The myths of the generational bargain

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Any errors or omissions remain the author's responsibility.

Executive Summary

- Since its introduction in 1908, the pension system has steadily expanded its cost and reach
- The percentage of the population of retirement age has risen from less than 2% in 1911 to almost 11% in 2011
- The percentage of people of retirement age receiving the pension has increased from around 30% in 1911 to 75% in 2011
- The full rate of the pension has grown significantly in real terms over the years; from $3,000 a year in 1911 to more than $20,000 (in 2012 dollars)
- Pension costs as a percentage of wages are at the highest level they have ever been, having nearly doubled over the past 40 years
- The means test has become much more generous: the upper limit of the assets was just under 12 times the full rate of the pension in 1911, whereas today the ratio between the single homeowner assets test cutoff is nearly 35 times the full rate (despite the massive increase in the full rate of the pension over that time)
- Another driving factor has been increasing life expectancy, which has impacted costs in two ways:
  - Prior to the 1970s, the primary change was rising life expectancy at birth increasing the number of people who reached retirement age, with an increase in life expectancy of 1 year for every 4 years between 1880 and 1970
  - Since then, there has been marked growth in life expectancy at 65, increasing the average time spent in retirement by more than 6 years for women and nearly 7 years for men
- Pension costs are projected to continue to grow into the future, with pension costs increasing against wages by another 50% by 2055
- The ageing of the population is likely to have a considerable impact on politics, which may mean these projections are an under-estimate, as older voters are more likely to resist changes to pension entitlements
- Regardless of the causes, the effect of this growth in income transferred from those of working age to retirees has made the bargain between the generations unbalanced
- Each successive generation is asking more of the next generation than they were willing to contribute to past generations

- The average worker is now expected to contribute $3,500 a year to everyone else's retirement, but only $6,270 to their own.
- To restore balance, the government needs to reform several aspects of the retirement income system:
    1. The retirement age should be increased by around 6 months every 4 years and be regularly reviewed to ensure that it is in line with life expectancy
    2. The superannuation preservation age should be increased in line with the retirement age: at a minimum it should be no more than 5 years before pension age and preferably much closer.
    3. Investigate restrictions on withdrawal of superannuation, especially early withdrawal, to increase incentives for workforce participation for older workers
    4. Investigate more substantial superannuation reforms aimed at increasing the number of people who are self-reliant in retirement by improving the effectiveness of superannuation tax concessions

Introduction

The idea of a bargain between the generations is hardly a new one. In one sense it arises from the formulation of a very old idea of family responsibility — that you would look after your kids when they were young and in exchange they would look after you in your old age.

This far predates the idea of retirement: for millennia, most people worked at a subsistence level from a young age until they died. For those who did survive until old age and infirmity, their family would be expected to support them until they died.

While it was hardly perfect, this system functioned best when society was largely agrarian and families lived, worked and died in the same place. It is less effective in a mobile society, where families are separated by significant distances, and it functions poorly when life expectancies start to rise.

For some time the gap was filled by charity, with almshouses taking in those elderly people who could not work or afford living expenses. The rise of the middle class in particular contributed to a shift in attitudes towards self-sufficiency in old age: after all, charity carried the stigma that one was poor and living in poverty in the sixteenth, seventeenth and eighteenth centuries was particularly unpleasant.

Workers' savings were not used for holidays and impulse purchases; what little money could be set aside was earmarked for a rainy day (unemployment) and for old age.

But there were two interlinked developments in the nineteenth and twentieth centuries that fundamentally changed this rather bleak landscape for the elderly. The first was the development of the welfare state via a government funded old age pension, and the second was the idea of voluntarily stopping work for reasons of age but not necessarily infirmity (the concept of retirement).

Germany introduced an old age pension in the late 1880s.[1] The retirement age was 70 and it was funded by contributions through a social insurance scheme. As life expectancy in the western world around that time was much lower than it is now, (it was less than 50 for males in Australia), the number of people who qualified for this scheme was probably fairly low.[2]

Australia passed legislation for an old age pension in 1908 (though some states had their own schemes for several years before this date).[3] The qualification age was 65 for men (or 60 for women, and for men who had become permanently incapacitated).[4] The maximum payment was £26 per year and had an income means test (maximum income including the pension was set at £52 pounds per year) and a property test (where the maximum value was £310 with a limited exemption for the family home).[5] This system was not contributory, and indeed has never been since; it is paid from general taxation revenue.

This creation of a social welfare system effectively created a retirement age. Those without means over the age of 65 no longer had to work, provided they were willing to rely on a taxpayer funded pension. For those who had served in the armed forces, this age was just 60, with the creation of an old age pension for servicemen and women (the service pension) effectively mirroring the age pension occurring in the following decades.

Yet the introduction of this safety net was not to reward citizens for making old age; from the beginning the aim was to alleviate poverty. Some believed the introduction of a state funded pension would encourage thriftlessness, but were reassured that the low value of the payment, and the high pension age, would mitigate that risk.[6]

But has the advent of the welfare state repudiated the generational bargain or has it now shifted to something different? Has it collectivised responsibility for old age where the 'bargain' is that you are paying taxes during your working life to support those in older age in the expectation that when you are older you will be looked after by the next generation of taxpayers — or is it more complex than that, involving issues of the allocation of resources to various generations?

There are two key principles that need to be kept in mind when examining what bargain exists between the generations, and between those generations and the state.

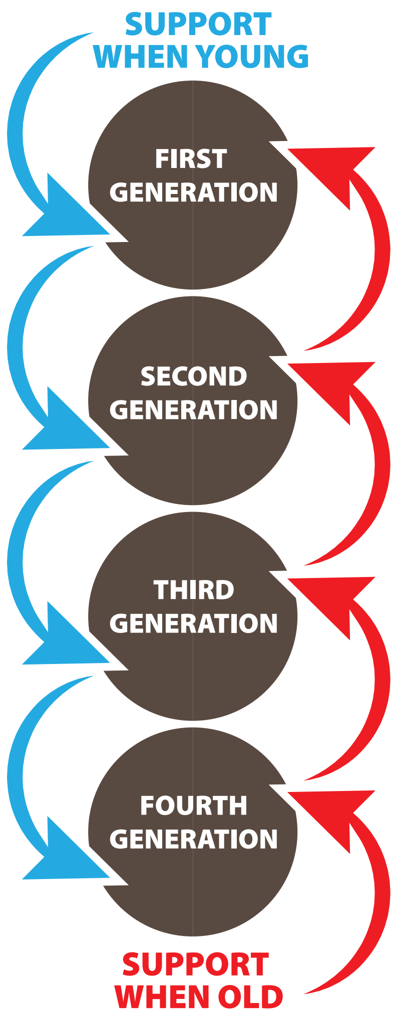
First, it needs to be fair to all sides. If the older generation continually ends up in poverty, or if each generation takes more from the next, the system will eventually collapse. Another complicating factor is the ageing of the population, which combined with slower economic growth will bring more and more pressure to bear on the system.

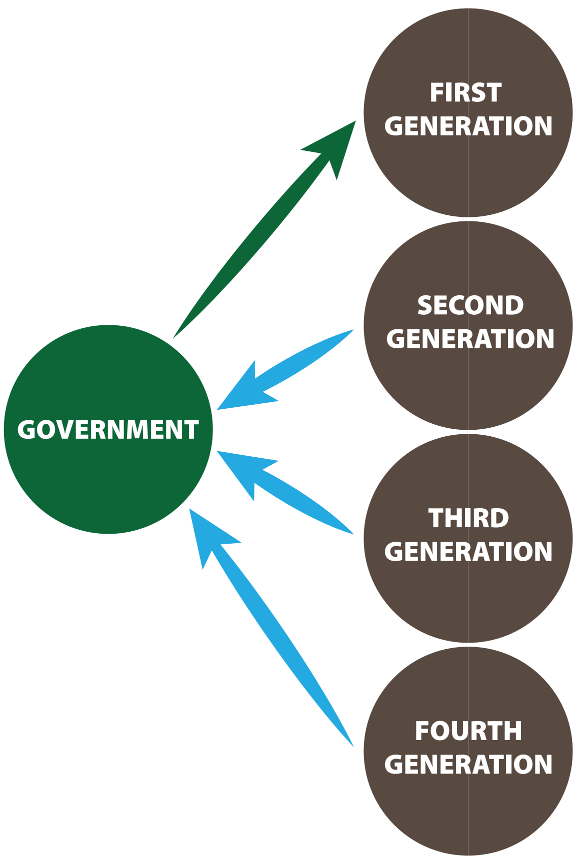
Second, a key principle of our welfare system (which was incorporated in the very first pension schemes in Australia) is that of vertical equity: help should be directed primarily towards those who cannot help themselves.

