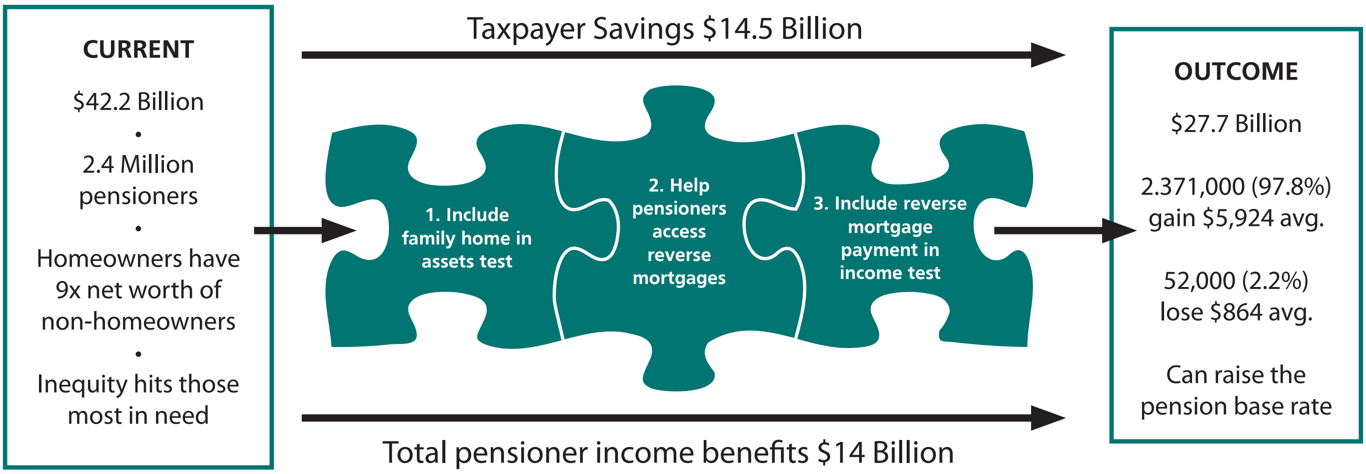
The Age Old Problem of Old Age: Fixing the Pension

Simon Cowan & Matthew Taylor

At $42 billion this year, the Age Pension is the largest single payment made by the federal government, exceeded only by combined grants to state governments. Annual expenditure is predicted to rise to nearly $50 billion by 2017–18.

Age Pension expenditure is large, growing, not sufficiently targeted—meaning those in need are not helped as much as they could be—and not sustainable. The cost of the Age Pension has increased in real terms by 35% between 2007–08 and 2014–15 due to the fact that at least 70% of people of retirement age receive some form of pension, and some estimates put it at 80%.

The Australian Treasury's Intergenerational Reports raise real questions about the affordability and sustainability of the nation's retirement incomes system as the population ages. The 2015 Intergenerational Report predicts age-related pensions would increase from 2.9% of GDP in 2014–15 to 3.6% in 2054–55. Other predictions suggest that growth in Age Pension expenditure could be even higher.



The cost of assistance to the aged (the Age Pension, aged care and home support and care) has risen by more than 50% in the decade to 2013–14, outstripping real GDP growth.

The maturation of the superannuation system will not substantially reduce these fiscal pressures.

There are other problems with the pension beyond looming fiscal pressures. The exemption of the family home from the pension assets means test creates significant inequities between homeowners and non-homeowners.

Homeowners tend to have more non-housing assets than non-homeowners. Hence, homeowners have substantially higher net worth, on average, than those who don't own their homes. They therefore have a much greater ability to support themselves. Yet homeowner pension entitlements are often similar to those with few assets and no other income. Homeowners also face lower housing costs and other advantages over those with no housing assets.

In practice, the emotional connection to the family home, together with the perverse incentives created by the pension system, means the vast majority of pensioners do not use their home to support their retirement.

The solution to the underutilisation of savings stored in housing assets lies in acknowledging and supporting the emotional connection to the home, while removing the distortions created by the family home exemption from the assets test, and encouraging pensioners to access the equity in their homes over time.

Addressing this underutilisation would both substantially improve pension living standards—increasing income by thousands of dollars each year—and cut the government's pension bill by a third.

A three-point strategy is needed:

1) The family home should be included in the pension assets test and the homeowner/non-homeowner distinction in the means test should be abolished.
2) The government should help pensioners unlock an income stream from their home equity by legislating for a default reverse mortgage product.
3) The government should then include deemed income from the default reverse mortgage in the pension income test — the same way income from financial assets are treated.

These reverse mortgage products would be provided by banks and superannuation funds but guaranteed or insured by government. These products would provide a regular annuity payment at a low interest rate up to a set equity limit. The government backing of the scheme would also ensure pensioners would never be forced to sell their home.

This scheme, when underpinned with reforms to the age pension means test would remove the distorting treatment of housing assets while providing a safeguard for pensioners and ensuring the pension is more focused on raising living standards of those who are reliant on it.

