

# Henry Retirement Income Consultation Paper

ASFA Submission

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Association of Superannuation Funds of Australia

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## INTRODUCTION

The Association of Superannuation Funds of Australia Ltd (ASFA) is pleased to provide its submission in response to the Australia's Future Tax System: Retirement Income Consultation Paper ("the Consultation Paper").

ASFA is the peak superannuation industry association representing all sectors of the Australian superannuation industry. Part of our mission is to advance retirement outcomes for members of funds through research and advocacy.

Some issues are closely linked to the outcomes of the Harmer review of the level of the Age Pension. It is recognised that if the level of the Age Pension is increased by the government, there may be a flow-on effect of better retirement adequacy to those who receive these benefits. However, the extent of any such flow-on to partially self funded retirees receiving a part Age Pension would depend on whether any changes are also made to the means test.

We recognise that this review is being undertaken in the context of a global financial crisis which has shaken the foundations of our financial system. Rather than focusing on the short-term issues around this crisis (of which there are many), ASFA has approached this process with the focus on Australia's long term retirement income system, recognising that the system will not mature until 2035. It is important to retain this long-term focus when recommending changes that will affect Australians over coming generations.

Having said this, the global financial crisis has thrown some well-known issues into even sharper focus, in particular investment and longevity risks for retirees. We include a detailed discussion and some recommendations in these areas.

## EXECUTIVE SUMMARY

### ASFA's strategic vision

ASFA considers that a fundamental part of any review of the retirement incomes system should be the setting of a goal for the level of retirement income to be achieved. This review affords the opportunity for such a long term vision to be set, together with specification of implementation steps to be taken over future years.

A careful transition is required in order to keep confidence amongst all those with current savings, which is essentially the bulk of the adult population. However, the vision should not be constrained by too much focus on the current system. In essence, goals and policies should be set on the basis of what would be most appropriate for a 20 year old entering the workforce over their entire workforce and retirement periods.

### Delivering income streams

Preparing and providing for retirement must be seen as focussing on delivering an income stream for retirement years. In contrast, the current system could not be judged to be as focussing on that clear goal.

The current system is built around various pillars which can or do generate income streams. However, there is a lack of clear integration between the Age Pension and compulsory and voluntary retirement provision.

Clear long term messages need to be given to the community around an income stream being the normal and preferred way of taking a retirement benefit. Obviously this needs to be explained and introduced carefully, but ASFA believes the focus of at least the young in our workforce should be moved to expecting an income stream.

### Delivering better retirement income products

The great bulk of retirement income streams provided in Australia are either in the form of defined benefit pensions now mostly closed to new member funds, or from account based income streams (allocated pensions in the previous terminology).

While account based income streams provide considerable flexibility and access to good long term investment returns, they are less successful at dealing with the financial consequences of longevity or with short term investment return volatility. ASFA's long term vision is for the development of retirement income products which build on the strength of current account based products to deal with such risks. Changes in both legislation and in consumer attitudes might be needed.

### Setting a retirement income goal

Having a system built around delivering an income stream as a goal invites the question of how much should be delivered. There currently is no clear messaging to the community of a retirement income goal.

ASFA believes that all Australians should have at least a modest standard of living in retirement. On our current assessment this requires a retirement income (including drawdown of capital) of the order of \$20,000 a year for a single person. This is consistent with the finding of the Westpac ASFA Retirement Standard. This would be delivered by a combination of the safety net social security pillar (the Age Pension) and a level of tax preferred mandated saving through superannuation.

We believe the starting point for retirees cannot be lower than “modest” in terms of the ASFA/Westpac Retirement Standard. Individuals should also be provided with guidance and assistance in achieving higher levels of retirement income where this is appropriate. Most individuals with income above very low levels will want and need a retirement income which is a percentage of their pre-retirement earnings. This will be in the order of 60% or 70% of pre-retirement income, depending on whether the figures are pre- or post-income tax.

While for some individuals contributions of 9% of earnings might be sufficient to provide the appropriate retirement income goal, for most a higher percentage will be required. Options include changes to the Superannuation Guarantee, compulsory member contributions, soft compulsion and enhanced incentives for voluntary contributions for certain groups. Specific recommendations on this are set out later in the submission.

### **The amount of tax concession to be provided**

Governments and the community need to consider what level of retirement savings above the level supporting the floor of “modest” should receive the benefits of concessional tax treatment.

Two issues must be weighed –

1. the importance of encouraging private provision to ensure the community has aspirations and retirees can contribute towards the country's future economic prosperity; and
2. recognition that in a country which supports a progressive income tax, the community should not direct too much tax support towards high income earners who are likely to save or provide for themselves in retirement in any case.

A “ceiling” on the level of tax concessional retirement income is therefore proposed, but at a level that is broadly aspirational in terms of retirement incomes to be achieved, but equally not seen by community standards as excessive. It in effect would be a multiple of the floor, although it might not necessarily be directly cast in those terms.

As noted above, between the range of a floor and a ceiling, an expectation would be set that the vast majority in the community should be saving for a simple proportion of pre-retirement income – the 60% to 70% replacement rate figure.

### **Providing long term projections and assisting fund members**

In terms of a long term vision, it also is ASFA's view that with technological advancements and data matching, the Government (or the person's primary superannuation fund) should be heading towards giving each Australian an annual projection of their total retirement income taking into account all sources including social security. Annual projections of retirement income would provide:

- regular updating of legislative changes (eg social security rules)
- a better translation of volatile investment environments into their long term effect
- an explanation of the role of an income stream rather than just focussing on a lump sum
- the cost of early retirement to be understood.

Annual projections would clearly describe in the terms of an achievable income stream in retirement how saving for retirement is going within the range.

### **Providing flexibility in the amount of tax preferred saving**

Currently a tax concession cap is administered through contribution limits.

However, some persons are likely to want to contribute high amounts as a catch-up mechanism for past low retirement funding, whilst others are able to make substantial long-term use of the annual allowed amounts. Only time will tell which proportion of those contributing at the highest levels belong in these two groups. In any case, a contribution cap does not give sufficient guidance and affordability for the community around the level of retirement income that the community is prepared to provide concessions for.

With a vision focussed on a range of retirement incomes and annual projections of retirement income, there may be a number of ways in the future for managing the tax concession available to those in the community likely to exceed the ceiling. These would be more sophisticated than annual contribution caps.

## **PROCESS**

In order to prepare this submission ASFA has been through a rigorous process of consultation:

- The initial draft paper was prepared by the Retirement Outcomes Policy Subcommittee.
- ASFA then held a round table to collect broader views from the industry (not just ASFA members).
- ASFA has participated in discussions with other industry groups at a forum organised by the Financial Planning Association and another organised by the Institute of Actuaries of Australia.

- We have circulated the draft paper to eight ASFA Policy subcommittees and made it available to all ASFA members via our website

As such we are confident that the paper has been through a rigorous testing process across the broad superannuation industry.

This submission has benefited from a number of research inputs, including:

- detailed research into the current distribution of superannuation account balances;
- analysis of gaps in superannuation coverage within the adult population using ABS and other data;
- preparation of projections of future superannuation balances and private retirement incomes;
- sensitivity testing of future outcomes based on changes in basic parameters such as contribution rates and years in paid employment;
- public opinion polling on attitudes to superannuation; and
- review of domestic and overseas literature on retirement income provision.

## SUMMARY OF RECOMMENDATIONS

A number of recommendations are made throughout the submission. These are summarised here and have been grouped into topic areas.

For ease of reading, ASFA's recommendations have also been highlighted in the body of the submission.

### Changes to contributions

ASFA believes that higher contributions are required across the board to achieve an adequate retirement income.

ASFA recommends that an additional contribution of 3% of salary be introduced, taking total contributions to 12%.

ASFA believes that increasing SG is the preferable method of implementation. However we understand the difficulties around an increase to the SG, so if this is not possible then our next preference is for a compulsory additional personal contribution. If the requirement was introduced gradually, individuals could in effect pay for the additional contributions from pay rises. For example the additional contributions could be introduced as follows:

- 1.0% from 1 July 2011
- 2.0% from 1 July 2013
- 3.0% from 1 July 2015

Our third preference is for a "soft compulsion" personal contribution individuals would be able to opt out of the system.

ASFA recommends that employers be required to provide employees with access to salary sacrifice facilities. A suitable period should be granted before the commencement date of this measure to allow employers to implement the required administrative procedures.

ASFA recommends that the current contribution caps be retained, with the proviso that individuals such as those with broken work patterns, part-time workers, immigrants and expatriates can apply for a higher cap.

ASFA recommends that a common age be agreed of 75 for cessation of all contributions (SG, personal, salary sacrifice).

For self-employed people, ASFA recommends that:

- a compulsory contribution is gradually introduced for self employed people:
  - starting at 1% of taxable income in 2010-11 and
  - rising to 9% of taxable income in 2018-19;
- the contribution would be made as a proportion of the person's taxable income, averaged over three years;
- the contribution would not be required in the first two years from start-up of a business;
- the contribution would either be made from after-tax income up to a certain limit (eg. \$80,000) and be fully tax deductible, or the person could choose to make part of it as a non-concessional and claim the Co-Contribution (if their income was under the limit); and
- the contribution would be assessed as part of the tax return process with an additional amount collected from the individual (which could be rolled over into a complying superannuation fund) if the required contributions had not been made to a complying superannuation fund;

For individuals with broken work patterns, immigrants and returning expatriates ASFA recommends that the current system of annual contribution caps is reviewed to enable “catch-up” contributions. The individual would have to apply to the ATO for a higher contributions cap on an individual basis. In the future, though, there may be a number of ways of managing tax concessions that are more sophisticated than annual contribution caps.

For immigrants and returning expatriates ASFA also recommends that:

- The existing system for transferring pension money from other countries be reviewed. ASFA provided recommendations on this point in our previous submission in the Detailed Issues section at 4.6.

For all Australians ASFA recommends that:

- SG applies to all Salary Continuance Insurance payments i.e. 9% of SCl insurance is paid into super.
- Government pays 9% SG on their proposed paid maternity leave.
- Employers pays 9% SG on paid parental leave.
- SG be paid on unused long service leave taken as a lump sum.
- Investigations are made into whether it would be effective to pay SG on payments from the Community Development Employment Program (CDEP) for Aboriginal and Torres Strait Islanders. We recognise the complexity around these issues so ask that this be given expert consideration. Investigations are also made of the ability to place native title payments into superannuation.
- SG is paid on entitlements to wage payments made after the cessation of employment, eg following legal action.
- Remove the provision that excludes SG for those earning under \$450 per month from a single employer. A minimum dollar payment such as \$10 should still apply for practical purposes.

### **Determining adequacy**

When determining and setting the parameters for adequacy in the retirement income system, and in communicating adequacy to individuals in financial education tools, ASFA recommends that:

- A combination of dollar and percentage-based measures of adequacy be employed, as follows:
  - the Westpac ASFA Retirement Standard “modest” standard of living of \$19,600 for a single (or around 33% of AWOTE) or \$27,500 for a couple be used as a dollar-based floor to the measure of an adequate retirement income; and
  - an average net of tax retirement income of 70% of net of tax pre-retirement income should be targeted at age 65.
- A standard working lifetime of 30 years is assumed rather than the current 35 - 45 years. This allows for the large number of individuals who experience broken work patterns.
- The issues around replacement ratios discussed in section 2.2.2 be taken into account.

### **Changes to superannuation taxation**

Although there is some merit in the idea of introducing a tax on investment earnings in retirement, ASFA considers it appropriate at this stage to leave investment returns in retirement tax free.

ASFA recommends that the age at which superannuation becomes tax-free is increased gradually to age 65. This would be consistent with the age we have recommended for preservation, and the eligibility age for the Age Pension. Consideration would need to be given to those aged less than 65 who cannot work (eg. due to ill-health) and may need access to their super beyond the existing tax-free amount available.

ASFA recommends improving the equity of superannuation tax for low and middle income earners by the following measures:

- Rebate (via the co-contributions system) the 15% contributions tax on SG and any other pre-tax contributions for low income earners – say below Average Weekly Earnings (currently around \$58,000 p.a.). This figure should be indexed.
- Expand co-contributions to middle income earners – for example lift lower co-contribution limit from \$30,342 to a higher income eg. \$50,000 so that it phases out at \$80,000 (limits continue to be indexed).

ASFA also recommends that:

- Death benefits paid after age 60 (or age 65 if the “tax free” age is changed) be exempt from tax.
- All Total and Permanent Disablement Benefits paid in income stream form to be tax free regardless of the age of the recipient. Tax on lump sum benefits remains before age 60 (or 65).

- For small business owners, simplify the CGT rules on the sale of businesses to encourage the transfer of lump sums to superannuation.

### Changes to the Age Pension and means testing

For older ages, simplify the tax/welfare position of an individual by administering the impact of age pension, superannuation and tax as related arrangements for those aged 65 and older.

