Zealand is in the rankings, and some quite interesting numbers fell out of that calculation. It would add about $24 billion to our annual GDP and take pressure off the budget as you would expect.

Other things have been done. Susan Ryan has been appointed as an ambassador for mature age employment. There is now a $10,000 grant to employers who take on mature age employees and other measures recommended by the Law Reform Commission.

My conclusion is that we can afford old age, but we need a more efficient retirement income system, although the ideas to achieve that are sitting behind recommendation 11 in the Financial System Inquiry. A lot of thought has gone into that so that's something that we can implement.

There have been age pension changes announced, the entitlement age going up progressively from 67 to 70, assets test changes and lastly the examination of the issues by the Productivity Commission in increasing the age at which we can actually access superannuation that has flow-on impacts on the cost of the age pension.

Jeremy Cooper – Chairman, Retirement Income at Challenger Ltd.

Simon Cowan

I think I'm stating the obvious to start with the claim that retirement is an emotive topic — and it's an emotive topic that has a very significant political impact. And that's why I really want to echo Cassandra's thoughts on this. It's so important that people who have an interest in policy and getting the right outcomes can work together on trying to come up with a reasonable solution. Because it seems to me that the politicians have a great deal of difficulty moving past the emotive nature of it and getting past that initial plan of 'well, if we just oppose this we can get extra votes'.

In that frame, I think we do need to look at a system-wide retirement income review. Not just the individual components, but how do all those components fit together and how do the components of the retirement system fit in with the rest of the welfare system and the rest of society? And Cassandra flagged, one area — the most obvious area, I think — which is the impact retirement policy has on housing decisions and on investment in real estate.

And, I think equally as importantly, this debate has to move past the initial short-term discussion and the desire for additional revenue from sources like superannuation. We have to fix the problems in the system first and then we can deal with the issue of revenue and the short-term budget deficit.

The results of our research bring me to the very simple conclusion that pension reform is inevitable. That is based on two simple factors: the cost of the pension, if it is not unsustainable now, will be unsustainable in the short term near future; and the current means test for the pension is unfair — and I use that word advisedly.

So why is the pension unsustainable? In 2009 the Harmer review said the purpose of the pension is to support those who cannot support themselves — and that's a sentiment the Cassandra echoed in her speech tonight — but pensioners themselves disagree with this. A lot of people in the wake of our report contacted me and said 'I've earned my pension… I've worked hard and I've saved and so I'm entitled to government support'. At a National Press Club speech earlier this year, Scott Morrison sided with that view.

So who is right? In practice, the pension is quasi-universal: four of every five people of retirement age in this country receive some form of pension. The pension is the largest single federal payment with more than 2.4 million pensioners getting more than $44 billion a year. And this is predicted to exceed $50 billion before the decade is out.

That is a 35% increase in real terms since 2007, during the height of the GFC. There have been discretionary increases in the last 15 years for the GST and for the carbon tax, and in 2009 Kevin Rudd greenlighted a $1500 a year increase in the pension; a move that cost $13 billion across the forward estimates, and a cost that is continuing to rise.

Benchmarking the pension against wages causes it to increase at nearly twice the pace of inflation. But superannuation is the answer to this problem … right? That's actually not true.

Today's Productivity Commission report showed that most people retire early and the bulk of them do so voluntarily on the basis of accessing their superannuation savings well before pension age.

What this means is that in 40 years, four out of five people will still be on the pension. Indeed, today's report shows the maturing super system will mean that just an additional 3% of retirees will be self-funded. Not surprisingly, Treasury modelling predicted that super maturing will reduce pension expenditure by only 6% a year, with the primary impact moving people from a full pension to a part pension.

This is my main concern about superannuation: it is not reducing pension expenditure. As a result I think it's a policy that needs reform. In 40 year's time, age pension expenditure will be more than $150 billion a year in today's dollars. Now this is a problem in itself — not surprisingly — but there's a bigger problem with demographics as well. Today there are 4.5 workers supporting every person of retirement at age, however in 2055 it'll be just 2.7 workers for each retiree and those retirees will be living longer and longer.

Given our current tax base, this level of expenditure cannot be supported. A lot of people talk about OECD averages in this debate, and for a lot of that you can really read European pension systems. We do not have a European tax system (thank God) and we don't have European economies — and you can give thanks for that too.

The fact is, most of those pension systems in Europe, particularly in the UK are massively underfunded now, and they're facing the same demographic challenges we are.

