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Asset portfolio retirement decisions: the role of the tax and transfer system

Inquiry into pathways to housing tax reform

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Inquiry into pathways to housing tax reform

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Peter Davidson	Australian Council of Social Services
Karen Doran	ACT Treasury
Saul Eslake	University of Tasmania
Glen Hepburn	Department of Treasury and Finance, Victorian Government
Brian Howe AO	University of Melbourne
Caryn Kakas	Department of Family and Community Services, NSW Government
Paul McBride	Department of Social Services, Australian Government
Greg Smith	University of Melbourne Law School
Peter White	Department of Health and Human Services, Tasmanian Government

Executive summary

Key points

The tax and transfer system has important implications for the choices Australians make around retirement and retirement planning. Any meaningful reform of the tax system must recognise that the financial incentives embedded in the tax and transfer system shape decisions of Australians throughout their working life and following their withdrawal from the labour force. Those financial incentives have implications for the portfolio choices of Australians. Given that owner-occupied housing usually represents the largest single component of the household wealth portfolio, the tax and transfer system is likely to have important implications for housing-related decisions.

This report examines how the rules embedded in the tax and transfer system, especially in relation to the age pension (AP), may impact on household choices. The empirical analysis identified the following patterns of behaviour.

- Notwithstanding that the exclusion of owner-occupied housing from the AP assets test creates an incentive to hold a larger share of household assets in this form, there is little evidence that households structure their wealth portfolio to maximise access to the AP.
- There is evidence that the 2007 reduction in the AP taper rate (from $3.00 to $1.50 for those households holding that held non-exempt assets exceeding the lower threshold) led to increases in saving. The estimated effects are in the order of $300,000 of additional savings for affected households. Such effects are large and likely overstate the behavioural response, with valuation effects likely influencing the estimated impact of the reduction of the taper rate.
- The empirical analysis indicates high-income individuals responded to the removal of the superannuation surcharge (SS) in 2005 by increasing contributions to superannuation.

Reform of the tax and transfer system as it relates to retirement incomes poses challenges because of the long-term horizon that such decisions usually involve. A useful starting point for addressing some of the issues raised in this report is to reassess the parameters of the AP assets test. Such steps will provide opportunities to develop a sustainable tax and transfer system in a manner that recognises the concessional treatment of owner-occupied housing in the tax system over the life cycle.

The report

This report addresses the question of how individuals respond to the incentives embedded in the Australian tax and transfer system. Much of the analysis focuses on decisions around asset allocation and how those decisions are shaped by taxes and rules that determine eligibility for AP payments. That is, the focus is on decisions relating to savings and wealth accumulation associated with retirement. In considering those decisions, the institutional and policy context means that housing-related questions are front and centre of the analysis.

This report is part of a larger AHURI Inquiry around the development of pathways to tax reform. The starting point of this report is that such an endeavour requires a life-cycle perspective reflecting the fact that taxes shape decisions both while individuals work and throughout their retirement. As noted, the focus in this report is on financial decisions associated with retirement. Examining decisions at and around retirement is pertinent because it represents the point in the life cycle at which many individuals make the transition from being a net contributor, in a fiscal sense, to drawing government funded benefits and services in excess of any contributions that they may still be making. Moreover, it is at this point that many Australians interact with the transfer system in a robust and continued manner. Hence, the interface between the tax and transfer system at this point in the life cycle is critical, not just for the individual but for the welfare and efficient operation of the economy more generally.

When examining tax policy in the context of retirement, an understanding of how the tax and transfer system shapes housing outcomes is critical for a variety of reasons. Often referred to as the 'fourth pillar' of retirement incomes, housing plays a central and significant role in sustaining Australians in their working life and during retirement. The rules embedded in the tax and transfer system provide significant incentives for home ownership. Moreover, in the Australian context, home ownership and the accumulation of housing equity is critical for households given the relatively low rates at which government funded pensions are paid.

An understanding of how financial decisions associated with retirement are shaped by the tax and transfer system is critical from a policy perspective. Notwithstanding the means-tested, targeted and non-contributory nature of the Australian AP, fiscal challenges associated with the ageing of the population present some stark policy choices for the Australian Government (Department of the Treasury 2010; 2015). Understanding how decisions around retirement, in particular those associated with portfolio choices, are shaped by the tax and transfer system is essential to the development of a tax and transfer system that encourages the efficient allocation of resources across the economy, is consistent with principles of equity, and is sustainable. For historical and institutional reasons, any such tax system is likely to have important implications, both direct and indirect, for housing choices and housing markets more generally.

The aim of this report is to gain a deeper understanding of how tax and transfer policies shape the behaviour of individuals. Arguably, identifying the behavioural responses to the incentives embedded in the current tax and transfer system is fundamental to developing a pathway to tax reform that is robust and consistent with the long-term prosperity of Australia.

Key findings

This report examines three distinct questions. These questions relate to savings behaviour or the choices that individuals make around portfolio allocation.

