A GUARANTEED MINIMUM PENSION

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Abstract

A guaranteed minimum pension has been adopted in several countries, and advocated by a number of economists, as a means of dealing with the tricky issue of how to integrate a private pension system with a minimum income guaranteed by governments. In the country the means test is the instrument for this integration. In the GMP proposal, the age pension would become an explicit top-up for those whose private pensions were insufficient to guarantee an adequate retirement income.

In the ‘classical’ form of the GMP, several changes would be involved. First, benefits from the compulsory superannuation tier would have to be taken in income (life annuity) form. Second, the pension means test might be tightened. Third, the new means test would be restricted in its application to income from the compulsory superannuation tier.

The concept of a lifetime income test underlying the GMP proposal appears to have considerable merit as opposed to the current annual basis for the pensions means test. The GMP, once the SG system is fully phased in and has been operating for some time, confines redistributions to the lifetime poor and avoids giving assistance to the lifetime rich virtually irrespective of their savings/investment, consumption and tax planning decisions. However there are a number of tricky issues which would need to be resolved in moving to a GMP.

The GMP, in its ‘classic’ form, would work best in a context where there was a substantial compulsory superannuation tier quite separate to any top-up superannuation schemes, and where all benefits from the SG tier were paid as indexed life annuities. Benefits from this tier would become the sole basis for assessing GMP entitlements.

Where there is a mixed system such as Australia’s, and many superannuants have entitlements derived from a mixture of SG and additional contributions, the conceptual basis of the GMP becomes watered down. A compromise proposal is to base it on the whole of the superannuation payout.

A further problem is that if annuity take-up is not compulsory, the GMP payment might, over time, not prove adequate for those who through poor planning or bad luck dissipate their superannuation lump sums. On the other hand compelling annuity take-up raises a number of difficult issues.

Because of these problems, in this country the GMP is probably most interesting in the “purchased pension” form, which is itself a form of the “minimum necessary annuity” proposal. In this, a specific part of the total superannuation payout would be given up in payment for receipt of a full pension. Appropriately modified, this “purchased pension” system might have the potential to entirely supplant the current system of superannuation taxation and means testing.
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1 A GUARANTEED MINIMUM PENSION (GMP) AS AN ALTERNATIVE TO
THE PENSIONS MEANS TEST

1.1 Introduction and summary

The proposal for a GMP has been around for some time in the UK pensions debate. It also
underpins the Chilean retirement income system and the new Swedish system.

The proposal reflects the difficulties of integrating privatised pension provision with some
form of state guaranteed minimum for those unable to save an adequate amount during their
working lives. In Australia this problem is addressed through the pension means test, but this
test has effects on incentives to work and save which might – at least in theory - be resolved
more effectively through some form of GMP.

The World Bank has endorsed the concept: “A variant of the means-tested scheme, a
minimum pension guarantee, may be the best option for the public pillar in countries that
already have a mandatory saving scheme to which the guarantee can be added” (1994 p17).

In 1998 I wrote:

“This option would involve converting the compulsory tier of occupational
superannuation and the age pension itself into a form of “social insurance” system.
The age pension would become an explicit top-up for those whose occupational
pensions were insufficient to guarantee an adequate retirement income, in the same
manner as many social insurance schemes depart from strict earnings-related
formulae in order to redistribute to the poorest within the scheme.

Several changes would be involved. First, benefits from the compulsory
superannuation tier would have to be taken in income (life annuity) form (there could
also be survivors benefits, if desired). Second, the pension means test would be
tightened…Third, the new means test would be restricted in its application to income
from the compulsory superannuation tier.

In effect the SG [superannuation guarantee] tier would become a form of national
superannuation, with general revenue supplementation for those with low
accumulated contributions. Such a scheme would have many similarities with the
[national superannuation] scheme recommended by the Hancock Committee in 1974,
except that it would be (a) substantially privatised and (b) substantially funded (rather
than the pay-as-you-go scheme recommended by Hancock). (Ingles 1998 p44)

Chart 1 describes a possible system, on the assumption that the GMP taper, like the new
pension taper, is 40%.
In this paper I consider problems with the GMP proposal and options to deal with them. One possibility is to extend the recommended system to all superannuation benefits, not just the SG tier. This is because of the practical difficulties in distinguishing SG from other superannuation benefits.

Further, because compulsory annuitization involves some difficult issues (see section 1.4.3), a possible option is to require annuitisation of lump sums only to the extent necessary to replace the GMP. The government would be the annuity provider and, like the age pension itself, it would be indexed to Male Total Average Weekly Earnings (MTAWE). I call this the “minimum necessary annuity” proposal.

With these modifications, the proposal develops into a way of forcing people to “buy” their age pension. However, for most people the purchase is on extremely favourable terms, with the purchase price being a fraction (illustratively, 40%) of their retirement lump sum. Another term for this system is the “purchased pension”.

A simple proportional GMP taper (tax) rate avoids problems relating to the definition of the income unit, shifting of assets between spouses, divorce and the like. A sub-option is that the 40% tax apply beyond a threshold, thus providing a concession akin to the means test ‘free area’. However - for reasons I will explain later - this loses some of the attractive simplicity of the proportional tax option, as well as increasing the cost.