A recent CIS report, The Age Old Problem of Old Age: Fixing the Pension looked in detail at the pension means test and demonstrated the pension assets test was unfair and that pension spending could be cut by almost $15 billion while boosting pensioner incomes by nearly $6,000 a year on average.[7]

Other reports have also looked at the increasing share of wealth accruing to older Australians, which should result in a greater number of pensioners being able to support themselves in retirement.[8] However, is this actually the case?

This report will look at whether the share of income going to older Australians in the form of the pension is increasing, and examine the state of Australia's generational bargain; asking is it fair and is it sustainable?





Pension coverage and spending

When examining data on government welfare expenditure, life expectancy and the proportion of the population receiving the pension, four distinct periods of time can be observed. While there are some trends that apply across all periods, each has distinct characteristics that show the changing nature of welfare, attitudes to government support, and generational fairness.

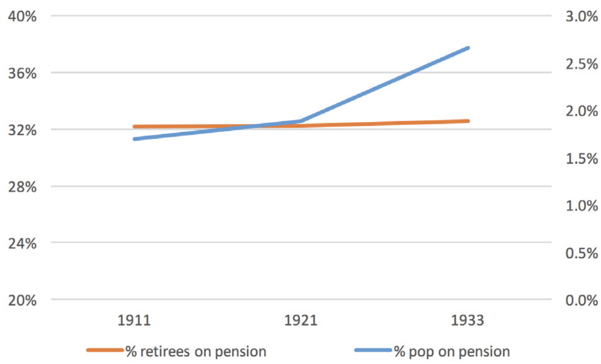
Pre-World War 2

The development of Australia's welfare state really began in 1909 with the first payments being made under the old age pension legislation passed the previous year. In 1911, the annual pension payment was £26, an amount that equates to about $3,150 in 2012.[9]

The original pension age for men was 65, nearly 10 years above life expectancy at birth for males between 1901 and 1910.[10] Indeed it wasn't until after the end of World War 2 that the male life expectancy at birth exceeded the pension age.[11] The age qualifications for women were lower (age 60) which meant — when combined with female life expectancy at birth being consistently between 3 and 5 years higher than men between 1901 and the mid-1950s — it was hardly surprising that a significant proportion of pensioners were women, and often widows (for example more than half of new female pensioners in 1911 were widowed).[12]

However the overall proportion of the population receiving a pension was quite low.

Figure 1: Pensioners as a percentage of retirees and general population



Sources: ABS Commonwealth Year Books 1912, 1922 and 1934[13]

Interestingly, around 70% of those over the age of 65 did not receive a pension during this period. This may in part reflect a stigma attached to welfare during this time, a lack of familiarity with the welfare system, and tighter means testing arrangements than those that exist today (in 1911, the assets test cut-off was just under 12 times the full rate of the pension, while the income test cut the pension out completely at twice the annual rate).[14] However, it should not be assumed that this low take-up was accidental, given attitudes towards self-reliance at the time.

It is towards the end of this period that the government introduced automatic increases to the pension to reflect changes in cost of living.[15]

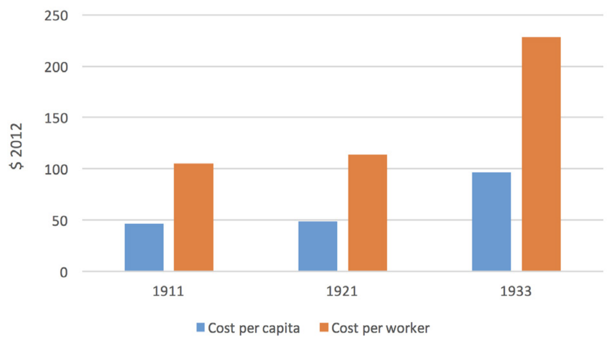
Prior to this, there were substantial real rises in pensions (particularly in 1923, 1925 and 1933) but there were also falls in real pension values in 1919 and 1932.[16]

Figure 2: Pen sion income relative to wages (real)

Sources: ABS Commonwealth Year Books 1912, 1922 and 1934[17]

Even so, across the pre-war period (despite the pressures on the public purse generated by the Great Depression) we can see the cost of the pension increased substantially faster than employment and population growth.

Figure 3: Cost of pensions (real)



Sources: ABS Commonwealth Year Books 1912, 1922 and 1934[18]

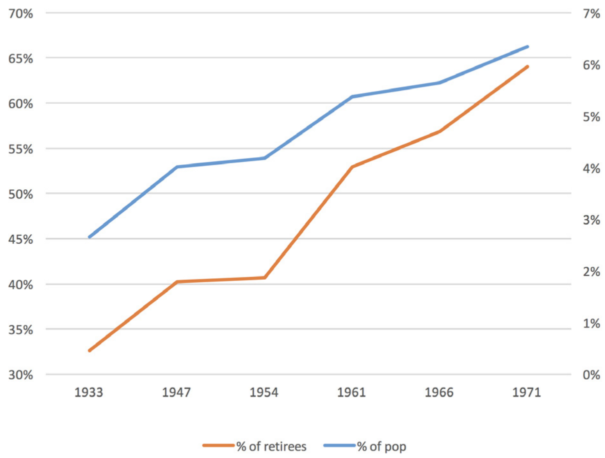
However, any restraint begins to dissipate as the end of the war brought the codification and expansion of the welfare state, particularly with the 1946 referendum on Commonwealth social services powers.

The baby boom era and beyond

The 1950s and 60s in Australia were a boom time of economic expansion and prosperity. The unemployment rate between 1950 and 1971 averaged less than 2% while real GDP growth averaged nearly 5%.[19]

This period also saw a significant expansion in the welfare state, both in the scope of existing payments and the introduction of new payments (such as rent assistance).[20] The number of pensioners began to rise, both as a proportion of over 65s and the overall population.

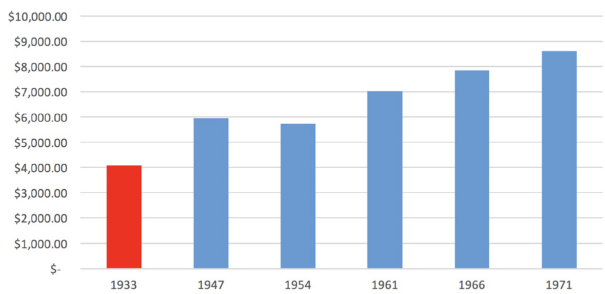
Figure 4: Pensioners* as a percentage of retirees and general population



Sources: ABS Commonwealth Year Books 1934, 1951, 1956, 1962 and 1972[21]

Yet there are not consistent increases in the real value of the pension until the 1960s. The real value increases by $2,000 a year between 1933 and 1947 but only by another $1,000 between 1947 and 1961. However, by the 1960s the trend of ever-increasing real pension payments becomes established, increasing by approximately $850 between 1961 and 1966, and the same amount between 1966 and 1971.

