RESEARCH REPORT
SNAPSHOT

The myths of the generational bargain

Simon Cowan

Since its introduction in 1908, the cost and reach of the pension system has steadily expanded.

The percentage of the population of retirement age has risen from less than 2% in 1911 to almost 11% in 2011, while 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 assets was just under 12 times the full rate of the pension in 1911, whereas today the single homeowner assets test cut-off is nearly 35 times the full rate (despite the massive increase in the full rate of the pension over that time).

Increasing life expectancy has also impacted on costs:

- 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

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.

Pension costs are projected to increase another 50% against wages by 2055.

To restore balance, the government needs to reform several aspects of the retirement income system:

- 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
- 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.
- Investigate restrictions on withdrawal of superannuation, especially early withdrawal, to increase incentives for workforce participation for older workers
- 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

Causes of increase in total pension spending

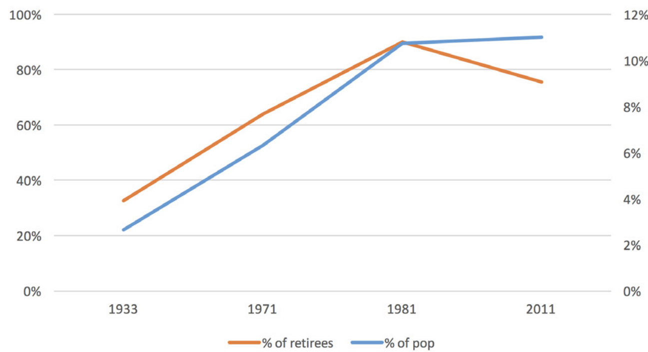
When examining data on government welfare expenditure, life expectancy and the proportion of the population receiving the pension, four distinct time periods can be observed: pre-World War 2, the baby boom era and beyond, the universal pension years and the modern era.

Over time pension costs have substantially increased, driven by a number of factors

The proportion of the population receiving the pension has significantly increased

The percentage of the population over the age of 65 has steadily risen since the pension was introduced, and 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



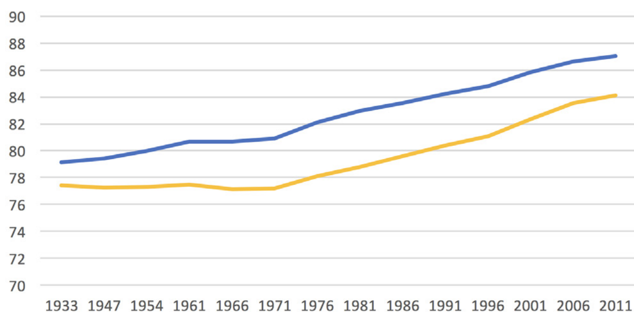
Sources: ABS Commonwealth Year Books 1934, 1972, 1982 and 2012

Life Expectancy gains have increased retiree numbers

Between 1880 and 1971 life expectancy at birth increased by more than 2 decades, rising 1 year every 4 years on average. However until 1971 life expectancy at age 65 barely increased.

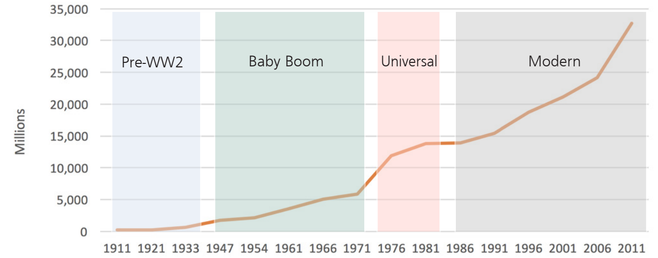
Since then both life expectancy at birth and life expectancy at 65 have increased, meaning more people living longer in retirement.

Figure 21: Life expectancy



Sources: ABS cat 3105 Australian Historical Population Statistics

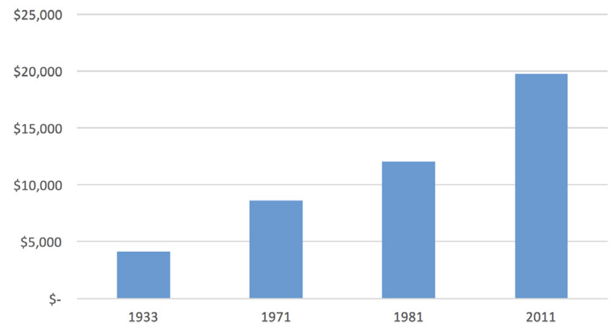
Total pension spending ($2012)



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 continually increase. Attempts to limit increases in the pension to CPI have been strongly resisted.