For the minority whose lump sums provide in excess of the “fair” purchase price ($365,000, if single, and $581,500 for a couple), the 40% end-benefits tax might nonetheless apply to the full lump sum, in order to keep the overall retirement system progressive. One interesting possibility is that the GMP implicit taper could be used to offset the tax subsidy for retirement savings which Australia still retains. Another is that the GMP “tax” could entirely replace the existing complicated superannuation tax regime – see Section 1.4.5.

The objective should be to achieve a pattern of real returns to retirement savings which was progressive by income class. This progressivity is achieved in this proposal not by the GMP tax rate itself, which is linear, but by the combination of the linear tax and the basic guarantee provided by the age pension. In effect the retirement income system would become a form of guaranteed minimum income for the aged, but the tax base would be cash flows from retirement savings, not ‘income’ as conventionally defined.

 Appropriately modified, this “purchased pension” system might have the potential to entirely supplant the current complicated system of superannuation taxation and means testing.

1.2 Savings incentives and disincentives in the current retirement income system

The age pension means test is at the centre of many criticisms of the retirement income system. It should be said in its defence that it saves over $5 billion pa (but less, net of potential tax clawback), and that these savings will rise substantially as the private superannuation system matures. Also, it helps improve horizontal equity as between the aged and low-income workers. That said, it can impose considerable costs in terms of its behavioural effects, and its impact on retirement savings incentives appears to be the opposite to that which superannuation tax concessions are meant to achieve.

Ross (1997), in a thoughtful article, has pointed to a number of adverse behavioural consequences of the current superannuation system and its interaction with the age pension means test. He concludes that “Fundamentally, we have:

- Two complex systems (age pension/social security and superannuation) which have conflicting effects - the means test ... discourages saving for retirement, while the superannuation system is designed to encourage it.
- A compulsory superannuation system ... which encourages the use of lump sums before entitlement arises to the means-tested age pension.” (1997 p9).

The Institute of Actuaries (IAA) make the same argument: “At present there is a basic conflict between the two pillars of the system. The superannuation system is designed to encourage saving for retirement. In contrast, saving is discouraged by the age pension system.” (1998 p1). The GMP 50% “purchased pension” might appear, on the surface, to be one means of resolving such problems.

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1 On the assumption that an indexed annuity of $7,000 pa would cost around $100,000.
2 Albeit to a lesser extent than many other countries employing a pure EET (Exempt contributions, Exempt fund income, Tax end-benefits) regime
3 But note that a proportional cash-flow tax has been likened to an ideal lifetime income tax (ref).
1.3 Relationship to similar systems/proposals

1.3.1 Chilean system
For workers who have contributed to the mandatory saving plan for at least twenty years, the state guarantees a minimum pension of about 22-25% of the average wage. This presumably indicates a 100% implicit tax rate on annuities (or their equivalent lump sums) below the minimum, with no free area. (There is also social assistance providing a bare subsistence, and a government profitability guarantee for pension funds, relative to the average earned in all funds.) "Simulations indicate that these guarantees will cost less than 1% of GDP" (World Bank 1994, p239).

This compares with a current cost for the Australian age pension system of just under 3% of GDP, rising to 4.5% by 2050. However it should not be assumed that a GMP would create expenditure savings in this country. Although a GMP could be designed to have a very tough implicit means test, the result would be to disappoint the legitimate expectations of many people and, possible, to discourage retirement savings in general. Hence it is assumed in this paper that any new system would be designed to have a roughly similar cost, and incidence, to the current one.

1.3.2 Swedish GMP
The Swedish pension system is in the process of being transformed from a traditional "social insurance" scheme to a Notional Defined Contribution (NDC) plan - that is, a DC plan financed mainly on a pay-as-you go basis. In addition there is a second tier of funded benefits in private accounts. The total contribution rate is 18.5%, levied equally on employers and employees; 16% is contributed to the notional account and 2.5% to an individual account managed by centrally contracted private funds. On retirement the accumulated total is converted to an income pension in the form of a CPI-indexed annuity provided by the Government.\(^4\) The income pension is available from age 61.

For individuals with no or low pensions\(^5\), the system will provide a guarantee pension. The guarantee pension will be means tested against the income pension, and only payable from age 65. Guarantee pensions will be funded from general revenue.

At low levels of income pensions - up to 20% of the average wage - the guarantee pension is fully offset: the implicit taper is 100%. Between 20 and 45% of the average wage the implicit taper is around half\(^6\) (Chart 2). Because the guarantee pension and associated taper is quite generous, it is estimated that some 40% of retirees will collect at least some of the guarantee benefit.

\[\text{\^4 Annuity costs are the same for men and women. Conversion rates are based on life expectancy tables and a real interest rate of 1.6%, the expected real growth rate of the Swedish economy.}\]

\[\text{\^5 Note that individuals will earn pension rights from transfers such as unemployment and disability insurance, as well as years spent in the military and at home caring for young children.}\]

\[\text{\^6 I calculate it as 48%, but do not have a reference for this.}\]

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Chart 2: Offset between income pension and guarantee pension, Sweden

The units in Chart 2 are 'base amounts' which are a reference unit used in the Swedish welfare system. One base unit equates to about 16% of the average wage.