Figure 5: Rising pension rates (real)

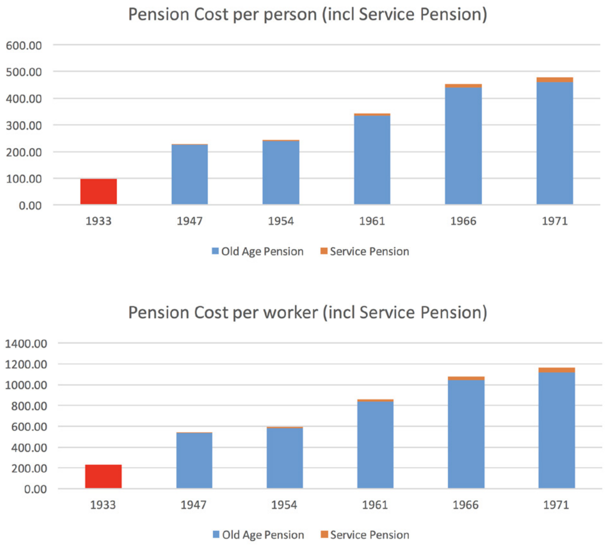


Sources: ABS Commonwealth Year Books 1951, 1956, 1962 and 1972[22]

* Calculations in this section and the following sections regarding cost of pensions per person or worker include veterans receiving the service pension, as well as an estimate of those dependants of those on the old age service pension. However, when considering the overall population or the population of retirement age (65 for men and 60, rising to 65 for women) the lower age at which veterans can receive the service pension is not factored in (as they represent a small proportion of the overall population, most of whom are ineligible for the age pension).

While the rapidly growing prosperity of the country could have led to greater self-sufficiency in retirement — which may have offset the increases in the real rate of the pension — the relative cost of pensions also continued to increase across this period.

Figure 6: Cost of pensions (real)



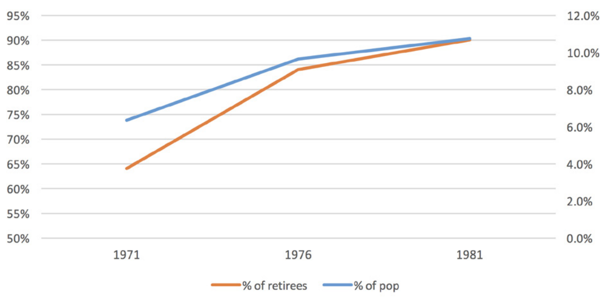
Sources: ABS Commonwealth Year Books 1951, 1956, 1962 and 1972[23]

The universal pension years

The election of the Whitlam government in 1972 again saw an expansion in the coverage and scope of the Australian welfare system. Whitlam introduced a number of new payments and also markedly expanded others, particularly the pension. Initially, Whitlam abolished the means test for those over the age of 75, and later reduced the age at which the means test ceased to apply to 70. He also raised the rate of the pension to 25% of average male weekly earnings.[24]

Whitlam was not alone in expanding the reach of the pension, with the Fraser government abolishing the assets test for all pensioners in 1976.

Figure 7: Pensioners as a percentage of retirees and general population



Sources: ABS Commonwealth Year Books 1972, 1977 and 1982[25]

This meant that between 80% and 90% of the entire retired population received a pension during this period, with the pension being theoretically universal provided you made it to age 70. While this brought Australia's pension system closer to European style universal pension systems, key differences remained.

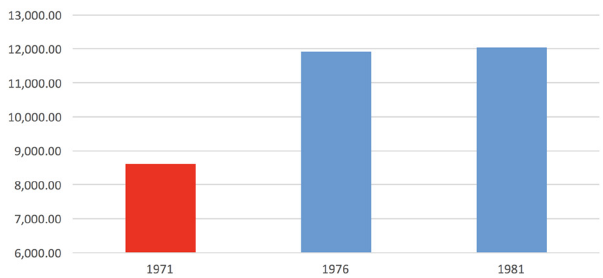
Many European systems were notionally or explicitly contributory (funded by specific tax payments made during the retiree's working life). While attempts were made to turn Australia's system into one based on contributory payments following the European social insurance model, our system remained funded by current revenue.[26] Chifley's National Welfare Fund disappeared in substance in the 50s when it was subsumed into general revenue, and was formally abolished in the 1980s.[27] The direct link between taxes paid and pension received is a misconception, not a reality.

Only Australia's superannuation system followed this contributory model, and only select public service pensions retained the flavour of a generous, publicly funded, contributory pension.

Another important point of difference is that many European pension systems make payments relative to pre-retirement income levels, with those who had higher incomes and made greater social security contributions receiving a bigger pension. There may be a similarity in thinking behind these systems and those in Australia who believe the pension is a right that represents a return on taxes paid, but the mechanics of these European systems and Australia's have always been different. Australia's system is a social safety net, with pensions unrelated to previous income and unconnected with contributions.

While this increase in the scope of the pension was occurring, there were also further increases in the full rate of the pension.

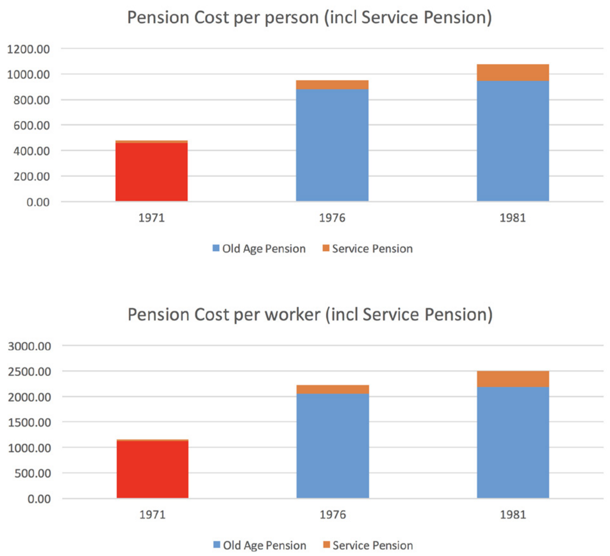
Figure 8: Rising pension rates (real)



Sources: ABS Commonwealth Year Books 1972, 1977 and 1982[28]

Not surprisingly this period represented a substantial jump in the cost of pensions over the previous period. Indeed the significant increase in the size of government from the Whitlam era has never been unwound, and the per-person cost of government programs has increased from then on.

Figure 9: Cost of pensions (real)



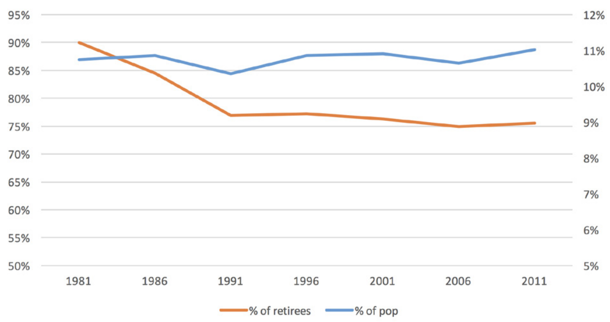
Sources: ABS Commonwealth Year Books 1977 and 1982[29]

In the short term, these costs were largely carried by increasing Commonwealth government debt, rather than increased taxation on workers. Substantial deficits were the norm between 1974 and 1980, though these debts would eventually have to be repaid by increased taxes on workers.[30] Either way, the share of national resources devoted to those in retirement was increasing.

The modern era

The paring back of a generous income test in the late 70s, followed by the reintroduction of the assets test on the pension in 1985, marks the end of any semblance of a genuinely universal pension.[31] Yet in practice, the pension remains quasi-universal. The new means tests only dropped the percentage of retirees receiving a pension to around 3 in 4, and the ageing of the population has seen the percentage of the overall population on the pension rise.