- Are patterns of asset accumulation consistent with the incentives associated with the AP means test?
- Do changes in the AP taper rate impact on savings behaviour?
- How did high-income individuals respond to the removal of the SS in 2005?

In each case, the tax and transfer system may have shaped behaviour by providing incentives for individuals to accumulate higher levels of particular types of assets or to alter the total amount of savings. Given that housing equity often represents the largest single asset in a household's wealth portfolio, there are clear policy implications for housing-related behaviours and outcomes. For example, in the presence of a more neutral policy regime that does not distinguish between different types of housing tenure, it is possible that portfolio allocation decisions—such as the amount of housing equity held—will be somewhat different.

The analysis is based on longitudinal data in the form of the Household, Income and Labour Dynamics in Australia (HILDA) dataset. For the second and third question, the analysis examines policy changes that provided natural experiments. These policy changes provide exogenous variation in the economic environment faced by individuals, which in turn allows the behavioural impact of changes in policy to be analysed.

The first research question focuses on the portfolio decisions of Australian households and the analysis attempts to identify if the patterns of wealth holdings are consistent with the incentives provided by the AP means test. For the AP a means test is applied to both assets and income. The AP assets test excludes owner-occupied housing from the set of assessable assets and thereby provides an incentive for households to accumulate a relatively high level of assets in the form of home equity rather than other forms of wealth. Observed patterns of asset holdings are as expected, with owner-occupied housing generally representing the largest single asset in a household's wealth portfolio. Such a result is not surprising, for a number of reasons. Housing plays a central role in supporting living standards during retirement in the face of a publicly means-tested AP that is relatively low in value and unrelated to contributions over an individual's working life. Moreover, there is clear evidence that individuals prefer to 'age in place' and remain in the family home rather than consuming the wealth associated with it. Given the increasing maturity of the mandatory superannuation scheme introduced in 1992, more recent cohorts of older Australians are holding relatively larger shares of their wealth in the form of superannuation assets.

We examine statistical analysis that considers how those individuals who are close to losing their AP eligibility in terms of income choose their asset portfolio and level of wealth holdings. The statistical analysis suggests that individuals and households are not structuring their asset portfolios to maintain eligibility for the AP.

The second question considers how changes to the AP taper (or withdrawal) rate in 2007 affected the savings decisions of households. The AP taper rate effectively acts as a wealth tax, reducing the level of consumption enjoyed by those with relatively high assessable assets by limiting the amount of AP they are eligible to receive. The changes to the AP taper rate in 2007 provide an opportunity to observe how those individuals who were affected by the change in the taper rate and became newly eligible for the AP responded. In addition to the total level of savings, their portfolio allocation decision may also have been impacted.

The empirical analysis suggests that following the reduction in the AP taper rate, those individuals who were affected increased their level of saving relative to those who were unaffected by the change. While the analysis identifies a large and statistically significant impact on savings, a number of caveats should be highlighted. In particular, the positive change in saving identified in the analysis may reflect passive accumulation of wealth through asset appreciation. Further, there is evidence that the households impacted by the 2007 reduction in the AP taper rate allocated wealth in a way that is consistent with the exemption of owner-occupied housing from the AP assets test. As the taper rate was reduced, this created an opportunity hold additional wealth in assets other than owner-occupied housing while still retaining access to the AP.

The final research question focused on changes to the taxation of superannuation for high-income earners. The analysis was possible because of the removal of the superannuation surcharge in 2005, which was announced with little forward notice. A priori, one might expect that such a change would lead to an increase in the savings directed to this tax-preferred form of saving. The analysis suggests that this was indeed the case, with relatively high-income earners increasing this form of savings.

The empirical analysis in this report was directed at understanding how the tax and transfers systems shape decisions around the asset portfolio. It is important to stress that the interface between the four pillars of the retirement income system (superannuation, AP, private savings and home ownership) mean changes that impact one pillar are likely to have important implications across a range of behaviours. Housing represents a central component of retirement planning in Australia and changes associated with the generosity of the AP have important implications for housing-related behaviours and policy. More generally, the analysis in this report is largely consistent with the framework provided by the life-cycle model and the findings add to the evidence base on which a sustainable pathway to tax reform can be developed.

Policy development options

The analysis in this report focuses on two specific policy changes and seeks to identify the impact of those changes on behaviour. The outcomes identified are consistent with the predictions of the life-cycle model and the economic framework more generally. In the case of changes to the AP taper rates, the evidence suggests this led to increased savings for those impacted by the reduction in the withdrawal rate. Similarly, in the case of superannuation, there is evidence that those affected by the increased concessional treatment of this form of saving increased their superannuation contributions.

The policy lessons to be drawn from this report reflect a number of key considerations. First, retirement income policy and the place of housing in that framework is complex. The pillars of the retirement income system are interdependent, and care must be taken when adopting piecemeal changes, as such changes can have unintended consequences. While this report has not considered changes to the taxation of housing assets directly, the interface between the pillars of the retirement income system mean that changes to one pillar are likely to impact on decisions related to other pillars.