Sunden notes: "... the design of the guarantee pension distorts the link between contributions and benefits under the NDC. For individuals with very low income, contributions are a pure tax since the basic guarantee is paid out irrespective of work effort. For individuals receiving part of their benefit [from the guarantee], an increase in work effort will not increase the benefit one-for-one" (2000, p11). In the phase-in range their contributions are about 50% tax, and 50% individual 'savings'. However this is not meant as a criticism of the scheme but merely reflects the fact that any guarantee pension will reduce the marginal return to contributions over some income ranges.

1.3.3 Atkinson (1995)

A B Atkinson is a noted UK academic (as are the other authors cited below). He notes that the proposal for a Minimum Pension Guarantee grows out of proposals for tax/benefit integration. "In its simplest form, the MPG would bring the total state pension, plus any occupational or personal pension, up to a minimum specified level... The MPG would differ from means testing in two important respects: (i) it would be calculated on an individual basis, and (ii) the calculation would not involve other elements of income, or capital assets." (1995 p320) The calculation would be made at the date of retirement, so that commutation of a pension to a lump sum, for example, would not provide an avoidance device.
Two objections to the MPG are that, on the one hand, it would be paid to people with sizeable savings... and on the other that it would discourage people from making their own pension provision... The first of these assumes that the sole purpose of pension provision is the abolition of poverty, whereas I have earlier stressed a wider view of pension objectives... The force of the second objection is mitigated by [compulsion]." Further, on the incentive issue: "It would also be possible for the guarantee to be provided, with the rate of withdrawal less than the 100% which is implied by the MPG formula" (Atkinson 1995 p320-321).

Atkinson’s calculation shows a fairly hefty cost for the proposal, although that in part due to the adoption of an independent basis (each partner in a couple to get the full guarantee rate) and in part to the big increase in basic rates proposed. If the guarantee were to apply to the joint pension income of the couple, the cost approximately halves (p321). Also, the cost will fall as private pension entitlements increase.

1.3.4 Falkingham and Johnson (1995)

Falkingham and Johnson (1995) have a somewhat similar proposal called a Unified Funded Pension Scheme (UFPS) "...which is designed to combine earning-related funded pensions with tax-financed minimum pension provision in a single, simple system. The scheme... targets tax-financed assistance to the lifetime poor without use of a traditional means test and gives pensioners complete control of their pension assets" (p204). This system is designed to ensure that "intergenerational, intrapersonal and interpersonal transfers are all separately identified and independently resourced" (p208).

"The scheme is based on the principle of every individual building up a personal retirement fund (PRF) over her adult life which is used to purchase a pension annuity". This is to be combined with a system of annual tax-financed capital transfers to people with low incomes or not in the labour market. The PRF is a "long-term savings account designed to facilitate intrapersonal income transfers over the lifetime cycle. These PRFs would be managed by competing retirement trust funds... An individual in receipt of average age-specific income across the earning life-span would have accumulated by some age (say 65) a PRF sufficient to purchase an index-linked annuity equal to some fixed amount (say 50 per cent) of average earnings. (F&J 1995 p208).

In any year in which an individual’s contribution into the PRF is insufficient to maintain the required path of capital growth, a capital transfer will be made into the account sufficient to achieve a minimum replacement rate of 33% of average male earnings. Capital top-ups will be clawed back if subsequent capital accumulation proves to be high, in order to prevent undue transfers to the lifetime wealthy. Retirement could be at any age, but if prior to age 65 would be subject to a test of adequacy of the annuity purchasable from the capital account. F&J note that "The system prevents undue transfers to the lifetime wealthy, but... without imposing the labour-market disincentives common in most systems of means-testing... the means test and claw-back occur entirely within the PRF account, and do not affect take-home pay. The means test here is on income across the entire working life, resulting in more effective targeting..." (p211). Their costing indicates that the scheme would result in a net saving to the treasury (p215). This may reflect the implicit 100% tax rate and absence of any free area.

My main comment on this scheme is that the system of annual subsidies and clawbacks appears clumsy. Why not simply do all the topping up in one hit when the individual reaches pensionable age, as with the Atkinson proposal? The rationale for this appears to be the desire to make the system fully funded. Since topping up at the time of retirement leaves the end result for the individual the same, it seems unlikely that the funding gain would be worth the administrative and other costs.

Another comment is that the 100% implicit tax rate makes some superannuation savings – those yielding below the guarantee amount - akin to a tax. I discuss this issues later.

Finally, the scheme fails to provide for the marginalised, drifters, substance abusers etc who are unlikely to enter into a complicated system of record keeping such as that envisaged. A safety net to provide for their old age would still be necessary.