The purpose of reforming the pension and the treatment of the family home is not just to save taxpayers' money. Drawing on the equity in their homes will boost living standards for the majority of pensioners (since three quarters own their home) and enable the government to focus pension expenditure on those who have little or no housing wealth.

These three core reforms should be coupled with other reforms, including:

- Increasing the rate of rent assistance for non-homeowner pensioners;
- Increasing the base rate of the pension for singles and couples in line with the modest standard advocated by the Association of Superannuation Funds of Australia; and
- Tightening the income means test taper from $0.50 in the dollar to $0.60 in the dollar.

This package of reforms would generate significant benefits to both pensioners and the wider community. Our modelling indicates:

- Nearly 98% of pensioners would benefit, with the average benefit exceeding $5,900 a year;
- Only 2% of pensioners would be worse off, with the average loss less than $875 a year.

Importantly, by moving those with the means to support themselves off the pension, the government can increase the base rate of the pension — providing more benefits to those who are completely dependent on the pension.

Tangible benefits would accrue even if housing prices did not rise as fast as predicted, or if interest rates were higher, or if the reverse mortgage equity limit were lowered.

The increase in pensioner income is so significant, many pensioners would move off the full-rate of the pension. More than 70% of single and couple pensioners would move off the full-rate and onto the part-rate, while more than 24% of single part-rate pensioners, and 32% of couple part-rate pensioners would move off the pension entirely.

In addition to this substantial increase in pensioner income, there would be a very large reduction in government pension spending. The modelling contained in this report estimates annual Age Pension expenditure will fall from $42.2 billion to $27.7 billion.

Reports that Australians do not save enough for their retirement typically ignore the impact the family home could have on lifting retirement incomes. Unlocking the $625 billion of home equity controlled by age pensioners has the potential to be the solution to the rising cost of the Age Pension as well as reducing poverty among pensioners.

THE PENSION

What is the pension for?

- The belief that the pension is a 'right' is mistaken for several reasons: pensons are paid by current taxpayers, and the idea of a universal pension entitlement goes against a fundamental principle of the Australian welfare system — that help should be prioritised for those who can't help themselves.
- The pension is a safety net for those with limited wealth. It should be tightly means tested and focus on allievating poverty for those most in need.
- However, in practice the pension is a quasi-universal scheme that boosts retirement incomes for many older Australians with substantial assets.

Who receives the pension?

- Approximately 10% of people in Australia are on the Age Pension.
- Between 1993 and 2013, the number of people receiving the pension grew by more than 55%, substantially outstripping population growth.
- Some estimates state that 80% of people of retirement age are on the pension, while others indicate that ratio is 70% of those of pension age.
- Just under 60% of age pensioners are on the full rate.
- Of those who are assets tested off the full rate of the pension, nearly all are homeowners (97%) and 75% of that group are couples.

Is the pension adequate?

- Adequacy, though a central consideration, is not the only consideration of pension policy. Removing undesirable incentives is also important, as is minimising unnecessary burdens on taxpayers.
- Adequacy can be measured against an absolute level of expenditure needed for a desired standard of living or by reference to the standard of living of others in the community.
- The base level of the single pension is in line with common measures of adequacy, both those looking at absolute expenditures and relative incomes.

This data does not make a strong case for an increase in the full rate of the pension based on the poverty of pensioners.

Figure 13: Income benchmark for singles — minimums

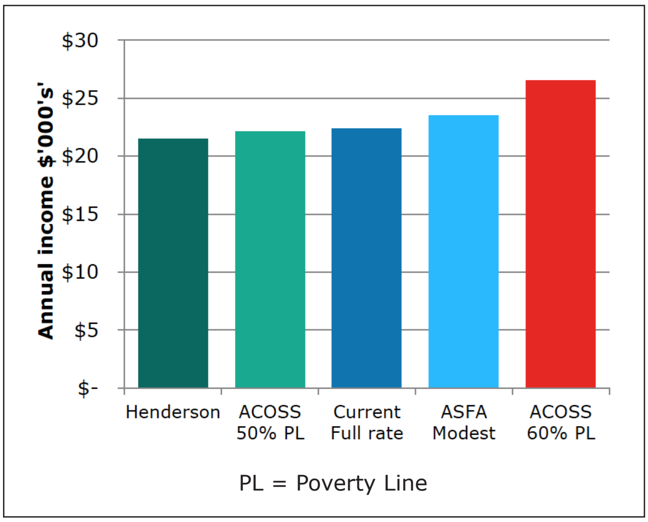
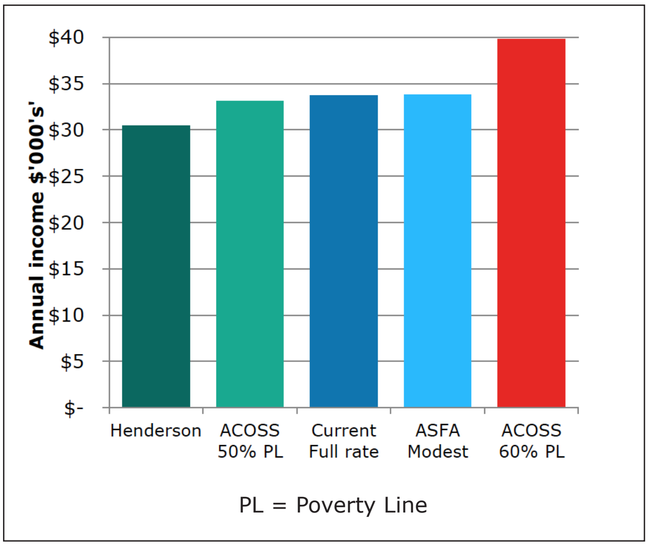