Figure 10: Pensioners as a percentage of retirees and general population

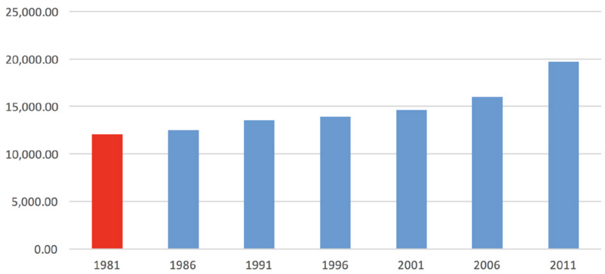


Sources: ABS Commonwealth Year Books 1982, 1988, 1992, 1997, 2002, 2007 and 2012[32]

During this period, the link between pensions and wages became more formalised, with the Howard government introducing a benchmark of pensions to 25% of Male Total Average Weekly Earnings in 1997 and the Rudd government creating the current benchmarking arrangements.[33] Under Rudd's system, pension payments increase at the rate of inflation but if the couples' rate falls below 41.76% of Male Total Average Weekly Earnings it is increased to that amount.[34]

In addition to this benchmarking, in recent years pensioners have received one off increases for the GST and the Carbon Tax, as well as a discretionary increase in 2009 in response to the Harmer Review.[35] Consequently there have been continued real increases in the cost of the pension, outstripping growth in wages despite a massive increase in the terms of trade and the one-off benefits of the mining boom (which alone raised real wages by an estimated 6%).[36]

Figure 11: Rising pension rates (real)

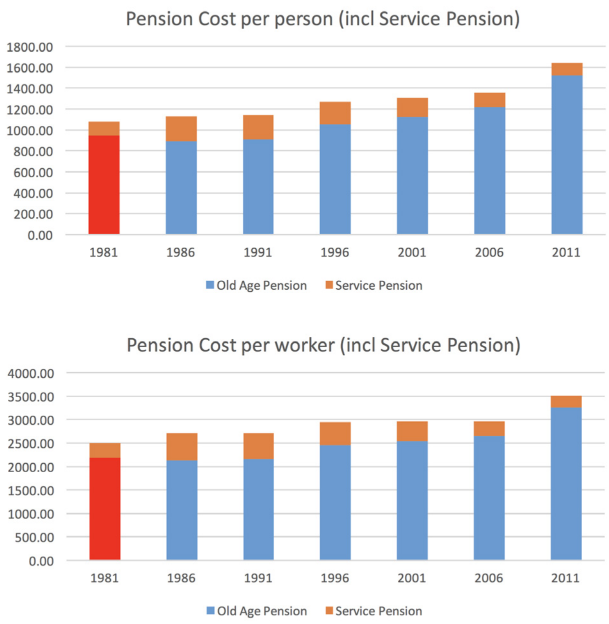


Sources: ABS Commonwealth Year Books 1982, 1988, 1992, 1997, 2002, 2007 and 2012[37]

It is worth noting that these increases in the relative cost of the pension have come at the same time as the introduction of a compulsory, tax-advantaged, retirement savings vehicle in superannuation. While it would be incorrect to assume that no-one saved for retirement prior to the introduction of superannuation, it is reasonable to assume that a compulsory retirement savings system should increase the overall level of savings for retirement and thereby reduce the reliance of retirees on the pension (and hence lower the cost of the generational bargain).

Whereas in fact, 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%.[38]

Figure 12: Cost of pensions (real)



Sources: ABS Commonwealth Year Books 1982, 1988, 1992, 1997, 2002, 2007 and 2012[39]

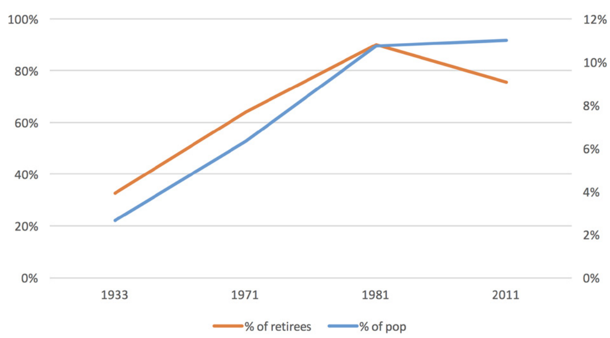
Trends across time

When comparing the various eras, several clear trends emerge.

The proportion of the population receiving the pension has significantly increased

There are two elements to this. First, the percentage of the population over the age of 65 has been steadily rising since the pension was introduced. Second, the proportion of those over the age of 65 eligible for the pension has also increased, though this figure fell after the abolition of 'universal' pensions.

Figure 13: Pensioners as a percentage of retirees and general population

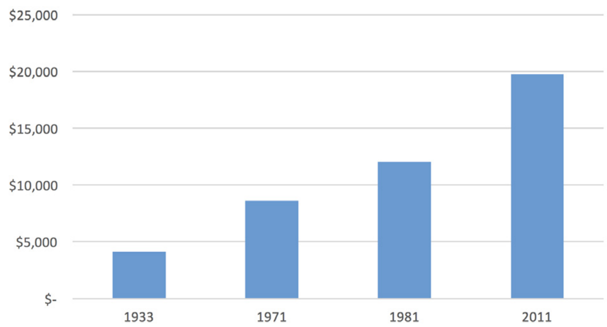


Sources: ABS Commonwealth Year Books 1934, 1972, 1982 and 2012[40]

The real rate of the pension has increased continuously since the Depression

While governments were initially hesitant to increase the value of the pension, over time the expectation has been established that the real value of the pension will increase. Attempts to limit increases in the pension to CPI have been strongly resisted.[41]

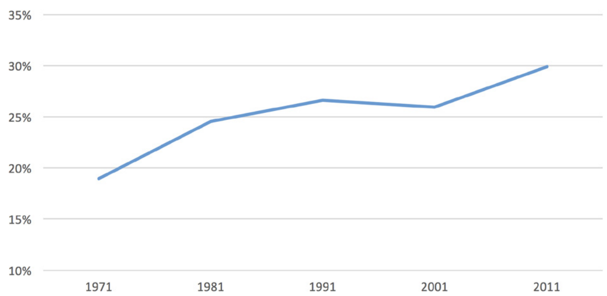
Figure 14: Real annual value of the pension



Sources: ABS Commonwealth Year Books 1934, 1972, 1982 and 2012[42]

Not only has the real value of the pension increased, but it has increased faster than real wages. The pension is now formally benchmarked to a higher percentage of wages than it was in the past.

Figure 15: Pension income relative to wages

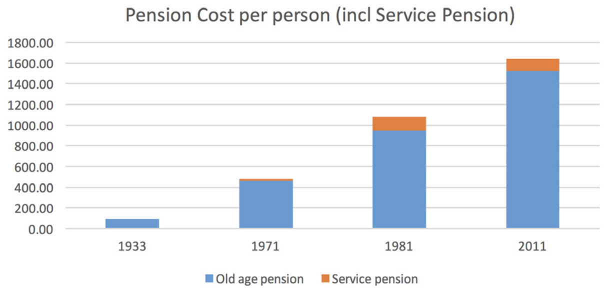


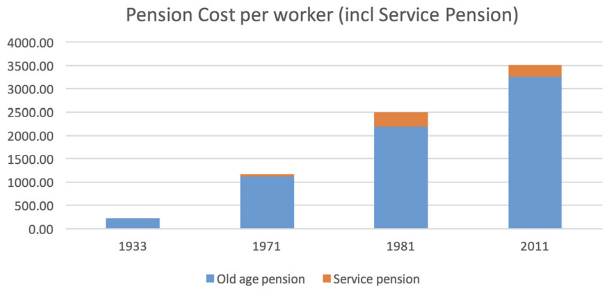
Sources: Author's calculations from ABS category 6302 Average Weekly Earnings and ABS Commonwealth Year Books 1972, 1982, 1992, 2002 and 2012[43]

The relative cost per worker of the pension has skyrocketed

The continued growth of the age pension into the largest single federal government payment has meant the burden of the pension borne by those of working age has increased. The cost per capita and cost per worker of the pension in 2011 is around 15 times the cost in 1933.