1.3.5 Field and Owen (1993)

This proposal provides for compulsory superannuation contributions totalling 8% of salary (5 from employers, 3% from employees) and includes a Guaranteed Minimum Pension (GMP) which would be paid in full up to an income almost equivalent to average full-time earnings (p10). Beyond this level a high marginal effective tax rate of up to 60% would apply. With the introduction of compulsory, tax reliefs for pensions would be abolished, helping to finance the scheme (p11).

In the Australian context this would translate into a very large free area of over $600 pw, before the 60% tax cut in. This could prove quite expensive, although it could conceivably be financed in the manner proposed by Field and Owen; ie abolition of the remaining tax reliefs on superannuation savings.8

1.4 A GMP in Australia?

1.4.1 Impact on incentives to save

In my 1998 proposal I argued that, by confining supplementation to the compulsory superannuation tier, issues of adverse savings incentives are side-stepped. This argument is a consistent and powerful theme running through the literature on this issue. The argument has less validity if supplementation affects all superannuation entitlements, not just the compulsory SG tier. However there may be good reasons for adopting this wider base, as discussed in Section 1.4.5. These centre on the difficulty in distinguishing SG from non-SG superannuation savings.

Using 100% implicit tax rates, as in the ‘classical’ GMP proposal, may not be attractive. If extra contributions provide no marginal benefit to the individual, then compulsory SG contributions by low-wage earners become akin to a tax, and issues of deadweight loss arise. Such contributions simply become part of the total tax “wedge”. Reducing the implicit taper below 100% - eg to the 40% used in the illustrative proposal - increases the gains from

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1 Compulsion is achieved in the UK system by the requirement that one can drop out of the state earnings-related pension scheme (SERPS) only if one takes up an occupational or personal pension having at least equal value.

2 There is also to be investment insurance to spread portfolio risk across people.

8 It must be said that costing superannuation tax concessions is a very contentious one, with little academic agreement about what – taking into account possible behavioural changes - the figure should actually be.
additional contributions, but extends the range of individuals subject to a wedge and also increases the total cost.

Once an individual’s total saving exceed the threshold at which no GMP is payable, the incentive to save is then fully restored at the margin. In fact the loss of GMP becomes a sort of lump sum tax, and no net economic distortion arises for this richer segment of the population. Hence the choice of a taper less than 100% involves a trade-off. It increases the marginal return from the superannuation savings of poorer individuals, but extends the range of individuals subject to lower marginal returns.

This parallels the trade-offs involved in designing any means test. In general terms, once an individual is beyond the reach of the taper, there is no disincentive to save. However it must be said that around 85% of the population of pensionable age do receive some means-tested payment, and even after full implementation of the SG system this proportion will not decline much below 75-80%. Rather, on Treasury projections, an increasing proportion of pensioners will receive part, not full pension. Hence, disincentives inherent in the current means test will continue to be an issue, perhaps more of an issue than they are now.

1.4.2 The distributional effect

The distributional impact could be designed to be very similar to the current system. If, at age 65, it costs $1,000 to purchase an indexed annuity of $70 pa, it can be shown that the single free area of $53 pw\(^{10}\) ($2,756 pa) is equivalent to a lump sum of almost $40,000.

Those with this, or a lesser, lump sum entitlement would receive the full GMP. Those with a lump sums exceeding this would receive a pension according to the formula

\[
Pension \text{ paid} = \text{Maximum Pension} - (LS - 40,000)^*T*A
\]

where T is the rate of taper (to become .4 in July), and A is the annuity conversion rate (assumed to be 0.7). Their combined factor is .028; on this math, the cutout lump sum for a single person to receive any GMP is $40,000 + (10.234/.028) = $405,500. If the free area were abandoned, this would be $365,500. Currently, the asset test cuts out any entitlement at $252,000 (homeowners) and $343,000 (non-homeowners).

For couples the corresponding cut-outs are $650,500 ($581,500 if no free area), compared with current asset cut-outs of $387,500 and $479,000 (non-homeowners).

One obvious issue is that the proposal ceases to discriminate between homeowners and non-homeowners. One solution would be to provide a free area only for non-homeowners; another is to accept the Rent Assistance scheme as the solution to this horizontal inequity. It must be said that the existing degree of discrimination is in fact rather small, given the relatively small percentage of pensioners affected by the asset test.

In the UK context Atkinson’s MPG scheme has a very pro-poor slant. The lion’s share of the gains go to pensioners in the two lowest decades of pension income, “...the MPG would therefore go along way to redressing the rise in inequality among the elderly in the past decade” (1995 p323). It is not clear whether the impact would be similar in Australia, however, since the proposal above largely replaces the pre-existing age pension – which is already highly redistributive. It also has the effect of extending the asset limits, although there are relatively few pensioners affected by the asset test currently – less than 5%.