Figure 14: Income benchmark for couples — minimums



Is the pension means test too generous?

This data does show that income test thresholds are too generous for those with substantial incomes.

If the main purpose of the pension is to ensure no pensioner lives in poverty, it is hard to see how providing support to people with incomes at nearly twice the poverty line is justified.

The cost of the pension is unsustainable

- The total real cost of the Age Pension has increased by 35% between 2007–08 and 2014–15.
- On a per pensioner basis, the real cost increased by nearly 10% between 2007 and 2013.
- In recent years, pensions have increased in several ways — benchmarking pensions to incomes has driven real growth, while pensioners were generously compensated for the introduction of the carbon tax and the GST on top of a discretionary increase in 2009 for single pensioners that cost $13 billion across the forward estimates.
- Cost pressures will only increase as by 2055 the ratio of people of working age for every person over 65 falls from its current level of 4.5 (already down from over 7.5 in 1970) to just 2.7.
- By 2055 the number of Australians aged 65–84 will more than double and the number of people aged 85 and older will nearly quadruple.
- This massive increase won't be offset by superannuation maturity — a number of studies suggest the percentage of retirees on the pension will remain constant over the next 40 years.
- Treasury estimates cited in the 2009 Harmer Pension Review Report claim the maturation of the superannuation system will reduce the total value of pension spending by only 6%.
- By 2060 more than 51% of voters will be over 50 years of age, this is likely to exacerbate an already strong trend towards politicians promising increases in the pension to win votes.
- This political impact is not included in estimates of future pension liability, meaning they are likely to underestimate future costs.
- Even those who wrongly believe the cost of the pension is sustainable should recognise that the inequities in the system need fixing.

Figure 15: Income means test thresholds — singles

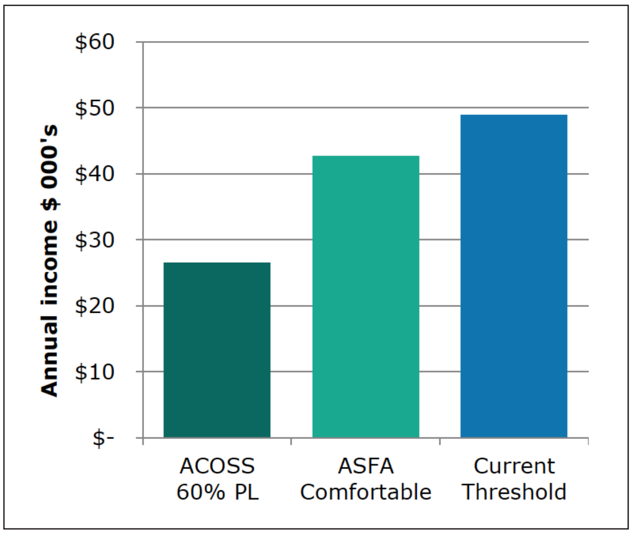
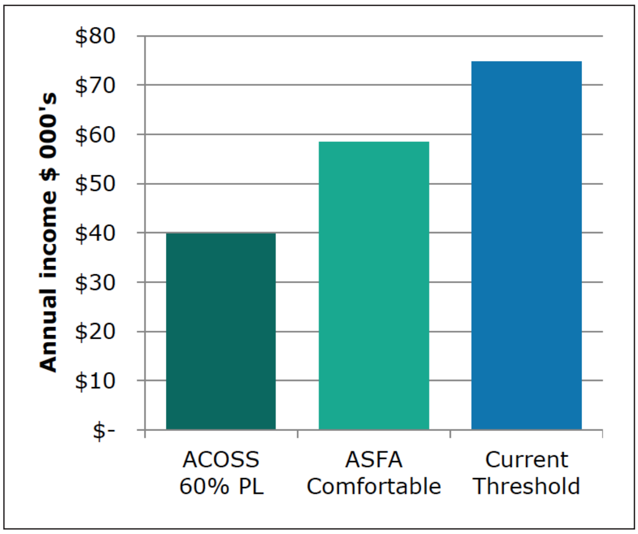


