Royal Commission into Aged Care Quality and Safety

Treasury’s response to Notice to Give Information or a Statement in Writing No. NTG-0797

31 August 2020

1 This is a response to the Notice to Give Information or a Statement in Writing No NTG-0797 dated 21 August 2020 (**Notice**), which has been issued by the Royal Commission into Aged Care Quality and Safety (**Royal Commission**) to the Department of the Treasury (**Treasury**).

2 This information is produced to the Royal Commission on the basis that it will be tendered and received in evidence by the Royal Commission and on the basis the information be treated as evidence pursuant to section 6DD of the *Royal Commissions Act 1902* (Cth).

Part A | Overview

3 The Royal Commission is considering the funding and financing arrangements for the aged care sector at a particularly challenging time for the Australian community, as it grapples with the impact of the COVID-19 pandemic. The COVID-19 pandemic is impacting the entire economy, including older Australians, and could significantly disrupt the financial position of residential aged care providers who care for some of the most vulnerable Australians.

4 The Australian Government has taken a series of decisions to provide additional financial support to residential aged care providers in response to the COVID-19 pandemic.

5 The COVID-19 pandemic has reinforced the importance of Australia having a robust aged care sector that can manage and adapt to sudden shocks that may be difficult to foresee. It has also brought into focus a range of funding and financing issues that were affecting the sector prior to the COVID-19 pandemic.

6 The Australian Government funds a range of services to support older Australians to access appropriate care in their home, in the community and in residential care services. In 2018-19, more than 1.3 million people accessed aged care services from more than 3,000 providers across Australia[1].

7 While many recipients of aged care services make some contribution to the cost of providing these services, Government funding accounts for more than 75 per cent of the total cost of providing these services.[2]

8 Changes are needed to ensure that the quality of care that the Australian community expects is delivered effectively and efficiently. Funding arrangements need to meet the requirements of an ageing population with changing care preferences and needs, including the preference to age in the home. Greater funding certainty will help encourage investment in the sector and ensure it has capacity to meet increased demand for quality aged care services.

9 Irrespective of financing arrangements, aged care services require appropriate quality, safety and financial regulation. To the extent that aged care services are pre-funded, such as through accommodation deposits or insurance arrangements, the sector would require regulatory settings that ensure prudent management, including appropriate prudential regulation.

10 Public funding combined with private contributions provides the most equitable and sustainable basis to finance aged care. A mix of appropriate public funding complemented by means tested private contributions would avoid the unnecessary complexity and potential duplication associated with introducing new systems such as a pre-funded arrangement.

11 There is scope to increase consumer contributions in aged care. The likelihood of requiring some form of aged care in old age is high and can be anticipated. It is appropriate that older Australians with the financial means to do so should contribute to the cost of their care. As Australia's retirement income system matures, there is likely to be more capacity for many

[1] Eight report on the Funding and Financing of the Aged Care Sector, page 13 and page 22

[2] Eight report on the Funding and Financing of the Aged Care Sector, page 13.

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Australians to use their retirement assets, including superannuation, to make a greater contribution to the cost of their aged care. Developing stronger mechanisms that ensure dependable income across the duration of retirement would significantly improve people's confidence that they will have sufficient income to contribute to their aged care.

12 Means testing arrangements can be used to target support to those who need it most and to address uncertainty associated with longevity risk. Similarly, increased contributions from recipients of aged care services can enable access to a broader range or mix of services that better match their preferences. Where individuals do not have the capacity to fully finance their aged care costs, there is a clear role for Government to fund a greater proportion of costs to ensure equitable access to essential aged care services for all Australians.

Part B | Alternative approaches to aged care financing

3) Identify and describe the comparative advantages and disadvantages of the following approaches to aged care financing as described in Consultation Paper 2:

   a) minimal change, based on the continued adaptation of taxation methods and co-contributions

   b) social insurance models, involving mandatory contributions to a dedicated pooled fund

   c) private insurance and other voluntary arrangements.

4) With respect to the alternative approaches described at paragraphs [3(a)] – [3(c)] identify:

   a) any risks associated with these approaches, and

   b) how any such risks may be managed.

5) What matters would Treasury take into account in providing advice to Government on any proposal to implement the approaches to aged care financing described at paragraphs [3(a)] – [3(c)]?

13 Treasury is responsible for providing advice to Government on economic and fiscal settings that enable the effective management of the Australian economy and public finances, and deliver outcomes for the good of the Australian people.

14 With regards to the financing of essential services, Treasury balances two competing considerations. First, we consider the settings that deliver the best outcomes for individuals accessing services and second we consider the broader economic and fiscal impact of financing these services.

15 The following principles inform Treasury's considerations:

(a) efficiency — ensuring that the aged care system is operating efficiently and effectively, with financing from Government and recipients being used to cost effectively deliver quality care;

(b) equity — ensuring access to quality care for all Australians, irrespective of their socio-economic means, and ensuring the impacts of financing arrangements are appropriately distributed equitably across generations and wealth cohorts;

(c) simplicity – ensuring the system of accessing and financing aged care is as easy to understand, transparent and simple to interact with as possible;

(d) sustainability — ensuring financing arrangements for Government and recipients are sustainable over time, taking into account economic and demographic trends, including appropriate prudential management;

(e) flexibility — ensuring financing arrangements can respond to changing community expectations and consumer needs and preferences, so that older Australians can make informed decisions about their finances and circumstances; and

(f) policy consistency — ensuring consistency with other programs and systems, such as the retirement income system and broader health system.