10 Retirement Income Modelling Unit – RIMU.
11 All figures are estimates for July 2000.

1.4.3 Cost implications

The cost implications are ambiguous. A smaller range of assets – only superannuation benefits – would subject to implicit means testing under this scheme. However there would be offsetting savings, in that lump sums would be fully assessed – that is, there would be no scope for ‘double dipping’. There are also possible cost implications in the area of superannuation taxation. The net impact on revenue is unclear without doing a full costing – an exercise beyond the current scope of this paper. However the main point is that it should be possible, by juggling the GMP parameters, to achieve a cost outcome very close to neutral.

In order to achieve cost neutrality, it might be necessary to steepen the taper somewhat and/or reduce the free area. However, recall that the steeper the taper rate the less the marginal gain from the contributions of low and middle income earners. The higher the taper, the more superannuation contributions will be perceived as a tax. An alternative approach would be to abolish the equivalents of the free areas, and have a single, lower taper. I have argued for this approach elsewhere (Ingles 1999).

However, reducing or abolishing the GMP free area can - in the absence of other changes to superannuation taxation - create difficulties for incentives to make superannuation savings. Savers with low annual incomes (under $20,000) may gain little net advantage from superannuation saving (compared, that is, to other forms of saving). The contributions tax of 15% will almost offset the tax saving of 17% on the July 2000 income tax rate for those earnings under $20,000, and the same is true for the fund earnings tax. In fact the GMP free area would need to be in excess of roughly $1.5,000 if a low wage earner with a 40 year contribution history were not to be disadvantaged (this is, relative to the outcome under a fully comprehensive income tax only) in this way. This argument is mitigated by the possibility that those with such low incomes would not contribute beyond the SG minima.

1.4.4 Impact on the fairness of the means test

The argument about the beneficial effect on incentives to save depends upon the GMP being tested only against compulsory (SG) savings. However some would not see the fairness of, in effect, confining means testing to SG savings, as in the ‘classical’ GMP proposals above.

One response to this is that the means test would cease to penalise those who have saved, compared to those who had similar incomes over their working lives but have not done so. Those with similar lifetime (wage) incomes would have paid similar compulsory superannuation, and would therefore receive a similar level of top-up. However this argument has limited force at the moment; it will have greater validity once the SG is fully phased in and had been operating for some time.

People acquire wealth through a broad variety of ways – shares and other investment, small business, etc, and superannuation wealth may not comprise the bulk of total retirement wealth, particularly now while the SG system is relatively new. But the implication is that, in Australia, the GMP proposal will become increasingly interesting over the next 40 years. Since major changes to superannuation invariably take a very long time to phase in, this means it might be useful to start thinking about a possible system now, so that it can be progressively introduced over a long time period.

Even if the SG system were fully phased in, the limitation to lifetime wage earnings (plus of course their accumulated capital growth and re-invested earnings) is an issue. One way around this might be to extend compulsory superannuation savings to income from all...
sources, but this would also raise a number of difficult issues (eg the concessional treatment of capital gains arising from the Ralph reforms).

The argument is further complicated by the proposal to include all superannuation savings, not just the guarantee component (which becomes 8% as of July 2000). In this option the equity of the proposal depends to a considerable extent upon the presumed tax benefits accruing to such savings. This is a point of some considerable academic debate. Further, tax benefits accrue to many forms of saving outside of superannuation, notably the owner-occupied house, which receives a tax treatment similar to an expenditure tax.

However it must be borne in mind that we are seeking rough justice, not perfection. It is interesting to note that analysts of the equity of the Australian retirement income system such as Knox et al (1997) have often adopted lifetime earnings as the benchmark for assessing the net distributional impact of taxes and benefits. These authors note that “the relationship between lifetime earnings and net retirement income is not progressive in some cases, and in other circumstances is actually regressive. The major cause of this problem is the very high effective marginal tax rates faced by many retirees…” (p13). The GMP does at least address this issue, particularly if it is used as an avenue to simplify the tax treatment of superannuation: on which, more below.

1.4.5 The requirement to take up an annuity

Such a requirement is involved in all the ‘classical’ GMP proposals described above. However it is not essential to the proposal. There would be considerable resistance in Australia to compulsory annuitisation of superannuation lump sums. This resistance is not wholly irrational; retirees often take advantage of lump sums to pay off housing or consumer debt, and also the purchase price of annuities is not always favourable 11. The implicit real interest rate can be as low as 1–2%. Also, products like allocated pensions can take advantage of superior returns on an underlying investment in risky but high-yielding assets like equities.

An alternative approach would be for the government to calculate a notional annuity and pay an appropriate GMP top-up, but allow the retirement lump sum to be invested in any manner the retiree wishes. Knox (1998) has proposed a somewhat similar system for implementing a “once for all” pension means test: his proposal does not place any restrictions on the investment of the lump sum. The risk with this approach is that some customers could nonetheless dissipate their assets and end up with a sub-poverty line income.

Another alternative is for a “minimum necessary annuity” approach, whereby the retiree is required to purchase an annuity only up to the level of the age pension. A variant of this is the purchased pension, whereby the retiree is asked to make a lump sum payment at age 65 reflective of the discounted value of the age pension itself. If their lump sum is insufficient, they are allowed to “buy” the pension at a discount. In effect their pension comprises 2 parts; the annuity which the retiree is required to purchase from the government12, and any top-up required to bring this up to the full pension rate. This is the model I further consider in this paper. However I make the further proposal that, even beyond the break-even level where the pension is fully paid, the GMP “tax” continue to apply at the relevant proportional rate.