Figure 16: Income means test thresholds — couples



THE FAMILY HOME

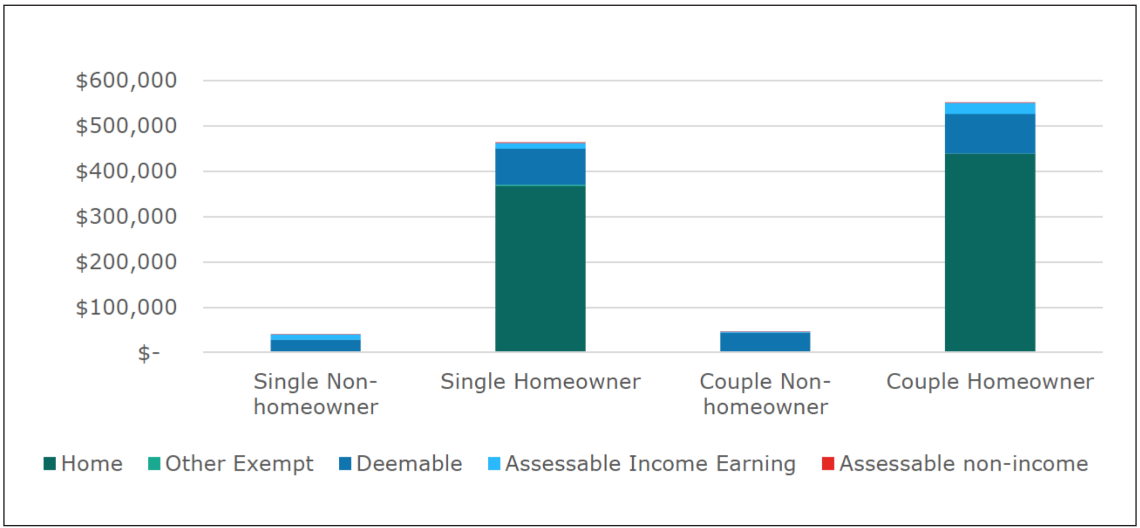
Homeownership among retirees

- More than 80% of retirees own their own home and the overwhelming majority of them have no mortgage.
- More than 75% of pensioners own their home and in 2010 average housing wealth for those on the full rate of the pension exceeded $400,000 for couples and $350,000 for singles.
- The total value of pensioner home equity is roughly $625 billion.
- The family home dominates the asset holdings of pensioners; especially those in the middle wealth brackets who have more than 70% of their wealth in home equity.
- In effect, the pension treats people with $500,000 or $600,000 in assets as being in the same position as those with less than $10,000.

The principal residence exclusion from the assets test

- While the principal residence is not currently assessed in the pension means test, there are two reasons to include it: fairness; and the potential to greatly improve the living standards of pensioners.
- The small difference between the homeowner and non-homeowner thresholds understates the average value of home equity — more than 94% of pensioners' homes are worth more.
- Exempting the home allows pensioners with different means to receive similar levels of support from the taxpayer as those with little or no assets.

Figure 30: Average wealth for full-rate pension recipients, 2010



Source: Household, Income and Labour Dynamics in Australia Wave 10

- The difference between homeowners and non-homeowners is stark: for full-rate pensioners, homeowners have more than nine times the net worth of non-homeowners.
- There is little correlation between net worth and pension payments, with many full-rate pensioners having in excess of $600,000 in assets (in 2010).
- If the family home were included in the assets test, more than 40% of full-rate pensioners would move to the part rate, and many others would be moved off the pension altogether.