16 In presenting the advantages and disadvantages of various approaches to financing aged care, Treasury has taken into account all of these principles and considerations.

Current system of aged care financing

17 Aged care in Australia is largely funded through Australian Government expenditure with some contributions from recipients. In 2018-19, the Australian Government provided approximately $18.1 billion across the Commonwealth Home Support Program (CHSP), home care services and residential aged care; spending by aged care recipients totalled $5.1 billion.[3] Additional funding was provided to the Department of Health and the Aged Care Quality and Safety Commission for the administration and regulation of the sector. Total funding for aged care in 2018-19 was $18.9 billion.[4]

18 Aged care costs broadly fall into three categories: accommodation costs, living costs and care and health costs. Currently, aged care fees and funding correspond to these three areas, with varying levels of contribution from consumers. Recipients of aged care services pay for their living costs through daily fees, and contribute towards their care and health costs through means tested care fees. In considering arrangements for consumer contributions it is important to recognise that those who are not receiving any aged care services are typically financing their own living and accommodation costs. From a horizontal equity perspective (that is, the equitable treatment of individuals in similar financial circumstances) this provides an indication of the quantum of consumer contributions that could be considered for these types of services.

19 Those entering residential aged care contribute to the cost of their accommodation through a lump sum accommodation payment, known as a Refundable Accommodation Deposit (RAD) and/or an equivalent daily payment, known as a Daily Accommodation Payment (DAP). In the event that an aged care provider becomes bankrupt or insolvent, the Australian Government guarantees to repay an amount equivalent to the RAD to the resident or their estate, through the Bond Guarantee Scheme. At June 2019, the average value of RADs held by providers was $318,000, up from $229,000 in 2013-14.[5] In 2018-19, the total RAD pool that the Government guaranteed was around $30 billion.[6]

20 The number of residents choosing to pay their accommodation costs through a RAD is in decline, as more people choose to pay their accommodation costs instead through a Daily Accommodation Payment (DAP), or a combination of the two. In 2014-15, 43 per cent of residents paid a RAD for aged care, and 33 per cent paid a DAP with the remainder paying a combination of the two. In 2018-19, 35 per cent of residents paid a RAD and 41 per cent of

[3] Eight report on the Funding and Financing of the Aged Care Sector, pages xi and 10.
[4] 2018-19 Department of Health Annual Report page 134.
[5] Eight report on the Funding and Financing of the Aged Care Sector, pages 89
[6] Eight report on the Funding and Financing of the Aged Care Sector, pages 90

residents paid a DAP.[7] Providers will increasingly require new sources of capital and will have to adjust their business models in response to this change in preferences.

Taxation and co-contributions

21 Based on the principles set out at paragraph 13 above, Australian Government funding from taxation of a broad base at low rates, combined with consumer contributions provides an equitable, sustainable and simple basis to finance aged care. Within the current system of taxation and co-contributions, there may be opportunities to enhance policy settings and incentives to facilitate the delivery of high-quality care, and enable innovation and investment in the aged care sector.

22 The greater the extent to which recipients of aged care services meet some of the costs of their aged care, the less taxes need to be levied on the broader Australian population to pay for care. Moreover, consumer contributions enable Government funding to be targeted to those most in need and help to ensure fairness and equity of access to services.

23 In addition, contributions from recipients of aged care services create opportunities for system improvements driven by consumer choice, as providers are incentivised to better meet the preferences of recipients. Neutrality in the means testing arrangements between different forms of care, such as residential aged care and home care, may also support recipients to make choices based on their care needs and personal circumstances, rather than the financial impacts.

24 In the future, there will be decisions for Governments around greater funding contributions from general revenue to meet the growing demand for, and changing preferences in, aged care. When considering revenue changes or increases, there is often a complex trade-off between simplicity, fairness and efficiency. In particular:

(a) a ‘simple’ tax system is one that is easy to understand and to engage with, helping to contain compliance costs and reduce the scope for tax avoidance activities;

(b) a ‘fair’ tax system is generally regarded as one that sees taxpayers in the same financial situation pay the same amount of tax (‘horizontal equity’) and taxpayers with higher incomes pay a higher amount of tax (‘vertical equity’); and

(c) an ‘efficient’ tax system is one that minimises the economic costs it creates.

25 When considering any change to tax arrangements it is important to consider the objectives of different taxes and how changes to individual taxes will interact with other taxes (and the welfare system) as a whole.

26 Further information on consumer contributions, including how these could be adjusted, is provided in paragraphs 62-88. Additional information on taxation, levies and hypothecation, including risks to be considered, is provided in paragraphs 45-61.

Social insurance

27 Social insurance is a system where individuals contribute to a pooled fund that is managed by Government or regulated insurers. These funds are used to cover the risk of particular events occurring, for example, loss of income, injury, disability or retirement. There are a range of social insurance systems across the world.

[7] Eight report on the Funding and Financing of the Aged Care Sector, pages 90

28 For the purposes of this statement, Treasury has considered that a social insurance arrangement would involve establishing a pre-funded system based on compulsory contributions made from income during the course of an individual's life, with withdrawals to meet aged care expenses.