Both the “purchased pension” and “minimum necessary annuity” approach ensure that people will continue to receive an income right through their retirement at a rate deemed adequate by government (as embodied in the basic pension rate), while having freedom to dispose of the remainder of their lump sums in any way they wish – without this having cost implications for government.

1.4.6 The income unit

It seems inevitable that, for cost reasons, the income unit would continue to be the couple rather than the individual 14. This means that the GMP (in its classical form) would need to be assessed against the combined assets of the couple at the time of application. If one of the couple were below pensionable age, a discount factor would apply to his or her GMP along the lines of the early retirement formula discussed above. If one or both of the couple were in a DC scheme this could become horribly complicated.

Difficult issues also arise in relation to couples splitting up or in formation. The once-for-all nature of the GMP means test (depending on the option adopted) in effect assumes that whatever relationship exists at the time of assessment will continue to exist. There would also need to be some sort of formula to deal with the situation when one of the partners dies.

These problems are overcome by the “purchased pension” proposal, whereby a retiree simply hands over a specified proportion of his retirement benefit in return for a free-of-means-test pension, and this pension is paid at the single or married rate depending on the circumstances of the retiree at the time. If however the purchased pension involves other than a linear rate structure – eg, if it includes a ‘fee area’ – then income unit definition problems are not entirely avoided.

1.4.7 Implications for the taxation of superannuation

A severe difficulty in Australia’s mandatory SG system would lie in the need to separately identify SG and non-SG superannuation savings. This would require a complicated apportionment formula based on the actual or implicit employer contribution rate, and would need to take account of all spells of employment with different employers. In practice it would be an administrative minefield.

An alternative is to apply the GMP means test to the whole of an individual’s undeducted retirement benefit. A possible justification for departing from the “lifetime income test” approach is that anyone with superannuation entitlements in addition to the SG tier will have benefited from substantial tax concessions over their working lives.

Undeducted employee contributions present something of a issue. One the one hand they receive the benefits of concessional tax rates on fund investment earnings. This advantage compounds over time. One the other hand there is very little concession attached to them if

11 Particularly for those with a less than average life expectancy. See eg Knox 1999.

12 A more market-oriented (ie privatized) alternative - but one having exactly the same effect - is to mandate that 40% of lump sums in excess of the threshold be privately annuitised (up to a maximum of the full pension rate), and the GMP means test would then operate at a 100% marginal rate against these annuities. A big problem with this approach, however, is that the market would need to provide annuities indexed to MTAWE to make them consistent with pension indexation. Another problems is the administrative and other costs associated with privatization.

14 Recall that Atkinson’s (1993) proposal for an individual income unit is very expensive.
they are made relatively close to retirement age. (This is also increasingly true of employer contributions for low wage earners close to retirement.)

It is not possible to fully compensate for all these variables. In practice a degree of "rough justice" is inevitable, and the important thing is that over the lifetime of an average contributor the net benefits from superannuation tax concessions and the age pension are approximately progressive. For these reasons one option is that all superannuation benefits except for the return of undeducted employee contributions would be included in calculating the GMP entitlement.

If tax concessions are to be the basis for inclusion in the GMP assessment formula, one could also argue that assets like the owner-occupied house should be included. Other forms of non-superannuation investment may also be tax advantaged – eg, negatively geared property investment. Is there then any real basis for discriminating between superannuation and non-superannuation assets? Perhaps not. We are left with the pragmatic argument that, while we ideally wish to include only SG savings, we cannot separate them from an individual’s total superannuation saving, so the latter of necessity must act as a proxy for the former. This also means that there must be retained, at the margin, some net incentive to make superannuation savings.

On balance, it seems unavoidable that for practical reasons all superannuation benefits would contribute to the GMP asset assessment, with the exception of undeducted employee contributions15. However the high implicit tax rate proposed – 40% - could make superannuation saving unattractive for some people16. For these reason the proposal may require a re-adjustment to the whole system of superannuation taxation. Given the complexities of superannuation taxation, and the fact that the Treasurer has expressed a wish to re-visit this area, this may not be a bad thing in any case.

One option is that the GMP tax might be the only tax on superannuation, so that for those with assets beyond the GMP cut-outs an end-benefits tax would continue to apply at the same rate. This converts the superannuation tax regime to an EET type favoured by the industry, but might need to employ a relatively high tax rate - eg 50-60% - in order to avoid revenue loss, and to remain distributionally neutral (relative to the current system).

A sub-option is to retain a tax on fund earnings, to avoid current revenue loss and to reduce the necessary (revenue-neutral) GMP tax rate. This waters down the conceptual basis for the new system – it is neither a pure expenditure tax nor an income tax – but then, that is equally true of the current system. I note that some other superannuation tax reformers have also accepted that there may be a case for retaining the fund earnings tax – see Appendix A.