Figure 16: Cost of pensions (real)



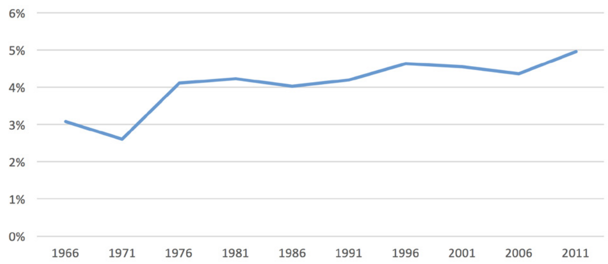


Sources: ABS Commonwealth Year Books 1934, 1972, 1982 and 2012[44]

Each generation has asked more of the next generation than they gave to the previous generation

Even if you take into account increases in community living standards over time, the relative burden on workers has increased. Looking at the relative proportion of an average worker's salary that goes to pension spending shows whether pensions keep pace with (or exceed) living standards. If the pension increased at the same rate as living standards for workers (and the proportion of pensioners to workers remained constant), this percentage would remain the same over time. This is a key justification for the policy of benchmarking pensions against wages.[45]

Figure 17: Pension cost per worker as a percentage of average income



Sources: Author's calculations from ABS cat 6302 Average Weekly Earnings, Australia and Commonwealth Year Books 1972, 1977, 1982, 1988, 1992, 1997, 2002, 2007 and 2012[46]

This percentage nearly doubled between 1971 and 2011, which in effect means that paying for those in retirement costs workers twice as much of their income in 2011 as it did in 1971. In fact, this relative cost has increased across the whole period; the cost in 1961 was five times the cost in 1911 (direct comparison between 1911 and 2011 is difficult because of differences in reporting average and minimum wages).[47]

Comparing income tax receipts (the primary tax contribution of workers) with pension spending (the primary welfare support for retirees) is also interesting. In the 2014/15 budget, the cost of the age pension accounts for nearly a quarter of all income tax revenue.[48] In isolation, this figure may not tell us much, but in the context of increasing wealth of retirees and rising real pension spending it is further evidence that the generational bargain is significantly shifting. It is noteworthy that (assuming a 9.5% superannuation contribution on an average wage of $66,000 in 2011) the average worker is now expected to contribute $3,500 a year to everyone else's retirement but only $6,270 to their own.

These metrics all suggest that today's retirees, who in their past working life paid a smaller proportion of their salaries to support the retirees of that time, now demand a greater proportion of the salaries of those working today.

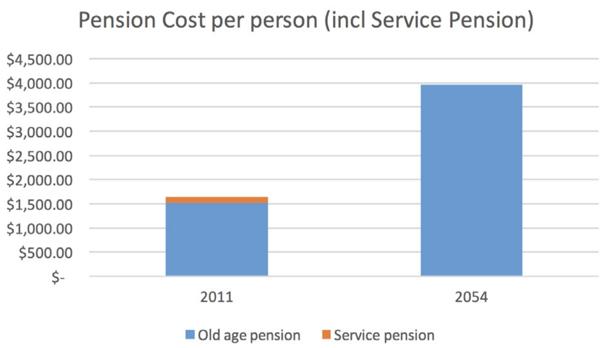
Projections of future spending

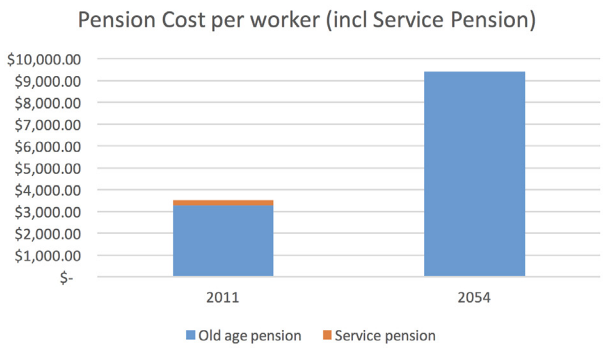
The 2015 Intergenerational Report makes a number of projections about future population and workforce, ageing trends, life expectancies and government spending.[49] These projections allow us to extrapolate forward the figures in previous sections and see what pension expenditure might look like in 2055.

Some caution is needed. Recent changes to pension entitlements were not included in the IGR calculations.[50] In the long run these changes could impact pension entitlement as well as behavioural choices for those about to retire. Another important consideration lacking from the IGR calculations is the political impact of an ageing population. Given that the pension has seen three discretionary increases in the past 15 years (from the GST, the Carbon Tax and in 2009 in response to the Harmer Review) it is highly likely that further discretionary increases will occur in the next 40 years.

Yet there is potential cause for concern. Even on the relatively conservative assumptions in the IGR, the real cost of the pension will more than double on a per capita basis and almost triple on a per worker basis by 2054. Indeed, in 2054 the average worker will contribute nearly as much to everyone else's retirement ($9,424.20) as to their own ($11,895 assuming the SG remains frozen at 9.5%) This increase in cost is driven largely by the significant relative increase in the number of retirees compared to the number of workers.

Figure 18: Projected pension costs





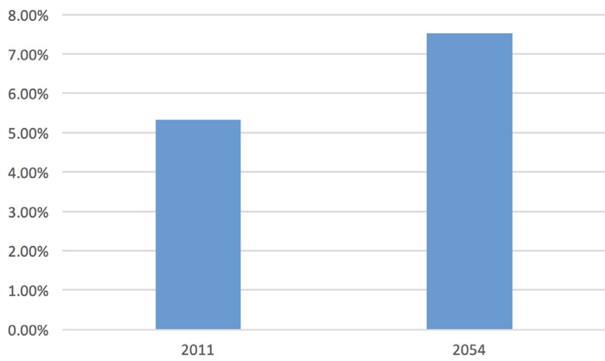
Source: Author's calculations from ABS Commonwealth Year Book 2012 and 2015 Intergenerational Report[51]

It also demonstrates one of the less obvious points in the IGR: that the relative tax burden on each worker would increase even if the tax to GDP ratio remained the same, since the same tax burden is shared by relatively fewer workers. Consequently, maintaining the status quo on pensions is in effect a tax increase. Any increase in the tax to GDP ratio, for example to fund pension increases for political purposes, would actually be a second increase in the per worker cost.

Already it is clear there will be a substantial increase in the proportion of average wages that will go towards pension spending

This continues the trend identified above of ever escalating transfers to age pensioners. Since its introduction, more and more funds have been redirected from workers' salaries towards retirees' incomes. Given these trends it is not hard to see how the political factors surrounding retirement might lead to the pension capturing as much as 10% of an average workers' salary. It is worth noting that this increase occurs in spite of the maturation of the superannuation system, which should result in the relative cost of the pension falling.

Figure 19: Pension cost per worker as a percentage of average income

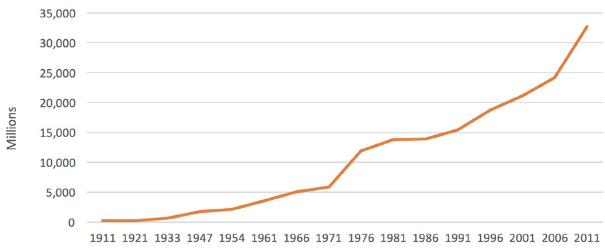


Source: Author's calculations from ABS Commonwealth Year Book 2012 and 2015 Intergenerational Report[52]

Causes of increase in total pension spending

Since the introduction of the pension, there has been a continual increase in the total real cost.

Figure 20 – total pension spending (real)



Source: inflation adjusted figures from various Commonwealth year books[53]

There are a number of factors driving this increase; some are the result of conscious choices by government and others are caused by demographic shifts

Policy decisions

The most obvious cause of the increase in the cost of the pension has been the conscious choice by all federal governments over at least the past 80 years to continually increase the real value of the pension. As can clearly be seen above, the real level of the pension has increased considerably since its introduction.

Another key factor driving this increase has been an expansion of the pension cohort by making the means tests increasingly generous. In 1911 the assets test cut-off was just under 12 times the full rate of the pension, whereas today the ratio between the single homeowner assets test cut-off is nearly 35 times the full rate of the pension including supplements.[54] The full rate of the pension has increased substantially in real terms but the maximum cut-off in the assets test has increased much further still.