29 A social insurance system is generally considered an appropriate policy solution in situations where it is desirable to levy a certain activity that creates a significant risk for the broader community, to ensure the cost, and therefore the level, of that activity takes the risk into account. Third party motor vehicle insurance and workers compensation are examples of effective social insurance schemes. For most participants in these sorts of social insurance schemes, there is a very low probability that they would access the scheme, but where they do the losses to be compensated can be large. This is different to aged care, where it is likely that a large proportion of individuals will access aged care services at some point in their later lives, and will require significant funding to cover the cost of their care. The higher probability of individuals needing to draw on an aged care social insurance system would likely result in higher premiums than for other social insurance systems.

30 A social insurance framework could be designed in a number of ways, including an entitlement model whereby payments are pre-determined and contributions do not determine entitlements. In this case, social insurance contributions are akin to a hypothecated tax (the risks and considerations for hypothecated taxes are further outlined at paragraphs 45-61). Alternatively, the framework could be designed as an account model where withdrawals from the scheme are determined by an individual's contributions to the scheme.

31 A social insurance system based on entitlement would face challenges in ensuring it has sufficient funding to meet the costs of aged care, in the short to medium term. Over the longer term, to the extent that individuals do not contribute to the scheme – such as those with limited or intermittent employment or with disability and caring responsibilities – government would likely need to provide funding to cover these costs. If these individuals were not included in the scheme, separate government support would still be required to ensure they had access to quality care.

32 On the other hand, an account model may raise equity concerns as payments from the fund would be determined by contributions, based on working-life income. Higher income earners would generally receive higher benefits from an account model social insurance system, despite generally being in a good position to fund aged care costs from other sources of income or wealth. At the same time, individuals who have limited employment income and generally rely on the age pension for their retirement would receive fewer benefits from such a system.

33 In the short to medium term, issues of intergenerational equity would need to be considered. Establishing a fund today would do little to fund aged care costs for the current generation of older Australians; many would not make sufficient contributions to fund their aged care. Current working age people would be funding both their future aged care needs and that of current retirees.

34 In Australia, general taxation arrangements and government payments (including the Age Pension, the Disability Support Pension and aged care services), along with the superannuation system are designed to achieve similar objectives to social insurance arrangements used in other countries. There are unlikely to be significant gains in introducing a social insurance system in parallel to the existing Australian social security and superannuation arrangements. Superannuation savings are available to fund a range of spending needs in retirement, including aged care expenses. As the superannuation system matures these savings will be able to play an even greater role in funding a range of retirement spending needs. As evidence shows that people's real spending generally declines as they age during retirement, there will be increasing capacity for retirement savings to fund aged care.

35 Consideration of additional contributions to an aged care related social insurance system would need to be balanced against the compulsory contributions already made to superannuation and recognise that all of these arrangements reduce income available to individuals to use during their working lives.

Private insurance

36 Insurance is a method of managing risk or uncertainty. Effective insurance arrangements can diversify and spread risk or uncertainty for those who are unable or unwilling to bear that risk or uncertainty alone. Where fully developed, an insurance market can effectively act as a means of financing certain activities.

37 The effectiveness of any private insurance arrangement would depend on the specific risks or the aspects of the costs of aged care that insurance would seek to address, taking into account how it interacts with the publicly funded system. A private insurance market seeking to manage 'tail risk', or the prolonged need for aged care above a certain age threshold (for example, 80 or 85), would face different challenges compared to a model where insurance acts as the first call to fund private aged care expenses (similar to private health insurance for elective surgery).

38 Generally, the viability of a private aged care insurance market would depend on having sufficient numbers of people taking up the product to allow pooling and risk sharing. There are both demand and supply side constraints to forming a market. For individuals, a range of factors would influence and may inhibit the decision to purchase insurance, including the availability of publicly funded aged care, complexity associated with the level and options of cover available, uncertainty around the need for aged care and uncertainty around future regulatory settings.

39 Insurers' willingness to develop and offer aged care insurance products ultimately would depend on whether the market offers a reasonable rate of return after the risks are taken into account. With settings in aged care being highly regulated, regulatory certainty and confidence in the process and objectives for future reforms would also be an important consideration for insurers.

40 Insurers would need to appropriately price risk and would require access to sufficient data (for example, detailed medical histories) to understand the risks being underwritten. They would face the risk of adverse selection where only those consumers who are likely or expect to make a claim on the product purchase insurance. Adverse selection reduces the benefits of pooling and sharing risks and therefore impacts the price of the product. In contrast, a mandatory private insurance scheme would be close in practice to a publicly funded social insurance scheme, and there may not be significant benefits in introducing this as discussed above.

41 The existence of a private market for aged care insurance could also be affected by the availability and pricing of reinsurance. Reinsurance enables an insurer to write policies while transferring some of the risks to another entity, the reinsurer. Reinsurance enables insurers to reduce risk concentrations and diversify risk, which can reduce volatility in income and make insurers' balance sheets more resilient to claims. Aged care insurance products would need to be designed in such a way that reinsurers would be willing to provide coverage.

6) Would a compulsory social insurance scheme for aged care provide more certainty about the availability of financing for future aged care needs? Why or why not?

42 It is unclear whether a compulsory social insurance scheme would provide more certainty around future financing arrangements.

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43 The design of a social insurance scheme for aged care would involve a complex range of considerations. These include:

(a) when the scheme might start making payments to fund care and how much it would pay;

(b) whether those payments change over time; and

(c) whether the balance of aged care costs are funded by government, from means-tested co-contributions or both.

44 These considerations involve trade-offs, such as the appropriate balance between the sources of funding. Given the complexity of designing such a scheme, and the length of time it would take to reach maturity, it is likely that there would be a need to modify elements of the scheme over time. This has certainly been the experience in superannuation.