Alternatively we could continue the whole of the current system of taxes on contributions and fund earnings, but in this case the desired GMP tax rate may need to be lower than the 40% rate in the illustrative proposal, and/or substantial thresholds be utilised.

15 An option is that the tax treatment of all contributions could be made more uniform (eg by extending a 15% rebate to employee contributions), in which case there would no longer be any case for discriminating between types of contributions.

16 But not too unattractive. The 40% tax rate applies to realisations and in effect provides an expenditure tax basis such that tax is deferred until such time as savings are drawn down. The tax rate therefore cannot be directly compared with the 30% rate to be generally applicable under the income tax.

1.4.8 Impact on early retirement

The scheme could help mitigate any adverse effect the current system can have in encouraging early retirement. The pension means test makes early consumption of assets relatively cheap for many people, in the sense that they give up relatively little consumption post-age 65 after their reduced assets increase their pension entitlement. In Ingles 1998 I argue:

“Early retirement would be allowed under such a [GMP] scheme, on an actuarially reduced basis, provided the superannuation pension so calculated was sufficient to provide a basic income without supplementation. Later retirement could be rewarded by increases in superannuation pension paid, in the same manner as many overseas social insurance schemes. Many of the issues are covered in the Hancock report (1975).

This scheme thus resolves some of the time of incentives to early retirement created by the current system, while at the same time leaving individuals considerable flexibility as to the age they retire. . . . However . . . early retirement would still be possible on payments such as DSP, MAA and Newstart.” (Ingles 1998 p44)

Looking again at this proposal, I would modify it slightly. In its current form it presumes an implicit 100% tax rate on the GMP, whereas in fact a tapered GMP would allow many people to receive a part-rate GMP, which early retirement might otherwise disqualify them from.

One approach, consistent with the ‘purchased pension’ option, might be to require that 40% of any superannuation end benefit on termination of employment, at any age, be taxed away as a GMP “contribution” unless it is rolled over into another fund. These taxes would be equal, in present value terms, to the tax that would have been paid had the whole of the end benefit been preserved to retirement age.

Early retirees would need to finance themselves from their residual lump sum (and any entitlement to social security benefits) prior to receiving age pension on reaching 65. The extent of any residual social security assistance for early retirement is limited by the fact that the current asset test rules require that preserved superannuation benefits be fully assessed after age 55.

Late retirees could choose either to receive their GMP from age 65, or to have their GMP as at age 65 augmented by an adjustment factor of roughly 10% for each year of deferred take-up, similar to the current deferred pension bonus scheme (this factor would be designed to achieve actuarial neutrality). This adjustment might take the form of a lump sum bonus rather than a permanent increase in pension, as with the current scheme.

Superannuation contributions post-retirement age are another complication. Possibly the easiest option is to pursue a policy of simple proportional taxation of any draw-downs, save those made from undeducted contributions.

1.4.9 Treatment of retirement income streams

Income streams purchased by commutation of a lump sum are easy to deal with, with the lump sum tax applying as detailed above. Alternatively the GMP ‘tax’ could be levied on a simple cash-flow basis, so that income streams would not be taxed until they were drawn down. For the government, the net present value of the revenue stream is invariant to the
timing. For the minority of schemes which continue to provide DB pensions, the cash flow basis provides a means for taxing them on an equitable basis. All current concessions for income streams would be abolished, save for the undeducted purchase price (which is not actually a concession). The argument here is that the government would no longer have any public policy rationale for encouraging annuities beyond the base amount set out in the GMP. Such a policy would nonetheless be moderately concessional to income streams, since it involves tax deferral. The option here amounts to a simple cash-flow expenditure tax applied at a flat rate to all retirement income lump sum and income stream products.

1.4.10 Other issues
There would be a number of potentially high-cost flow-ons should the model be adopted. These include availability of concession and health care cards, means testing for aged care, access to state rental housing and the like, for which receipt of pension is a surrogate means test. One option is that a ‘passport’ - type system be set up whereby access to such concessions and services is means-tested on a nationally consistent basis.

1.4.11 Relationship between GMP, superannuation tax and means test options
These options look remarkably similar to an increased lump sum tax combined with a means test free pension, and therefore resemble, for example, Atkinson et al’s (1995, 1997) Options A and (especially) B: see Appendix 1 (this is the Australian, not the UK, Atkinson). As Atkinson et al show, different combinations of looser means testing and tighter superannuation benefits taxation can be designed to have a broadly similar impact on net returns to retirement savings and net income replacement rates in retirement.

