#### 23 February 2005

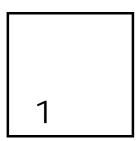
The Mercer Response to
The Productivity
Commission's Draft Report
"Economic Implications of
an Ageing Australia"

## **MERCER**

**Human Resource Consulting** 

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#### Recommendations for policy consideration

In response to the Draft Report of the Productivity Commission, Mercer Human Resource Consulting recommends that the following policies be considered to alleviate some of the adverse economic implications arising from Australia's ageing population.

- Permit more flexible employment conditions;
- Provide a framework which encourages employers to recruit and/or retain older workers;
- Encourage older workers to remain in the workforce through appropriate financial incentives;
- Review the lack of any clear integration between superannuation benefits and eligibility for the age pension by establishing a framework that provides a clear relationship between the benefits;
- Bring forward the funding of the existing unfunded superannuation liabilities through a program of decreasing capital injections;
- Gradually increase the eligibility age for the age pension;
- Reduce the front end taxation of superannuation, with some increases to taxes on benefits over the longer term.

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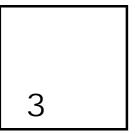
#### Some background

This Draft Report represents an excellent analysis of some of the issues arising from Australia's demographic changes that will influence Australia's society and economy in the decades ahead. The Report highlights many effects but the following are worth noting as they provide the necessary background to the comments and recommendations contained in this response.

- The inevitability of the ageing population. The fact is that we can do nothing to stop it:
- An ageing population is not a new phenomenon for Australia as the proportion of the Australian population aged over 65 has increased by an average of 0.1% pa from 1922 to 2000. However, the fundamental change is the increase in this ageing rate with the rate being above 0.3% pa for 20 years from 2010;
- The significant change in the labour force participation rate which is projected to decline steadily from the current level of 63.5% to 55.4% in 40 years time;
- This decline represents a decrease in the supply of labour, which is likely to have very different effects from the previous changes in the labour market which were often associated with an increase in the demand for employment;
- Significant increases in the projected level of health and related costs, when expressed as a percentage of the GDP;
- A slowing in Australia's economic growth with the rate of growth per capita expecting to fall from about 1.8% pa in 2010 to 1.25% pa in 2025, before partly recovering;
- The steady development of significant fiscal pressure on all Governments as the projected expenditures increase from 18% of GDP in 2002-03 to 25% of GDP in 2044-45, accentuated by a slight drop in taxation revenue;
- The need for early action. The Report notes that early intervention would avoid the need for inefficient or inequitable interventions.

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However, it is worth noting that the Report has very limited discussion on the impact of the ageing population on employers or the role of the maturing superannuation industry. This submission tackles some of these issues.



#### Long term changes in the labour force

As noted by the Commission, the labour force effects are likely to vary with each age cohort. For example, the participation rates for females have been increasing at all ages and with every cohort since Federation. It is also reasonable to expect that the "new old" will be both better educated and healthier than the previous generation, thereby opening up the possibility of increased participation at older ages.

Hence, with these community changes in view, together with the changing balance between the demand for and supply of labour, it is reasonable to expect some increase in the labour force participation rates at the older ages. We therefore endorse the thinking behind the Commission's projected increases in the female participation rates, particularly for ages 50-70. Of course, the actual size of these increases can be debated but it is important to recognise this likely trend.

The Commission also notes that the progressive deferral of access to the age pension for females below aged 65 will slowly increase participation rates among females aged 60-64. (p 3.23)

One of the recommended policy responses discussed later in this submission is to further increase the pension eligibility age for both males and females from 65 to 67. Such a change is likely to cause an additional increase in the participation rates for both genders.

Overall, this inevitable increase in the supply of older workers will have significant ramifications for employers. A recent Mercer survey of Australian employers showed that during the next three years, the ageing workforce will have a large or moderate impact on 80% of employers. Although these effects may be difficult to estimate with precision, it is disappointing that the Commission did not discuss the possible impacts of the ageing population on employers (including Governments).