45 Further, the difficulty in predicting the future costs of care as well as contributions over time would limit the certainty provided by a social insurance scheme. The difficulty of setting those contributions today for a 20 year old, who may need aged care in 70 years' time is likely to be significant, even with actuarial estimates.

46 Pre-funded social insurance schemes can face solvency pressure, which can result in increases to contribution rates or reductions in benefits to ensure the viability of the scheme. These outcomes can limit certainty for members.

47 As already discussed, a pre-funded account-based social insurance scheme would be unlikely to generate a stream of benefits that would adequately fund aged care expenditure. This is because aged care costs largely relate to factors not directly related to incomes or time spent in employment, but are more closely linked to factors such as an individual's health status, frailty and longevity. Low income earners would receive smaller benefits, and require additional government funding having been required to sacrifice disposable income during their working life and early years of retirement with significant implications for their wellbeing. High income earners would make larger contributions, but to a fund that they may not need, given their ability to access other forms of personal income or wealth.

Part C | Levies and hypothecation

7) Generally, what are the advantages and disadvantages of hypothecation? Does Treasury have an institutional view on hypothecation?

48 As outlined in paragraphs 19-24, there are a range of factors to taking into account when considering changes to taxation arrangements, such as introducing levies and hypothecated taxes.

49 Levies can be a useful funding tool in circumstances where benefits provided by the revenue raised from the levy flow exclusively to those who pay the levy, rather than broader society. For example, agricultural industry levies are designed to support research and development and marketing for specific industries, and are designed so businesses that benefit from this spending contribute to it.

50 In such circumstances, levy-funded interventions should respond to a demonstrable market failure, come at a lower economic cost than the market failure, come at a lower cost than general revenue funded interventions, not create competitive distortions within the covered sector, and be amenable to ongoing monitoring and challenge by levy payers to ensure that levy proceeds are being used to finance the stated activity.

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51 A levy may also be useful where it is intended to provide a price signal or indicate the risk of an activity. While there are some steps that individuals can take to promote good health as they age, many factors leading to frailty and loss of acuity in older age are unavoidable. Given this, a levy on income that is intended to signal the price of risks for ill-health or to encourage behaviour modification is unlikely to be an appropriate or equitable way to fund aged care.

52 Alternatively, a levy may effectively operate as an increase in marginal personal tax rates. For example, in the 2019-20 income tax year, the Medicare levy adds a flat two per cent to the marginal personal tax rates faced by taxpayers once they earn income more than $28,501 (or $45,069 for taxpayers eligible for the seniors and pensioners tax offset). The Medicare levy does not apply to incomes of $22,801 ($36,056) or below for singles and is phased in at a rate of 10 cents for each dollar in excess of that point until it reaches two per cent. Different thresholds based on combined family income apply for couples and families with children. In the 2019-20 Budget, the Medicare levy was expected to raise $18.1 billion in revenue in 2019-20, well short of the $37.5 billion in government spending on the Medicare Benefits Schedule and the Pharmaceutical Benefits Scheme in 2019-20.

53 Levies can be designed to cover a portion of the costs of a Government program. Where Government spending is in excess of revenue raised by a levy, there would be a need for additional 'top up' funding from other revenue sources. In such circumstances, the revenue raised from a levy and the cost of the related program may diverge over time and create the potential for public misperceptions about the cost of the program and their contributions to that cost. Similarly, if funding for the levy is higher than the costs of the program it is intended to cover, using these funds for other essential programs or priorities may not be possible due to public commitments and can limit capacity for Government to appropriately manage its revenue.

54 It is also important to consider the relative economic cost of a levy compared to other arrangements, such as other sources of revenue or consumer contributions. Levies can increase complexity and reduce the efficiency of the personal income tax system. Depending on the design of the levy, they can lead to high effective marginal tax rates, which can act as a disincentive to work, save and invest, particularly for low income earners. In addition, they can lead to tax planning activities as individuals seek to reduce their tax burden.

Hypothecation in taxation

55 Hypothecating taxation revenue for specific purposes (for example, aged care) can limit spending flexibility and inhibits the Government's ability to manage its cash-flows most efficiently. Furthermore, by focussing on funding rather than desired outcomes, it may not result in the intended public policy outcomes being delivered as effectively as possible.

56 Where money is locked away for specific purposes, the Government may find itself having to raise more debt or collect more revenue than would otherwise be required. Hypothecation also reduces the Government's ability to direct or redirect resources in a way that reflects its priorities and unanticipated events. Changes in the broader economic conditions can result in fluctuations or variability in the level of revenue generated and may result in shortfalls in funding and uncertainty for providers and people receiving services. In these circumstances, Government may have to provide additional revenue from consolidated revenue.

57 For the above reasons, from a public policy perspective, Treasury is usually not supportive of the hypothecation of funding for particular purposes. Instead, Treasury considers that flexibility should be maintained within the balance sheet to allow for the delivery of government outcomes. However, we note that funding can be publicly committed for specific purposes without requiring hypothecation. For example, the Government's spending on the Medicare Benefits Schedule and the Pharmaceutical Benefits Scheme is accounted for in each Budget update as part of the Medicare Guarantee Fund. These funds are drawn down from

consolidated revenue, providing flexibility for government budgeting but enhancing public accountability.