1.4.12 Transition issues
Under a ‘fast-track’ option, a date would be set for the transition and announced, say, one year in advance, allowing those close to retirement to either defer or bring forward their retirement depending on how they assessed the relative gains or losses form the new system.
Alternatively the new system could be phased in over, say, 40 years, with an extra 2.5% of total retirement benefits being taxed under the GMP arrangement in each year, and an extra 2.5% of the age pension becoming universal in each year.
One problem would be the very complicated ‘grandfathering’ arrangements now protecting pre-1983 and pre-1987 superannuation entitlements. Some proposals for reforming superannuation taxation have taken the view that there should be a “once-for-all” washing out of these arrangements; at this point the government would levy taxes on or - more likely - pay subsidies in respect of existing entitlements to compensate them for future, uniform taxation of the end-benefits. The main drawback of this is that there might be several immediate cost to revenue - although this is not calculable without much more detailed information.
While any such cost would be recouped in the future (in present value terms), Governments are not indifferent to the timing of receipts. A sub-option with no current cost to government is to pay tax credits which could be redeemed only when superannuation tax liability eventually arises. Such credits would probably need to be indexed, either to the CPI or the long-term bond rate. Alternatively a transition involving further ‘grandfathering’ might be adopted.

1.5 Conclusion
I conclude that the concept of a lifetime income test underlying the GMP proposal has considerable merit as opposed to the current annual basis for the pensions means test. The GMP, once the SG system is fully phased in and has been operating for some time, confines redistributions to the lifetime poor and avoids giving assistance to the lifetime rich virtually irrespective of their savings/investment, consumption and tax planning decisions. Unlike the means test, it does not reward “knavish” behaviour. However there are a number of tricky issues which would need to be resolved in moving to a GMP.

The GMP, in its “classic” form, would work best in a context where there was a substantial compulsory superannuation tier quite separate to any top-up superannuation schemes, and where all benefits from the SG tier were payed as indexed life annuities. Benefits from this tier would become the sole basis for assessing GMP entitlements.
Where there is a mixed system such as Australia’s, and many superannuants have entitlements derived from a mixture of SG and additional contributions, the conceptual basis of the GMP becomes watered down. A compromise proposal is to base it on the whole of the superannuation payout, except for that component representing the return of any undeducted contributions.
A particular problem is that if annuity take-up is not compulsory, the GMP payment might, over time, not prove adequate for those who through poor planning or bad luck dissipate their superannuation lump sums. On the other hand compelling annuity take-up raises a number of difficult issues, among which are the relatively low returns on indexed life annuities compared, say, to allocated pensions underpinned by a sharemarket portfolio.
Because of these problems, in this country the GMP is probably most interesting in the “purchased pension” form, which is itself a form of the “minimum necessary annuity” proposal. In this, a specific part of the total superannuation payout would be given up in payment for receipt of a full pension.
It is interesting to see how closely this proposal conforms with existing academic proposals for easing or abolishing the pension means test and taxing superannuation more severely. This proposal poses a number of issues, of which the most difficult are the phasing in arrangements that might need to apply, including how to treat equitably the various superannuation components (pre-1983, etc). While these issues are soluble, this could lead to additional complexity which might undermine the hoped-for simplicity of the proposed new system.
Appendix 1: Suggestions for means test free pension and higher taxation of end-benefits

1.5.1 Institute of Actuaries (IAA) Task Force

This model (Institute of Actuaries 1994, 1998) proposes a universal age pension, partly clawed back through taxation surcharges, financed by higher tax rates on large retirement benefits. It involves the following elements:

1. employer contributions continue to be deductible
2. personal contributions by employees, self-employed and low income earners rebate at 16.5%, up to age-related limits similar to those now applying to employer contributions - and not subject to 15% contributions tax (but fully taxed as end benefits)
3. continue 15% tax on fund earnings
4. lump sums taxed on new, higher scale (reduce threshold to 2*AWOTE, 25% rate up to 4*AWOTE, 35% up to RBL)
5. 10% rebate for pension and annuity income
6. social security means tests to be abolished, and replaced by tax surcharge which, at high income levels, extinguishes the value of the pension. Pension would be raised if retirement is delayed.

In addition, a number of suggestions are made to facilitate transition to the new system over twenty years. The IAA proposals have been taken up and modified by several other researchers – see below.

1.5.2 Atkinson, Creedy and Knox (1997, 1999)

This scheme involves simplifications in common with, but more extensive than, those in the IAA scheme (see also Creedy 1998). Basically their option A involves eliminating the age pension means test (but retaing taxation of pensions), higher taxation of lump sums (and remove rules on excessive or maximum benefits) and no rebates for annuities. (The concept of undeducted contributions is removed, although it is replaced by a full purchase price allowance.19) There is a 10% rebate for all employee contributions (unlike the current rebate which is limited as to amount and income).

For budgetary reasons, the 15% fund ‘income’ tax is retained.

Option B simplifies the taxation structure even further. “The rationale behind this proposal is to abolish all maxima (whether expressed in terms of contributions or benefits) and introduce a progressive superannuation benefits tax [which is paid at retirement irrespective of the form of final benefits]...With these tax rates there is very little incentive for excessive benefits to accrue...The superannuation tax in Option B is paid on the capital value of the total superannuation benefits received and the tax rate is independent of any other income...Any subsequent annuity payments, generated from the superannuation benefit, are exempt from the tax system.” (Atkinson et al 1997, p334)

19 The purchase price allowance is the cost of the annuity divided by the expected term of payment (14.6 years for males aged 65).
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