

Work Decisions of Older Australians: Age Pension and Taxation "Incentives"

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Question: What is meant by "population ageing"?

- A term for a sustained increase in the proportion of older age groups in the population
- Due to:
 - increased life expectancy
 - "baby boom" in 1950s and 1960s
 - reduced fertility since then
- An economic problem?
 - Yes, if age pensions are paid out of current taxes
 - Major changes in structure of economies
- Is working longer (or harder) a solution?

Work Decisions of Older Australians - An Economist's Approach

- Individuals maximize utility from consumption and leisure over lifetime
 - choose how much to save each year
 - choose consumption and leisure (hence hours of work) each year
 - smooth these choices out over time
- Take as given
 - probabilities of survival at different ages
 - wage-age relationship
 - interest rates
 - income taxation and government retirement policy settings
- Part of whole economy
 - production sector - uses labour and capital to produce goods
 - government sector - chooses policy mindful of the budget balance
- Do policy settings encourage older Australians to work longer?
 - *Current settings discourage work!*
 - *Alternative policies are needed.*

Outline of Presentation

I will deal with the following topics.

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- **Question 3:** How does an economist perceive these work decisions?
- **Question 4:** What are the behavioural responses to these and alternative policies?

Changing Age Structure

Figure 1 **From pyramid to coffin**

Changing age structure of the Australian population, 1925-2045

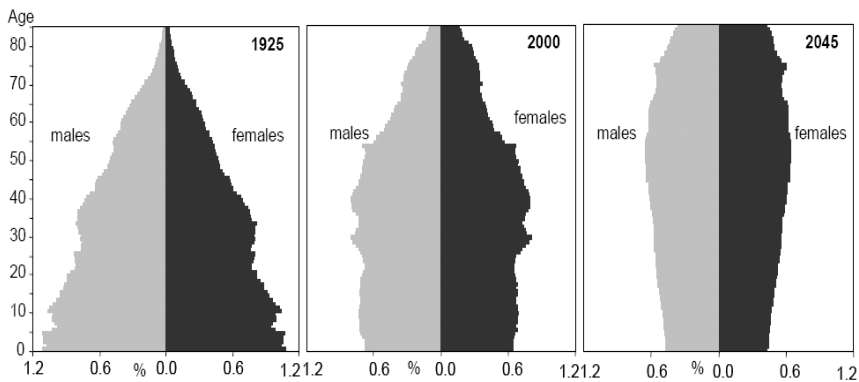
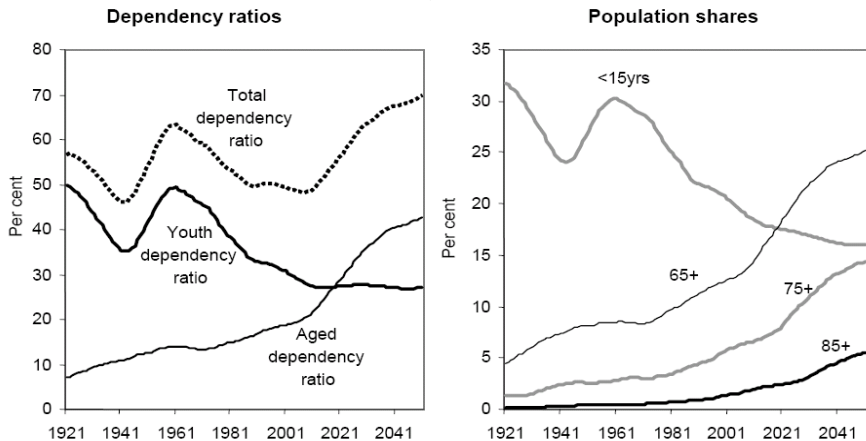
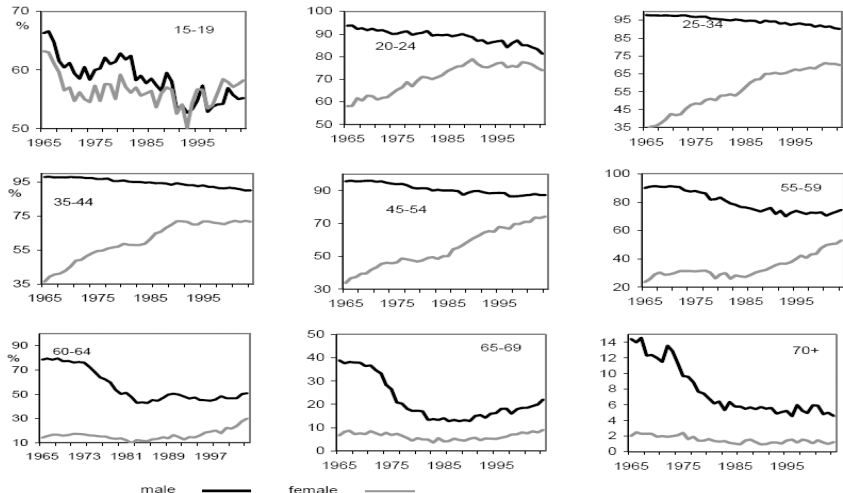