These impacts on employers will include:

- A need to adjust recruitment practices and employment conditions, to reflect the desires of older workers;
- A need for more flexible reward structures reflecting the different expectations and requirements of different age cohorts;
- A shortage of skilled labour in some areas, due to the ageing labour force.

Such developments require innovative practices by employers and encouragement and/or permission by Governments. It is therefore essential for the Government to develop policies that

- Permit more flexible employment conditions including part time, flexible and casual work; for example, for parents returning to work, or grandparents sharing childcare responsibilities;
- Provide a framework which encourages employers to recruit and/or retain older workers.<sup>1</sup> In previous years, employers have been provided with financial incentives in respect of particular groups of younger employees and apprentices. It is worth considering the merits of a similar scheme for employees over aged 60, and the merits of providing organisations with corporate tax breaks for every employee over 60. These tax breaks can be ultimately recouped via the individual income tax yielded from people who are working who otherwise would not have been;
- Encourage older workers to remain in the workforce. Many older Australians are receiving a Government pension (e.g. age pension) which means they are subject to very high effective marginal tax rates (EMTR) if they receive additional income. Should this EMTR be reduced for those over age 65 in receipt of employment income? Further, the Government could expand the superannuation co-contribution for those over age 60, thereby providing both an incentive to remain in the workforce and contribute to superannuation, at a time when many are very much aware of the need to do so;
- Provide support structures such as sponsored child care centres to enable parents and grandparents (who currently provide childcare) to remain in the workforce;
- Provide subsidised training for older / casual workers, particularly in developing skills and competencies which will assist them in transitioning into and re-training for new jobs; for example, information and communication technologies can ensure marketable skills and competencies to support ongoing employment;
- Supplement the Australian talent pool by looking offshore for younger workers as well as developing strategies to retain Australian workers, both young and old, thereby stemming the rates of expatriates seeking opportunities overseas.

It is essential that the Government develop policies which encourage older workers to remain in the workforce thereby:

- raising the labour force participation rate;
- increasing productivity through not losing the skills of these workers;

<sup>1</sup> In its latest Policy Brief of January 2005, the OECD encouraged policies that, amongst other things, create stronger incentives to participate in the labour market, especially for older workers.

- responding to demand from employers;
- deferring the draw down on accumulated superannuation benefits.

A more immediate way of improving productivity that would affect all workers would be the payment of tax-free bonuses on individual rates of productivity. Bonuses would need to be based on actual productivity gains (eg. sales, production of widgets) so that these bonuses can also apply to front line employees. Ultimately, they need to be supported by policy which defines how and when bonuses are paid, as well as what constitutes productivity gains at the enterprise level.

Such action represents an important step in reducing, at least to some extent, some of the adverse economic implications of an ageing population.

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#### Age pension costs

The Commission projects that the cost of the age and service pensions will increase from 2.86% of GDP in 2002-03 to 4.90% of GDP in 2044-45. The projected cost is slightly higher than the costs shown in the Intergenerational Report of just two years earlier, due to the use of more recent data and new demographic projections, including lower mortality rates. The Commission also comments that the age pension costs are sensitive to the performance of superannuation funds (p13.9) with a poorer performance leading to lower benefits and higher age pension costs. This possibility will be discussed later in this submission.

Although the age pension costs are expected to increase by more than 2% of GDP over four decades, the Commission correctly notes that Australia does not face a pension crisis, in contrast to several other developed countries. Nevertheless, it is certain that the future age pension costs will be affected by the ongoing development of the Australian superannuation industry and the relationships between superannuation and age pension eligibility. It is therefore important that the integration between these two major sources of retirement income be improved.