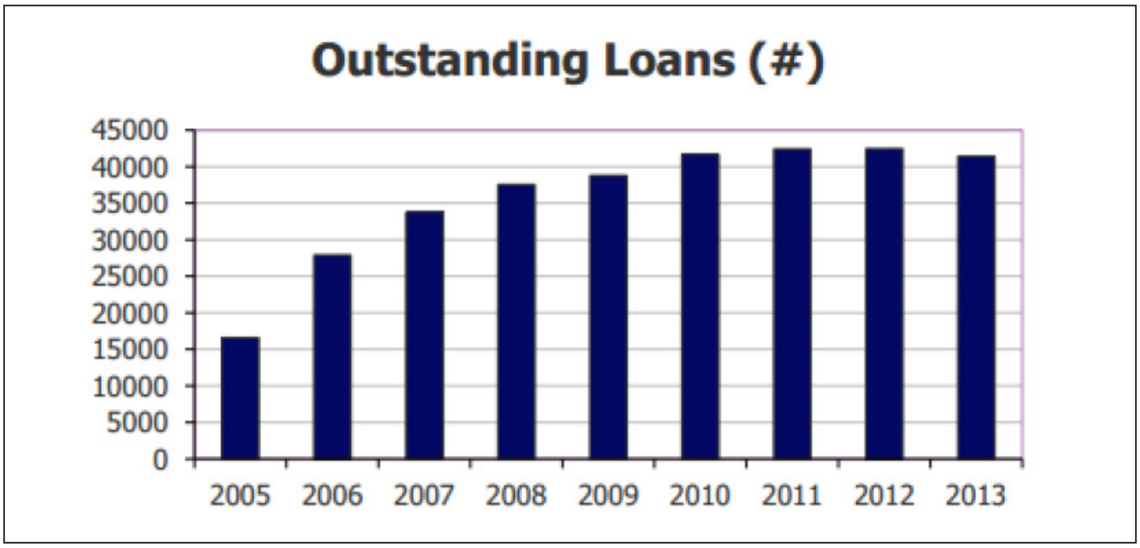
The family home is an untapped asset

- The family home is not widely viewed as a retirement savings tool — an MLC Wealth Survey found just 11% of Australians plan to sell their family home to fund their retirement.
- Surveys suggest the vast majority of older Australians would prefer to 'age in place', remaining in their home as long as possible citing diverse reasons including proximity to family and friends, familiarity with the community and access to health, shopping and transport services.
- Pensioners could both age in place and use the savings in their home to fund their retirement – through a reverse mortgage — but very few do, as the MLC Wealth Survey found only 8% of Australians plan to draw down equity in the family home in retirement.
- This reluctance has many likely causes; an aversion to risk and debt, with particular concerns about the perceived riskiness of reverse mortgages, a lack of understanding of the products available and the safeguards already in place or a desire to use the house as insurance against potential future health costs and living costs.
- While this is understandable, it does not make it in the best interests of taxpayers or society — it makes little sense to spend taxpayer's money now while a million dollars or more in assets is exempt from the means test just in case more money might be needed later on in life.
- Another motivation for the desire of pensioners to hang onto their home equity is to pass the home onto their children. The Productivity Commission found that for nearly 10% of people, bequest motives were driving saving decisions, while another study found 51% of those aged 50 and over felt it was somewhat or very important to leave the family home to their children.
- The government cannot afford to subsidise bequests by providing pensions to people who have assets that can be used to support themselves in retirement.

Reverse mortgages

- The government runs a reverse mortgage scheme (Pension Loans Scheme) for pensioners, but the total value of loans under the scheme in 2014 was just $31.9 million.
- The number of mortgages in the private market remained almost unchanged between 2011 and 2012, and actually fell in 2013.
- While 91% of outstanding loans in 2013 were to people of pension age, just 6% of the loans settlements in 2013 were income stream products.
- Interest rates on private reverse mortgages are noticeably higher than on standard mortgages, and maximum Loan to Valuation Ratios (LVR) at 45% and below are low by international standards.
- Less than 1.1% of people of retirement age have taken out a reverse mortgage, meaning there is enormous unused capacity to utilise home equity.
- Given the government currently pays tens of billions of dollars in pensions annually to boost living standards in retirement, there is a strong financial incentive to support alternative sources of income such as reverse mortgages.

Figure 29: Reverse mortgages in Australia by number and value



Source: Deloitte Reverse Mortgage Survey 2013[83]

RECOMMENDATIONS FOR REFORM

Three key interlocking reforms

1. Include the family home in the assets test
2. Boost the take-up rate of reverse mortgages
3. Include the income from reverse mortgages in the income test

Include the family home in the assets test

- It is simply inequitable for a pensioner with no savings or assets, and renting an apartment, to receive the same pension payment as someone with hundreds of thousands of dollars in assets — regardless of whether the value of those assets are realised.
- Excluding the family home from asset means testing creates a large incentive to own and live in your home in retirement.
- It also creates artificial distinctions between different classes of assets, and encourages over-investment in housing equity at the expense of other investments.
- It discourages pensioners from downsizing their homes (though there are schemes designed to alleviate this problem).
- Excluding the family home from asset means testing is a driving factor behind Australia's problem with housing affordability.

Support development of the reverse mortgage market — the default annuity product

- Having included the family home in the pension assets test, the government should also move to ensure pensioners can adequately access the equity in their home to boost living standards.
- One way to do this is to massively expand the Pension Loans Scheme to provide these annuities. However the potential cost to government of underwriting an expansion in the Pension Loans Scheme of the scale required should not be underestimated.
- The government does not need to run the reverse mortgage market, it can simply regulate and incentivise it through government backed insurance or guarantee for reverse mortgages.
- This is not a radical concept. A government-backed reverse mortgage scheme exists in the US and there have been calls for a similar scheme to be introduced in Australia for aged care costs.
- The government could insure or guarantee a standard form default reverse mortgage annuity product for the family home provided it meets certain conditions, including: an 80% maximum LVR, set fees, agreed valuation procedures, and a regular review process.
- The government guarantee/insurance would ensure pensioners could never lose their home through a reverse mortgage.
- The government should also offer a form of this product through the Pension Loan Scheme to ensure pensioners who could not access private reverse mortgage funding would have access to a reverse mortgage in some form.
- Another advantage of the government offering a competing product is that it creates a floor price, encouraging existing providers of reverse mortgages to compete to provide better terms.
- The risk to government of default on these loans is very low — the fees for the US scheme are designed to cover the cost of defaults — and in Australia the risk would probably be lower still; even if the property market falls, it is unlikely to fall 20% across the board.
- The government could also substantially expand the funds available in the reverse mortgage market by opening up provision of these reverse mortgage products to superannuation funds.