Figure 2.2 The demographic transition, 1921 to 2051



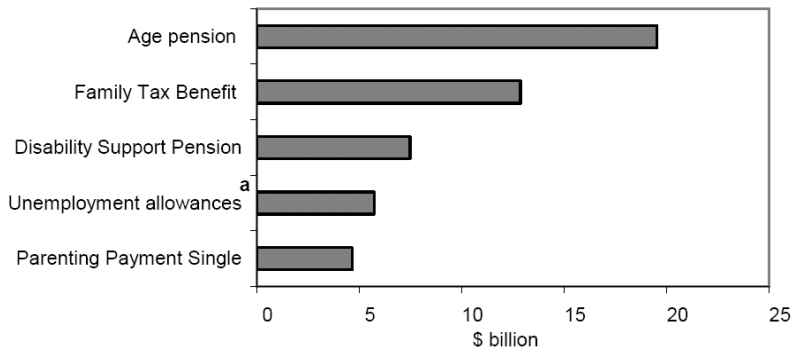
Participation Rates by Age

Figure 3.5 **Participation rates by age groups, male and female**
August 1965 to August 2004



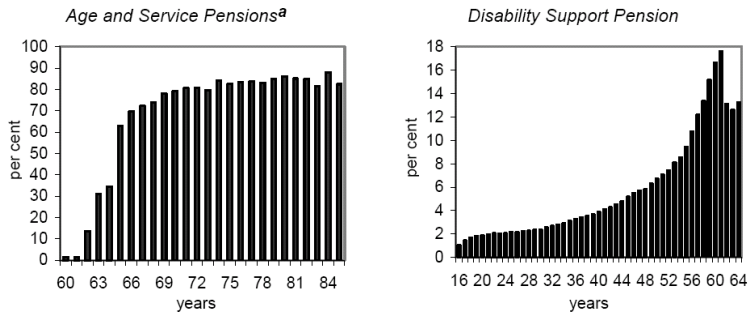
Social Support by Type

Figure 8.1 **Expenditure on selected personal benefit payments 2003-04**
\$ billion



Pension Payments by Age

Figure 8.2 **Benefit coverage rate by age**



Summary on Population Changes

- Demographic changes
 - Australia's population is rapidly ageing
 - Ageing will continue for another 30 years
 - Life expectancies rising; fertility falling
 - Dependency ratio increasing
- Labour force is also ageing
 - Participation rates for males declining; rising for females
 - Participation rates lower for older workers
 - Labour supply will fall
- Government expenditures will rise
 - age pension paid to retired people
 - health costs for older people
 - tax growth lower due to fewer young

What are Some of the Policy Issues?