Second, it is important to note that the guiding principles of tax reform have been clearly articulated in the past. It is widely accepted that steps should be taken to develop a tax system that is fair, promotes efficiency and does not impose high administrative costs on those it taxes. Moreover, in terms of the tax and transfer system, any changes must be sustainable. Finally, in the context of retirement incomes policy change, it is critical that actual or proposed changes provide sufficient time and guidance for individuals to make appropriate decisions in the life-cycle context.

There is a reasonable degree of consensus across the political spectrum about what changes to the tax and transfer system might be desirable, in order to make it compatible with the aims it seeks to achieve while at the same time being sustainable in the face of increasing fiscal challenges. A number of these changes have direct implications for housing. For example, the removal of the exemption of the family home from the AP assets test has been mooted in the past by commentators across the political spectrum. The most comprehensive set of tax reform proposals in the past decade, the Henry Tax Review, recommended the inclusion of owner-occupied housing in the means test, above a relatively generous threshold (Henry, Harmer et al. 2009).

This report identifies the relatively high levels of financial wealth held by households that are owner-occupiers. Moreover, there is evidence that notwithstanding the predictions of the life-cycle model, households do not tend to draw down wealth following retirement (DSS 2016). In light of this and the continuing fiscal challenges associated with an ageing population, a step toward the sort of comprehensive reform that has been identified in the past should focus on how housing is treated in the assets means test for the AP. While removal of the exemption for owner-occupied housing has been identified as a laudable goal, there is unlikely to be a political consensus to adopt such a change in the near to medium term. Rather, more modest changes may provide opportunities to rebalance the tax and transfer system in a way that achieves desirable outcomes. The treatment of housing assets and wealth is likely to be a key component of any such changes. In particular, changes to the AP taper rate and thresholds for home owners and non-home owners present opportunities to more accurately reflect the value associated with owner-occupation. The AP assets means test effectively taxes the wealth of those households whose AP is reduced by virtue of having assessable assets that exceed the lower threshold. Changes in the taper rate and thresholds have the potential to alter the financial advantage associated with home ownership, potentially mitigating the distortionary effects associated with the concessional treatment of housing more generally and addressing the need to develop a fiscally sustainable tax and transfer system.

It is important to emphasise that any such changes must, however, be gradual. Moreover, they need to take account of the lessons learned from the analysis in this report. In particular, the finding that households and individuals are likely to respond to the incentives provided by the tax and transfer system and shape their behaviour accordingly.

The study

This study is part of a wider AHURI *Inquiry into pathways to housing tax reform*. This report focuses on how tax and transfer policies shape decisions at and around retirement. Specifically, the analysis considers behaviour around the accumulation of assets and allocation of wealth across alternative asset classes. The policies considered are those relating to the AP and superannuation. In both cases, we have found that the parameters or rules of the programs potentially create incentives that impact on housing and housing-related outcomes. For example, the exclusion of owner-occupied housing from the AP assets test creates an incentive to hold more wealth in this form than would be the case in a more ‘tenure-neutral’ regime in which housing was treated like other assets. Similarly, the generous tax treatment of superannuation savings creates an incentive to accumulate additional savings of this nature relative to a tax system that was more asset neutral.

Housing is a critical component of the wealth portfolio of Australian households and it plays a central role in retirement planning. Tax and transfer settings that impact on decisions at this critical life juncture are likely to have important implications for housing-related decisions and housing markets. In turn, such policies impact on the broader functioning and performance of the economy.

The analysis in this report uses the HILDA Survey: a longitudinal dataset containing detailed information on the behaviours and outcomes experienced by Australian households over a period spanning more than 15 years. Specifically, the wealth modules available in 2002, 2006, 2010 and 2014 provide detailed insights into decisions around portfolio allocation and wealth holdings.

Importantly, the data allows a comparison of the behaviour of households before and after the Global Financial Crisis (GFC). Moreover, in the period covered by the analysis, important changes were made to the rules associated with the AP taper rate and taxes applied to superannuation savings. In turn, the statistical analysis considers how decisions and outcomes were shaped by the AP assets test and generous tax treatment of superannuation savings.

The findings of this report add to the existing evidence base in a number of ways. First, we provide additional insight into the patterns of asset accumulation by Australian households and how they are shaped by the AP assets test, by utilising additional waves of the HILDA data. Further, we conduct some original analysis, using HILDA, of the impact of the changes to the AP assets taper rate. Finally, the removal of the SS in 2005 provided an opportunity to consider how the tax treatment of this form of saving impacted on high-income earners affected by the change. Together, the analyses of these policies provides new insight into how the behaviour of Australian households is shaped by the tax and transfer system.

This report is timely in light of recent changes to the AP assets test that effectively reversed the AP policy change considered in this report. As a result, the research provides insight into the likely behavioural implication of these changes. More generally, the study provides additional evidence upon which an efficient, equitable, enabling and sustainable tax system can be developed.

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Lachlan Dynan's contributions were made during his time as an Honours student at the University of Sydney, and not during his subsequent employment at the Reserve Bank of Australia. As such, the views represented here are unrelated to the Reserve Bank of Australia.

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