



The Dialogue

Leading the conversation

Spending in retirement and the taper rate

Andrew Boal

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Spending in retirement and the taper rate

Executive summary

- The current taper rate creates a potential 'trap' for retirees who don't draw down and spend their retirement savings fast enough.
- Longevity protection products would help to reduce some of the uncertainty faced by retirees to encourage them to spend more of their savings sooner (i.e. faster).
- The system is complex and many people would benefit from low cost access to information, guidance and advice.
- Any changes to the system need to consider the inter-connectedness of its various policy levers.



1. The purpose of superannuation

Australia has one of the best retirement systems in the world for accumulating savings. Yet, like many other countries, we continue to struggle with how to design an efficient retirement spending system. To some extent, this can be attributed to the absence of a clear purpose on what we are trying to achieve.

The current Age Pension system, including the operation of the means test, is very complex and this makes it difficult for individuals to optimise their financial position in retirement without seeking advice. For many Australians, there is a risk they will fall into a retirement income 'trap' if they don't drawdown and spend their retirement savings fast enough and as a result their retirement income is less than optimal.

Equity issues have also emerged over time in relation to the cost to taxpayers of providing the Age Pension and the tax concessions and incentives provided for superannuation contributions, investment income and end benefits. Questions have been raised regarding the sustainability of the system in its current form, especially when considered in conjunction with the expected increases in health and aged care costs over the next 40 years.

Following a recommendation by the Financial System Inquiry, the Superannuation (Objective) Bill was introduced to Parliament in 2016 to establish the primary objective of the superannuation system as being "to provide income in retirement to substitute or supplement the age pension."

While it is a start, it does not provide a lot of direction. The Explanatory Memorandum provided more guidance, noting at the time that the proposed subsidiary objectives are to:

- Facilitate consumption smoothing over the course of an individual's life.
- Manage risks in retirement.
- Be invested in the best interests of superannuation fund members.
- Alleviate fiscal pressures on Government from the retirement income system.
- Be simple, efficient and provide safeguards.

Unfortunately, these objectives have lapsed in Parliament, so we still have some uncertainty about the overall pathway to better retirement outcomes.



2. Guiding principles for the retirement incomes system

While the system needs to be affordable and fair, it also needs to help Australians spend their money in retirement. The Actuaries Institute considers that retirement incomes policy should be guided by the following principles:

- Sustainability, including a long-term regulatory outlook focused on providing retirees with a reliable, secure and adequate income flow during retirement.
- Flexibility within regulation to reflect individuals' different retirement income needs and varying capacity to exercise choice.
- Equity, particularly in relation to the combined cost to the taxpayer of the Age Pension and various tax concessions and incentives, as well as inter-generational equity.
- Efficiency, so that the cost to taxpayers is efficiently meeting the core objective of providing adequate retirement incomes.
- Simplicity, particularly in retirement so that, to the extent possible, retirees can optimise their position without having to obtain expensive advice.
- Regulatory frameworks which support competition and do not unreasonably impede innovation, including an appropriate balance between the social objectives of regulation and the implications for industry including the cost of compliance.

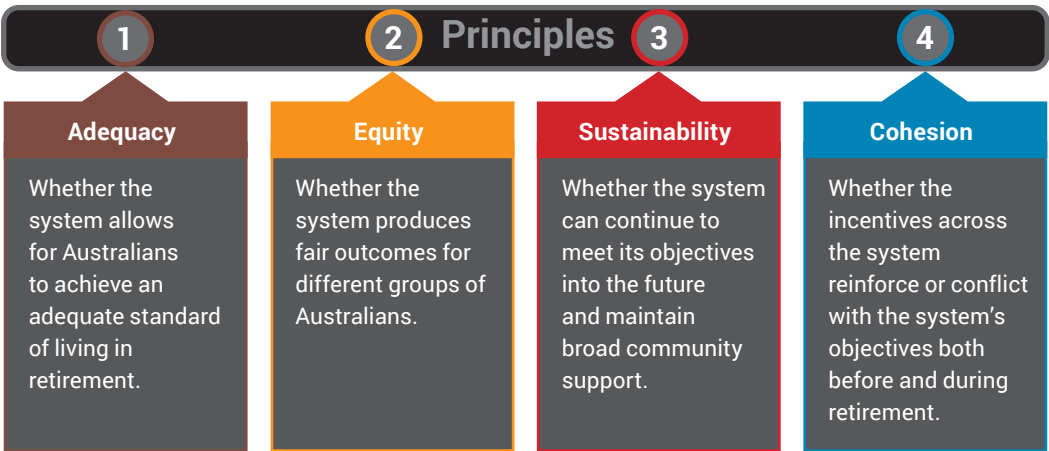
Enabling retirees to sensibly and sustainably spend during their retirement, benefits not only the retirees themselves, but also the general economy.