Increases in life expectancy

While it is not surprising that life expectancy has increased across the 100 years since the introduction of the pension, the detail of the increase has important ramifications for pension policy. It is not only general life expectancy of the population that matters. Life expectancy in retirement also has an impact on pension spending, and while both have increased, they have increased at different times and at different rates.

Between 1880 and 1971, life expectancy at birth increased by more than two decades (21 years for males and 24 for females), increasing on average by around one year every three to four years over this period.

Year	Male at birth	Male at 65	Female at birth	Female at 65
1881-1890	47.2	76.1	50.9	77.3
1891-1900	51.1	76.3	54.8	77.8
1901-1910	55.2	76.3	58.8	77.9
1920-1922	59.2	77.0	63.3	78.6
1932-1934	63.5	77.4	67.1	79.2
1946-1948	66.1	77.3	70.6	79.4
1953-1955	67.1	77.3	72.8	80.0
1960-1962	67.9	77.5	74.2	80.7
1965-1967	67.6	77.2	74.2	80.7
1971	68.3	77.2	74.8	80.9

Source: ABS cat 3105 Australian Historical Population Statistics [55]

However, over that same period, life expectancy from 65 (ie the likely number of years spent in retirement) barely moved, increasing by just over 1 year for males and less than 4 for females.[56] This suggests that until the 1970s, the rising number of pensioners was largely driven by more people surviving to retirement age, who in years past would have died before then.

The average time spent in retirement didn't really change, which is important because it meant the proportion of wages the average person had to save for retirement remained constant.

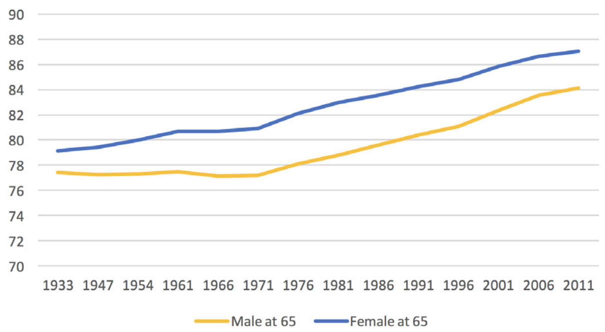
Yet since then things have changed.

Year	Male at birth	Male at 65	Female at birth	Female at 65
1971	68.3	77.2	74.8	80.9
1976	69.4	78.1	76.4	82.1
1981	71.4	78.8	78.4	83.0
1986	72.9	79.6	79.2	83.6
1991	74.4	80.4	80.3	84.3
1996	75.6	81.1	81.3	84.8
2001	77.4	82.4	82.6	85.8
2006	79.0	83.5	83.7	86.6
2011	79.9	84.1	84.3	87.0

Source: ABS cat 3105 Australian Historical Population Statistics [57]

Life expectancy at birth has continued to increase at the same rate as before — one extra year for every three or four years on average — but life expectancy from 65 has increased rapidly. Between 1972 and 2012 it increased by nearly 7 years for males and more than 6 years for females. [58]

Figure 21: Life expectancy



Source: ABS cat 3105 Australian Historical Population Statistics [59]

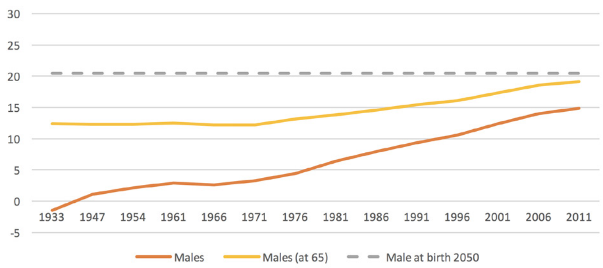
During this significant increase in life expectancy, while the female pension age was slowly brought into line with the male pension age, the male pension age remained unchanged.[60] The pension age is slated to increase to 67 over the next decade, but moves by the government to increase it further to 70 have not yet been legislated.[61] As a consequence, people are now living much longer in retirement than ever before and are expected to live still longer in retirement in the future.[62]

Year	Male retirement age	Female retirement age
1994	65	60
1998	65	61
2002	65	62
2006	65	63
2010	65	64
2014	65	65
2020	66	66
2024	67	67

Source: Social Security Legislation Amendment Act (No. 2) 1994 and Department of Human Services website[63]

For men in particular, the average time in retirement has increased enormously and will continue to rise over time.

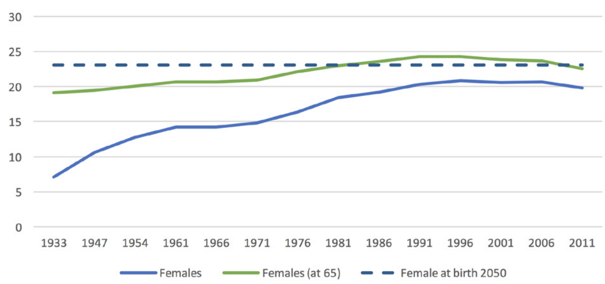
Figure 22: Years spent in retirement (men)



Source: figures derived from ABS cat 3105 Australian Historical Population Statistics and the 2015 Intergenerational Report[64]

Women, on the other hand, have always spent a longer time in retirement than men, due to a higher life expectancy and lower pension age. Women's years in retirement will remain more than men and will continue to increase — however at a much slower rate.

Figure 23: Years spent in retirement (women)



Source: figures derived from ABS cat 3105 Australian Historical Population Statistics and the 2015 Intergenerational Report[65]

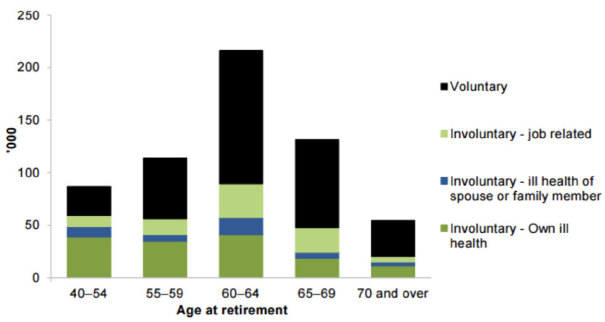
Savings, superannuation and early retirement

While the factors identified above have driven an increase in pension costs, several factors could operate to counteract that trend, reducing pension costs and enabling retirees to look after themselves in retirement.

Retirees have built up significant capital in residential property, with pensioners alone having more than $600 billion in residential property in 2011 (likely in excess of $700 billion in today's dollars).[66] 70% of pensioners have more than 75% of their net worth tied up in their home, but have not been expected to use any of that wealth to support themselves. It is clear that the exclusion of the family home from the pension means test has undoubtedly resulted in the government paying tens of billions of dollars of pensions to retirees who could support themselves in part or in full.[67]

Compulsory superannuation has also given retirees additional capacity and tax advantages to encourage greater savings, but it too has largely failed to substantially increase the number of retirees who are self-sufficient, or to slow the growth in pension expenditure.[68]

Figure 24: Age of retirement



Source: Productivity Commission[69]

Instead, some retirees have also taken advantage of rules that allow access to superannuation well before pension eligibility to retire early.

More than half of all retirees leave the workforce before the age at which they could access the pension.[70] Most of those who retire early do so between age 60 and age 64 and the bulk of those retire voluntarily (far more so than retire because they can't find another job).[71]

While what people do with their own money should not be the concern of the government, a significant proportion of those who voluntarily retire early end up receiving the pension (only 20% of retirees are self-sufficient while at least 1/3 of retirees voluntarily leave the workforce before pension age). The government has forgone revenue to enable retirees to build up a superannuation nest egg in the hope of reducing pension expenditure, and that money is used to take early retirement, with the lesser balance supplemented by pension payments.