Deem income from the family home in the income test

- Deeming income from reverse mortgages in the income test links the two reforms above and increases the benefit from both of them.
- Having removed the artificial distinction between different classes of assets under the means test, it would be anomalous to ignore the income from real estate assets.

- Importantly, including the income from the home (rather than just the asset values) accepts that two houses with roughly similar values may not have the same income producing capabilities – under this scheme pensioners who received lower annuity payments would get a higher pension.
- Another reason for deeming income is that including the family home in the pension assets test may not be a sufficient incentive to force a change in attitudes about reverse mortgages (or be seen as a punishment for owning your home).
- Focusing on income generated by the home shifts the focus of the pension means test to living standards (not to the composition of asset holdings).
- Deeming income from the default annuity channels pensioners into a product providing a growing income stream similar to the pension, which will alleviate the pressure on the pension itself.
- Another benefit in practical terms is that it will also enable an accurate assessment of the value of the family home in the pension assets test.

Other reforms

- These reforms are designed to be taken as a package; it is not intended for certain recommendations to be cherry-picked (e.g. increasing the base rate of the pension) in the absence of implementing the whole suite of reforms (especially the reforms above which generate savings to fund the changes).
- The intention of these changes is not to leave those at the bottom end of the income and assets distribution worse off, but to target the pension more appropriately and reduce the distorting impact of ignoring a typical pensioner's main asset.
- Increase the rate of rent assistance ($202.50 a week for singles and $198.75 a week for couples) to better cover the costs of low wealth pensioners and reduce the disparity between homeowners and non-homeowners.
- Remove the asset deeming thresholds and implement a universal deeming rate of 3.5% to better reflect actual returns achievable in the marketplace.
- Unify and simplify the assets test (thresholds at which pension payments would begin to taper would be $350,000 for singles and $400,000 for couples) regardless of whether they own their home.
- Increase the taper on the income test from $0.50 in the dollar to $0.60 in the dollar.
- Benchmarking should be abolished and pensions indexed to the Pensioner and Beneficiary Cost of Living Index, with periodic review and discretionary increases if needed.
- However, if benchmarking is retained then the benchmark should be average wages not the anachronistic male wages.
- The base rate of the pension should be raised to the following levels.

Table 10: New pension rates for singles and couples

	Singles		Couples (combined)	
	Current	New	Current	New
Per Fortnight	$860.20	$902.65	$1,296.80	$1,298.69
Annual	$22,365.20	$23,469	$33,716.80	$33,766

Benefits of these reforms

A note on modelling

- The model simulates pension and home equity annuity outcomes using data from the Household, Income and Labour Dynamics in Australia survey, March 2015 pension settings and the illustrative parameters below. For more detail on the parameters see pp. 30-35 of the report (the modelling methodology is explained in detail in Appendices II, III and IV)

Table 8: Proposed key parameters for the default reverse mortgage annuity

Parameter	Rate
Interest rate on loan	5.25%
Housing equity growth rate	6%
Growth in annuity payment	3%
Inflation	2.5%
Residual value	The greater of $100,000 (inflated in line with CPI) or 80% Loan to Valuation Ratio
Minimum equity value to participate in the scheme	$125,000
Annuity age range	65 to age 100

Overall benefits to pensioners

- An overwhelming majority of pensioners would be winners under our proposed reforms.
- The average gain for those whose incomes would increase (winners) substantially exceed the average loss for losers.
- Nearly 98% of age pensioners would experience an increase in their incomes by an average of $5,900 a year. The relatively small percentage of those whose incomes decline (2.2%) experience an average loss of just $864.

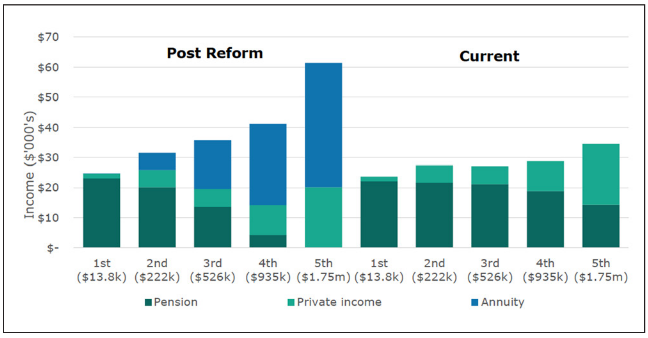
Table 11: Winners and losers under our reforms

	Winners	Losers	Total
Ave change in income	$5,924	-$864	$5,777
% of pensioners	97.8%	2.2%	100
Number of pensioners	2,371,382	52,460	2,423,842‡