Some policy issues:

- Finance expected government expenditures
 - public pensions
 - public health
- Encourage labour force participation by older Australians
 - tax and pension rules
- Encourage saving for retirement
 - tax and superannuation rules
- Aim is to adapt to a major, gradual demographic change

Three Pillars of Retirement Policy

- **Pillar 1:** Age Pension
 - Started in 1909
 - Universal but means tested
- **Pillar 2:** Superannuation Guarantee
 - Started in 1992
 - Almost universal
- **Pillar 3:** Private Saving and Occupational Superannuation

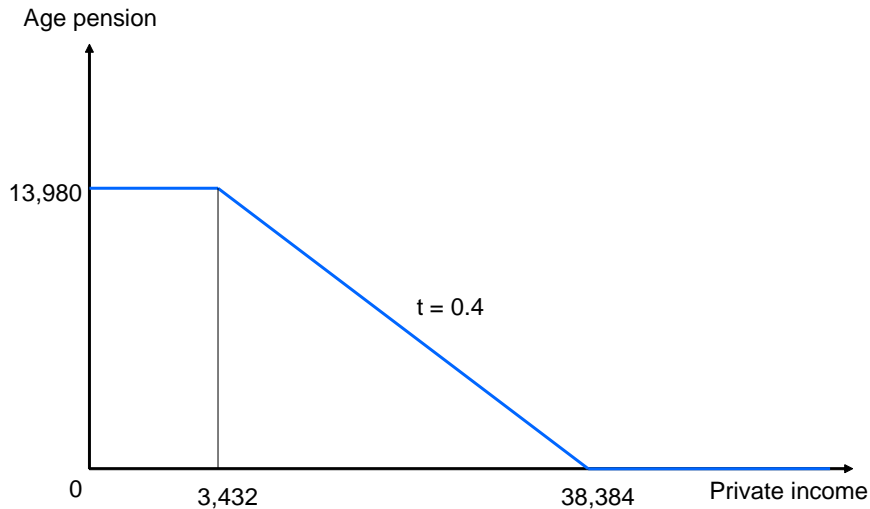
- **Pension**

- Eligibility - ≥ 65 years of age (less for females)
- Pension is 25% of average wage

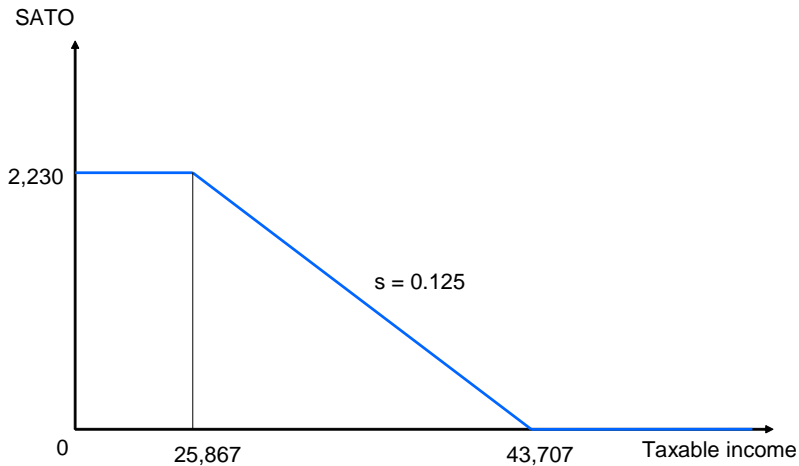
- **Means tests**

- Income test
- Assets test

Age Pension - Income Test (single)



Senior Australian Tax Offset (SATO)