In fact, 2 of every 5 retirees — or 40% — have no superannuation at all by pension age, and half of those retirees who have exhausted their superannuation balances did so between preservation age (the age at which you can access your superannuation) and retirement age.[72] While it is not clear what proportion of this cohort voluntarily retired early, it is concerning that superannuation is lasting such a short period of time in retirement: only 17% of retirees aged 80 and over have any superannuation left at all.[73]

The decision to use superannuation to retire early has both generational and equity concerns. Retiring early is typically not an option for those under pension age without any wealth; consequently it's only those who are relatively well-off who have the choice to leave the workforce. These are people who may be able to support themselves for some or indeed all of their retirement. Regardless of whether you consider this to be 'fair', increasing the pension entitlements of the relatively well-off undoubtedly results in additional generational transfers.

This issue is potentially much more problematic than it first appears in light of two factors. First, running down your super balance by retiring early — especially given rapidly increasing life expectancy trends — is in effect shifting even more longevity risk onto the government (and by extension future generations). Those over the age of 50 already significantly underestimate their life expectancy (by up to 7 years for those aged 50-54 and 4.5 years between 60 and 64), which may lead to non-optimal decisions on when to retire and how much superannuation is needed.[74]

Second, as superannuation balances increase significantly due to maturation of the system, and the gap between the preservation age and the retirement age increases, many more retirees will have the option to retire early.

In 2012, the average superannuation balance on retirement was $197,000 for men and $105,000 for women.[75] Estimates vary as to the future value of superannuation balances. Industry Super Australia predicts that by 2030, average balances are projected to be $262,000 for women and $432,000 for men.[76] The Association of Superannuation Funds of Australia suggests that those earning $70,000 a year at the moment can expect to receive between $420,000 and $440,000 on retirement.[77] The Australian Institute of Superannuation Trustees estimated that a person on median wages (around $55,000 pa) would end up with a balance of $325,000, while those on $80,000 a year would have $550,000 in superannuation when they retire.[78]

At a minimum, we can expect superannuation balances to more than double, and possibly triple, in real terms over this time. We have no idea what the behavioural impact of these changes in wealth will be. People who have lived off moderate incomes their whole working lives will now have access to hundreds of thousands of dollars, backed up by a quasi-universal pension system providing a standard of living not dissimilar to that which those people experienced during their working lives. Those who cannot afford to retire early under the current, immature system are more likely to be able to do so in the future — and it seems likely they will.

To accumulate half a million dollars in superannuation today, a person would most likely have been receiving an income well over average earnings. The consumption and savings patterns of people in the top two income quintiles are different from those in the bottom three.[79] That makes the spending behaviour of those currently with balances around the predicted future averages a poor estimator of spending behaviour in the future. It is more likely that those with average balances in the future will behave much more like those with proportionally smaller balances now (who the Productivity Commission found are more likely to take their super in lump sums and consume it faster).[80]

This suggests that, even if we do not have a problem with leakages from the current superannuation system now, we are likely to have one in the near future and those leakages will place more pressure on the age pension.

The Productivity Commission found that increasing the superannuation preservation age to 65 would increase workforce participation by those aged 50 to 64 by 2 percentage points, and households that delayed retirement would spend 2 extra years in work and have around 10% more in superannuation.[81] They also found that $5 billion per year in additional taxes would be collected, and government spending would fall by $2 billion a year, with the biggest single impact being a reduction in pension spending.[82]

Having identified these trends and their causes, what will they mean for the sustainability of pension spending?

Sustainability for the future

Sustainability is a contestable concept. While the word itself simply means capable of being maintained, in connection with government budgets two interpretations are possible. Some prefer to compare spending across countries, suggesting a level of spending is sustainable if it is at or near the average for developed countries. In that context, it is argued that Australia's pension system is sustainable because other countries spend a much greater percentage of GDP on their pensions.[83]

However such an approach has several flaws. First, it assumes those foreign countries' pension systems are themselves sustainable. In many cases this may not be true; some countries have already begun to rein in pensions due to sustainability concerns, while others face significant future challenges.[84]

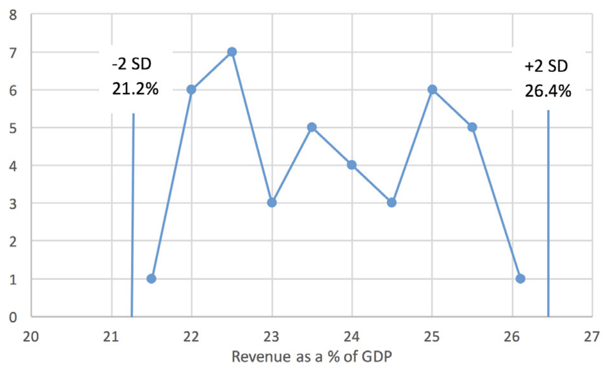
Secondly, and perhaps more importantly, if a level of spending would require an order of magnitude increase in taxation that the voters appear completely unwilling to accept, is it really sustainable?

For example, while the authors of a recent survey of attitudes to taxation noted that more than 50% of respondents would be willing to pay more tax for better health and aged care services, there are strong reasons to doubt this extends to a willingness to continue to fund a lopsided generational bargain.[85] First, the survey itself notes that just 3.4% of respondents felt that they paid too little tax, hardly indicating broad support for rises in taxes to maintain the status quo.[86] Second, politicians on all sides have been extremely reluctant to propose across the board changes to taxation, something that would be necessary to significantly shift the tax to GDP ratio.

Therefore the second, and perhaps more realistic, interpretation of sustainability is to compare levels of spending with medium to long term trends in taxation. This suggests that pension spending in Australia is only really sustainable if it can be funded within the existing taxation envelope.

Between 1974-75 and 2014-15, Commonwealth government revenue as a percentage of GDP has fluctuated within a relatively small window. The lowest value was in 2010 when revenue was 21.5% of GDP, while the highest was 26.1% in 1985. Over this period, revenue as a percentage of GDP averaged 23.8% (from 2005-06 to 2014-15 it was 23.4%). Two thirds of budgets delivered during this period were within 1 standard deviation of that mean and no budget was more than 2 standard deviations away from the mean. What this means is that no budget in the last 40 years has had revenue as a percentage of GDP 10% above or below the average.

Figure 25: Revenue as a percentage of GDP – budget frequency histogram



Source: Budget 2015/16[87]

During this time, there have been a number of attempts to substantially reform the tax system. When taken with the noted reluctance of Australians to pay more tax, the fact that none of these reforms have shifted the tax to GDP ratio outside these parameters suggests that a funding envelope of average tax to GDP plus or minus 10% (approximately 2.4% of GDP) is a relatively good marker for sustainability.

If at no point during the last 40 years could the budget fund a welfare project, it is not sustainable now, and it would only become so once it was demonstrated that the capacity existed to fundamentally change the tax system. The 2015 IGR predicted that increases in spending on health and pensions alone would amount to 3.6% of GDP, well outside this envelope.[88] This suggests the current system is not sustainable.

And it is on this basis that claims about sustainability based on other countries' examples must be rejected. Germany may have spent 3.4% of GDP more on pensions than Australia (excluding the cost of superannuation tax concessions, however calculated) in 2013, however the German tax to GDP ratio is 10.4% higher.[89] Sweden spent 4.2% of GDP more on pensions in 2013, but its tax to GDP ratio was 17% higher. [90]

Regardless of whether these countries' pension systems are sustainable within their own tax bases — which is questionable — neither of them would be sustainable with Australia's tax base.

However, capacity to pay (sustainability) is not the only relevant consideration here; willingness to pay must also be looked at.

While it is wrong to think of taxation as a direct payment for government services, someone is not entitled to more from government because they pay more in taxes. It is also wrong to assume that taxpayers will continue to contribute more and more of their income for services they don't benefit from. In other words, there may well be a point at which the generation bargain tips so much towards retirees that workers are no longer willing to pay, especially if they believe that a similarly generous pension system will not be available when those workers retire.

On that basis, the current trajectory of the pension is at least arguably unsustainable — and in addition, fairness between generations has become significantly skewed.

A generational bargain?