This integration is currently complex and inefficient. Whilst some recent policies represent a small improvement, there is no doubt that the present arrangements mean that the Australian superannuation system (including its compulsory component) has a very limited effect in reducing future age pension costs. In fact, research by Treasury's Retirement Income Modelling Unit<sup>2</sup> shows that the introduction of the Superannuation Guarantee scheme will reduce the cost of the age pension by less than 0.25% of GDP in 2049-50. Such a result does not condemn the concept of a compulsory saving pillar within Australia's retirement income system. Rather, it highlights the consequences of a number of the current features including:

<sup>&</sup>lt;sup>2</sup> As cited by Vince FitzGerald in CEDA (2004), Australia's Ageing Population, p 90.

- The inadequate benefits provided by the current level of contributions;
- The lack of any meaningful integration between the superannuation and age pension systems;
- The current complexity, which permits many retirees to receive significant benefits from both superannuation and the age pension.

It is therefore recommended that the Government review the lack of any integration between superannuation benefits and eligibility for the age pension. Any such review need not affect existing pensioners or those approaching pension age. Rather, it could establish a framework that provided a clear relationship between the superannuation benefits received and age pension eligibility.

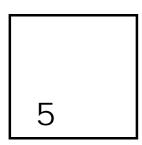
A further recommendation in respect of the age pension is to gradually raise the eligibility age for the age pension age from 65 to 67 after the female eligibility age reaches 65. As outlined in the Attachment, it is feasible for this occur so that age 67 is reached on 1 January 2022.

Such a change would not affect any person aged over 54 as at 1 January 2005 as the eligibility age of 67 would only apply for those aged under age 50 as at 1 January 2005.

The benefits arising from this change would be many including the important psychological change within the community from changing age 65. This age is perceived as "the retirement age" by the Australian community, notwithstanding the fact that most Australians retire before that age.

However, the whole concept of a retirement age is now outdated. The male pension age has not changed in a century and many employment practices have used this age as a base. With an ageing population, it is important to change this perception within the Australian community. A decision to increase the pension age, with an appropriate transition, would represent a really important signal to all Australians. It would also need to be supported by a communication program targeted at informing the community on the need for the change.

Furthermore, as noted in the Report, the deferral of the age pension for females will slowly increase labour force participation rates among females aged 60-64. A similar result is likely to occur if the pension age is raised to 67 for both males and females.



#### The multiple benefits of deferring retirement

As noted in the previous sections, there are real productivity advantages of deferring an individual's retirement. However, the benefits go beyond economic production. They also include:

- Additional savings within the economy (through compulsory superannuation and voluntary savings) as most individuals have a greater propensity to save in their later working years;
- Additional investment income as the superannuation and other savings are realised later;
- Higher retirement benefits due to these additional contributions and higher investment income;
- Potential for an even greater proportionate increase in retirement income as the retiree now has both a higher level of savings and a shorter life expectancy when compared to an earlier retirement; and
- Potentially lower age pension costs due to the higher savings.

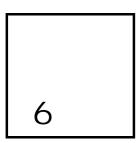
In brief, the combination of a longer period in the workforce and the resultant higher savings can have a marked effect on the level of retirement income available.

Although every situation is different, the following example highlights the effect. Let us assume that a male enters the workforce aged 20 and receives an employer superannuation contribution of 9%<sup>3</sup> of the average wage until age 60, 65 or 70. The following table highlights the lump sum available at each age and the level lifetime annuity that could be received during the person's retirement years. Both the lump sum and annuity are expressed in current dollars.

<sup>&</sup>lt;sup>3</sup> There has been some allowance for administration and insurance costs.

Age of	Size of lump	Increase from	Size of level	Increase from
retirement	sum	age 60	annual annuity	age 60
60	\$268,382	n.a.	\$20,691	n.a.
65	\$329,096	+22.6%	\$27,859	+34.6%
70	\$399,186	+48.7%	\$38,085	+84.1%

The effect of deferring retirement from the full time workforce by even five years produces a substantial impact on the living standards available to the retiree.