ASFA recommends that earned income is treated favourably in terms of Centrelink means testing in retirement.

ASFA recommends that the pension bonus system be reconfigured to provide a higher pension for those opting to defer commencement of the age pension.

ASFA recommends that the work test for eligibility to make superannuation contributions at older ages be removed. This would also simplify the way individuals can save as they get older.

ASFA recommends that the income test is removed and retirees are tested on assets only.

- We understand that some adjustments to the assets test may be required as a result – for example there would need to be a lump sum equivalent for non-account based income streams or deferred “longevity insurance” guarantees purchased in retirement.

ASFA recommends that assets are tested annually by Centrelink as part of the tax return process. If a person does not put in a tax return, they must provide Centrelink with a schedule of assets at the end of each financial year.

- Reduce costs and complexity - bring dates for social security updates and indexation in line with tax i.e. change from at 1 March and 1 Sept – twice a year – to just once a year.

ASFA recommends that the Centrelink means testing thresholds are indexed to AWOTE – not the current CPI.

ASFA supports simplifying the system by aligning the eligibility age of the age pension and superannuation. Given the increase in life expectancies and the lengthened time in retirement the Age Pension age, the “tax free” age and the preservation age should all be 65.

- A gradual phase-in for the increase to the preservation age is recommended – the existing scale could just be continued for another five years to 2029 such that those born after 1 July 1965 have a preservation age of 65.
- ASFA does not recommend an increase to the Age Pension age to 67 or 70 as has been proposed by some other groups.

ASFA recommends that:

- Research be undertaken to identify whether the storing and use of wealth in the family home is likely to be prevalent for future generations of retirees; and
- If it is likely, solutions are found which address the identified issues of inequity and wastefulness for future generations.

### Longevity risk

ASFA recommends that the current legislation which restricts product development in the retirement space is amended as follows:

- Abolish Income Ruling IT 2480
- Modify or repeal SIS regulation 1.06(2)

ASFA also recommends that there be co-operation between the Regulators in terms of approving new retirement products. Currently product providers must deal separately with the ATO, APRA, ASIC and DFACS.

ASFA recommends that one of the following approaches is adopted:

- All new retirees from a certain date (or those currently under age 55) be required to spend a proportion of the value of their superannuation benefits to purchase longevity insurance. There should be requirements around what the product provides, but there should not be a requirement to purchase a particular style of product such as a lifetime annuity. ASFA would be happy to work with Treasury to assist in determining the product requirements.

Where retirement lump sums are less than a certain limit eg. \$400,000 the individual should be exempt from this requirement i.e. where the amount to be invested into longevity insurance is less than \$100,000. As such this requirement will affect wealthier retirees from when it is introduced, but will only become effective for most people when the SG system is mature and retirement lump sums are higher than today.

- An alternative approach is to introduce another method to protect against premature exhaustion of savings such as a minimum and maximum payment requirement each year in income stream products.

Centrelink means test incentives could be offered to invest more than 25% in longevity insurance or income stream products.

ASFA recommends that the Government make available “longevity bonds” i.e. long term inflation-linked securities which can be used by product providers to “back” longevity insurance products.

ASFA does not recommend that it be compulsory for retirees to defray investment risk. We believe that financial consequences of longevity risk is the greater of the two evils, and any move to push retirees into more conservative investments in retirement will increase their longevity risk.

### Financial literacy

ASFA recommends that:

- A tax deduction should be available for advice paid for on a fee for service basis. Alternatively a tax rebate could be available.
- All Australians receive an annual projection (called a “Retirement Income Estimate”<sup>1</sup>) with their superannuation statement which gives them an indication of the income they can expect in retirement from both their superannuation and the relevant Age Pension. Industry wide standards should be introduced for all superannuation projections.
- Industry wide standards be introduced for the use of life expectancy in projections, and other information given to superannuation fund members. This will allow people to more readily understand and plan for their longevity risk.
  - For example, life expectancy figures need to allow for mortality improvements. Perhaps ASIC could mandate a certain improved life expectancy table be used for all projections and member discussions.
  - Where an average life expectancy is shown the member must also be shown the likelihood of ‘beating the odds’ by living to certain ages beyond the average expectancy. Some projections indicate a 10% chance of living to age 100 for a 65 year old.
- Government funds initiatives through the Financial Literacy Foundation to educate prospective retirees about what they can expect in retirement and how they can influence the outcome.
- Government funds and implements an education campaign for the self-employed on the taxation benefits of superannuation. This could be done through ASIC’s Financial Literacy team.

### Other changes

ASFA recommends that SIS is reviewed to disallow gearing through superannuation.

## 1. THE RETIREMENT INCOME SYSTEM

### ASFA’s Current Policy

#### Characteristics of a Retirement Income System

ASFA’s Policy Principles state that ASFA will support retirement income policy that has the following characteristics:

- a. provides adequate and sustainable retirement incomes;
- b. increases national savings;
- c. is equitable;
- d. is simple and understandable;
- e. supports products that have administration and selling costs that represent value for money;
- f. is run efficiently;
- g. has an appropriate balance between private and public responsibilities;
- h. is made more secure by an appropriate, efficient and clear regulatory regime;
- i. has adequate consumer protection and ensures members are well informed and educated on retirement income issues and on their rights and responsibilities;
- j. has effective and low cost mechanisms for resolving member problems and disputes;
- k. deals with the fiscal consequences of an ageing population and increases in the longevity of that population;

<sup>1</sup> Please refer to ASFA’s submission to ASIC on Consultation Paper 101 - Superannuation Forecasts on 31 October 2008.

- l. has a legislative and regulatory regime that does not create distortion and ensures a level playing field among market participants; and
- m. recognises workforce diversity.

These are the criteria against which ASFA assesses current policy arrangements and any policy initiatives from government and industry.

ASFA supports reform of taxation of superannuation so as to reduce current complexity and increase the fairness of arrangements.

In any review of proposals in relation to retirement income policy, the principles of equity and simplicity must be considered and balanced with an evaluation of whether the proposal is likely to improve the adequacy of income in retirement.

#### ASFA supports the Three Pillar system

ASFA's policy recognises that there is broad political and community support in Australia for the "three pillar" system which involves:

**Pillar 1** provision of an **adequate public safety net** (the Age Pension) funded out of general revenue;

**Pillar 2** **compulsory payment of a set level of contributions** for those in the labour force; and

**Pillar 3** encouragement of **voluntary self-provision** (by way of superannuation or other savings preserved until retirement).

We provide some more detailed discussion under Question 1.1 below on the role of each pillar.

#### **Q1.1 The Objectives of the System**

**In considering the future of Australia's retirement income system, which objectives are relevant in setting retirement income policy? Does the current system of the Age pension and compulsory and voluntary savings meet these objectives? If not, how should the system be changed to meet these objectives?**

We understand that in dealing with the retirement income system government is balancing the triple narrative of Adequacy, Sustainability and Simplicity of the system. These three factors often pull in different directions, however are also interrelated. Along with the heterogeneous nature of the Australian population, this makes the considerations and the decision making process extremely complex.

##### **1.1.1 What are the objectives of a retirement income system?**

The World Bank (1994, Averting the Old Age Crisis, Policies to Protect the Old and Promote Growth) has noted that old age security programs should help the old by:

- facilitating people's efforts to shift some of their income from their active working years to old age;
- redistributing additional income to the old who are lifetime poor; and
- providing insurance against the many risks to which the old are specially vulnerable.

Then Holzmann and Hinz from the World Bank in 2005, Old-Age Income Support in the 21st Century said:

- There is continued relevance of the main objectives of pension systems – poverty alleviation and consumption smoothing – and of the broader social goal of social protection
- All pension systems should, in principle, have elements that provide basic income security and poverty alleviation across the full breadth of the income distribution

Therefore ASFA believes that the objectives of a retirement income system should be:

1. poverty alleviation: that is, a minimum income for all;
2. to provide mechanisms to smooth one's income over one's whole lifetime; and
3. the provision of some mechanisms by the Government to protect retirees from certain risks eg inflation, investment, longevity, public policy, system failure.

##### **1.1.2 Is Australia's retirement income system meeting these objectives?**

The first aim is met by the Age Pension (pillar 1). Our existing compulsory SG (pillar 2) and also tax incentives for voluntary saving (pillar 3) meet aim 2 of smoothing income, and also provide adequacy of retirement income to some degree.

However the third aim is only met indirectly through the Age Pension. It is not met through any current Government policies, and there are not many current retirement products within or outside of superannuation which provide insurance to deal with the risks listed. As such ASFA recommends that this review address the provision of additional protection mechanisms for retirees. Please refer to section 4.2 for more details.

### **1.1.3 What are the characteristics of an ideal retirement income system?**

The factors outlined in Chapter 1 of the Consultation Paper as “Objectives for a retirement income system” should rather, we believe, be the characteristics of such a system. We have found it helpful in our analysis to break these objectives up (and add to them) in the following way:

#### Overall design

- Broad and Adequate – protects the poor and provides mechanisms to save
- Sustainable – financially sound over the long term
- Robust – able to withstand shocks to the system

#### Interaction with individuals/community

- Transparent – i.e. Simple and Approachable
- Accepted by society
- Equitable
- Affordable by individuals; attractive and flexible

#### Some secondary goals

- Minimise possible hidden costs
  - excessive fiscal burden
  - misallocation of capital
  - high administration costs
- Minimise negative impact on labour market - particularly relevant within an ageing population
- Reward risk taking and development of capital markets
- Recognise that we are not all the same i.e. ensure some flexibility
- Enable reasonable levels of retirement income to be provided

### **1.1.4 Does Australia’s retirement income system display these characteristics?**

ASFA believes that the current system does display many of these characteristics, however there are some areas of weakness as follows.

#### Major areas of weakness

- Lack of transparency/simplicity: eg. complexity with the means tests and income tax. Retirement and social security systems designed in isolation and are not integrated at the most fundamental level.
- Protection of risks facing retirees (eg inflation, investment return volatility, financial consequences of longevity)
- Labour market effects: current system discourages later retirement
- Levels of retirement income available for some are not adequate
- System is not broad enough – there are many gaps i.e. those not covered or inadequately covered by the current system

ASFA’s recommendations addressing these areas of weakness are detailed in the following sections.

### **1.1.5 The role of the three pillars**

#### Pillar 1: The Age pension should be a government funded safety net

The Consultation Paper (p9 “Setting the retirement income parameters”) discusses the differences between an Age Pension which is intended:

1. to supplement retirement income; or
2. as a safety net for those unable to save.

ASFA's view is that the primary focus of the Age Pension should continue to be a safety net funded by the government. However, whilst not designed (nor should it be) to supplement retirement income for all Australians, the Age Pension should continue to play an important role in topping up the income of those with only modest super benefits. Please refer to section 6.1.1 for more details.

In other words, ASFA supports a guaranteed minimum retirement income provided by government on a means tested basis to provide for protection against poverty while recognising that for many this is an important part of their overall retirement income.

ASFA believes that government involvement in the financing and provision of the safety net provision is essential.

#### Pillar 2: Compulsory savings

The role of pillar 2 is more complex, and is heavily inter-related with pillar 1.

In today's system approximately:

- 50% of retirees receive a full Age Pension (pillar 1);
- 25% of retirees are partially self-funded (pillars 2 and 3) and receive a partial Age Pension (pillar 1); and
- 25% of retirees are self-funded (pillars 2 and 3) but can fall back on pillar 1 in later years when their assets decline (longevity risk), or in times of sharemarket losses where asset values have sharply declined (investment risk).

The Harmer review may be considering tightening up the means test to reduce the proportion of people on partial Age Pension. Whilst this would reduce government expenditure for those in the early years of retirement, this will mean people exhaust their self-funded super sooner so fall back on pillar 1 at a younger age – increasing government expenditure in the older years.

ASFA believes a sensible aim for the system would be to move towards something like the following:

- 25% of retirees receive a full Age Pension (pillar 1);
- 25% of retirees are partially self-funded (pillars 2 and 3) and receive a partial Age Pension (pillar 1); and
- 50% of retirees are self-funded (pillars 2 and 3) but may fall back on pillar 1 in their older years when their assets run out.

ASFA supports mandated contributions as well as the private management and investment of superannuation contributions (subject to appropriate government prudential and regulatory requirements) as necessary for the control, security and maximisation of earnings rates on savings.

ASFA considers that for many Australians, a 9% SG requirement will not be sufficient to generate adequate retirement incomes. Please refer to section 2.2.3.

ASFA would support an increase in savings through measures which enhance attitudes of ownership and mutual responsibility between employees, government and employers.

ASFA supports all Australians being required to save for their retirement. Employees, the self-employed and those relying on business and investment income should be included in the compulsory savings arrangements, as well as being able to save on a voluntary basis. Unless and until a group can be exempted unconditionally from later access to the Age Pension safety net, it is the responsibility of all to shoulder part of the burden of planning for future retirement income needs.