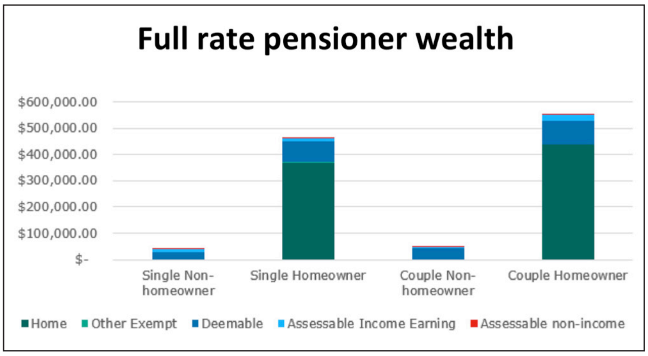
So will people wear the necessary tax increases to meet this level of expenditure? I don't think so. But there is a bigger danger there, too, because in the next couple of decades the average age of voters will exceed 50 — which is to say there will be more people in the system who have an incentive to vote for increases in pension payments.

What impact will that have on the politics of retirement income and what will it have on the politics of budgets? In my mind, this means action must be taken now, though not everyone agrees on this.

But there is another reason why we need to do something. The means test is unfair to people who don't own their home, and those people are the poorest people in society. The pension means test currently excludes the value of the family home other than a small amount that is incorporated in different means tests, but the family home is where pensioners' wealth is.

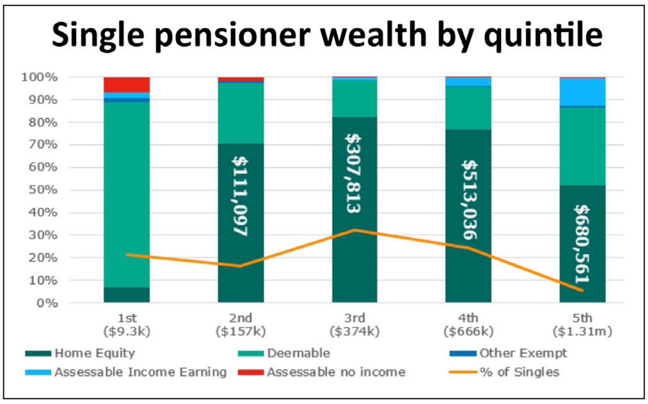
Couple pensioners on average own a home worth around $500,000, single pensioners have around $400,000 in home equity. More than 90% of pensioners have more housing wealth than that $200,000 difference in the pension means test.

But that is not the only advantage homeowners have. Housing costs for homeowners are substantially lower, and there are also tax advantages. But what it really means is that there are people on the same rate of pension with very different net worth.



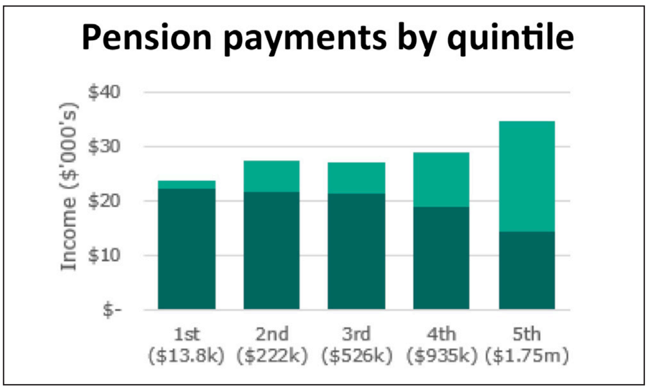
Graph 1 covers single pensioners, and what is clearly reveals is that full rate homeowners have nine times the net worth of non-homeowners. That is nearly $500,000 in net worth, compared with less than $50,000 for those who don't own their home. That is a very significant difference in the ability of those two groups to support themselves in retirement, but they receive the same pension payment.

The advantages of homeownership have led to a massive overinvestment in housing assets, particularly among retirees. And as Jeremy noted, more and more people are using superannuation balances to increase their investment in housing. Around 75% of pensioners have 70% or more of their wealth in their home, and our research estimated there are $625 billion in housing assets owned by pensioners at the moment.



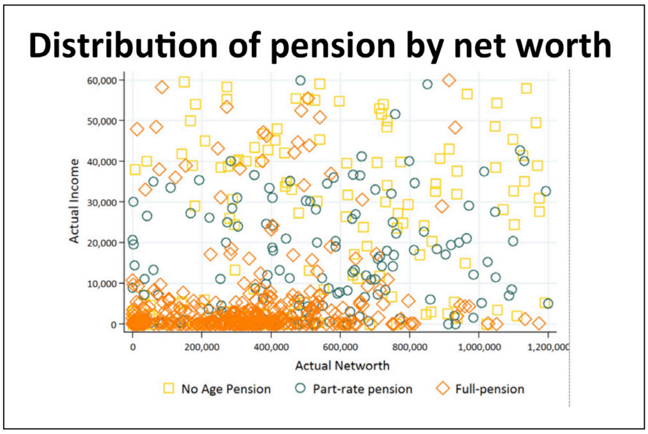
In graph 2 from 2010, you can see just how big a disparity there is between people in different net worth quintiles. The people in the left-hand quintile of less than $10,000 in total assets, the people on the right in contrast have more than $1.3 million.