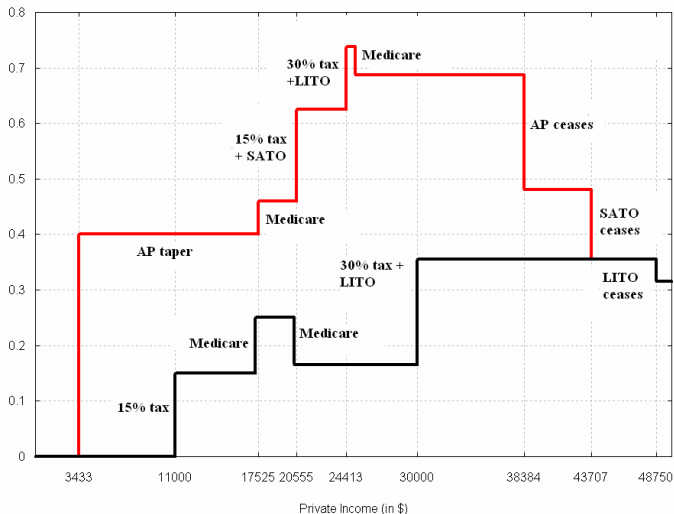
- **Benefits**

- Pension is taxable
- Tax offsets mean no tax on full pension
- Seniors benefits - subsidies for drugs, travel, etc.
- Benefits reduce if earnings are too high

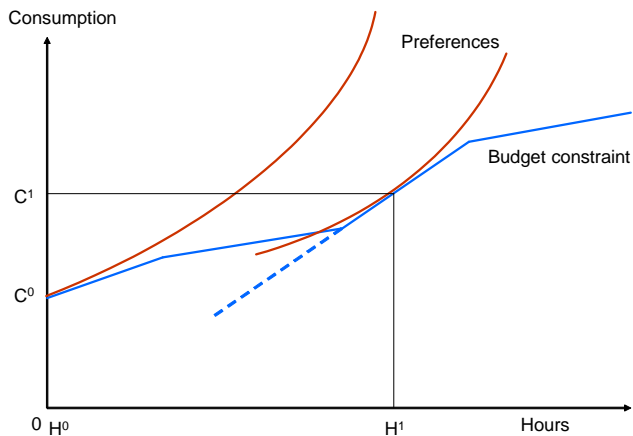
- **Effective Marginal Tax Rates on Earned Income**

- Very high - 65.5% for earnings from \$20-30,000
- Major disincentive to work after age 65

Age Pension - Effective Marginal Tax Rates - 2007/2008



Budget Constraint and Work Hours Decision



● **Individuals**

- Live from 20 to (possibly) 90 years of age
- Uncertain life span (date of death)
- Aim to maximize discounted lifetime utility (welfare)

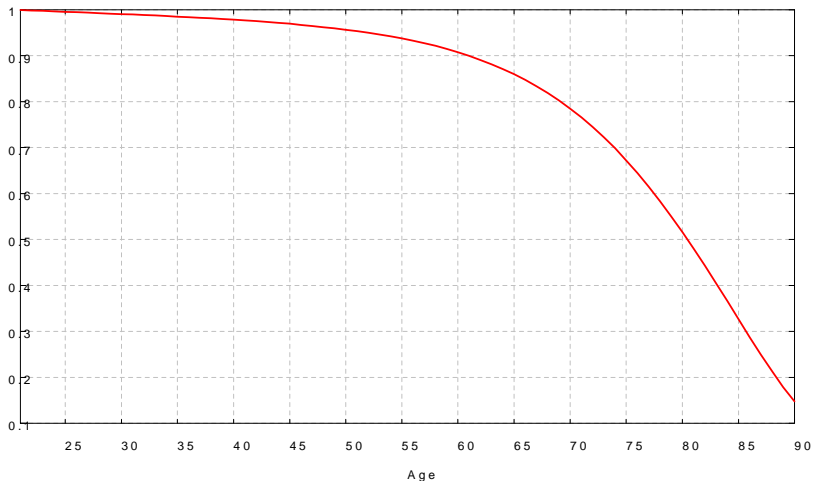
● **Decisions**

- Hours of work and leisure
- When to retire
- Consumption
- Saving and asset accumulation