3. Retirement Income Review

The Panel appointed to run this important Review has been tasked with identifying the facts that will help improve understanding of how the retirement income system operates and the outcomes it is delivering for Australians. The terms of reference for the Review state that “it is important that the system allows Australians to achieve adequate retirement incomes, is fiscally sustainable and provides appropriate incentives for self provision in retirement.”

In this context, the Panel has identified four principles it proposes to use to assess the performance of Australia’s retirement income system. They are:

The system should enable the generation of adequate retirement incomes, be fiscally sustainable and also promote self provision.



These principles each provide a different lens on the performance of the retirement income system. They may reinforce or conflict with each other for different aspects of the system, reflecting the trade-offs that exist within the system.



A major concern for Australians approaching the retirement age, or already in retirement, is the ability to maintain an adequate standard of living.



It is only recently that a significant number of Australians began retiring with material amounts of retirement savings.

4. Spending in retirement

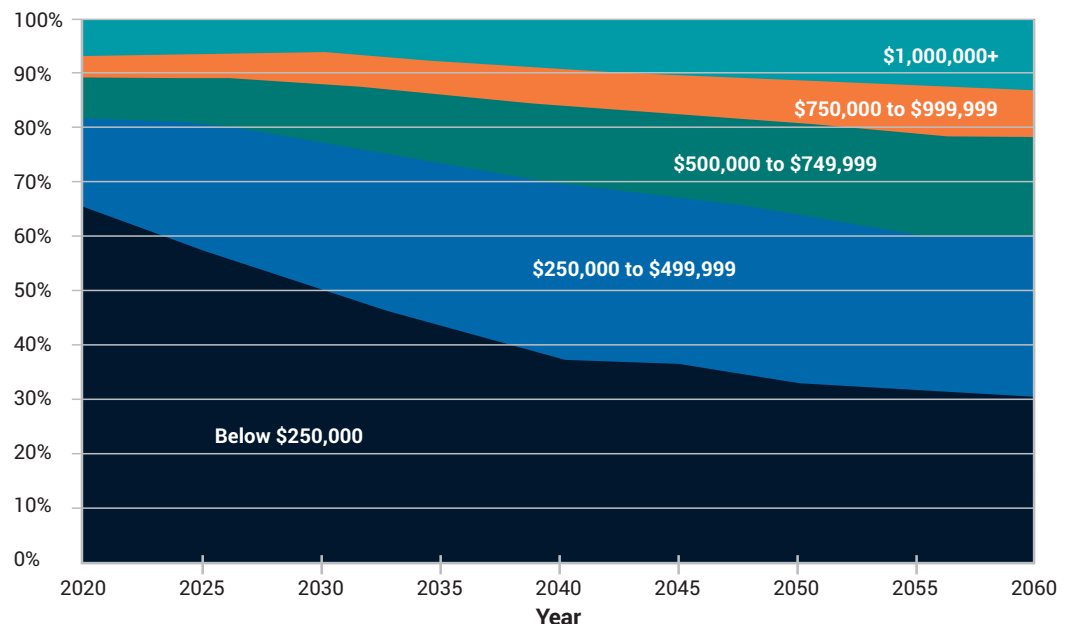
There are a few key questions that people need to think about when planning for their retirement, such as:

- How much do I need (and can afford) to save for my retirement?
- How do I invest my superannuation to improve my retirement outcome?
- How do I safely draw down and spend my savings during retirement?

As compulsory Superannuation Guarantee (SG) contributions only commenced in Australia in 1992, starting at 3% of earnings and gradually increasing to 9% by 2002, it is fair to say that our superannuation system is still relatively immature. In addition, the SG only applies to employees who earn more than \$450 in a calendar month, and doesn't apply at all to the self-employed and contractors in the so-called 'gig economy'.

Thus, it is only recently that a significant number of Australians began retiring with material amounts of retirement savings, with around 35% of superannuation balances at retirement reaching \$250,000 or more.

Figure 1: The Treasury: Proportion of superannuation balance ranges at retirement (2019 dollars, AWE deflated)



Over the next 40 years, this proportion is expected to double, with around 70% of superannuation balances at retirement in 2060 expected to reach \$250,000 or more (in today's dollars). Indeed, by then, around 40% of superannuation balances at retirement are expected to reach \$500,000 or more (in today's dollars).

4.1 So how much do retirees typically draw down in retirement?

There have been numerous studies, including one by CSIRO-Monash Superannuation Research Cluster, which indicate that most retirees in their 60s and 70s draw down on their account based pension (ABP) at modest rates, close to the minimum amount each year (which is 5% of their account

Based on current draw down rates, many retirees will live an unnecessarily modest retirement or even behave as if they are in poverty.

balance for those aged 65 to 74). This behaviour will result in them living an unnecessarily modest retirement, many behaving as if they are in poverty.