Figure 14: Real annual value of the pension

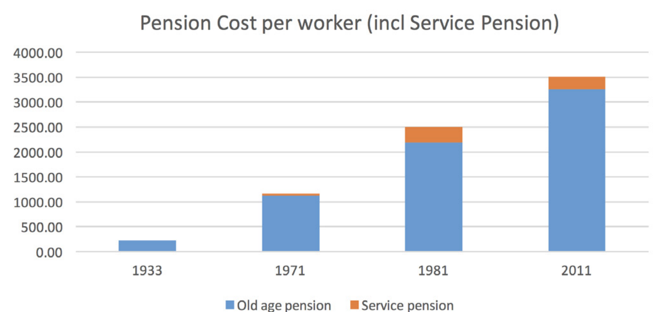


Sources: ABS Commonwealth Year Books 1934, 1972, 1982 and 2012[42]

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)

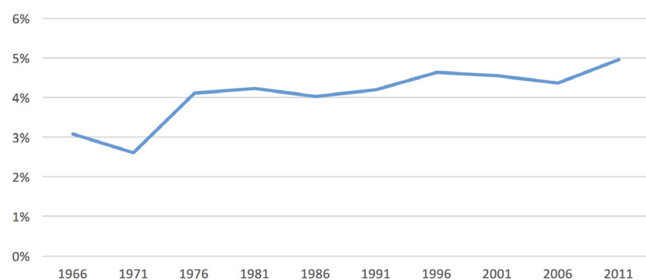


Sources: ABS Commonwealth Year Books 1934, 1972, 1982 and 2012

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

Over time the percentage of wages dedicated to paying for the pension has substantially increased, suggesting that each generation is demanding a greater share of national wealth in retirement than they were willing to contribute while working.

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

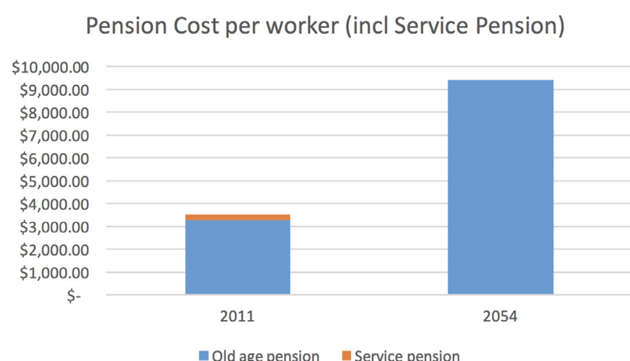


Sources: Author's calculations from ABS cat 6302 Average Weekly Earnings, Australia and Commonwealth Year Books 1972, 1977, 1982, 1988, 1992, 1997, 2002, 2007 and 2012[46]

Projections of future spending

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]

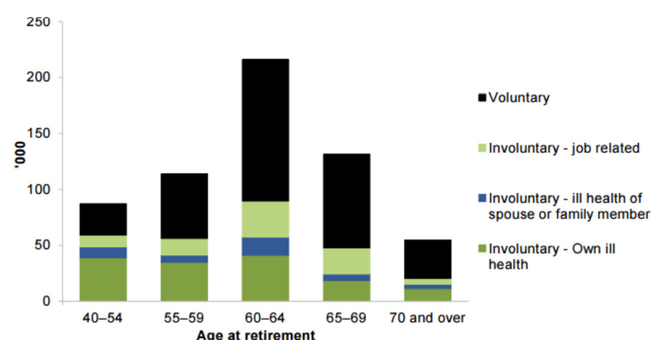
This presents two problems. First, there is a concern that the increases in cost due to ageing, particularly in health and pensions are unsusatinable with the current tax base.

Second, as the generational bargain becomes more imbalanced, there is an increasing chance that it will exceed the taxpayers willingness to pay.

Savings, superannuation and early retirement

Compulsory superannuation has also given retirees additional capacity and tax advantages to encourage greater savings, but it too has largely failed to increase the number of retirees who are self-sufficient, or reduce pension expenditure. Instead, some retirees have also taken advantage of rules that allow access to superannuation well before pension eligibility to retire early.

Figure 24: Age of retirement



Source: Productivity Commission[69]

More than half of all retirees leave the workforce before the age at which they could access the pension. 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).

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 (40%) have no superannuation at all by pension age, and half of those retirees have exhausted their superannuation balances between preservation age (the age at which you can access your superannuation) and retirement age. Only 17% of retirees aged 80 and over have any superannuation left at all.

Further, as superannuation balances significantly increase 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.

How will people who have lived their whole lives on moderate incomes while working behave when faced with several hundred thousand dollars in superannuation backed up by access to a quasi-universal pension? Especially if that pension offers a standard of living similar to what they had while working? How will they wield their increasing poitical power, in their own interest or in that of future generations?

Recommendations for reform

Means test family home

To reduce pension expenditure and increase pensioner income the pension means test needs to incorporate the main source of retirees' wealth (the family home).

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

Retirement age

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

Recommendation: increase the retirement age

The age pension eligibility age should increase by around 6 months every 4 years and be regularly reviewed to ensure that it is in line with life expectancy.

Superannuation eligibility age

This reform will not be as effective without changes to superannuation eligibility.

Recommendation: increase the superannuation preservation age

The superannuation preservation age should continue to rise in line with the age pension eligibility age. It should be no more than 5 years before pension age and preferably much closer.

Pre-retirement withdrawals

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 only commence payment at age pension age).

Recommendation: investigate restrictions on pre-retirement withdrawals

The government should also 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.

Superannuation reform

While these measures will treat the symptoms of the problem of sustainability of the retirement system, they won't impact on the incentives already in the system. To do that will require more substantial reform, particular of superannuation to encourage people to be self-sufficient in retirement rather than rely on the taxpayer.

Recommendation: consider more substantial superannuation reforms

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.

Author

Simon Cowan is a Research Fellow in the economics program, and Director of the CIS TARGET30 program that aims to reduce government spending to less than 30% of GDP over the next 10 years. He is a leading media commentator on policy and politics, frequently appearing on the Sky network, ABC television and commercial radio. He has also written on government industry policy, defence and regulation and appeared before the Australian Senate discussing the budget and health policy.

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