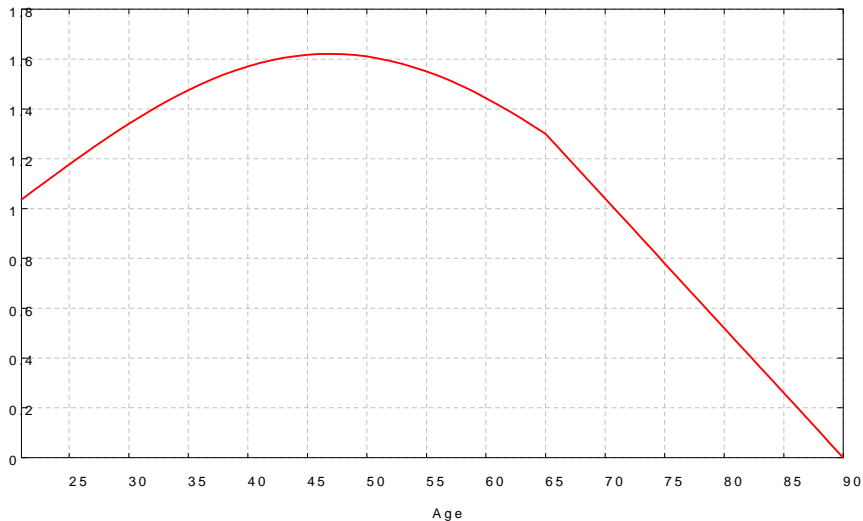
● **Take as given**

- Wage profile
- Interest rate
- Retirement policies of government
- Tax schedule