Distributional impacts of our reforms

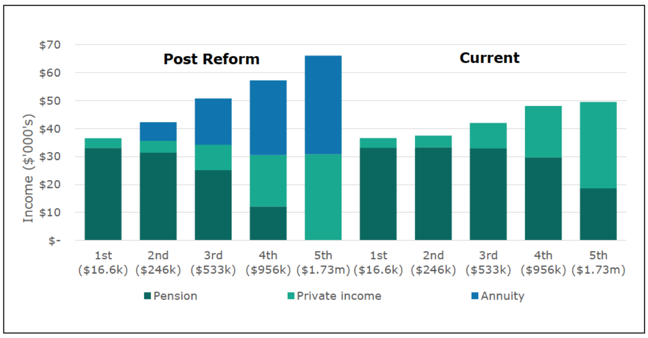
- After our reforms, the pensioners who remain on the full rate of the pension will be those who have the lowest net worth and the least income — those who need the most assistance.
- Those with few assets and no income other than the pension will benefit from the increase in the base rate and, in many cases, the increase in rent assistance as well.
- In fact, people with no other income other than the pension benefit at every level of net worth.
- Singles in every wealth quintile will see an average increase in their income.
- Singles in the bottom quintile will benefit from the proposed increase in the full-rate of the pension, providing a significant benefit of more than $1,000 on average.
- Single pensioners in the top quintile no longer receive a pension, yet their total income more than doubles.

Figure 49: Comparison of simulated annual income by quintile of net worth — singles



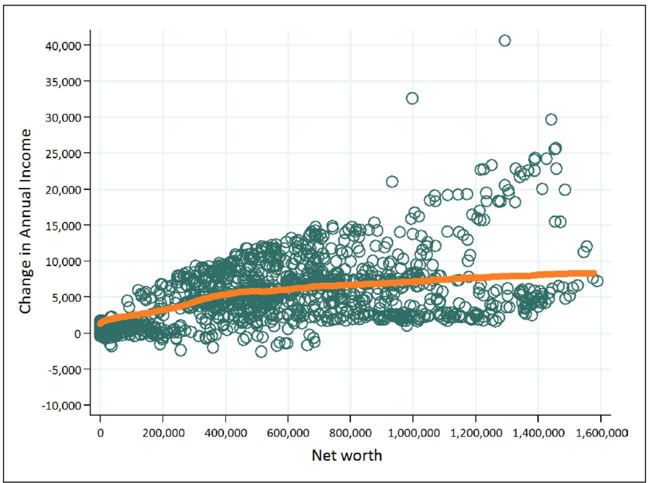
- Couples also see a rise in the base rate of the pension, as well as increased rent assistance for those with no other income than the pension.

Figure 50: Comparison of simulated annual income by quintile of net worth — couples



- Couple pensioners in the top four quintiles see an average increase in their incomes of between $4,800 and $16,500 a year.

Figure 55: Change in income by net worth including reverse mortgage annuity income



- Our reforms generate a strong positive trend of benefits accruing across the wealth distribution.
- There will be some losers under these reforms; it is impossible to responsibly pass reforms that leave every person better off.
- These reforms are not riskless, but nor are they reckless. As the bulk of the pension cohort would be much better off, these reforms are important and timely.

Savings to government

- Under our reforms, pension expenditure is reduced by nearly $15 billion a year.

Table 12: Simulated Commonwealth Government Outlays on the Age Pension

Current expenditure	Expenditure under our reforms	Savings
$42.2 billion	$27.7 billion	$14.5 billion

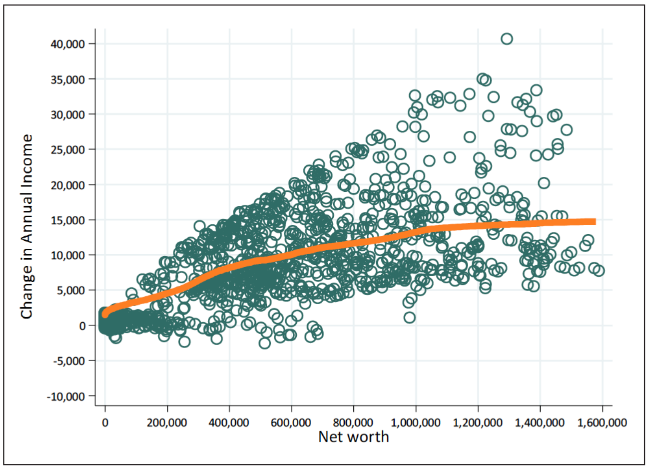
- It should be noted that some of the savings identified below may be offset by increased government spending on aged care, but it is highly unlikely that the scale of these additional aged care costs will approach the level of our anticipated savings.

- Under our revised assets test thresholds, more than 75% of single full-rate pensioners and nearly the same amount of couple full-rate pensioners, would move to a part-pension.
- Between 6.5% and 7.5% of full-rate pensioners would move off the pension entirely.
- Almost a third of couple part-rate pensioners and about a quarter of single part-rate pensioners would be moved off the pension altogether.
- As these percentages take no account of the current level of income, they are conservative estimates of the impact of the reform of the means test.