Now you would think that would result in a significant difference in pension payments… except that it actually doesn't. By upgrading these quintiles to today's dollars you can see where the payments go. The dark green bar at the bottom is the level of average pension payment.



Pension payments barely fall across the first four quintiles of net worth, it's only the last quintile you see a significant difference. Even the richest pensioners, those with more than $1.3 million in net worth, still receive more than $10,000 a year on average from the government.

By excluding the family home from the assets test, that test has no correlation to people's net worth.



I love this graph and it's probably because it is such a mess. And you know, like Jeremy, I appreciate the complexity of this sort of thing, but what this shows is a distribution of people's pension entitlements based on their net worth and their income.

You can see up going up the graph a clear division between the full rate pensioners in the dark circle, and the part rate in the green circle, while the triangles at the top are those who have no pension. But what you can't see is a clear division horizontally.

There is no clear distinction between your amount of assets and the amount of pension you receive. Now this is a concerning factor in my mind. But perhaps even more concerning is pensioners are not using their home equity to boost their living standards.

The reverse mortgage market in Australia is exceptionally undeveloped. Of that $625 billion in housing that pensioners hold, just 1% of them have a reverse mortgage, and the number of reverse mortgages has been flat between 2011 and today.

There are several reasons for this: the interest rates on reverse mortgages are much higher than our record low mortgage rates; there is a very limited equity range in which people can access reverse mortgages; there are significantly higher fees especially on exit; and there is a notional and real strong sense that pensioners do not want to take on any additional risk.

So what can we do about this? Well our research proposes three key interlocking reforms to deal with this situation. The first is to include the family home in the pension assets test to acknowledge the fact that the bulk of pension assets are held in their home. The test should reflect the true net worth of pensioners because that is their ability to support themselves in retirement. That is what we should be measuring.

Some people have claimed that this is stealing the next generation's inheritance, and I've had a number of emailers who were quite outraged that I would consider allowing pensioners to use their home to support themselves rather than pass it on to their kids. But I do not believe it's the taxpayers' job to subsidise the inheritance of the next generation.

And beyond this, this subsidy is in fact a transfer of wealth from lower middle-income taxpayers to middle and upper class landowning families. This is not a punishment for pensioners for owning their home, for saving diligently. It is simply reflecting the ability of those pensioners to support themselves — a key principle on which our welfare system is built.

But this has to be linked with other reforms, and one of the key ones is focusing on allowing those pensioners to help themselves — and that means we have to boost the take-up reverse mortgages. That means we need to create a government-backed reverse mortgage product. And I know that a CIS person proposing government intervention might seem a bit unusual, but I think this is important politically, but is not unprecedented. The government currently runs its own reverse mortgage scheme… it's just that no one knows about it. It's called the Pension Loan Scheme and has $29 million in loans outstanding at the moment.

The US government of course has its Home Equity Conversion Mortgages, which is very similar to the process we are proposing here. But our loans would feature a few key things: low interest rates, below the amount on the government pension loan scheme currently; low fees; but importantly it must be structured as an annuity, a regular payment designed to supplement or replace the pension.

By creating a government backed product you get in effect a guaranteed return on these products, which means we can open the delivery of them to superannuation funds and we can ensure that pensioners can never lose their homes.

It builds in the growth in house prices and uses the increasing wealth that comes from recent booms in Sydney to boost pensioner living standards — which here is in fact the entire point. This is about increasing living standards.

The last part necessary to make all this work is to deem the income from those reverse mortgages in the pension income test; because the pension income test should focus on living standards, not on where income comes from.

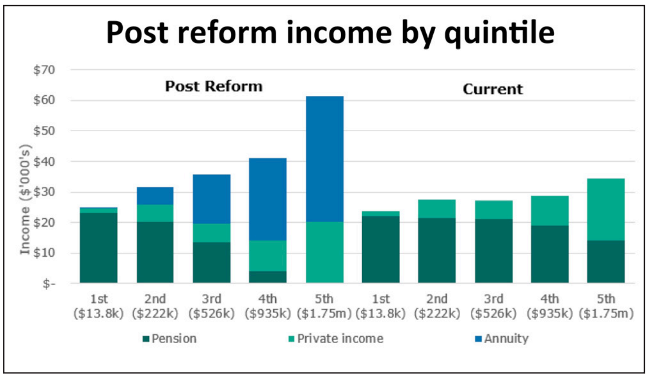
Including income from reverse mortgages removes the distinction between asset classes where some assets are deemed and others aren't. But the other thing it does is allow pensions to automatically adjust. If your income stream from your home is lower, you automatically get a higher pension.