Hypothecation can be managed in a number of ways

58 Hypothecation can be achieved in a number of ways, and can occur with or without the introduction of a new funding source (whether a levy or a tax increase). If funding from a levy was hypothecated, the revenue can be allocated to the specific purpose by holding financial assets in an investment fund, or without holding financial assets through the creation of a special account.

59 A special account is a limited special appropriation that notionally sets aside an amount that can be expended for specific purposes. It may also enable amounts to be collected from third parties for the purposes of the special account, which are held in the Consolidated Revenue Fund and drawn as needed. The appropriation amount that may be drawn from a special account is limited to the balance of the special account. The special account balance comprises amounts held in the Consolidated Revenue Fund and appropriation amounts credited to the special account. Generally, as the Government is only required to fund the special account when funds are drawn this arrangement can be a lower cost way of achieving hypothecation, but can still reduce budget flexibility.

60 An investment fund is an alternative hypothecation arrangement that can be considered. An investment fund involves the purchase and management of financial assets to fund a particular policy objective by drawing on earnings and/or capital from the financial assets. A fund is bound by legislation and an investment mandate, specifying the benchmark rate of return on the investment and other requirements, such as the appropriate levels of investment risk and the purposes for which the funds may be used.

61 The establishment of an investment fund is generally considered appropriate to efficiently manage some future known stream of payments that the Government will be liable for. This was a key rationale for the Future Fund, which was established to strengthen the Government's long-term financial position by making provision for what was the single largest liability on the Government's balance sheet: the unfunded payments arising from the Commonwealth's defined benefit superannuation arrangements. The assets in the Future Fund have been accumulated over the past decade and will be run down as these superannuation payments are made over coming decades.

62 Building up financial assets in advance of making payments, however, involves additional borrowing, which increases the Government's gross debt and public debt interest costs. Investment funds are exposed to variations in economic conditions and exposes the Government's balance sheet to these risks. During periods of unexpected downturn, there is a risk that they may fail to generate expected earnings or that their capital may be eroded. The Government may face requests to top up the revenue or capital from the budget, particularly if the decline in revenue is likely to affect the level of services provided.

63 Effective funds management generally requires specialist investment fund managers. Management fees must be factored into calculations about funds available for disbursement after costs. A fund which needs to make frequent disbursements may need to invest in fairly liquid assets that are generally low yielding. The initial capital outlay required to generate sufficient revenue to fund aged care may be significant, particularly if the fund is required to make frequent disbursements and maintains low yielding liquid assets.

64 Treasury does not consider that the establishment of an investment fund would be an appropriate mechanism to fund the aged care sector given the ongoing nature of the program, and the costs and financial risks that would be associated with the establishment and operation of such a fund.

Part D | Co-contributions and means testing

8) Should older Australians be asked to contribute more to the cost of their care if they have the capacity to pay? How would this be best achieved? For example, should the government facilitate reverse-mortgage-backed annuity arrangements?

65 Australia makes widespread use of mean-tested arrangements across a range of programs to ensure that support can be provided in a way that is scaled and targeted to the individuals who need it most, while managing the overall costs to the taxpayer.

66 Individuals who have the capacity to contribute more to the cost of their aged care already make some contributions, and consideration should be given to ways to further enhance these arrangements. Additional consumer contributions would add to the total funds available for aged care, allow for consumer-driven system improvements, better manage demand for care, improve equity in the system overall, and ensure that Government support can be targeted to those most in need.

67 In Australia, recipients of aged care services contribute to their living costs, and care costs where they have capacity to do so. In 2018-19, recipient contributions represented about 9.9 per cent of total Commonwealth Home Support Program funding, 4.2 per cent of total Home Care funding and 24.6 per cent of total Residential Care funding.[8] Previous reforms to aged care have sought to increase consumer contributions towards the cost of accommodation and general living in residential aged care (cleaning, meals, heating, cooling etc.), recognising that individuals had been responsible for meeting those costs prior to entering residential aged care. As a result, a substantial portion of consumer contributions in residential care go towards accommodation and living costs, rather than the costs of care.

68 For those who live to old age, the likelihood of requiring a form of care in the home or in another facility is relatively high. The probability of a woman aged 65 entering residential aged care is 53 per cent, and for a man it is 39 per cent. There will also be some people who access home care, but never enter residential care. Certainty and awareness around future policies for consumer contributions is necessary to ensure Australians are able to appropriately plan for the costs of aged care, in addition appropriate signalling early about the expected costs of care for people as they age may help make planning for aged care part of the regular process of planning to meet expenses during retirement.

Superannuation and retirement assets

69 There is likely capacity for many Australians to better use their retirement assets, including superannuation, to make a greater contribution to the cost of their aged care. There is evidence that a significant proportion of retirees die with most of their initial wealth intact, and the size of these balances is expected to increase over the next two decades. Rice Warner project that average death benefits from superannuation, where payments are made to beneficiaries from decreased estates, will grow from around $200,000 in 2020 to around $386,500 by 2040 (in 2019 dollars). Further, studies that track Age Pensioners and super fund members over time show that most people die with the majority of superannuation assets they had upon entering retirement.

70 In Australia, the two largest savings vehicles used by households are owner-occupied housing and superannuation. Superannuation accounts for around 18 per cent of assets held by households. ATO statistics indicate that in 2017-18, the average superannuation account balance for males aged between 65 and 69 was $399,872 (median $178,326). For the same

[8] Eight report on Funding and Financing in Aged Care, page 13

period, the average superannuation balance for females aged between 65 and 69 was $358,055 (median $171,679). The difference between average balances and median balances reflect the skewed distribution of assets held in superannuation – a small proportion of the population has accumulated very large balances and a large proportion of the population has accumulated very small balances.