#### Costs for unfunded superannuation costs

A significant cost faced by the Commonwealth government and several State governments is the funding of the existing unfunded superannuation liabilities for public servants, which the Commission estimates, in total, to exceed \$120 billion.

The NSW and Victorian Governments are aiming to fully fund their unfunded liabilities by 2030 and 2035 respectively. The Commonwealth Government has indicated that it will establish a dedicated fund (the Future Fund) out of future budget surpluses to fund, in part, their superannuation liabilities.

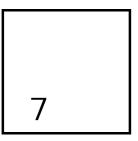
Most of these defined benefit superannuation schemes for government employees are now closed to new entrants, thereby capping the future liability. However, the unfunded liabilities will remain significant for many years. Therefore, from a Government's financial perspective, the desire to fund these liabilities is laudable.

As noted by the Commission, all Governments will face increasing fiscal pressure with the ageing population. However, given the commitment by many Governments to fund these liabilities, there is an opportunity now to increase the level of capital injections in the shorter term, before the ageing pressure builds. Governments could then gradually reduce the size of the capital injections as the expenditure caused by the ageing population increases. A decreasing capital injection over the next two or three decades is also consistent with the fact that many Governments will face increasing contributions to their funded defined contribution plans as an increasing percentage of staff will be members of these superannuation funds.

Although such an approach does not solve the fiscal pressure, it would provide governments with a rational approach to allocating the capital injections and thereby reducing the fiscal pressure in the years ahead.

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It is therefore recommended that all Governments consider bringing forward the funding of their existing unfunded superannuation liabilities through a program of decreasing capital injections, such that this item of expenditure will reduce as the fiscal pressure increases.



#### The options available in going forward

We agree with the Commission that prudence is desirable and that "downside risks are more important for policy makers than upside risks" (p13.10). Hence something needs to be done now. Furthermore, there is not a single policy prescription. Rather, the economic and social consequences need to be tackled on several fronts with a coordinated approach.

The Commission notes that the choices in financing the fiscal gap that will emerge over the next 40 years come down to the following three broad options (p13.12):

- 1. Increased Government debt;
- 2. Greater user contributions to service costs; and
- 3. Higher taxes.

They note that continued borrowing for ever increasing Government services is not sustainable. We agree. This leaves the other two options.

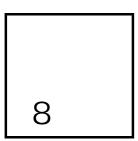
An increase in taxes represents a possible option but current taxes across all tiers of Government already represent 31% of GDP. The Commission calculated that if the future fiscal gap were to be fully financed by taxes, this would represent an average increase in taxes of 23%, i.e. up to 38% of GDP. Although some increase in taxation may be feasible (especially if there is continued economic growth), such a significant increase is not a long term and sustainable solution.

Therefore, there **will** need to be greater contributions by all users so that the Australian community can receive the services they expect, particularly in respect of health and aged care. However, most of this increased expenditure will be in respect of the growing aged population (i.e. predominantly the baby boomers). It therefore appears inevitable that these individuals will be required to make a greater contribution towards receiving the

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services they desire. Yet, the level of household savings (excluding the family home) for most Australians is low.

Hence, savings through superannuation and other long term saving vehicles represent a critical approach to enable the necessary saving for the payment of these future services. However, the Commission makes no comment on the role of the Australian superannuation system and how it may be affected by the ageing population. This omission is even more surprising given the growing importance of superannuation within the Australian economy. As highlighted earlier, there is a very positive relationship between working longer and building up savings for the financial needs in retirement.



#### Superannuation and the longer term outlook

The Australian superannuation system has assets of more than \$650 billion and is continuing to mature as the 9% SG contribution level was only reached in July 2002. In addition, it is expected that the total assets will continue to increase for many years to come, when expressed as a percentage of Australia's GDP.