Conditional Probabilities of Survival by Age



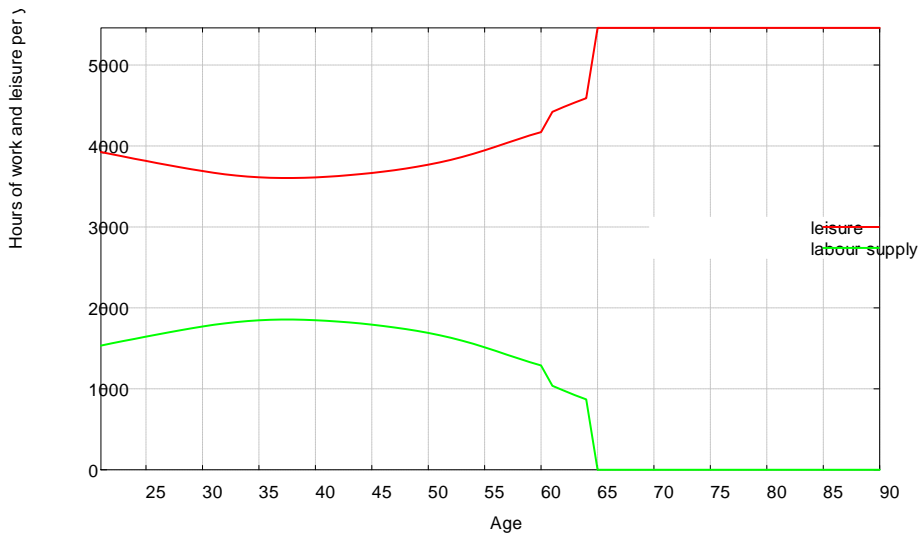
Labour Efficiency by Age



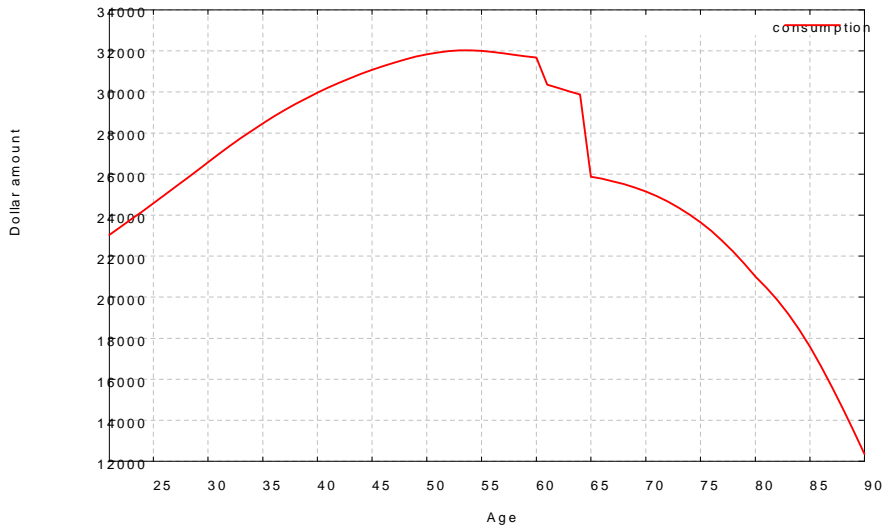
- **Assumptions**

- Gets superannuation at age 60
- Eligible for Age Pension at age 65

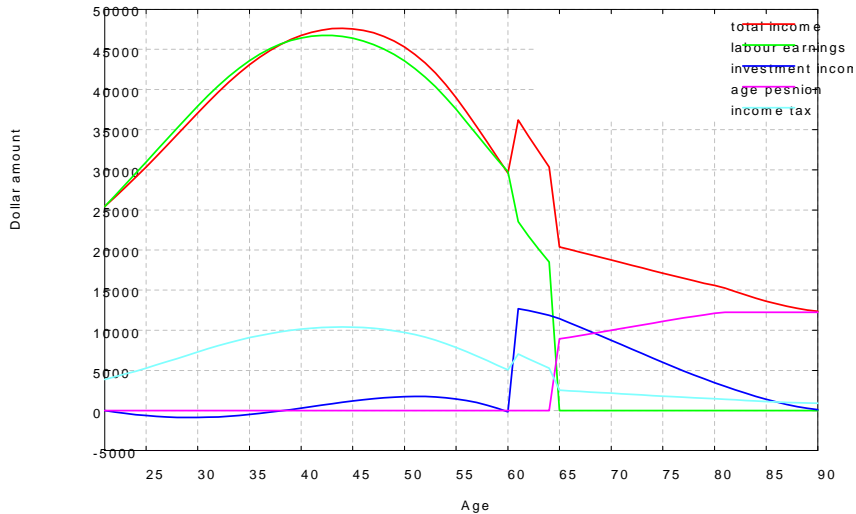
Labour Supply and Leisure Profiles



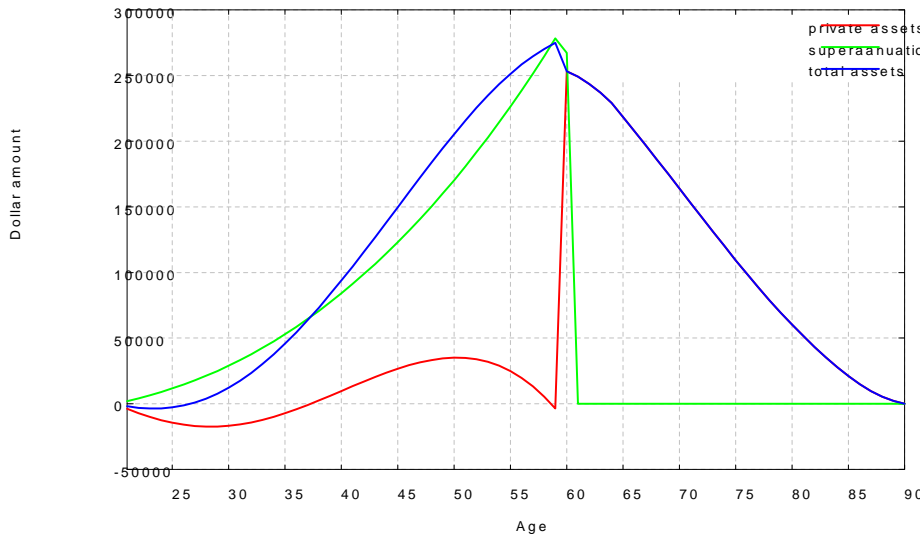
Consumption Profile



Income Sources and Taxation



Asset Profiles



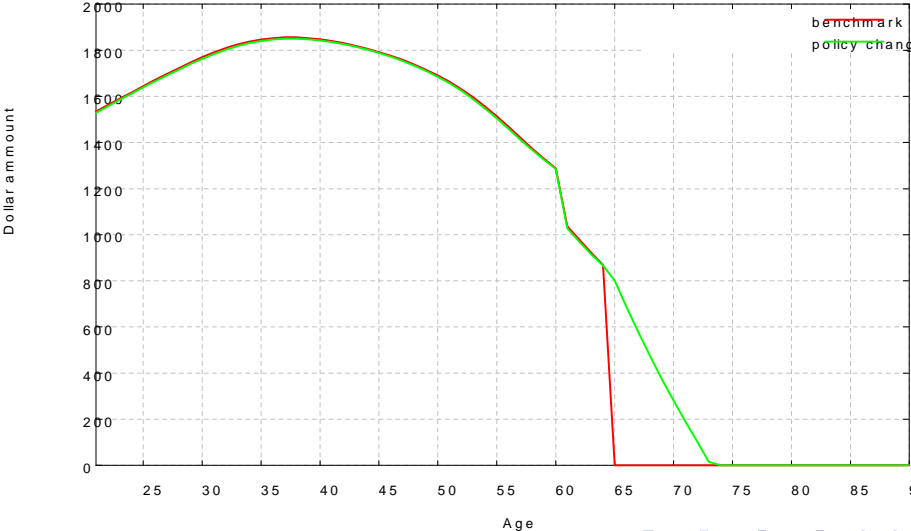
- **Benchmark**

- Income test
- Assets test
- Most stringent one applies

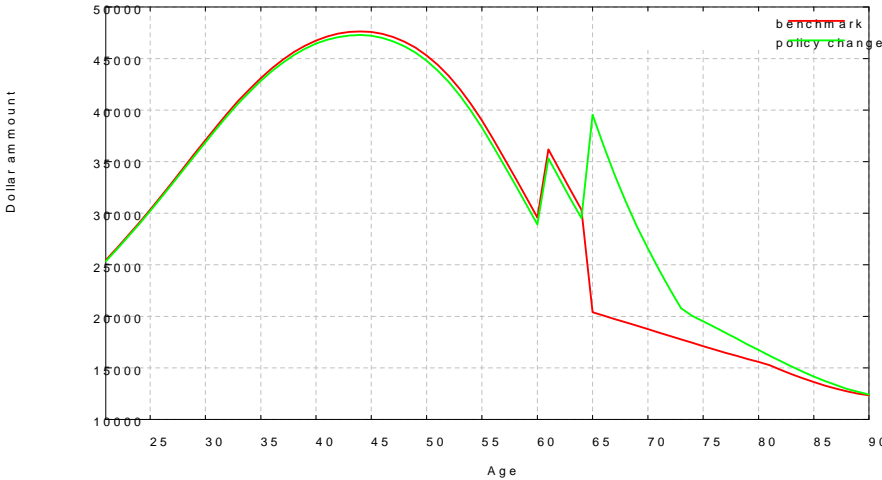
- **New Policy**

- No income test
- No assets test

Effect on Labour Supply



Effect on Income

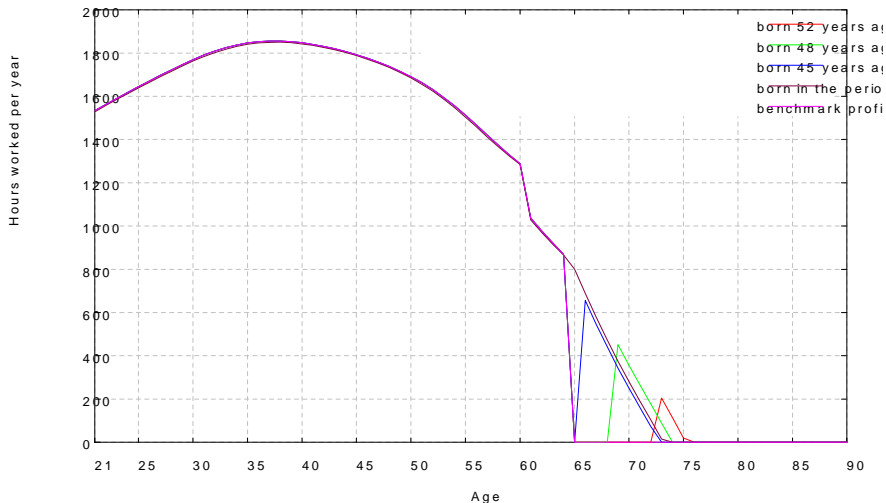


Summary on Effects of Means Tests Removal

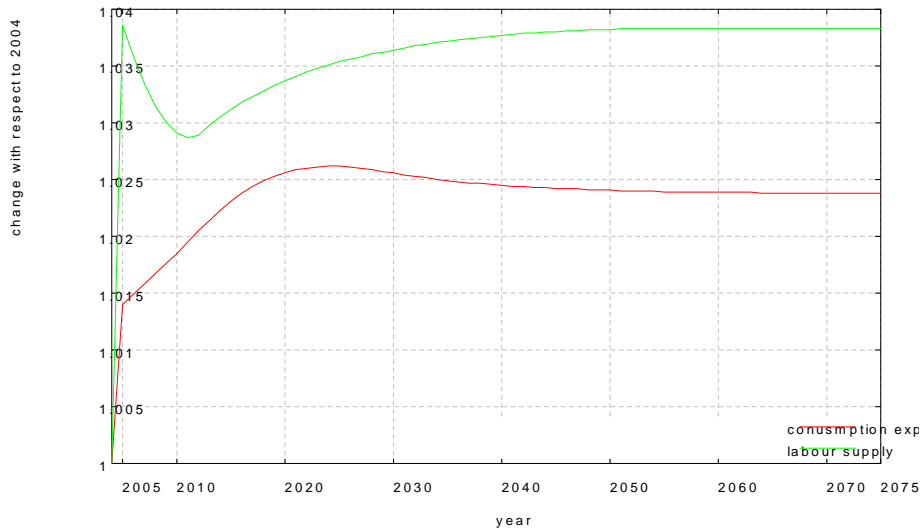