ASFA supports arrangements that aim to be more inclusive rather than less. Individual needs and capacity to contribute should be the test, not employment status.

#### Pillar 3: Voluntary savings

Voluntary savings and retirement income beyond the levels mandated should be a matter for individual decision. Tax and other incentives can play an important role in supporting and encouraging voluntary savings.

ASFA supports steps that aim to achieve a broader level of superannuation coverage.

ASFA supports permitting contributions to be made to a superannuation fund by or for those not in employment, providing incentives for contributions made on behalf of target groups; and provisions which allow the division of superannuation entitlements at the time of divorce.

## 2. A BROAD AND ADEQUATE RETIREMENT INCOME SYSTEM

### Q2.1 The Gaps in the System

**As the SG system matures, it will become a greater part of an employee's retirement income. What are the implications for individuals partially or fully excluded from the mature SG system (the self-employed, individuals with broken work patterns such as carers, women and migrants), and how can the retirement income system best accommodate these groups?**

As the SG system matures, there will be an increasing disparity in retirement living standards between those who are in and those who are (fully or partially) out of the SG system.

ASFA believes that many of the current "gaps" i.e. individuals excluded from the system, can be remedied. For those who are partially excluded, some additional flexibility and other measures are recommended which give these individuals the best possible chance of accumulating an adequate retirement income.

#### ASFA's current policy

Some Australians, for example those with broken paid work patterns or those returning from overseas employment, are likely to be disadvantaged by the concessional contribution limits, particularly when the transitional provisions end. ASFA supports early review of the concessional limits to develop the best model to meet the retirement savings needs of such people.

Now that mandated contributions have reached 9% of salary, and because the introduction of choice and portability have removed the concerns raised about finding a suitable fund to accept smaller contributions, ASFA supports the removal of the provision that excludes SG to those earning under \$450 per month from a single employer. This will particularly assist those in casual and part-time work (predominately women).

ASFA supports the extension of the SG entitlements to wage payments made after the cessation of employment, eg following legal action.

There is a case for tax concessions or other government assistance to be targeted to encourage additional savings of those with historically the poorest savings records - those on low to middle incomes, women with broken work patterns and/or expectations of depending on a spouse's savings, and social security recipients. The co-contribution plays a role in assisting such individuals but more needs to be done. However, any discussion of such targeting should be conscious of the need for both simplicity and equity.

#### 2.1.1 The self-employed

As stated in the Consultation Paper, *unlike employees, the self-employed have different characteristics and generally fall into two main categories:*

- *those with minimal business assets; and*
- *those who have business assets which they can sell to potentially finance their retirement. Many self-employed may qualify for the small business capital gains tax concessions intended to encourage investment in their business and use the proceeds from the sale of these assets for retirement purposes.*

The problem is that it is difficult to determine which self employed people will end up with a saleable asset at the end of their working lifetime. As such we do not propose to distinguish between these two groups, but recommend that all self-employed people are required to fund their retirement through superannuation. For those who are not making any provision the case for compulsion is relatively clear. For those who are making their own provision typically superannuation forms part of this and compulsion will generally fit in with what they were already doing and planning to do.

The Consultation paper states that *The proportion of the working population that is self-employed has been gradually decreasing over the past two decades. At the start of the 1990s, approximately 15 per cent of the work force was self-employed. Today the proportion is around 12 per cent.* However the nature of the work patterns of self employed is changing. There is an increasing trend for self employed people who are in contracting type arrangements whereby they are similar to an employee but working on an hourly rate. Anecdotal evidence suggests that a growing number of self employed people are working as contractors on an hourly rate. In this case there will be no saleable asset at retirement.

*The Consultation paper states that Many self-employed also save outside superannuation, including through their business. Taking into account wealth held outside of superannuation for individuals in the 55-64 years age group, the self-employed have a higher proportion of individuals with assets above \$150,000 than full-time employees.*

ASFA recognises that some people will have a saleable business asset, and that some self-employed also save outside of superannuation, however not all self employed do so. To distinguish a different contribution rate for self-employed would unnecessarily complicate the system, and would mean that those self-employed who are not already contributing to super would not build an adequate retirement income.

A possible approach would be to exempt a self employed individual from having to make superannuation contributions on that part of their taxable income over, say, \$80,000 per year. This reflects the fact that the wealthier self employed are those more likely to be making additional superannuation contributions or building assets outside the superannuation system.

It's important to recognise that even if there is a saleable business asset, some business assets may take quite some period of time to sell once a person decides to retire. Their superannuation savings can be used to provide an income during this time so they are not forced into a quick sale at a low price.

ASFA suspects that some small business owners simply keep working as they do not have the funds to retire and find that the business is not saleable, or saleable but for a very modest sum. Having superannuation could allow such a person to retire as their super can be used to supplement the income from their Age Pension and deliver a better standard of living in retirement.

*The Consultation Paper states that Self-employed may prefer to have access to liquid savings rather than superannuation, given the higher risks associated with being self-employed. Requiring compulsory superannuation saving may also influence the business decisions of the self-employed especially in the establishment phase of their business.*

It's important to recognise that a high proportion of small businesses fail each year. The business owners end up with little or no assets and have had a number of years out of the paid workforce. If such a person had some super contributions being made during the time they were running their business, they would not have as big a gap in retirement funding. Given the higher risks of being self-employed, it is even more important that these people fund for their retirement.

An averaging mechanism could be considered such that the required contributions are based on average income over say 3 or 5 years. Such a mechanism would be important for those businesses such as farming which produce fluctuating incomes from year to year. Perhaps there should be a period of grace for start-up businesses whereby contributions are not required in the first 2 years of the business being operated.

The Consultation Paper states that approximately two-thirds of owner-managers in unincorporated enterprises (a proxy for the self-employed) make superannuation contributions (ABS 2008). Whilst it is encouraging that some self-employed people already fund for their retirement, a significant proportion do not. Previously unpublished data from the Household, Income and Labour Dynamics in Australia (HILDA) Survey provides information on individuals of Age Pension Eligibility age in 2001 who were either employed or self employed five years earlier. The data indicate that for the previously self employed, 51% of this group were receiving some Age Pension, with 30% receiving the full Age Pension. Whilst this was a better result than for employees (75% receiving some Age Pension, with 44% receiving the full Age Pension) it still shows that self employed are under-funded at retirement. Therefore self employed people should be compelled to provide for their retirement. Given that around two-thirds are already doing so, making the requirement compulsory should not be a great imposition for the majority of self employed people.

#### Recommendations – The self-employed

ASFA recommends that:

- a compulsory contribution is gradually introduced for self employed people:
  - starting at 1% of taxable income in 2010-11 and
  - rising to 9% of taxable income in 2018-19.;
  - the contribution would be made as a proportion of the person's taxable income, averaged over three years;
  - the contribution would not be required in the first two years from start-up of a business;
  - the contribution would either be made from after-tax income up to a certain limit (eg. \$80,000) and be fully tax deductible, or the person could choose to make part of it as a non-concessional and claim the Co-Contribution (if their income was under the limit); and
  - the contribution would be assessed as part of the tax return process with an additional amount collected from the individual (which could be rolled over into a complying superannuation fund) if the required contributions had not been made to a complying superannuation fund;
  - the Government funds and implements an education campaign for the self-employed on the taxation benefits of superannuation. This could be done through ASIC's Financial Literacy team.

## 2.1.2 Individuals with broken work patterns

This is a difficult issue, and the solution will depend on how much time a person spends in the workforce. As stated in the Consultation Paper *For many individuals with broken work patterns, or no work history, changes to superannuation policy may have minimal effect on their retirement income. Policies which support an efficient, robust economy and remove disincentives to work may have a greater effect on these individuals' retirement income than superannuation policies. For example, policies which support child care may encourage more women to return to the workforce. This may have a greater influence on their retirement income than increasing superannuation concessions.*

However it is important to distinguish between those with little or no time in the workforce, and those with broken work patterns but who still spend a significant period of time in the workforce.

- It is not necessarily true as stated in the Consultation Paper that *the Age Pension is likely to provide the majority of retirement income for individuals with broken work patterns*. This is only the case where there are substantial periods spent out of the workforce. There are many people who have broken work patterns but who will still spend a significant proportion of their life in the workforce, either on a full-time or part-time basis. These are the people who need to be considered in terms of potential changes to superannuation policy.

As indicated by Table 2.1.2, even over a 35 year period of accumulating superannuation, the combined effects of a lower income at the start of the accumulation period, and a break from the paid labour force for 7 or so years in the first half of the period, leads to relatively modest lump sums and associated retirement incomes.

**Table: Impact of breaks from paid labour force**

Scenarios (based on SG contributions)	Lump Sum
Starting at \$20,000 for 10 years. A break for 7 years then \$45,000 for 17 years	\$115 365
Starting at \$40,000 for 10 years. A break for 7 years then \$40,000 for 17 years	\$140 090
On \$40,000 for 34 years, no breaks	\$181,000
Starting at \$40,000 for 10 years. A break for 7 years then \$80,000 for 17 years	\$212 601
On \$60,000 for 34 years, no breaks	\$271,700

The Consultation paper states that *Women are more likely to have career interruptions because of caring responsibilities, and are therefore not able to benefit from superannuation policies in these periods*. The economic realities for many families are that they cannot afford for one partner to have substantial periods completely out of the workforce. A very common pattern for families with children is for one parent to spend some time out of the workforce, then spend substantial time periods working part-time.

### Part-time workers: the hidden gap

Those working part-time are a hidden gap in the retirement income system. An interesting statistic in the Consultation paper is that the median income in the workforce is 75% of AWOTE ("The evolving retirement income system" – Chapter 1). This means that half of our working population is earning less than 75% of AWOTE. A large proportion of these will be part-time workers.

Whilst it may seem logical to say that these people will always end up on the Age Pension so there is no need to be concerned about filling gaps in their super funding, it's important to recognise that:

- There is a minimum income required income to live at even a very modest level in retirement (refer to section 2.2.3) and the Westpac ASFA Retirement Standard indicates that this is around \$19,450 p.a. for a single person or \$27,350 for a couple. The Age Pension alone will not provide such an income.
- Many part-time workers are working and earning income for a substantial number of years so there is the ability for them to build a superannuation balance
- Many part time workers have low incomes and cannot afford to make large additional contributions
- Those who build a superannuation balance are more likely to be engaged with their super and to make additional contributions in years when they can afford to do so; and
- Such employees can return to full time work later in life and sometimes have the ability to make additional contributions in later years.

We considered whether a higher SG contribution rate should apply to part-timers or those returning from breaks in the workforce, however we do not recommend this approach for the following reasons:

- It provides disincentives for employers to hire part-timers or people returning from career breaks;

- It provides disincentives for people to returning from career breaks; and
- Many such people are on low incomes and need the money now to meet basic living expenses.

As such we favour an incentive-based approach and not a compulsory approach.

#### Individuals off work due to illness or injury

It is important that retirement funding is not disturbed when a worker is unable to work due to illness or injury. As such those who are receiving workers compensation or salary continuance insurance payments should continue to have SG contributions made for them.

#### Individuals on parental leave

It is important that retirement funding is not disturbed whilst a worker is on paid parental leave. As such those who are receiving parental leave payments should continue to have SG contributions made for them.

#### Recommendations – individuals with broken work patterns

The current superannuation system is designed to suit full-time employees with a 35-40 year working lifetime. Today's work patterns look very different for many people, so it's important that the system have the flexibility to allow those with broken or part-time work patterns to fund an adequate retirement income.

As such ASFA recommends that:

- The current system of annual contribution caps is reviewed to enable "catch-up" contributions for those with broken work patterns. Options that could be considered include:
  - A lifetime contributions cap which is a dollar contribution amount (indexed to inflation each year). This approach is not favoured as it would create significant administrative complexity as experienced under the old Reasonable Benefit Limit rules.
  - Introduce an averaging provision for concessional contributions (similar to the current one for non-concessional) – for example allow everyone to average their concessional contributions over five years. This approach is not favoured as it will create problems for employers and the ATO in administering the cap. Also a five year averaging period may not be long enough for a parent caring for small children as they often spend longer than this out of the workforce.
  - The ability to apply to the ATO for a higher contributions cap on an individual basis. This may be more sensible as many people with part-time or broken work patterns will find the existing caps sufficient, so the number of exceptions could be expected to be small. However the ability to have a higher cap for those people would have a big impact on their retirement position.

The conditions under which the higher cap would be granted would include having spent time out of the workforce, or having worked part-time for a long period of time. Existing superannuation balance could also be taken into account. The higher cap could apply for a set period of time depending in the person's circumstances.

This would create additional work in approving the higher cap, but an online instant approvals process based on a fixed formula-based approach could ease this workload. It would be easier to administer than an averaging system for employers and ATO, as they would simply need a field in which to record the higher cap and the date at which it ceases to apply.