71 The capacity to contribute to aged care using superannuation is expected to grow in coming decades as the system matures, and people therefore retire with larger balances. Compulsory superannuation was introduced in 1992. Accordingly, people retiring around 2040 will be the first cohort to retire after receiving compulsory superannuation contributions for their entire working lives. Rice Warner projections indicate that the median 85 to 89 year old male in 2019 will have an annual income in retirement (including from superannuation and the age pension) of around $23,000, and a superannuation balance of only around $29,000. A comparable male in 2040 is projected to have an annual income in retirement in 2019 dollars of around $38,000, with a superannuation balance of around $169,000.

72 Many older Australians have significant assets outside of superannuation. The wealthiest one-fifth of Australian households aged 55-64 have average assets of over $3.5 million. The next wealthiest one-fifth of Australian households in this age group have average assets of over $1.2 million. Accordingly, there is significant scope for the wealthiest 40 per cent of Australian households to make significant contributions to the cost of their aged care, whether it is from superannuation or other assets.

73 While the capacity of individuals to contribute to the cost of their aged care is expected to increase significantly in coming decades, not all individuals will achieve sufficient savings to meet their aged care costs. This includes individuals with variable employment, or those on lower incomes. For some individuals, general taxation will continue to play a role in meeting their aged care expenses.

Assisting retirees to better utilise their assets

74 An under-developed part of the retirement income system involves private products or mechanisms that would provide retirees with dependable sources of income in retirement. This is critical to the purpose of the retirement income system, as it involves using superannuation assets to generate an income stream (such as provided under a defined-benefit superannuation scheme or through an annuity) that can defray living expenses and manage longevity risk. The need for these products or mechanisms will only grow in significance as balances increase and are highly relevant for aged care financing, as they would give retirees more certainty that they will have sufficient income to pay for aged care expenses for the rest of their lives.

75 As noted, older Australians can tend not to run down their assets to fund retirement living expenses, rather they largely live off the earnings from these assets. This precautionary approach to spending in part reflects uncertainty about their life expectancy. In addition, previous aged care funding arrangements where lump-sum accommodation bonds were a requirement likely still contribute to the belief that people need significant lump sums to access care.

76 There are a number of strategies for using assets more effectively that have the potential to achieve significantly higher income over retirement and also manage longevity risk. One of these strategies would involve immediate annuities that provide a regular income stream from the time of purchase for a fixed term or for life. Where these are pooled products, they can manage longevity risk whilst maintaining market exposure to generate relatively high returns. Another strategy would involve deferred annuities that provide income once a person reaches a certain age. These approaches have the potential to generate significantly higher income than if a person drew on their assets conservatively to manage their own longevity risk. In the future,

income from such strategies in combination with a part-rate Age Pension (and maturation of the superannuation system, as outlined above), would mean middle income earners could generate significantly higher incomes throughout retirement than current retirees.

77 However, developing a retirement income strategy is not straightforward for people to do. Superannuation funds are well placed to provide members with information and guidance on the strategies available to manage retirement incomes. While Treasury is aware of active development of integrated retirement income products by some funds, this is a relatively immature part of the industry. A variety of approaches by government could support and or direct this development. Current Government policy is to develop a Retirement Income Framework, which will enhance these aspects of Australia's retirement income system.

78 While not necessarily targeted only to aged care, developing mechanisms that provide a dependable stream of income payments across the duration of retirement would significantly improve the confidence that people have that they will have sufficient income to pay for aged care. This approach would complement the move to fund aged care accommodation costs through a stream of payments, rather than lump sum payments, and facilitate additional contributions by individuals who have the capacity to pay.

Accommodation payments, capital financing and prudential regulation in aged care

79 Refundable Accommodation Deposits (RADs) represent both a significant contribution from the recipients of aged care towards their accommodation costs and a source of capital funding for residential aged care providers. When considering future aged care setting, alternative forms of capital financing may be more appropriate, such as private equity.

80 If an aged care provider becomes bankrupt or insolvent and cannot refund lump sum balances, the Government guarantees to repay an amount equivalent to the RAD, including any interest due since the resident left care, to the resident or their estate. The guarantee is provided at no cost to providers. Currently, the total RAD pool that the Government guarantees is about $30 billion.

81 The increasing preference of residents to pay a DAP instead of a RAD means providers are having to adjust their business models. Aged care providers will also increasingly require new sources of capital and appropriate liquidity management to ensure they can meet future RAD liabilities and fund capital costs.

82 Increased use of DAPs instead of RADs means superannuation income streams can be used for aged care accommodation expenses.

83 Appropriate prudential management and oversight is important to manage the risks to Government, providers and the sector as a whole of the Bond Guarantee Scheme and RADs. Prudential regulation of the sector needs to recognise the Commonwealth's balance sheet exposure to approximately $30 billion in RAD liabilities and ensure providers maintain appropriate financial management practices to meet their RAD liabilities. It is also important to manage reputational risks within the sector that would arise if the Guarantee were called upon. Prudential oversight of the performance of providers is important for identifying financial concerns early, managing smooth transitions within, and exits from, the sector, and attracting investment and new entrants to the sector.