Age Pension means test removal

- has **big** effect on retirement date
- has big effect on labour supply
 - shift work effort away from young period of life
 - more work effort from age 65 to 75
- raises consumption from age 65
- reduces saving by the young
 - assets lower when young
 - assets higher after age 65

Labour Supply Profiles by Age at Time of Policy Change



Aggregate Effects on Labour Supply Over Time



Summary on Cross-Sectional Effects of Means Tests Removal

- Life-cycle effects:
 - induces more work effort from older people of pension age
 - less work effort from the young
- Impact (year of change) effects
 - young work less
 - old work more
- Aggregate effects over time
 - labour supply higher
 - Consumption higher
- Overall, means test is a deterrent to work effort of older people
 - removal encourages their work effort

- General equilibrium effects
 - Higher pension payments require higher GST or income taxes
- Heterogeneous types of people
 - Low, middle and high wage classes
 - Low - pension only. High - no pension. Middle - part pension
- Alternative policy settings
 - remove means test on earnings, not interest income
 - change the taper rate on the pension - mesh with tax schedule

- Australia's population is ageing
 - Will continue to do so for many years
 - Challenge to economic adjustment
 - Challenge to government policy
- I considered one policy change
 - removal of age pension means tests
 - **encourages** labour supply in aggregate
- *Australia needs to reform its age pension and tax structures if it wishes older people to work longer or work more*

The End