There are several economic implications of an ageing population which will affect the superannuation industry. In particular, the long term investment return achieved by the funds represents a key driver in determining the size of the future retirement benefits received by Australians and the extent to which we will be able to make the necessary contributions in respect of the required services. Some of the relevant factors are now discussed.

First, the Commission has suggested that the rate of economic growth will decrease by 0.5% pa. If this eventuates, it will have a negative impact on the profitability of Australian companies and hence the investment returns achieved by superannuation funds. A similar effect is likely in respect of overseas equity investments due to ageing populations throughout the developed world.

Second, as the baby boomers move into retirement with their assets, it is likely that there will be a change in the asset allocation of the assets held by Australian households due to the fact that risk aversion tends to increase with age. This may have several significant implications for the Australian economy, which were not discussed by the Productivity Commission. In particular, it is feasible that there will be a gradual shift away from equity investments thereby exerting an adverse impact on the long term return from equities as well as the availability of capital.

Third, the economy will change with an ageing population. Certain industries (such as health, tourism, personal services) are likely to become more important at the expense of

other sectors. These sectoral changes within the economy were not discussed in the Report. However, from a superannuation investment perspective, different sectors of the economy may provide different investment opportunities which may have an impact on the returns received by those saving for retirement.

These long term results cannot be known for certain. However, it is more than likely that the forces arising from an ageing population, both globally and within Australia, will cause the long term investment return from superannuation funds to decline. In addition, there exists a range of other global factors which may also have an adverse effect on investment returns. These include:

- The maturing of pension plans throughout Europe and North America which produce more bond-like liabilities and the associated desire to reduce equity exposure;
- The introduction of International Financial Reporting Standards which is likely, over the longer term, to encourage pension plan sponsors to reduce their equity exposure thereby reducing the volatility in their reported results;
- The impact of climate change on long term economic growth.

The result is that some of the long term projections used by Government and others, based on current or previous investment returns, are likely to be optimistic. In short, it is feasible that the retirement benefits received from superannuation plans in 2020 and 2030 may be much less than is currently projected.

Such long term effects can be ameliorated with one or more of the following changes so that the baby boomers will be in a better financial position to be able to pay for the services they are likely to seek in their retirement years:

- Increased public awareness of the likely financial stresses caused by an ageing population;
- Longer participation in the workforce, as discussed earlier;
- Higher contribution rates to superannuation;
- Reduced superannuation taxation during the pre-retirement years.

The higher contribution rates are best achieved by making superannuation clearly attractive as a long term investment. Currently this is not the case. There are four points of taxation that can affect an individual's superannuation. These are:

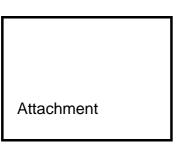
- 1. The 15% upfront tax on all deductible contributions;
- 2. The superannuation surcharge in respect of high income earners;
- 3. The 15% tax on the fund's investment income; and
- 4. Taxation on the benefits received.

Whilst acknowledging that superannuation has recently become more attractive for some individuals through the reduction in the rate of surcharge and increasing the attractiveness of the co-contribution, it must be acknowledged that such changes are at the margin or not applicable for most workers. For example, for an employee with an income of \$50,000 (which is about AWOTE), the surcharge reduction has no effect and the maximum annual

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co-contribution is \$400 for a member contribution of \$267. In other words, the net increase in the contribution is 1.3% of salary.

A preferred approach would be to reduce the level of taxation of superannuation for all members during the pre-retirement years and to indicate an increase in the level of taxation on the benefits received. Such a move would not only make superannuation more attractive immediately but would also defer the receipt of taxation to future years when there will be greater fiscal pressure. The Attachment provides some background to the latest statistics in respect of superannuation fund taxation and suggests that tax rates on both contributions and investment income could be reduced from 15% to 10% at a cost of less than \$2 billion.