There have been many reasons proposed for why retirees behave this way, among them a fear of running out of money and uncertainty about how long they will live. Some might also want to leave the home as a bequest, so they don't consider using the equity in their residence. Hence, they try to manage their own longevity risk by spending cautiously.

4.2 How can we give retirees the confidence to draw down more of their savings?

Since the early 1970s, the life expectancy of the average 65-year-old has increased from about 12-13 years to 20 years for men and 22 years for women. But longevity is not uniform, it varies considerably from person to person, so some form of longevity protection will be helpful for many Australians.

A retiree's draw down and spending strategy is also going to be driven by how much savings they have and how the assets test affects their eligibility for the Age Pension.

The relevant assets test thresholds are set out in Table 1, with a full Age Pension applying below the lower thresholds and gradually reducing to zero when the value of assessable assets exceeds the upper thresholds (noting that some assets are excluded from the assets test, such as a person's main residence).

Table 1: Assets test thresholds (indexed at September 2019)

	Homeowners		Non-homeowners (renters)	
	Lower Threshold	Upper Threshold	Lower Threshold	Upper Threshold
Singles	\$263,250	\$574,500	\$473,750	\$785,000
Couples (combined)	\$394,500	\$863,500	\$605,000	\$1,074,000



Uncertainty about how long they will live means that many retirees are overtly cautious in their retirement spending patterns.



The high proportion of Australians with medium level superannuation balances could benefit greatly from more certainty for more of their retirement income.

If a retiree has less than \$300,000, then they will be entitled to a full Age Pension for most (if not all) of their retirement and it will be their major source of income. In this situation, their superannuation savings will supplement their income and the Age Pension provides a good income base as well as adequate longevity protection in most cases.

On the other hand, if a retiree has more than \$800,000 then they are also likely to be homeowners and, after taking into account other non-superannuation assets, are less likely to be eligible for much Age Pension during their retirement (if any). In this situation, their superannuation is predominantly a substitute for the Age Pension and, in addition, they often have the capacity to not have to draw down as much of the capital component of their savings.

Thus, while the Age Pension is likely to provide enough certain lifetime income for low balance members, and high balance members won't necessarily need to draw on as much of their capital anyway, the high proportion of Australians in the middle (with superannuation balances between say \$300,000 and \$800,000) could benefit greatly from more certainty for more of their retirement income.

This 'middle' group will be eligible for a part Age Pension for a substantial portion of their retirement and, as a result, the means test rules will be an important consideration for them.

For this middle group, it is therefore worth noting that legislation was passed in February 2019 to amend the means test rules that apply to longevity protection products with effect from 1 July 2019. Under the new rules, only 60% of the purchase amount of a lifetime income stream will be an assessable asset and only 60% of the payments will be income for the means tests.

These regulatory changes should, in time, promote the development of new longevity protection products such as deferred lifetime annuities (DLAs) or deferred group self-annuitisation (GSA) products which should help retirees plan their retirement spending with more confidence.

4.3 How do DLAs and the new means test rules help?

Consider a person who is a homeowner and retires at age 67 with a superannuation account balance of \$500,000 and uses \$50,000 to purchase a DLA. At the date of purchase, the life expectancy of a 67-year-old male is 18 years (i.e. age 85). However, in our scenario, the DLA does not start making payments until age 87.

Under the income test, only 60 per cent of the payments from the DLA are assessed as income. However, no income is assessed at all until payments commence at age 87. Under the assets test, 60 per cent of the purchase amount (i.e. \$30,000) is assessed as an asset from the date of purchase for 18 years (i.e. to age 85), after which only 30 per cent of the purchase amount (i.e. \$15,000) is assessed as an asset.

With \$20,000 less counting for the assets test, this person will be entitled to \$1,560 p.a. more in Age Pension payments until their assessable assets falls below the lower threshold of \$263,250 (or until age 85 if earlier). With a small amount of other assessable assets (say \$30,000), if this person invested the remaining \$450,000 in an ABP and withdrew the minimum amount each year, they would be eligible to receive the additional Age Pension payments for about 10 years (i.e. to age 77) and they will accumulate to approximately \$15,600 extra payments.

4.4 What is the 'taper rate' and when did it change?

The taper rate is another important part of the assets test used to determine eligibility for the Age Pension. Since 1 January 2017, a retiree's annual pension is reduced by \$78 for each \$1,000 of assets above the relevant lower thresholds (set out in Table 1) – before 2017, the taper rate was half that amount, at \$39.

More and more people will be retiring with higher superannuation balances, but will also lose more of the Age Pension.