We favour this latter option.

- Remove the provision that excludes SG for those earning under \$450 per month from a single employer. A minimum dollar payment such as \$10 should still apply for practical purposes. This will particularly assist those in casual and part-time work.
- Remove the current taxation anomaly whereby low income earners are taxed relatively highly on their superannuation compared to their salary. This will mean part-time workers have the ability to build superannuation more quickly. Please refer to section 3.2.3 for details.
- Increase incentives for low and middle income earners to contribute to superannuation (please refer to section 3.2.3.)
- Legislate that SG applies to all Salary Continuance Insurance payments i.e. 9% of SCl insurance is paid into super. We note that some policies already have this feature. We also note that insurance premiums would need to be adjusted accordingly.
- Government pays 9% SG on their proposed paid maternity leave.
- Employers pays 9% SG on paid parental leave.
- SG be paid on unused long service leave taken as a lump sum. We note that some people partially fund parental leave this way.

- Investigations are made into whether it would be effective to pay SG on payments from the Community Development Employment Program (CDEP) for Aboriginal and Torres Strait Islanders. We recognise the complexity around these issues so ask that this be given expert consideration. Investigations are also made of the ability to place native title payments into superannuation.
- SG is paid on entitlements to wage payments made after the cessation of employment, eg following legal action.
- When setting the parameters for the retirement income system, a standard working lifetime of 30 years is assumed rather than the current 35 - 45 years. This allows for the large number of individuals who experience broken work patterns.

### 2.1.3 Immigrants and returning expatriate Australians

#### Immigrants

The Consultation paper states that:

*Around 80 per cent of permanent immigrants are aged less than 35 years. Over two-thirds arrive in Australia as skilled migrants. This suggests most immigrants should have a reasonable period in the workforce. As with individuals with broken work patterns, the Age Pension is likely to provide the majority of the retirement income for those immigrants who may not have a full working life in Australia.*

Australia's immigration program has been significantly boosted - in the last Federal Budget there was an appropriation for more than 150,000 new migrants and it is recognised that they are key in stimulating the economy. The majority of them will be skilled in areas such as IT, accounting, medicine, engineering, nursing and the trades.

Over the past decade there has been more than half a million skilled migrants enter Australia on permanent basis. With most coming from under-develop countries, they tend to commence accumulation of assets and savings much later than the general public.

It is important to recognise that whilst their contributions to Australian society begin almost immediately, they have had to pay for all their education and training. They cannot access Centrelink benefits for the first two years and their children are unable to access tertiary education until they become citizens which takes four years. As such their initial contributions in terms of taxation far outweigh their costs.

Being professionals and potentially high earnings, they are more likely to want to provide for themselves in retirement than the general public. In many ways they are in a similar position to those who have had broken work patterns.

ASFA believes that this initiative has the potential of encouraging more skilled migration and will have positive long term benefits of freeing government from making pension payments.

#### Recommendations – immigrants

The current superannuation system is designed to suit full-time employees with a 35-40 year working lifetime. Today's work patterns look very different for many people, so it's important that the system have the flexibility to allow those with broken or part-time work patterns to fund an adequate retirement income.

As such ASFA recommends that:

- The current system of annual contribution caps is reviewed to enable "catch-up" contributions for immigrants. As for those with broken work patterns (refer 2.1.2 above) we recommend:
  - The ability to apply to the ATO for a higher contributions cap on an individual basis.
 

The conditions under which the higher cap would be granted would include having immigrated from another country. Existing superannuation balance in another country could also be taken into account. The higher cap could apply for a set period of time depending in the person's circumstances.
- That the existing system for transferring pension money from other countries be reviewed. ASFA provided recommendations on this point in our previous submission in the Detailed Issues section at 4.6.

#### Returning expatriates

The Consultation paper states that:

*Expatriate Australians also have different circumstances. Like some immigrants, many expatriates will have built up savings and assets overseas which they can live on in retirement in Australia. Others may not have many assets but may qualify for support from another country's retirement income system. ... Other submissions note that some expatriates are unable to transfer equivalent superannuation savings in overseas funds into Australian superannuation funds if they are greater than the cap on after-tax contributions. This cap is \$150,000 a year, however, individuals under age 65 years can bring forward up to two years of future contributions.*

ASFA recommends that:

- The current system of annual contribution caps is reviewed to enable “catch-up” contributions for returning expatriates who have not built up superannuation whilst overseas.
  - The ability to apply to the ATO for a higher contributions cap on an individual basis.

The conditions under which the higher cap would be granted would include having not has superannuation support whilst overseas. The higher cap could apply for a set period of time depending in the person’s circumstances.
- The existing system for transferring pension money from other countries be reviewed. ASFA provided recommendations on this point in our previous submission in the Detailed Issues section at 4.6.

## Q2.2 – The concept of adequacy

**Noting that the adequacy of the Age Pension is being considered by the Pension Review, what is an appropriate concept of adequacy for the retirement income system? Should it be to ensure there is a minimum level of income in retirement, to replace a proportion of income earned prior to retirement, or some other alternative?**

The Consultation paper states that: *There is no consensus as to how to measure adequacy for an individual, and any decision needs to take account of what benchmark is used to judge adequacy... Common adequacy benchmarks used to assess the retirement income system are replacement rates, budget standards and wellbeing measures... The most commonly used measure is the replacement rate, which this section uses to discuss the outcomes of the retirement income system.*

The Consultation paper states that *Other decisions would be required if the system was intended to provide a particular income level (benchmark income). For example, at what level would the government’s contribution be set and how much government support would be needed once an individual achieved the benchmark income? Depending on the benchmark income this may be more progressive than a system aimed at providing a replacement income.*

### 2.2.1 A combination percentage and dollar measure of adequacy

ASFA prefers the concept of a replacement ratio rather than a benchmark income (other than for setting minimum targets or requirements) because it is very difficult to make a dollar-based income target suit a broad range of incomes. It makes more sense to link adequacy measures to an individual’s income by using a replacement ratio.

Whilst replacement ratios (percentage of salary) are a useful measure of adequacy for the majority of individuals it is important to recognise that different treatment may be required at the low end of the income scale.

As such ASFA recommends that a combination of dollar and percentage-based measures of adequacy be employed.

#### A dollar-based floor – minimum adequate retirement income for low income earners

The Consultation paper (“The evolving retirement income system” – Chapter 1) notes that the median income in the workforce is 75% of AWOTE. This means that half of our working population is earning less than 75% of AWOTE. It is important to get the right measure of adequacy for these low income earners as they make up such a large proportion of the workforce.

The Age Pension is being considered by the Pension Review, and may be increased from current levels which target 25% of AWOTE. However even if it is increased it will provide only a very limited standard of living. This is in line with its main role as a safety net.

A replacement rate calculated as a proportion of a very low salary may still not produce an adequate retirement income. If it is an adequate retirement outcome which is being considered, ASFA believes that there is a minimum income required income to live with dignity in retirement.

The Westpac ASFA Retirement Standard is a budget standard that is reviewed regularly in terms of both the basket of goods and services included, and indexation to CPI. As such this measure avoids some of the potential pitfalls of budget standards outlined in Appendix D of the Consultation paper.

The Westpac ASFA Retirement Standard has become the definitive indicator of required expenditure levels in retirement consistent with specified levels of living standards. It is commonly cited by both financial planners and government agencies.

The Standard indicates that as at September 2008 a “modest” standard of living in retirement will cost around \$19,600 p.a. for a single person or \$27,500 for a couple. For a single person this measure represents approximately 33% of AWOTE.

The same index also considers a “comfortable” standard of living in retirement, which will cost around \$37,800 p.a. for a single person or \$50,500 for a couple. For a single person this measure represents approximately 84% of AWOTE.

ASFA recommends that the Westpac ASFA Retirement Standard “modest” standard of living of \$19,600 for a single (or around 33% of AWOTE) or \$27,500 for a couple be used as a dollar-based floor to the measure of an adequate retirement income.

The full Age Pension as at 20 September 2008 was \$14,655 for a single person and \$24,481 for a couple (combined). This falls

somewhat short of the \$19,617 for a single person and \$27,454 for a couple needed at that time for a 'modest' lifestyle in retirement. Even with an increase, the Age Pension alone is unlikely to provide such an income.

To get from the Age Pension alone to the recommended "floor" of 33% of AWOTE, and individual will have to accumulate approximately \$100,000 in superannuation balance.

The proposed floor will mean that very low income people are targeting the dollar-based limits, whilst higher income people are targeting a percentage of their income.

#### Replacement ratio adequacy target for most income earners

Any adequacy target expressed as a replacement ratio will be appropriate for most income earners.

The Consultation paper states that *It is generally accepted that for most individuals a replacement rate of less than 100 per cent is appropriate, as they do not have costs associated with working, raising children, paying off their mortgage or accumulating wealth.*

ASFA recommends that an average net of tax retirement income of 70% of net of tax pre-retirement income should be targeted at age 65.

ASFA's current policy is a replacement ratio of 60% of gross income, however due to lower tax in retirement this is broadly equivalent to a 70% net replacement ratio.

#### Should there be a different replacement ratio adequacy target for high income earners?

There is an argument that replacement ratios should be lower for higher income earners, for the following reasons:

- they are more likely to accumulate wealth outside of super;
- they are more likely to own an expensive home which is not means tested, so is a store of wealth which can be accessed in later years through down-sizing;
- higher income individuals get a proportionately greater tax break on making superannuation contributions, as their average tax rates are higher; and
- there should be a limit on the amount of tax support which the government funds an individual to build up assets.

However, the annual contribution limits of \$50,000 for concessional contributions and \$150,000 for non-concessional contributions will to some extent act to prevent high income earners building up excessive balances in the tax-advantaged environment of superannuation.

It is likely that the contribution limits will also prevent high income earners from reaching the target replacement ratio through superannuation alone, however as high income earners are more likely to accumulate additional wealth outside of superannuation, this is not seen as a major problem.

Some persons are likely to want to contribute high amounts as a catch-up mechanism for past low retirement funding, whilst others are able to make substantial long-term use of the annual allowed amounts. Only time will tell which proportion of those contributing at the highest levels belong in these two groups. In any case, a contribution cap does not give sufficient guidance and affordability for the community around the level of retirement income the community is prepared to provide concessions for.

ASFA does not recommend a different target replacement ratio for high income earners. However with a vision focussed on a range of retirement incomes and annual projections of retirement income, there may be a number of ways in the future for managing the tax concession available to those in the community likely to exceed the ceiling. These would be more sophisticated than annual contribution caps.

#### **2.2.2 Issues with a replacement ratio target**

The Consultation paper states that *The Senate Select Committee on Superannuation (2002) suggested replacement rate targets as an appropriate objective. However, replacement rate targets can result in unintended consequences and need to be carefully considered. Too high a target can result in individuals forgoing more consumption during their working life and saving more than they consider necessary to fund their retirement. This may also result in excess saving being transferred to younger generations. It may also encourage early retirement, which could create problems in an economy with an ageing population. Too low a target may result in insufficient retirement income for individuals on low incomes during their working life.*

*The trade-offs associated with reaching a target need to be considered. For example, if achieving a replacement rate for all income earners is considered appropriate, how is this to be achieved? It could include relaxing eligibility rules so more individuals receive some part of the Age Pension or supporting savings with greater concessions. Alternatively, an increase in compulsory saving could make it easier for higher income earners to attain the replacement rate. The first option would*

reduce the progressivity of the system and increase the tax burden. The second option may adversely affect the living standards of low and middle income earners during their working years by requiring them to save more than they prefer.

When considering the settings of the retirement income system, the replacement ratio being targeted should have the following characteristics:

- It should be calculated using a wage-based discount rate as illustrated in Table 2.2 of the Consultation paper. This is because we are targeting a standard of living in retirement, and community standards of living tend to move with wages and not just with CPI. This becomes particularly important over periods of retirement exceeding 20 years.
- It should be calculated as average income over retirement divided by income averaged over the last five or ten years of work. We note that the ratios in the Consultation paper appear to have as their denominator the last year of work. This is a problem where there are rapid pay rises in the last few years of work, or where an individual “scales back” to a lower income prior to retirement. (We note that these arguments are more relevant for individual cases rather than the general scenarios modelled for the system as a whole)
- It should be calculated using after-tax income.
- It should assume a 30 year working lifetime, not the 35-45 years assumed in many of the figures presented in the Consultation paper (Assumptions in Appendix E)). Many Australians have broken work patterns, and with the trend towards longer periods of study for all careers, the age at which paid employment commences is increasing.
- The assumed period in retirement should adequately reflect increasing life expectancies and mortality improvement, and not be an average life expectancy but an age that the person has say a 25% chance of living to..
- It should count income from all three pillars i.e. the Age Pension, SG and voluntary savings such as salary sacrifice and non-concessional contributions. This is because the government is funding the third pillar of voluntary contributions through tax concessions.