#### Detailed policy proposals

# Proposal: Gradually raise the eligibility age for the age pension age from 65 to 67

The pension age for men has been 65 for 100 years. During that time, the life expectancy of an Australian male aged 65 has increased from 11.3 to 17.7, with half that increase occurring since the mid 1980s.<sup>4</sup>

The female pension age was decreased from 65 to 60 after World War II and is now being gradually increased from 60 to 65 with a six month increase every two years until age 65 is reached on 1 January 2014.

It is feasible that this process could be continued for both men and women so that age 67 is reached on 1 January 2022.

It is important to stress that such a change would not affect any person aged over 54 as at 1 January 2005 and that the eligibility age of 67 would only apply for those aged under 50 as at 1 January 2005.

The benefits arising from this change would be many including the important psychological change from age 65. The age 65 is perceived as "the retirement age" by the Australian community notwithstanding the fact that most Australians retire before that age.

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<sup>&</sup>lt;sup>4</sup> Source: Australian Government Actuary (2004), Australian Life Tables 2000-02.

Furthermore, as noted in the recent Productivity Report<sup>5</sup>, the deferral of the age pension for females below age 65 will slowly increase labour force participation rates among females aged 60-64. A similar result is likely to occur if the pension age is raised to 67 for both males and females.

Age 65 is also used to define the aged dependency ratio. However with improving health amongst older Australians and increasing life expectancy, the use of a constant age over many decades does not lead to rational and sustainable polices.

 $^{5}\ \ Productivity\ Commission\ (2004),\ Economic\ Implications\ of\ an\ Ageing\ Australia,\ Draft\ Research\ Report,\ page\ 3.23$ 

#### Proposal: Reduce the taxation of superannuation funds

Tax deductible contributions to superannuation (eg. contributions by the employer and the self-employed) are currently subject to a tax of 15% as part of the tax payable by superannuation funds. In 2001-02, the level of taxable contributions was \$29.6 billion.<sup>6</sup> Since 1993-94 this represents an average compound growth rate of 12.1% per annum. In recent years, this will have increased due to economic growth and the increase of the SG rate.

The net tax payable by superannuation funds has also doubled from 1993-94 to 2001-02<sup>3</sup> The following table represents a summary of the tax payable by funds in 2001-02.

Major Items	\$ bill
Taxable employer & employee contributions	29.574
Interest, dividends, rents & capital gains	13.901
Other income	5.315
Total income	<u>48.790</u>
Deductions	<u>15.700</u>
Taxable Income	33.090
Gross tax at 15%	4.987
Total rebates & credits	<u>-0.634</u>
Net Tax	$4.353^{7}$

At the same time as the tax from superannuation funds is rising, the revenue that is expected to be received in future years from the accumulated superannuation benefits, when the fiscal pressure is accelerating, has not changed significantly.

It is therefore recommended that the Government reduce the level of front end taxes and adjust, in a gradual manner, the taxes payable on lump sum retirement benefits received after say 2015.

One approach could be to cut the level of the tax rate on superannuation funds (say from 15% to 10% over a five year period) and to indicate a future increase in the tax rate on lump sum benefits in excess of twice the current tax-free threshold (i.e. approximately \$250,000). Using the above and latest Taxation Statistics available, a reduction in the tax rate from 15% to 10% for superannuation funds (which would affect the tax on both contributions and investment income) would cost in the order of \$1.7 billion pa.

funds in respect of contributions and earnings for 2003-04 was \$4.5 billion. Hence, the cost estimate shown above

remains reasonable.

<sup>7</sup> The latest Budget papers show that, under both the cash and accrual basis, the taxation raised from superannuation

<sup>&</sup>lt;sup>6</sup> Based on the latest issue of Taxation Statistics

Such changes would have several benefits including:

- Encouraging superannuation savings for the long term;
- Providing a clear message from the Government for all superannuation investors, which neither a reduction in the surcharge nor the co-contribution provides;
- Increasing by at least 6% the level of contributions to superannuation without imposing additional costs on employers;
- Providing a further incentive for income based products.

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