The savings from these reforms allow us to achieve some other things: a targeted increase in the base rate of the pension aimed at those who don't have significant net worth; an increase in rent assistance to acknowledge the fact that the pensioners who are struggling most are those who who don't own a home and who live in high rent areas,.

The results of our modelling on this were extraordinary. Government pension spending under our model falls by $14.5 billion every year, an amount that will only increase as superannuation increases. Pensioner income increases by a total of $14 billion each year. 98% of pensioners will see an increase in income, which is to say more than 2.37 million people will get an average of $6000 a year in additional income through a combination of an increase in the base rate, and the annuity payments.

75% of full rate pensioners would move onto the part rate or off the pension altogether. And between 25 and 33% of part rate pensioners would no longer need the government pension at all because their income is increased so much that they would no longer qualify.

7% of people who are currently receiving more than $20,000 a year in government support will have income so high that they also no longer qualify for the pension. That's the impact of including the family home; and the benefits extend across the entire income spectrum.

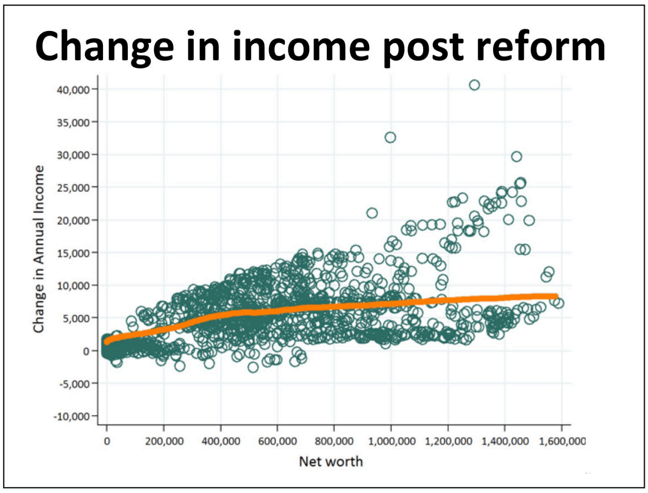


Post reform income by quintile

The big blue bar at the top of the graph is the increase in income from these annuity payments. And you can see, moving across the wealth quintiles, that pensioner numbers are now falling much quicker but total incomes go up at each level of net worth.

People in the fifth quintile no longer receive a pension — as they should not be — because they have net worth of $1.75 million on average. But people in the fourth quintile, with about $1 million, get a very small pension indeed. There are big gains across the whole spectrum.

The graph below is another way of looking at exactly that same data. This is basically spread out net worth and the change in the benefit from our system. There are big gains for those between $400,000 and $600,000 in net worth; this is not something that just benefits those who live in Sydney.



Change in income post reform

Our reforms are aimed at solving the quintessential problem of retirement which is to say people who are asset rich but cash poor. In our research report, we examined a lot of other scenarios: we modelled significant downturns in property; increases in interest rates; all those sort of things … and basically what we found is that in each scenario our reforms hold up.

In my mind we have a very small window in which to implement these reforms before the baby boomer generation moves into retirement and the demographics really start to hit us. Right now we can implement reforms in stages over a period of time, so we can give certainty to people in the system now. But the fiscal pressures we are facing are mounting. Predictions are 15 or 20 years of consecutive budget deficits, with little end in sight.

No doubt some people may be concerned by the level of state intervention we've proposed in our report. But I ask, how interventionist is spending $44 billion a year on pensions? Others may be concerned that we're just focused on attacking pensioners and aren't there are other targets that we could go after first? But this is not just about government saving. This is a way to increase pensioner living standards.

I started off this presentation talking about a simple truth of pension reform and I'm going to end it with what I think is another very simple truth of pension reform. Given our current fiscal situation, and given our ageing population, pensioners cannot continue to rely on the taxpayer to continue increasing pensions forever.

They cannot bank on government underwriting living standards in the future. But fortunately they can use their assets to have a standard of living that we all think they deserve. Unlocking $625 billion in home equity can solve many of the problems of the ageing population.

Simon Cowan – CIS Research Fellow and Target30 Director at the Centre for Independent Studies.