### 2.2.3 How will the current system perform compared to a replacement ratio target?

The Consultation paper shows some statistics as to how the current system of Age Pension plus SG, when mature, will perform on a replacement ratio basis.

Table 2.2 of the Consultation paper illustrates that the Age Pension and SG alone over a working lifetime of 35 years will provide replacement rates as follows:

**Table 2.2: Replacement rates based on income(a) — using wages discount(b)**

Income as a proportion of AWOTE(c) – 35 year working lifetime	Replacement rate (SG only) %
0.75	65
1.0	56
1.5	47
2.5	40

(a) Appendices D and E provide further discussion of replacement rates and how they are calculated.

(b) Increases deflated by wages.

(c) AWOTE is average weekly ordinary time earnings and is approximately \$1,150 a week.

Source: Australian Treasury projections.

Reducing the standard working lifetime assumption from 35 to 30 years could be expected to reduce these figures by around 7% of their total (if we assume the same proportionate reduction as shown in Table E.2 from 79% to 74%) to around:

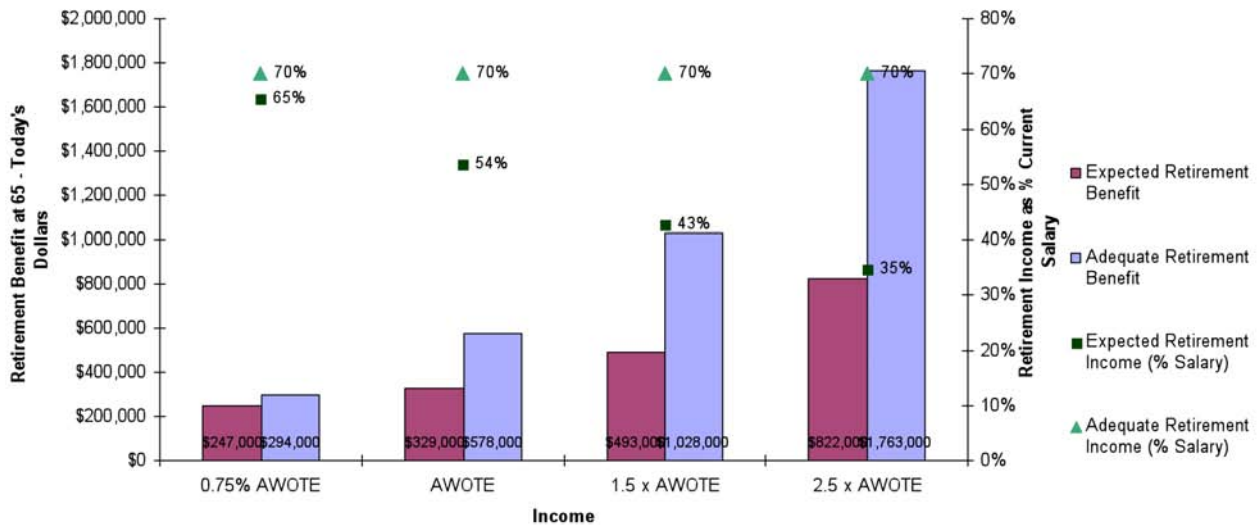
Income as a proportion of AWOTE(c) – 30 year working lifetime	Estimated Replacement rate (SG only) %	Estimated Replacement rate (SG + Voluntary)
0.75	60	60
1.0	52	52
1.5	44	50
2.5	37	50

The addition of voluntary savings (pillar 3) would be expected to increase the achieved replacement rates. Discretionary (pillar 3) contributions are more likely to be made by those on higher incomes. It is unlikely that those on 0.75% of AWOTE or even on AWOTE would have enough discretionary income to make additional contributions.

Based on the above (rough) analysis it appears that most individuals with a 30 year working lifetime will be able to achieve around a 50% replacement ratio. Those on incomes below AWOTE may achieve 60%. However it appears that no group will achieve 70%, which is ASFA's recommended target.

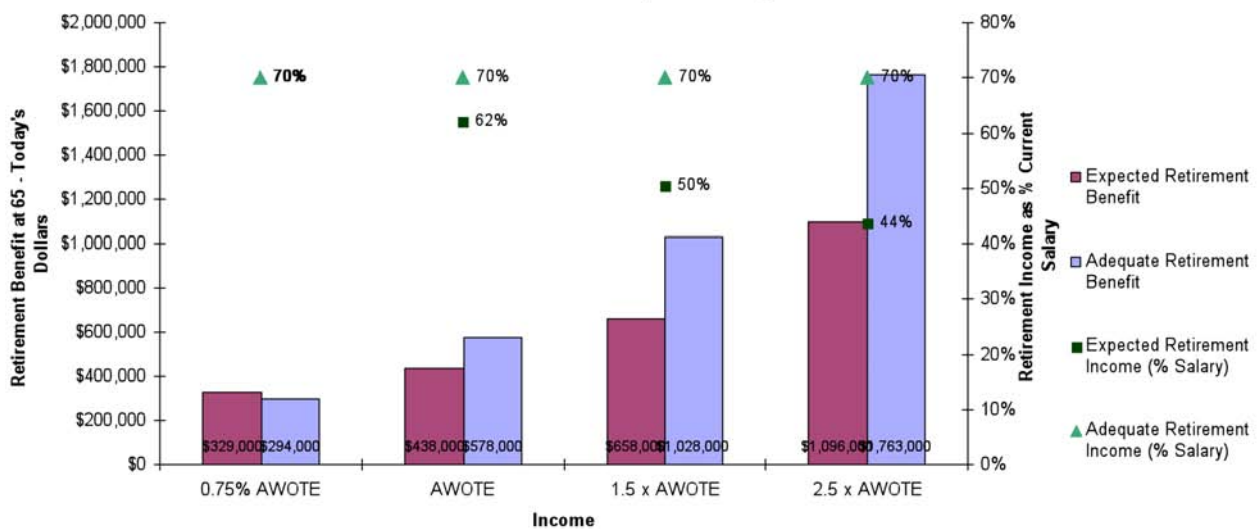
ASFA modelling shows that on a 30 year working lifetime (i.e. allowing for career breaks), no group is adequate to ASFA's target of the greater of 70% or the Westpac ASFA "Modest" retirement income.

**Adequacy - Couple targeting Highest Adequate Retirement Income at 65 (Higher of 70% of salary and WestpacASFA Modest Index including Centrelink Age Pension) - 9% compulsory contributions and 30 year working life**



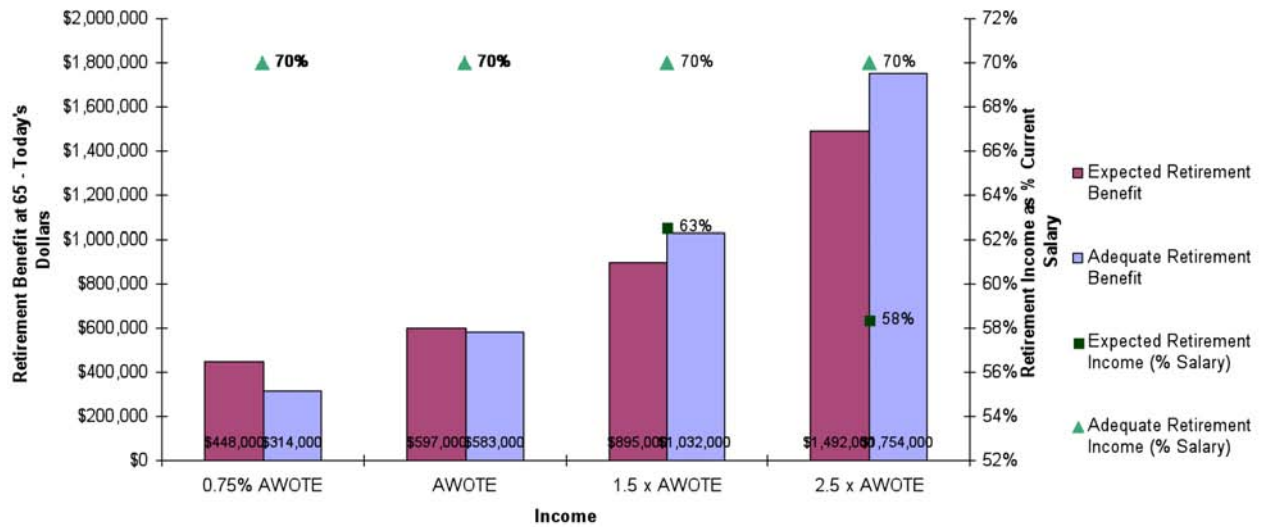
If contributions are increased to 12% the picture improves, with median income earners (75% AWOTE) now having adequate super:

**Adequacy - Couple targeting Highest Adequate Retirement Income at 65 (Higher of 70% of salary and WestpacASFA Modest Index including Centrelink Age Pension) - 12% compulsory contributions and 30 year working life**



If we assume a 35 year working lifetime with 12% contributions, average income earners also end up with adequate super:

**Adequacy - Couple targeting Highest Adequate Retirement Income at 65 (Higher of 70% of salary and WestpacASFA Modest Index including Centrelink Age Pension) - 12% compulsory contributions and 35 year working life**



The assumptions behind the above projections are outlined in Appendix A.

Current system will not produce adequate retirement outcomes

Most Australians would find it difficult to maintain their lifestyle with a 40-50% drop in income in retirement. As such the current system does not appear to be able to produce an adequate retirement income for most Australians.

This indicates that higher contributions are required across the board. We discuss this further in section 3.

Calculations by the ASFA Research Centre illustrate the greater and the earlier additional superannuation contributions are made, the more likely an adequate retirement income, which may include the Age Pension, will be achieved.

In brief, the calculations show:

- Shortening the period of contributions and savings by even five years generally lifts the required saving task by 3% or more of salary a year. Delay is costly, and those many Australians with broken work patterns will need higher contributions.
- Achieving a gross income in retirement of \$21,000 (or 60% of pre-retirement income of \$35,000) requires contributions at 9% of wages for at least 35 years.
- Contributions above the 9% Superannuation Guarantee level are needed for most income earners and retirement targets, or where full-time employment amounts to less than 40 years.
- Putting off an increase in contributions from 9% to 15% for, say, five years means the increase then needs to be to 18%. Compound interest and additional years of higher contributions are powerful forces.

Table 6 outlines the amount that needs to be saved above the current 9% SG level to achieve certain retirement income targets. The estimates in the table take into account the abolition of the tax on superannuation benefits received at age 60 and older, as well as the easing of the assets test for receipt of the Age Pension.

**TABLE 6: Extra percentage of income to be saved for 60% of pre-retirement income**

Years to retirement	Final Income (Retirement income sought)		
	\$35000 (\$21000)	\$50000 (\$30000)	\$75000 (\$45000)
10	37%	51%	59%
15	19%	29%	35%
20	10%	17%	22%
25	5%	10%	14%
30	2%	6%	10%
35	0%	3%	6%
40	-	1%	3%

Assumptions: 9% SG already paid by employer, includes value of age pension, nominal fund earnings of 7% after fees and taxes, and 15% contributions tax and 15% earnings tax are payable, no superannuation at the start of the period to retirement.

### Improving lifestyle outcomes through additional contributions

Another way of looking at the impact of additional employer (whether through salary sacrifice or soft compulsion) and/or member contributions, is to compare the lump sums generated by various levels of contribution with the lump sums needed to support a retirement lifestyle matching either the 'modest' or 'comfortable' benchmarks outlined earlier.

Most retirees from age 65 onwards will rely at least in part on the Age Pension. Accordingly, receipt of a part-rate Age Pension is assumed in the calculations of the lump sums needed set out in Table 7.

For both a single person and a couple, a lump sum of only around \$100,000 is required to support expenditure in retirement consistent with a 'modest' lifestyle, namely \$25,786 a year for a couple and \$18,375 for a single person. The reason for this is that the Age Pension provides most of the necessary income.

For a 'comfortable' lifestyle, larger retirement savings are needed. For a single person the amount required is around \$500,000 (assuming nominal investment returns of 7% per annum), while for a couple the amount is just over \$500,000. Receipt of the Age Pension at the couple rate means the amount to be saved by a couple is not double the amount needed by a single person.

As shown in Table 7, even a person on a salary of \$100,000 a year would need to make contributions at the rate of 12% or more to achieve a 'comfortable' standard of living in retirement, assuming he or she was single or the only person with superannuation within a couple household.

For a person on \$50,000 a year, contributions in the order of 20% per year over 30 years would be needed to support a 'comfortable' lifestyle in retirement.

Alternatively, if both members of a couple had incomes of \$50,000 a year and each made total contributions (including the SG) of between 11% and 12% per year, they would be able to achieve a 'comfortable' lifestyle. Of course, some single persons and couples might be assisted in achieving their retirement savings from receipt of an inheritance or from savings outside the superannuation regime.