At the time of the change to the taper rate in 2017, the lower thresholds were increased by more than 30% which, according to the government meant that more than 50,000 part-pensioners would become eligible for a full pension for the first time. As the SG system matures, more and more people are expected to retire with higher superannuation balances and as a result of this change are expected to lose more of the Age Pension.

4.5 How does the taper rate impact retirees?

To understand its impact, let's look at some cameos for a worker on average annual earnings of \$90,000 and compare the results for a superannuation contribution rate of 9.5% versus 12% (i.e. an additional 2.5%) paid over 40 years to age 67. Based on a marginal tax rate of 32.5%, if fully offset or sacrificed, the person's net take home pay would reduce by about \$61,000 over the 40 years.

Following retirement at age 67, if the retiree is a single non-homeowner and draws down the minimum amount over 23 years to age 90, then the increased income produced by the additional savings is partially offset by a reduction in the Age Pension as set out in Table 2. On the other hand, if the retiree gradually draws down all their capital over the 23 years to age 90, they not only gain the benefit of spending more of their savings but they also become eligible for higher Age Pension payments sooner. Note that the 'minimum drawdown' scenario ignores any residual payments to beneficiaries and focuses on spending in retirement.

Table 2: Accumulated increase in annual retirement income over 23 years to age 90

	\$78 annual taper rate (current since 2017)	\$58.50 annual taper rate	\$39 annual taper rate (rate before 2017)
Minimum drawdown	\$21,000	\$43,000	\$64,000
Capital drawdown to age 90	\$73,000	\$85,000	\$96,000

As Table 2 shows, if the retiree draws down and spends the minimum amount each year, the annual taper rate would need to be close to \$39 for the retiree to receive total additional retirement payments higher than the accumulated reduction in the person's net take home pay of \$61,000. Based on the current taper rate of \$78, the retiree is caught in a 'trap' whereby their total additional retirement payments over the 23 years to age 90 (i.e. \$21,000) are \$40,000 lower than the accumulated reduction in the person's net take home pay to fund their higher retirement savings.

The retiree would be in fact be better off under a \$78 annual taper rate if they also gradually draw down and spend all their capital by age 90. In this scenario, the retiree's overall net benefit would further improve with the lower taper rates.

It is worth noting that a higher taper rate does encourage retirees to spend their savings as quickly as possible until they become eligible for the full Age Pension, but there is little evidence that this occurs in practice. Indeed, the Mercer submission to the Retirement Income Review¹ dated 3 February 2020 provides some analysis about the behaviour of 2,518 retirees in the Mercer Super Trust as at 1 July 2019 who have invested in an account based pension with total assets of \$945.5 million at that date. Table 5.2 in that submission shows that 39% of those retirees have selected a draw down rate equal to the minimum rate, with a further 13% selecting a rate no more than 1% above the minimum. Of the remaining 48%, who selected draw down rates more than 1% above the minimum, more than half of them are concentrated amongst retirees with smaller account balances (up to \$200,000).

¹ <https://treasury.gov.au/sites/default/files/2020-02/merc030220.pdf>



One of the key problems facing retirees is the complexity around the means test.

5. The confidence to spend


Longevity risk is one of the major risks faced by retirees. As mentioned earlier, the fear of running out of money and the uncertainty about how long they will live cause many retirees to try and manage their own longevity risk by spending cautiously. In addition to its favourable treatment under the means tests, a DLA partially solves that problem by providing a guaranteed amount of income for life once payments commence. This allows the retiree to more safely draw down the remainder of their savings up to that point, thereby enjoying a lifestyle that is better than would otherwise be the case during the early and more active years of retirement.

One of the problems facing retirees is the complexity around the means test. Without assistance, it is impossible for the lay person to know how much to withdraw and when a DLA might be a suitable product given their circumstances. We need to find a way to deliver appropriate advice cost-effectively to help the growing number of people entering retirement with sufficient superannuation savings to encounter these problems. In particular, the 'middle' group identified earlier, who will be eligible for a part Age Pension for a substantial portion of their retirement, need this guidance the most.

If one of the objectives of the superannuation system is to "facilitate consumption smoothing over the course of an individual's life", and during retirement, then this 'middle' group would benefit from:

- encouragement to acquire longevity protection to give them more confidence to spend their savings during retirement;
- a fairer taper rate that does not unduly encourage them to spend their retirement savings too quickly; and
- low cost access to information, guidance and advice to help them make better decisions about their retirement.

Given the interconnectedness of the system, it is important that all the relevant levers are considered in conjunction with each other, including how it impacts on the efficiency and effectiveness of any other changes such as increasing the SG to 12%



Longevity risk is one of the major risks faced by retirees. The system should provide retirees with the confidence to safely spend more – enjoying a better lifestyle particularly during the early and more active years of retirement.



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