Incremental reform models

- One way to alleviate concerns about the scope of these reforms is to implement them incrementally — by initially exempting 50% of home equity and annuity income in the means test, falling to a 25% exemption over time—and then moving to full implementation.
- A 50% exemption in expected conditions would see the average benefit exceed $9,000 a year, with fewer than 50,000 pensioners worse off.

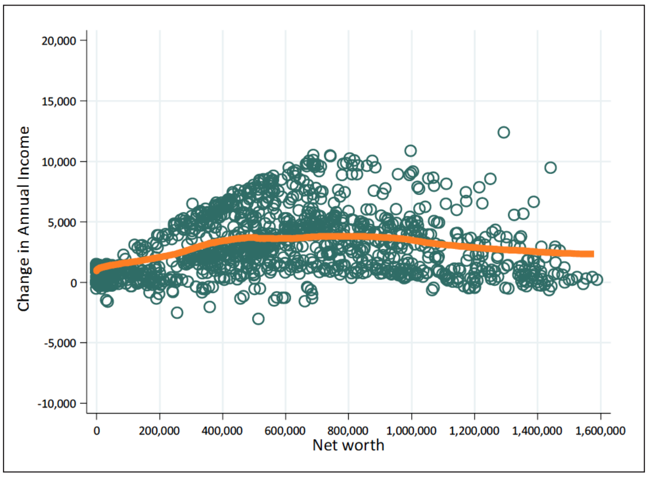
Figure 84: Change in income by net worth under 50% exemption



- For a 25% exemption, the average benefit is still nearly $7,500 and the pension savings would exceed $10 billion a year.
- In these circumstances, even in scenarios much less favourable than expected, most pensioners will be better off.

- For example, despite a scenario where the annual return on housing equity remained at just 0.5% for over three decades, if 50% of equity and annuity income was exempt, benefits would accrue across the wealth spectrum on average.

Figure 96: Change in income by net worth under 50% exemption in Scenario 6

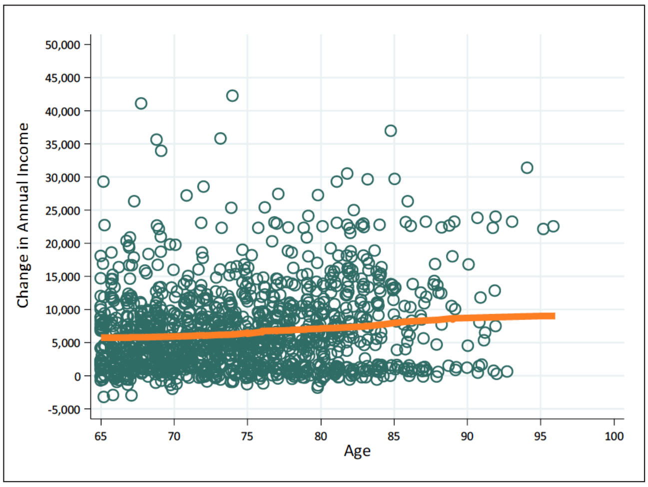


- With a 50% exemption, the number of winners is just under 95% — only slightly lower than when the housing market is strong.
- Pensioners who receive income increases gain an average of just over $3,000 each per year while the 5.2% of those who lose would suffer average losses of just $815. The average gain is $2,876 across the pensioner population.
- Savings of more than $3 billion would still be expected.

Grandfathering

- An incremental reform model might be a better option than grandfathering existing pensioners entirely.
- This is especially true given the considerable benefits that would accrue to existing pensioners if the full suite of reforms were implemented in the absence of grandfathering.

Figure 58: Winners and losers by current age



- Nearly 98% of existing pensioners would be better off with an average gain of more than $7,000 a year.
- Approximately 50,000 pensioners — or just 2% — of Australia's more than 2.4 million pensioners would be worse off, with average losses less than $875 a year.
- These reforms would save $16.4 billion a year in pension expenditure.

Sensitivity analysis

- The table below shows that even allowing for potential deviations in interest rates, house price increases and maximum LVRs, our simulations show strong benefits to many pensioners (for more information see Appendix I).
- An unavoidable consequence of encouraging homeowner pensioners to draw upon their home equity in retirement is that it will tie their living standards to the strength of the housing market.
- However, the government could assist pensioners in the event of falling house prices without exempting home equity altogether.

Different scenarios for the default reverse mortgage product

	Scenario 1	Scenario 2	Scenario 3	Scenario 4	Scenario 5	Scenario 6
Maximum LVR	Higher of 80% or $100K	50%	50%	50%	Higher of 80% or $100K	Higher of 80% or $100K
Interest rate on loan	5.25%	5.25%	6.7%	6.7%	5.25%	5.25%
Return on home equity	5%	6%	6%	5%	4%	3%
Average benefit	$3,136	$2,251	$496	-$1,054	$926	-$772
Percentage of winners	88.4%	80.3%	65.8%	52.4%	69.2%	54.7%
Savings	$13 Billion	$12.7 Billion	$12.4 Billion	$12.2 Billion	$12.4 Billion	$12.2 Billion

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