**TABLE 7: Lump sum retirement benefits after 30 years in a taxed fund for a person aged 60 or over (a)**

Tax treatment and contribution level	Wage of \$30,000	Wage of \$50,000	Wage of \$100,000
9% contributions and investment earnings taxed at current rates	\$110,000	\$183,000	\$366,000
Pre 1 July 2007 net amount after benefits tax on lump sum	\$110,000	\$174,214	\$327,018
Improvement after 1 July 2007 with no benefits tax	Nil	\$8,786 (5.0%)	\$38,982 (11.9%)
Lump sum if contributions made at the rate of 12% of salary	\$146,000	\$244,000	\$487,000
Lump sum needed to support comfortable lifestyle (assumes receipt of part Age Pension).	\$500,000	\$500,000	\$500,000

All figures in today's dollars (using 3.75% AWE as a deflator), investment earning rate of 7% assumed.

### **2.2.4 Costs of health care and aged care**

The above discussion on adequate retirement assumes access to cost-effective adequate health care. Whilst we acknowledge that this is outside the scope of this Review, it is in effect the elephant in the room in all of these discussions.

This is linked to issues like cost of health care and what a retiree can get from the public system vs. the need to be insured. Rising medical costs and cost of health insurance out of reach for many retirees. Private health insurance costs are in the Comfortable Westpac ASFA Retirement Standard but are not in the Modest Standard.

It should also be noted that the Westpac-ASFA budgets are prepared on the basis that retirees are in relatively good health without the need for any extensive expenditure on health needs or assistance with personal care. Retiree households facing such costs, particularly if there are only limited government subsidies available, would require higher expenditures in retirement than those in the table. As well, health and personal care costs tend to rise more quickly than other prices in the economy.

The budgets also assume the retirees own their own suitable housing. For those in private rental or needing to move to more suitable owner-occupied housing, higher costs will generally be involved.

### The quandary – how to cope with lumpy expenses in later stages of retirement

During the first phase of retirement, individuals are generally active and healthy, so their medical costs are relatively small. At this time many still have access to self-funded superannuation benefits so they have some flexibility in their income. As retirees age however they enter a "frail" stage where they may have large and unpredictable medical expenses, and

may also required full-time care. At this stage many individuals have exhausted their superannuation, and are on the Age Pension. As such they do not have the flexibility of income to deal with large and lumpy expenses. At present most such expenses are paid for by the public purse.

Even in future years if ASFA's recommendations are taken up and retirees "insure" their longevity risk, they will have "locked in" to a fixed or indexed income in their later years so again will not have flexibility of income.

Whilst the issue of aged and health care is outside the scope of this review, we believe that this issue must be kept in mind when considering the income needs of retirees especially in later years.

### **Q2.3 – The role of government**

**What should the role of the government be in assisting individuals to meet their retirement income expectations in relation to the support provided by the Age Pension, the level of compulsory savings and incentives to make additional savings? Should the role of government change as an individual's income increases over their working life?**

#### **2.3.1 Government's role**

The role of government should be to assist as many individuals as possible to achieve an adequate retirement income (please refer to discussion of adequacy in 2.2 above).

#### **2.3.2 Expectations vs. adequacy**

It is important to distinguish between an adequate level of retirement income and an individual's retirement income expectations. For current generations who have not had SG over their whole working lifetime, expectations often greatly exceed the reality of the level of income they can expect in retirement. ASFA research has found that the bulk of Australians indicate that they need or want \$50,000 a year to retire comfortably. However less than 10% of those aged 65 and over in 2005-06 received an income of \$50,000 a year or more.

ASFA does not believe that it is government's role to meet expectations – rather to assist individuals to achieve an adequate retirement income. It will be important however to close the gap between expectations and reality. There is an important education exercise here.

ASFA makes a number of recommendations in section 5.1.2 with regard to the government's role in terms of financial literacy.

#### **2.3.3 Should government's role change as income increases over working lifetime?**

It's important to recognise that as income increases over an individual's working lifetime, so does their required "adequate" income on a replacement ratio basis. This is because the denominator of many replacement ratios is a person's income in their last year of work.

This is a problem where a person has rapid increases in income in their last few years of work – it will be very difficult to achieve their "new" replacement ratio. However it could be argued that they have been living on a lower income for most of their working lifetime so an adequate retirement income would be better measured on their average income in the years leading up to retirement.

One theory is that once an individual has reached an adequate level of funding, government support to fund above an adequate level should be reduced or removed. In practice this could be difficult to achieve because adequacy is a fluid concept. An individual can move in and out of adequacy based on changes to their income and changes to their account balance. The events of 2008 have resulted in most individuals' balances being reduced by market movements. Many previously "adequate" individuals would now be considered inadequately funded. One would expect them to return to adequacy as markets recover.

It is also important to recognise that the "more adequate" an individual becomes the less likely they are to fall back on pillar 1 later in life. Removing tax concessions for such people once they reach a certain level of adequacy also removes their incentive to make any further voluntary contributions, and increases the likelihood that they will fall back on the Age Pension.

As such ASFA does not believe that the role of government should change as income increases. The role should continue to be to ensure as many individuals as possible retire with an adequate income.

## **3. AN ACCEPTABLE RETIREMENT INCOME SYSTEM**

### **Q3.1 – Acceptability of the system to individuals**

**Do the settings of the retirement income system, such as the level of SG and access to concessions, adequately consider the needs and preferences of individuals both before and after retirement?**

ASFA's current policy supports the maintenance of adequate and easily understood tax concessions for superannuation on the basis of the public policy objectives that it achieves. These incentives should be sufficient to encourage additional savings and to offset the negative impact of the preservation requirements on people's saving behaviour.

### 3.1.1 Should compulsory saving be increased?

The Consultation paper states that *Various submissions recommend increasing the level of compulsory saving. Proposals include increasing the SG or requiring employees to make additional contributions. Under either proposal the increased payments are likely to fall on the employee, either directly from their wages or, if the SG is increased, potentially through reduced wages growth. An implication of increasing compulsory savings is that it will require individuals to have a lower standard of living during their working life, to increase their standard of living in retirement.*

*Compulsory saving may not be acceptable to individuals if they have to forgo too much consumption before they retire.*

As discussed in section 2. above the current system is unlikely to produce an adequate retirement outcome for Australians. As such additional contributions are required.

ASFA's previous policy was to support an increase in the savings target towards 15%. In our previous submission to the Henry review, we stated that we supported an increase in compulsory savings to 15% by 2015. However we have amended this recommendation as our modelling suggests that a contribution of 12% is appropriate.

ASFA recommends that an additional contribution of 3% of salary be introduced, taking total contributions to 12%. This would go a long way towards closing the adequacy gaps identified in section 2. above.

The question is the mechanism through which the additional contribution should be delivered.

ASFA believes that increasing SG is the preferable method of implementation.

However, we understand the difficulties around an increase to the SG, so if this is not possible then our next preference is for a compulsory additional personal contribution.

If the requirement was introduced gradually, individuals could in effect pay for the additional contributions from pay rises. For example the additional contributions could be introduced as follows:

- 1.0% from 1 July 2011
- 2.0% from 1 July 2013
- 3.0% from 1 July 2015

Our third preference is for a "soft compulsion" personal contribution individuals would be able to opt out of the system.

### 3.1.2 Access to compulsory savings and tax concessions

#### ASFA's current policy on access

ASFA's current policy supports provisions which allow all Australians to have access to the pre tax and post tax contribution limits to optimise their savings for retirement.

The Consultation paper states that *The superannuation tax concessions are not universally accessible.*

ASFA recommends that employers be required to provide employees with access to salary sacrifice facilities. A suitable period should be granted before the commencement date of this measure to allow employers to implement the required administrative procedures.

The Consultation paper states that *An individual can make contributions up to age 65 years without having to work but must work to make contributions after age 65 years. The SG is paid up to age 70 years. After that age, an individual is not paid SG but can ask their employer to make salary sacrifice contributions up to age 75 years.*

ASFA stands by our recommendation at 2.3 in our previous submission that the superannuation work test should be removed so that older Australians who are dipping in and out of the workforce can continue to make superannuation contributions. Please refer to section 5.1.4 for more detail of this recommendation.

### Q3.2 – Appropriateness and sustainability of income tax concessions

**Is the current level of superannuation income tax concessions appropriate and sustainable into the future? Are the current concessions properly targeted and, if not, how should they be reformed?**

#### 3.2.1 Are tax concessions appropriate and sustainable?

We believe overall that the structure of SG and access to concessions is sound for most people, though we have recommended amendments in a number areas in this Submission. The discussion below focuses on the sustainability of the concessions.

#### Tax concessions for contributions and investment returns

From time to time some commentators and lobby groups have criticised the level of assistance provided to superannuation through tax concessions. If anything, Australia is an outlier in terms of international practice in regard to the taxation of

private pensions (superannuation). A 2004 OECD study into the taxation of private pensions showed Australia had the third highest effective rate of taxation on superannuation, with only New Zealand and Denmark having higher rates of taxation.

Since then New Zealand has introduced a system of government subsidies and tax concessions for superannuation. The introduction of what is called KiwiSaver was a direct result of the previous system which provided no concessions at all for superannuation resulting in practically no contributions being made.

International experience shows individuals require some level of tax concessions before committing to long-term and inaccessible retirement savings vehicles such as superannuation.

As Australia has been able to deliver a string of substantial budget surpluses in recent years, the existing superannuation tax concessions clearly have not led to fiscally irresponsible outcomes. In fact, tax collections from superannuation contributions and fund investment earnings are substantial and have grown strongly in this period.

In 2006-07 over \$8 billion in tax revenue was collected from superannuation funds, with additional superannuation related tax revenue paid by insurance companies.

#### Should investment earnings in retirement be taxed?

We have given serious consideration to whether a tax on investment returns should be introduced on assets in retirement.

We considered whether the investment tax should be restructured to a flat 12% rate for investment returns before and after retirement. By default, those with higher balances would share a greater burden of such increases and as such this is a progressive measure which would assist in addressing the equity issue between high and low income earners.

The reason for a 12%/12% rather than 15%/15% investment returns tax structure is that if the current 15% structure was retained and a 15% investment returns tax introduced in retirement, all Australians would suddenly become "less adequate". However a reduction in investment returns tax during an individual's working lifetime would mean they can accumulate a higher superannuation balance at retirement. This reduces the outlay on the Age Pension (pillar 1) in the early years of retirement and compensated for the slower growth in the super balance in retirement due to the returns tax.

Without access to Treasury modelling, we suspect that this would be close to revenue neutral as the additional revenue gained from a 12% new tax on returns in the retirement space would roughly equate to the 3% reduction in returns tax in the accumulation phase.

#### *Arguments for 12% investment returns tax before and after retirement*

A primary advantage is the simplification of the superannuation system whereby only one tax rate would be in operation throughout. This would greatly reduce the administration costs currently paid by superannuation fund members from having two different taxation systems.

It immunises government revenue from the investment returns tax from future changes in the mix of pre-retirement vs. post-retirement assets as the SG system matures.

A change to the taxation system on retirement was logical when retirement was a point in time. We are moving towards a society where individuals transition to retirement over a number of years, and may "dip back in" to the workforce after having retired. In such a society it does not make sense to have two different tax rates – in fact it opens up some arbitrage opportunities.

Currently an individual can pick and choose their tax environment for their assets and minimise tax eg. the "transition to retirement allocated pension" strategy, whereby tax on employment income is virtually eliminated during transition to retirement years. These strategies are generally only understood and employed by wealthier individuals who can afford financial advice.

This also addresses the arbitrage whereby many individuals wait until entering the retirement phase before to selling assets thereby avoiding Capital Gains Tax.

#### *Arguments against investment returns tax before and after retirement*

Whilst the idea has merit, the "show stopper" issue is that once there is a 12% tax rate in investment returns in super, for many retirees non-superannuation investments will become more tax effective than superannuation investments. The combination of the marginal tax rates with the \$5,400 tax free threshold and the Senior Australians Tax Offset mean that the average rate of tax outside super is less than 12% up to reasonably high levels of non-super income. So people would be incentivised to take a lump sum (tax free) out of super to avoid the 12% tax.

The introduction of such a measure would have to be given careful consideration such that the current generation of retirees is not disadvantaged and suddenly made "less adequate" by the introduction of a new tax. Also defined benefit pensions in payment could not be changed to accommodate a higher taxation rate. As such current retirees would have to be protected from this change. This could not be done by running different taxation rates for different people, as this would create enormous additional cost in superannuation funds (they would have to create separate products for each

tax rate). Any compensation to current retirees would have to be on a rebate basis and would be complex for the ATO to calculate.

There may be an impact on public confidence in the superannuation system due to such a major change.