Reverse mortgages could help finance consumer contributions to aged care

84 Reverse mortgages, such as the Pension Loans Scheme, provide a means for drawing down on the equity held in housing assets to fund a greater proportion of aged care costs. This is particularly relevant to the consideration of consumer contributions by current retirees who are likely to hold a greater proportion of their wealth in the family home.

85 The Pension Loan Scheme enables Australians of age pension age, including full and part-rate pensioners and self-funded retirees, to borrow against the equity in their Australian real estate to access a regular income stream of up to 150 per cent of the maximum rate of the age pension. Being a reverse mortgage scheme, repayment of the loan principal and compound interest is only required when the secured property is sold or the borrower dies.

86 The Pension Loan Scheme can be accessed by full and part-rate pensioners, as well as self-funded retirees. The payments are non-taxable and do not count towards the age pension income test or aged care means test. Income received under the Pension Loan Scheme can be used to meet aged care expenses, including Daily Accommodation Payments and privately funded aged care services.

87 There are a number of factors which have limited the take up of the Pension Loan Scheme and other commercially available reverse mortgage products. These include: a general reluctance among older Australians to hold debt in retirement, particularly debt that is secured against the family home; the perception that reverse mortgages are only a means of 'last resort'; and bequest motives, particularly if the family home is the retiree's most valuable asset.

Fee settings should be transparent, consistent and easy for people to understand

88 The various approaches to means testing arrangements and fees across different aged care programs results in complexity and inequitable access to services. As far as possible, fee settings should be transparent, consistent and easy for consumers to understand. Simplifying fees and means testing for aged care across all programs would improve consumer understanding of how to navigate the system and may improve the ability for people to better plan for their needs as they age.

89 The current aged care system and funding arrangements can be difficult to navigate. Fees, consumer contributions, means testing and financing arrangements lack transparency and are inconsistent across programs. Each of the three current aged care programs (the Commonwealth Home Support Programme, Home Care Packages and residential aged care) are funded through different mechanisms and have multiple consumer fees, each with separate pricing rules and separate means testing arrangements.

90 Current settings do not allow for appropriate contributions from those with the capacity to contribute more, reduce provider flexibility to respond to the preferences of recipients of aged care services who may wish to pay for additional services, and create complexity for providers about what they can and cannot charge. This complexity unnecessarily adds inefficiency to the aged care system.

91 Appropriate quality and safety regulation as well as prudential management where required is important to ensure the delivery of high-quality aged care services in Australia. Governments have a clear role in ensuring regulators are appropriately resourced to ensure the delivery of aged care services meets the community's expectations. Funding arrangements can also improve delivery of services, such as encouraging older Australians to play a greater role in making early decisions about aged care.

9) Should the current treatment of the family home in the residential aged care means test applicable to the means tested daily care fee and the accommodation supplement be tightened to ensure that taxpayer funds are directed to the most needy? For example, should some limit be applied to the full exemption of the family home which currently applies where an eligible person is in occupation, and should more of the family home's value be included where an eligible person is not in occupation? Under what circumstances might the value of the family home be included, and to what extent?

92 Along with other assets, including superannuation and other income streams, a portion of the value of the family home (up to a cap of $170 000) is included in the means test arrangements to determine a resident's contribution to their accommodation and care costs. A resident's family home is excluded from the means test if it remains occupied by a protected person (such as a partner or dependent child). This results in a significant asset not being included in residential aged care means testing arrangements. Individuals with a greater proportion of their wealth in their family home are contributing relatively less to the cost of care than a person with wealth in other assets, such as cash, equities or a rental property.

93 In addition, the $170,000 cap is inequitable for individuals whose homes have a lower market value because a greater proportion of their total wealth is included in the means test. This means that individuals whose homes are worth more benefit more from the cap. All else being equal, an individual with a home worth $1,000,000 will make the same contribution as person whose home is worth $250,000, even though they have significantly greater means.

94 Including a higher value of the family home in the means test (potentially the full value) would provide more equitable treatment of different types of wealth between home owners and non-homeowners, and ensure that recipients of aged care contribute to the cost of their care based on their means. It would also be a more efficient and less distortionary means of funding consumer contributions to aged care than raising this funding through general taxation. Existing programs such as the Pension Loan Scheme would be required to support this change in policy to assist individuals who do not wish to sell their family home but who do not have other sources of income to make the higher contributions that would be required of them.

95 It is appropriate that the family home should be excluded from the means test when a partner or a dependent child is occupying the residence. However, the inclusion of carers and close relatives may create incentives for people to arrange their circumstances to avoid means testing. In addition, in circumstances where a partner or dependent child is still living in the home, equity in the home could still be incorporated in the means test through the use of the pension loan scheme.

Part E | Regulatory arrangements

10) Describe any regulatory arrangements that would need to be developed in the case of each of the following long term financing arrangements:

a) private insurance

b) social insurance, provided through a competitive market for social insurers

c) social insurance, provided through a single government-operated provider.

96 An aged care insurance market would require effective prudential regulation. The general, life and private health insurance industries are subject to several forms of regulation. Australia's financial regulatory system is often said to be a 'twin peaks' model, with prudential regulation separated from conduct regulation. For general and life insurers, the Australian Securities

Investment Commission (ASIC) is responsible for conduct regulation and The Australian Prudential Regulation Authority (APRA) for prudential regulation. For private health insurers, while APRA is responsible for prudential regulation, the Department of Health is responsible for conduct regulation.