The popular conception of the pension has changed significantly over the years. The pension is a measure for poverty alleviation, and has been since it was first introduced. Yet the belief that the pension is a 'right' for working hard and paying taxes has become pervasive.[91]

This belief plays into the broader concept of a bargain between the generations, facilitated by the state. In this model, the pension is a return for paying for pensions for the previous generation and paying for education for the next generation.

Certainly welfare, which once had a stigma that strongly motivated people to make provision for their own retirement, has now become a normalised part of retirement for the overwhelming majority of seniors. This changing attitude to the pension has been driven by seniors but facilitated by politicians, and has caused significant cost increases.

While there are broader issues involved in the nature of the generational bargain than just cost, affordability is impossible to ignore. It is appropriate to ask what level of taxpayer funded retirement (both in terms of duration and standard of living) is fair and reasonable, but there are also fairness considerations when confiscating additional income through taxation to fund retirement.

Should the pension have a role beyond a poverty reduction measure in old age? For those without the luxury of owning a home and without substantial savings, the pension may seem like a meagre income, but it is quite generous for a retiree with both those advantages.

Over the decades, the taxpayers have been expected to fund many additional years retirement and to lift living standards for those in retirement. While successive governments have moved to ensure the pension doesn't fall below community expectations and that pensioners share in productivity gains among the workforce, massive increases in life expectancy that have far outstripped increases in retirement age have in fact led to significant, and increasing, transfers of income from those working to those in retirement.

We have transitioned from a system based on self-sufficiency and familial support to one where the primary method of supporting people in old age is a state based pension, with self-reliance expected of only a few.

That the primary justification for this increasingly unbalanced system is a misplaced sense of entitlement suggests we need reform of how the retirement system functions.

Realistically, changing attitudes to the pension and government support will be difficult. Retirement plans are put in place over decades and once set in motion, it is difficult (and potentially unfair) to arbitrarily change the rules. However some changes can be made that do not disadvantage existing retirees or those close to retirement. Other changes can be phased in over time to minimise their disruptiveness.

It is clear that, as a whole, the system is increasingly tilted towards retirees at the expense of workers. This is not an excuse to raise taxes on seniors or to evict them from their homes. What needs to happen is that the rules must tilt back towards self-reliance and the weight on the retirement 'pillars' must shift away from the pension and towards reliance on superannuation and major assets like the home.

Recommendations for reform

In The Age Old Problem of Old Age: Fixing the Pension, we outlined changes to the pension means test that would incorporate the main source of retirees' wealth (the family home), thereby reducing government pension expenditure and increasing pensioner income.

Recommendation: tighten the pension means tests by including the family home

Given the expectation of continuing increases in life expectancy, the pension cohort will only continue to grow and pension costs continue to increase if no change is made to pension eligibility age.

Recommendation: increase the retirement age

Since the introduction of the pension, life expectancy has increased by nearly 25 years for men and women, and life expectancy in retirement has increased by nearly 10 years, yet the pension age has increased by only 2 years for men and 7 years for women. While serious consideration should be given to reducing the amount of time the taxpayer is expected to fund retirement, at a minimum, future increases in life expectancy should be offset by increases in pension age.

Indexation of age pension age to life expectancy, while superficially attractive, would not provide sufficient certainty for those nearing retirement. Instead, the age pension eligibility age should increase by around 6 months every 4 years and be regularly reviewed to ensure it is in line with life expectancy. This increase mirrors the trend in life expectancy at age 65 and so should not result in the retirement age rising too high.

This reform will not be as effective without changes to superannuation eligibility. Others, notably Ken Henry in the Australia's Future Tax Review and Andrew Baker in Tax Welfare Churn and the Australian Welfare State, have called for the preservation age to be aligned with the retirement age (possibly with increased ability to access superannuation for involuntary retirement).[92]

Recommendation: increase the superannuation preservation age

As a consequence of the increasing ability and propensity to retire early on superannuation, the effectiveness of moves to increase the retirement age will be limited without increasing the superannuation preservation age. Therefore the superannuation preservation age should continue to rise in line with the age pension eligibility age. The gap between them should be no more than 5 years and preferably it should be much closer.

An alternative solution to prohibiting access to superannuation before age pension age would be to require people accessing superannuation to use a specified percentage or amount of their balance to purchase an annuity (which would commence payment only at age pension age). This would both quarantine the bulk of superannuation to be used to reduce pension costs, and limit restrictions on the use of people's money.

Recommendation: investigate restrictions on pre-retirement withdrawals

The government should investigate whether requiring people accessing superannuation before age pension eligibility age to purchase a deferred annuity would have a greater impact on workforce participation for older workers than aligning the superannuation preservation age and age pension age.

While these measures will treat the symptoms of the problem of sustainability of the retirement system, it won't impact the incentives already in the system. To do that will require more substantial reform, particularly of superannuation, to encourage people to be self-sufficient in retirement rather than rely on the taxpayer. At the moment, the expectation is that the pension is the default means of support in retirement. This needs to change.

Recommendation: consider more substantial superannuation reforms

Superannuation is not reducing age pension expenditure and is not substantially increasing the number of people who are self-reliant in retirement. Much consideration has been given to the fairness of superannuation tax concessions, but little thought has been given to their effectiveness.

As balances increase and behaviour changes, the effectiveness of the superannuation system will become more and more important. A substantial review of how superannuation is functioning is needed. The review should focus on ways to reduce the burden of taxation and boost balances without increasing the superannuation guarantee rate and lowering real wages.

Conclusion

Since the introduction of the pension in 1908, we have seen marked growth in its cost and a steady increase in the pension cohort. The percentage of the population of retirement age has risen from less than 2% in 1911 to almost 11% in 2011 and the percentage of people of retirement age receiving the pension has increased from around 30% in 1911 to 75% in 2011

In part this has been driven by increasing life expectancy, which has impacted costs in two ways. First, in the period from 1908 to the 1970s there was a substantial increase in life expectancy at birth, particularly for men, which means a lot more people reached retirement age and were able to access a state pension. The second impact of rising life expectancy has been the increase in life expectancy at age 65, which has occurred over the last 40+ years. This has meant the average time spent in retirement has increased, leading to a larger pension cohort who receive much higher lifetime transfers.

In addition, the full rate of the pension has grown significantly in real terms over the years, from $3,000 a year in 1911 to $20,000 (in 2012 dollars). This growth has been much faster than wages, with pension costs as a percentage of wages at the highest level ever and having nearly doubled over the past 40 years.

While this increase in cohort and payment rates has occurred, the means test has become much more generous. At the introduction of the pension, the upper limit of the assets test was just under 12 times the full rate of the pension. Today that ratio has blown out to nearly 35 times the full rate (despite the massive increase in the full rate of the pension over that time)

While these figures are concerning, this imbalance is projected to get worse in the future, with pension costs increasing against wages by another 50% despite the maturation of the superannuation system. The ageing of the population may also have a considerable political impact, which has not been factored into government projections on pension spending — which may mean these projections are an under-estimate, as older voters are more likely to resist changes to pension entitlements.

While there are several causes, it is clear that the effect of this growth in income transferred from those of working age to retirees is to make the bargain between the generations unbalanced. Each successive generation is asking more of the next generation than they were willing to contribute to past generations.

Reform across the retirement income system is necessary to restore balance.

The pension means tests should be tightened by implementing the reforms set out in the CIS report The Age Old Problem of Old Age: Fixing the Pension, specifically the 3 interlocking reforms to incorporate the family home in the pension means test.

The retirement age should be increased by around 6 months every 4 years and be regularly reviewed to ensure that it is in line with life expectancy, and the superannuation preservation age should be increased along with it. At a minimum there should be no more than a 5 year gap between the two — and preferably much less.

Reform of superannuation is also necessary. Initially the government should consider whether restrictions on withdrawal of superannuation, especially early withdrawal, could increase incentives for older workers to remain in the workforce. However, a bigger discussion on superannuation reform is needed, moving beyond consideration of additional revenue available from superannuation tax concessions to ways to improve the effectiveness of those concessions at increasing the number of people who are self-reliant in retirement.

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