Given the above issues we do not consider that this is something that could be introduced at present. It would need further consideration and would need to be linked to either: encouragement or compulsion to take income streams (please refer to discussion in section 4.2.1); or alternatively a change to the taxation of non-superannuation investments to retain the relative attractiveness of the superannuation tax system in retirement. Unless and until such measures are in place ASFA considers it appropriate to leave investment returns in retirement tax free.

#### Tax concessions for those aged 60+

Some commentators have questioned whether removing taxation on benefits received from a taxed fund for persons aged 60 and over is sustainable.

While there are no detailed long-term projections of the tax foregone as a result of this measure, the reality is most retirees never paid much benefits tax. In addition, a number of other investments where money now in superannuation was previously invested, such as negatively geared investment properties, have actually drained tax collections.

For the foreseeable future, most lump sums received by retirees will still be below what was the tax-free threshold for lump sum superannuation benefits.

For those with larger sums, the usual practice was and will continue to be to take an income stream. Prior to 1 July 2007, the vast bulk of income stream recipients paid little tax. This was due to the typically modest levels of taxable income derived from income streams after allowance was made for return of capital and the benefit of the 15 per cent tax rebate. As well, individuals who achieve Age Pension eligibility age were, and continue to be, eligible for the Senior Australians Tax Offset.

Current average superannuation balances are modest. While average balances and retirement payouts will continue to grow, it will be many decades before average balances will be at a level that would have attracted significant amounts of benefit tax.

In addition, the new contribution limits applying to both concessional and non-concessional contributions will limit the ability of individuals with substantial assets to minimise taxation through the accumulation of superannuation balances. This will particularly be the case when current transitional arrangements relating to concessional contributions come to an end in 2012.

Preservation of superannuation benefits for most individuals to their preservation age also means the very rich who want access to all or part of their savings will only put part of their wealth into superannuation.

In summary, the really rich cannot and do not want to put a large part of their wealth into superannuation, while the relatively poor will not have that much in superannuation and never were going to pay much tax on benefits.

In addition to there being little future revenue need to reinstate benefit taxation, there would be both practical and political constraints on such a move.

At a political level, public opinion polling indicates there is a high level of community support for the abolition of taxation benefits because individuals regard the new arrangements as both simplifying the taxation of superannuation and offering potential benefits to them (ANOP, 2006).

On a practical level the abolition of Reasonable Benefit Limits, ending the collection of information about the level of benefits paid, and shifting from benefit limits to contribution limits means in practical terms it would be very difficult to reintroduce benefit taxation.

#### Increasing the age at which benefits become tax free

We understand that the tax-free nature of benefits in retirement is outside the scope of this review. However a future increase to the age at which benefits become tax-free should be considered.

The main reasons for recommending such an increase are:

- to prevent early draw-down and spending of superannuation;
- to change the mind-set on when a person should retire; and
- to curtail the "transition to retirement" income tax minimisation strategy currently employed from age 60 by many people still working.

ASFA recommends that the age at which superannuation becomes tax-free is increased gradually in future to age 65.

This would be consistent with the age we have recommended for preservation, and the eligibility age for the Age Pension.

Consideration would need to be given to those aged less than 65 who cannot work (eg. due to ill-health) and may need access to their super beyond the existing tax-free amount available.

### 3.2.2 Leakage from the system

The Consultation paper asks us to consider the sustainability of the system. Where tax concessions are granted to place money into superannuation it is important that:

- superannuation benefits are used for retirement and not for other purposes;
- the benefits are available at retirement and not promised as security for a loan;
- individuals do not have the ability to gear their superannuation; and
- excessive benefits are not passed on tax-free to beneficiaries in the individual's will (please refer to section 4.2).

#### ASFA's current policy: Use of Superannuation for other purposes:

For the retirement income system to be effective its focus needs to be on retirement income. ASFA does not support members being able to access their superannuation savings for purposes other than retirement as this leads to the dissipation of funds. Perceived or actual problems with the acquisition of housing, aged care, unemployment benefits, or health services should be the subject of separate public debate.

If individuals are to be permitted to use retirement income financing arrangements to achieve any additional purposes (eg housing, health services), additional contributions above what is needed for retirement income purposes would need to be made to cover the purpose and management expenses.

#### Loans and gearing super

Changes to SIS were made in 2007 which were designed to facilitate investment in instalment warrants. However perhaps inadvertently, the door was opened much wider and there is now the ability for a self-managed superannuation fund member to gear their superannuation.

We strongly recommend that this section be reviewed and the intention of the law (i.e. the inability to gear superannuation) be reinforced.

There is also the ongoing issue of individuals retiring with mortgages or other debt, which they then pay off using their superannuation. This issue is discussed further in Section 6.3.

### 3.2.3 Equity of the system – are concessions properly targeted?

#### ASFA's current policy on equity

It is ASFA's view that equity must be considered in the context of overall retirement incomes, including access to superannuation and the Age Pension. The community funds retirement income support for both superannuation and the Age Pension recipients, and some will benefit from one or other or partly from each. The Age Pension supports those who have not received tax concessions for super and it tops up the income of those with only modest super benefits.

In any review of proposals in relation to retirement income policy, the principles of equity and simplicity must be considered and balanced with an evaluation of whether the proposal is likely to improve the adequacy of income in retirement. Flat rates of tax on contributions are generally not compatible with equity goals but to introduce variable tax rate on contributions would introduce complexity.

ASFA supports equitable income tax treatment for those aged 60 and over who are re-entering the workforce, regardless of whether their superannuation benefit was paid from a taxed or untaxed source.

The Consultation paper states that *Savings invested in superannuation are generally not taxed at the individual investor's personal tax rate (income streams paid from an untaxed superannuation fund are taxed at personal tax rates with a rebate). Instead superannuation contributions and earnings are taxed at a flat rate of 15 per cent within the fund. This tax structure means that superannuation concessions are higher for an individual on a higher personal tax rate while an individual on a low personal tax rate receives little concession on their contributions.*

ASFA addressed the tax inequity issue for lower income earners in our previous submission to the Henry review in Section 1 – Contributions and Adequacy Issues. ASFA stands by two of our previous three recommendations as follows:

- Rebate (via the co-contributions system) the 15% contributions tax on SG and any other pre-tax contributions for low income earners – say below Average Weekly Earnings (currently around \$58,000 p.a.). This figure should be indexed.
- Expand co-contributions to middle income earners – for example lift lower co-contribution limit from \$30,342 to a higher income eg. \$50,000 so that it phases out at \$80,000 (limits continue to be indexed).

In our previous submission ASFA also recommended offering a tax deduction on all personal (after tax) superannuation contributions by the employed and the self employed (i.e. the removal of the 10% rule). This was designed to allow employees without access to salary sacrifice facilities to make tax advantage contributions to super. However we recognise that this

recommendation could make it more tax effective for an employee to contribute post-tax than pre-tax. If salary sacrifice were broadly available as recommended above in 3.1.2 then this measure is not required.

The Consultation paper states that *The proportion of concessions that flow to individuals on higher personal tax rates has been increasing in recent years due to reductions in personal income tax. For 2005-06, it is estimated that 5 per cent of individuals accounted for over 37 per cent of concessional superannuation contributions. Concessionally taxed contributions include SG contributions, salary sacrifice and deductible contributions by the self-employed. This distribution reflects the fact that these individuals are paid more SG contributions, and have greater capacity to make voluntary superannuation contributions within the contribution limits.*

It's clear that super tax concessions benefit higher income earners more than lower incomes earners, largely because they can afford to salary sacrifice larger amounts voluntarily, and because of the higher dollar value of SG contributions.

We don't see this as necessarily a bad thing, provided the contribution limits are in place and the Centrelink income and assets tests act to limit access to the Age Pension for those with higher super balances. The Age Pension, as well as a 'safety net' for those who simply have insufficient to live on in retirement, can be used (and is used currently) to go some way toward supplementing people with up to moderate level super balances.

The Consultation paper states that *To limit the concessions available to an individual there are two caps on the amount of contributions an individual can make each year. Individuals can make up to \$50,000 a year (indexed) of before-tax (concessional) contributions (those made by an employer or that are tax deductible). Individuals aged 50 years or older can contribute up to \$100,000 a year until 30 June 2012. A cap of \$150,000 a year (indexed) applies to personal contributions made from after-tax income. Individuals under age 65 years can bring forward up to two years of future after-tax contributions.*

ASFA believes that these caps address the equity issue in that they are sufficient in limiting the quantum of assets a wealthy individual can build up in the tax-advantaged superannuation system. In fact the caps mean that in future wealthy individuals are unlikely to be achieving the adequacy target through superannuation alone. They will need to have other investments outside super to create a 70% replacement ratio.

As such ASFA recommends that the current contribution caps be retained, with the proviso that individuals such as those with broken work patterns, part-time workers, immigrants and expatriates can apply for a higher cap (please refer to Sections 2.1.2, 2.1.3 and 2.1.4).

## **4. A ROBUST RETIREMENT INCOME SYSTEM**

### **Q4.1 – Age of access to super and Age Pension**

**At what age should an individual be able to access their superannuation and at what age should they become eligible for the Age Pension?**

Current ASFA Policy - Flexible retirement

ASFA supports rules relating to paying benefits and accepting contributions for older workers which reduce complexity, improve equity, increase ease of application for administrators and that make them more suitable for the modern workforce. ASFA supports equitable income tax treatment for those aged 60 and over who are re-entering the workforce, regardless of whether their superannuation benefit was paid from a taxed or untaxed source.

#### **4.1.1 Eligibility Age**

The Consultation paper states that *The earlier an individual accesses their superannuation, the higher the risks associated with longevity and inflation. Currently, an individual can start accessing their superannuation from age 55 years. From 2015, this will gradually increase, reaching age 60 years by 1 July 2024 for individuals born after 1 July 1960, which is still below the Age Pension age of 65 years.*

*Aligning the eligibility age for superannuation to the Age Pension age would reduce the period individuals need to draw on their superannuation, thereby reducing the risks associated with longevity and inflation. However, some individuals have a working life interrupted by illness, unemployment or caring, for whom it may be inappropriate to delay access to their superannuation.*

There are disconnects between preservation age, the age from which superannuation benefits can be taken tax-free, and the pension age. These anomalies complicate retirement planning, and encourage poor behaviour such as using superannuation savings to fund lifestyle in early retirement before reaching pension age. They also complicate the transition to retirement process.

ASFA supports simplifying the system by aligning the eligibility age of the age pension and the preservation age and tax-free age for superannuation. Given the increase in life expectancies and the lengthened time in retirement the Age Pension age, the "tax free" age and preservation age should all be 65.

A gradual phase-in for the increase to the preservation age is recommended – the existing scale could just be continued for another five years to 2029 such that those born after 1 July 1965 have a preservation age of 65.

ASFA does not recommend an increase to the Age Pension age to 67 or 70 as has been proposed by some other groups. We believe that this change will be ineffective as it will just push people onto the Disability Pension for an additional period. Please refer to section 6.1.2 for a detailed discussion of this point.

Consideration needs to be given to those individuals who cannot work to age 65 due to health issues. The Disability Pension is currently used as a proxy Age Pension for low income people in this situation, and this safety net would continue to be provided. Wealthier individuals who want to retire before age 65 will have to amass savings outside of superannuation to fund the years between when they retire and when they can access their superannuation.

Ideally to further simplify and integrate the system, superannuation benefits would only be tax-free from age 65 and we have recommended this in 3.2.1 above.

#### **Q4.2 – Investment and longevity risk**

**What is the role of individuals in dealing with investment and longevity risk in accumulating and drawing down their retirement income? Do financial markets provide the means to deal with these risks? If not, is there a role for government to address these shortcomings??**

##### **4.2.1 Longevity and inflation risk**

The Consultation paper states that *Many individuals tend to underestimate how long they will live. For many, increasing life expectancies pose a risk to the maintenance of their income.*

The January 2009 Ambachtsheer letter states that

“Specifically, Australians seem particularly averse to dealing with the reality that some retirees will live much longer than others.”

“If everyone has to bear their own longevity risk, everyone has to decide how many years of post work life to provide for: ten? twenty? thirty? It is clearly inefficient for everyone to provide for thirty years of post-work consumption through retirement saving, when post-work life expectancy averages twenty years.”

Pooling individual longevity risks through life annuities allows everyone to save for twenty years of consumption, rather than thirty. A lower savings rate permits a higher pre-retirement consumption rate, making everyone much better off. Such risk pooling does not mean that all accumulated retirement savings should be fully annuitized. It does mean that some portion should be automatically channelled into purchasing longevity insurance in ‘accredited default funds’.”

It’s also important to recognise that Australia currently has one of the longest life expectancies in the world, so longevity risk is a significant challenge.

##### The role of individuals

Whilst some may argue that it is the role of individuals to manage their own affairs to ensure their money lasts as long as they do, the reality is that longevity risk can only be managed for a group or pool of individuals and is next to impossible for an individual to manage for themselves.

As such we have two choices:

1. force retirees to take steps to defray their longevity risk; or
2. provide adequate, well-priced products that encourage and reward retirees for defraying their longevity risk.