97 Most general and life insurance contracts are financial products. Providers are generally required to hold an Australian Financial Services License (AFSL) and are subject to financial services regulation. AFSL holders must comply with general obligations set out in the *Corporations Act 2001* (Cth), which include acting honestly, efficiently and fairly, having dispute resolution systems in place and ensuring that representatives are competent and conflicts of interest are managed appropriately.

98 Private health insurance contracts are not financial products and private health insurers are prudentially regulated by APRA under the *Private Health Insurance Act 2007* (Cth). The contracts are regulated by the Private Health Insurance Rules, which sit under the Act. These Private Health Insurance Rules are developed and administered by the Department of Health. Private health insurance providers must be registered, and there is a private health insurance ombudsman service that is an independent Government agency responsible for investigating complaints involving private health insurance and reporting. This differentiated treatment reflects the distinct context in which private health insurers operate, including their interaction with publicly provided and/or funded healthcare services.

99 The regulation of a private sector aged care insurance market would likely require a similar model with prudential regulation separated from conduct regulation. Given the complexity of an aged care insurance market, a separate legislative framework to govern the sector and protect the interests of consumers may be necessary.

100 A consideration for Government in regulating a private insurance market would be whether any constraints should be placed on how risks are priced. In general, insurance markets determine the factors and methodology for risk rating to determine whether to offer cover and at what price (for example, a motor vehicle or house insurance). An alternative would be to use a community rating, whereby each consumer pays the same price for a particular policy regardless of their health status and other demographic characteristics. Community ratings, however, can result in issues with the long-term sustainability of insurance given that young and healthy members are paying the same premium as older members or members in ill health, who are more likely to make claims.

101 For a social insurance model, a range of regulatory arrangements would need to be put in place for either a competitive market of private providers or government provision. Legislation would be required to establish the scheme and make provision for oversight by relevant regulators. The complexity of the regulatory regime would likely mirror that for Australia's superannuation system.

102 There is a risk that the costs of operating a social insurance model could be very high due to the regulatory arrangements, administrative costs and investment costs. As a guide, average superannuation investment fees are around 0.5 per cent per annum, in addition to the administrative costs of such arrangements. These costs do not exist for funding aged care through consolidated revenue or increased consumer contributions from existing assets. The Australian Government would likely experience an increase in its administrative functions to establish, monitor and regulate a new scheme.

Part F | Implementation and transition

11) Does Treasury have a view as to whether a social insurance model would have any effect on Australia's sovereign risk rating? If so, what effect would it have?

103 The impact on Australia's sovereign risk ratings of the government providing social insurance would depend on the significance of the associated actual and contingent liabilities this would create (as well as any revenue streams put in place to cover these) relative to other liabilities, as well as the broader fiscal context. Even if only at the margin, actual or contingent liabilities added to the Commonwealth balance sheet would be expected to put some minor downward pressure on Australia's sovereign risk ratings.

12) What transitional arrangements, if any, would need to be in place to implement a long-term pre-funded financing arrangement? Does Treasury have a view on whether a transition would be easier for a pay-as-you-go model as compared to a fully funded model?

104 In Treasury's view, a pre-funded system for funding aged care is not necessary in Australia, and does not provide the best solution to ensure funding is available to meet aged care costs. A pre-funded model for aged care in Australia would unnecessarily duplicate the existing pre-funded superannuation system.

105 Pre-funded financing arrangements would present a wide range of design and implementation challenges and transitions may be costly. As outlined in paragraphs 40-44, a pre-funded system is unlikely to cover funding needs in aged care in the short to medium term and would likely need to be supplemented with additional funding in the longer term. In setting up a scheme to be pre funded, there would be significant start up and ongoing costs in managing funds, both for Government and private fund managers.

106 A pre-funded social insurance scheme would require an investment composition that would enable it to meet liquidity requirements and to match liabilities. In a low interest environment, such as we are currently experiencing, this may be difficult to achieve without larger upfront contributions.

107 If a pre-funded system were established, it is likely that current arrangements would need to continue for a significant period of time, until the scheme had accumulated enough funds to fully provide for the costs of aged care. This would result in significant issues of intergenerational equity, as younger working age people would be required to pay for the existing system of aged care twice: once through existing arrangements and again to contribute to the pre-funded scheme. Transitional arrangements could also contribute further to the complexity of the aged care system, and may create difficulties for Australians to plan for their care needs and navigate the system.

108 A key transitional issue for a pre-funded model, as noted in paragraph 29 above, is the many decades it would take for the system to mature. Compulsory superannuation was introduced in 1992 and the first cohort to retire with the full benefit of the system will be retiring in around 2040. It would be premature to introduce an entirely new aged care funding arrangement before the superannuation system has reached maturity. A pre-funded social insurance scheme would make the largest contribution to aged care funding needs from around 2070 onwards. Rather, it is appropriate to ensure that the existing superannuation system is meeting the retirement income needs of Australians.

109 A pay-as–you-go model would not suffer the latency issues that are involved in a social insurance model. Treasury considers that pay-as-you-go models are overall more appropriate for financing aged care. While insurance models may help to pool risk across the community, this can also be achieved in a pay as you go model, for example through the use of annuities in superannuation, as outlined at paragraph 73, enhanced contributions from individuals who have the capacity to contribute, and the progressive taxation system. Pay–as-you-go models also provide greater flexibility, involve lower start up and management costs and avoid the need for costly transitions.

110 Strengthening the link between superannuation assets, retirement income and aged care funding would achieve a similar objective to pre-funding aged care funding systems employed in other countries.