ASFA believes that given the present level of financial literacy in the community and the aversion of Australians to giving up access to part of their lump sum to insure against longevity, the compulsion option (option 1.) should be followed. Details of our recommendations are given below under “The role of government”.

The role of individuals then becomes to choose between the various ways in which they can defray their longevity risk.

##### The role of financial markets

The role of financial markets is to provide products with which retirees can choose (or are compelled) to defray their longevity risk.

There is no doubt that the current Australian post-retirement income market is poorly developed. Reasons for this include:

- the lack of long term government indexed bonds with which to back longevity insurance products (such as lifetime annuities or hybrid products that provide an allocated pension that converts to a fixed income at older ages);

- taxation disincentives whereby the “insurance” element of hybrid products does not receive the investment returns tax exemption enjoyed by other retirement assets;
- a move away from fixed or indexed annuities due to the higher returns available in market-linked products – resulting in inability for product providers to pool risks and share fixed costs resulting higher costs of products;
- the high cost of products currently on offer (refer above); and
- a desire by Australians to retain access to their capital.

ASFA recommends that the current legislation which restricts product development is amended as follows:

- Abolish Income Ruling IT 2480
- Modify or repeal SIS regulation 1.06(2)

ASFA also recommends that there be co-operation between the Regulators in terms of approving new retirement products. Currently product providers must deal separately with the ATO, APRA, ASIC and perhaps DFACS to get a product approved. Each have different requirements and do not know what the other regulators require. This makes product development time consuming and expensive.

This will facilitate the introduction of “new generation” retirement products which would enable retirees to retain the investment risk (as they do now through account based pensions) but share the longevity risk through pooling. Such products are well established in other markets.

The products could also include a guaranteed minimum number of payments, with the annuitant choosing the minimum, which would not be subject to an upper limit.

#### The role of government

*Requiring an amount of superannuation savings to be taken as an income stream would better integrate the Age Pension and the superannuation system and provide greater protection against longevity and inflation risks. Income streams could be purchased to receive a set income for life (a lifetime annuity) or a flexible income based on the balance of an account (an allocated pension). The proportion of superannuation that an individual would need to assign to an income stream is a threshold question.*

*Alternatives include requiring an individual to take all their superannuation as an income stream at the time of retirement, or requiring individuals to insure against living beyond their life expectancy by putting aside part of their superannuation to purchase an income that commences from a particular age.*

*Allowing access to lump sums provides flexibility for events outside normal retirement income needs. Such flexibility may be a relevant feature of a retirement income system. Requiring superannuation to be taken as an income stream would limit this flexibility.*

Government does already provide inflation and longevity protection to age pensioners but does not provide any direct support to non-pensioners.

ASFA supports the concept that retirees should be encouraged to take income streams and encouraged or compelled to defray their longevity risk.

ASFA supports choice as to the method by which a retiree defrays their longevity risk. This includes choice as to which products should be able to be used.

ASFA recommends that one of the following approaches is adopted:

- All new retirees from a certain date (or those currently under age 55) be required to spend a proportion of the value of their superannuation benefits to purchase longevity insurance. There should be requirements around what the product provides, but there should not be a requirement to purchase a particular style of product such as a lifetime annuity. ASFA would be happy to work with Treasury to assist in determining the product requirements.

Where retirement lump sums are less than a certain limit eg. \$400,000 the individual should be exempt from this requirement i.e. where the amount to be invested into longevity insurance is less than \$100,000. As such this requirement will affect wealthier retirees from when it is introduced, but will only become effective for most people when the SG system is mature and retirement lump sums are higher than today.

- An alternative approach is to introduce another method to protect against premature exhaustion of savings such as a minimum and maximum payment requirement each year in income stream products.

We note that the previous tax incentive to take an income rather than a lump sum was removed when lump sum tax was removed for those aged 60 and over. We believe that it is important to incentivise Australians to use income streams in retirement which reduce longevity risk. Centrelink means test incentives could be offered to invest more than 25% in longevity insurance or income stream products.

It is recognised that such a requirement could be seen to be disadvantageous for those at lower socio economic levels who, on average, die earlier, and for those with reduced life expectancy – unless they can be offered enhanced terms i.e. higher annuities. However, longevity risk is a risk at all income levels that requires some form of collective support because individuals clearly cannot do it themselves.

There are arguments that a larger proportion such as 50% or even 100% of retirement benefits should be placed into an income stream product. ASFA is against this proposal for the following reasons:

- it's important for retirees to retain flexibility of income to allow them to manage unexpected costs or lumpy cash flows; and
- it's important for confidence in the system that people are allowed to retain control over the bulk of their superannuation.

ASFA recommends that the Government make available "longevity bonds" i.e. long term inflation-linked securities which can be used by product providers to "back" the above products.

Such securities would enable providers to offer life annuities and/or inflation protected products with greater certainty and flexibility, as the mismatch risk should be able to be reduced. At the moment, the absence of such assets restricts the length of income products available to retirees – as assets are not available to match the liability profile.

The current Pension Bonus scheme provides inadequate incentive to defer taking the age pension. Provision of a lump sum bonus is not consistent with the principle of encouraging retirement income. The current bonus is not perceived to provide "fair" value for the foregone age pension income;

As discussed in section 6.1.2 ASFA recommends that government provide a higher pension for those opting to defer commencement of the Age Pension.

#### Estate planning

The Consultation paper asks us to consider the sustainability of the system. Where tax concessions are granted it is important that excessive benefits are not passed on tax-free to beneficiaries in the individual's will.

The requirement to spend 25% of a person's lump sum to purchase longevity insurance (and incentives to spend more) will reduce the ability to pass on large lump sums tax free to beneficiaries on death.

#### **4.2.2 Investment risk**

The Consultation paper states that *The way Australia's retirement income system deals with investment risk will become more important as the SG becomes as a greater proportion of retirement income.*

*Investment risk has two elements. The first involves inappropriately allocating assets during the accumulation of an individual's benefits... A higher level of investment risk can be positive as individuals can receive, on average, higher investment returns than from a system based on more conservative investments.*

*The second involves the impact that substantial falls in investment returns have on an individual once they retire... As life expectancies increase, retirees could expect assets to fall perhaps two to three times over their retirement. The effect of a fall in investments can be magnified depending on how soon it occurs before or after they commence retirement.*

*The government shares investment risk through the interaction of the Age Pension with other retirement income. During periods of negative returns, a loss of income may be made up, in part, by an individual being eligible for some, or more, Age Pension at a rate of 40 cents in each dollar of lost income. Where investment returns rise, the income test allows the government to share in these returns through reduced Age Pension outlays. Investment returns also affect Age Pension outlays through the assets test.*

#### The role of individuals

There is an argument that it is the role of individuals to manage their investment risk.

However the reality at present is that before retirement many individuals remain in default investment options where they are in effect deferring the investment decision to the trustee of the superannuation fund.

When a person retires there is no default product selection, but a retiree must make a decision as to which retirement product to purchase with their lump sum. There has been a strong trend towards market-linked retirement products in recent years due to strong investment market performance. The default investment option in such products is often a balanced fund where the retiree retains a significant exposure to financial markets. This strategy has generally worked well for retirees up until 2008.

Whilst the events of 2008 have been distressing, it's important to recognise that these events are temporary and markets will recover. It would not be wise to set long term retirement incomes policy with the expectation that a global financial crisis of the magnitude that is currently being experienced will happen on a regular basis.

2008 does, however, lend focus to the fact that most retirees are significantly exposed to financial markets and there is an argument that they should be offered tools with which to defray market risk should they so desire.

ASFA does not recommend that it be compulsory for retirees to defray investment risk. We believe that financial consequences of longevity risk is the greater of the two evils, and any move to push retirees into more conservative investments in retirement will increase their longevity risk.

A sensible strategy that many retirees put in place (often with the assistance of a financial adviser) is to have small portion of their superannuation invested in cash. Typically the amount will represent the amount needed for spending over a 2 year period. Those retirees

In order to benefit from such strategies retirees need access to good, cost effective financial advice – please refer to discussion in section 5.1.1.

There is one argument that the industry should be designing products with this feature “built in” i.e. a cash pool from which income payments are drawn with an automatic top-up facility to replenish the pool of cash only when prices are high.

#### The role of financial markets

The role of financial markets is to make products available to retirees to allow them to access the level of market risk at which they feel comfortable.

ASFA believes that the market in this regard is well-developed and retirees have a wide choice of products catering to different risk profiles.

Without major barriers to product development we believe the market is operating efficiently here to deliver products that retirees want. For example the events of 2008 may see an increased demand amongst retirees for capital guaranteed style investment products.

#### The role of government

ASFA does not believe that any government intervention is required in terms of investment risk.

#### **4.2.3 Treatment of the family home**

The Consultation paper states that *Home ownership is a significant factor in retirement planning and can be used to counter investment, longevity and inflation risk. Instead of receiving investment income, a home owner receives the benefit of not having to pay rent during their retirement. Housing is therefore a form of voluntary retirement saving.*

*In addition to not having to pay rent, an individual can access the equity in their home through downsizing or through a reverse mortgage. These products allow an individual to convert the equity in their home to either a lump sum or a stream of payments. The access to capital in a home can also provide insurance against the risk of exhausting other assets while still alive. The reverse mortgage industry is still in its infancy in Australia, with approximately 1.4 per cent of individuals over the age of 60 years holding a reverse mortgage (SEQUAL 2008). The value of the market is approximately \$2 billion, made up of over 33,700 reverse mortgages, with an average value of \$59,000 per mortgage (Trowbridge Deloitte 2008).*

*Investment in the family home can result in the home being a significant asset (perhaps an individual's only significant asset) that can be drawn against in retirement. Payments from a reverse mortgage on a primary residence are treated as a loan for the purposes of the tax system and are therefore not treated as income for tax purposes.*

*However, if a reverse equity mortgage is taken as a lump sum, the first \$40,000 is exempt from the Age Pension assets test for up to 90 days. Amounts over \$40,000 are assessed under the assets test if held as an assessable asset. The whole amount is immediately assessed under deeming rules if held in a financial investment. If taken as a stream of payments, the amount drawn down is not counted in the income test.*

*The social security system provides additional assistance to individuals who are non-home owners. Individuals who receive the Age Pension and do not own their home may qualify for Rent Assistance if renting in the private rental market. The maximum payment is \$107.20 per fortnight for a single individual with no children and \$101.00 for a couple with no children.*

*Owner-occupied housing is exempt from the assets test. Non-home owners can accumulate higher non-housing assets (\$124,500) without affecting their eligibility for the Age Pension. Implicitly valuing a person's home at a maximum of \$124,500 can discourage Age pensioners from making decisions to move into more preferred housing arrangements, as it may reduce their total income because the additional income they earn by selling their house does not make up for the reduction in their Age Pension.*

The home is a major store of wealth – but currently it is not asset tested. This leads to inequity in the Age Pension between renters and owners since the rent assistance offered to Age Pensioners will not cover rental costs in most capital cities.

It also leads to estate planning – with the ability of assets on sale of the family home to be passed on tax free to children. Older Australians are incentivised to buy or remain in large expensive houses they do not need in order to maintain their Age

Pension. In times of housing shortage and desire for lower green footprint, this incentive for retirees to live in large expensive houses with more room than they need or want is poor public policy.

Many retirees will need to downsize houses as required to release capital to meet their income needs over and above the Age Pension. However the assets released from downsizing are means tested which can discourage them from downsizing.

In any case storing wealth in the family home and then downsizing is quite wasteful – the individuals incur high costs (stamp duty and sales commission) on sale of the property and if this is done a few times it is very inefficient.

Whilst the above pattern is in place at present, we recognise that with changing demographics and housing affordability this issue may not exist to the same extent for future generations of retirees.

ASFA recommends that:

- Research be undertaken to identify whether the storing and use of wealth in the family home is likely to be prevalent for future generations of retirees; and
- If it is likely, solutions are found which address the identified issues of inequity and wastefulness for future generations.

## 5. A SIMPLE AND APPROACHABLE RETIREMENT INCOME SYSTEM

### Q5.1 – Reducing cost and complexity

**In what ways does the retirement income system impose undue complexity and cost on retirees and workers? How could this complexity be reduced?**

#### 5.1.1 The role of financial advice

##### ASFA's current policy

ASFA's policy is that all Australians should have access to affordable financial advice.

Research conducted last year by a major fund in conjunction with QUT<sup>2</sup> has highlighted a correlation between switching behaviour, market activity and media build up that supports the view that many investor directed decisions achieve sub-optimal outcomes. We submit that while this tendency may be mitigated by the provision of low cost, specific advice on relevant matters, ASIC's research<sup>3</sup> confirms that only a small percentage of investors actually seek advice before making investment decisions. There are many reasons why investors do not seek financial planning advice<sup>4</sup> but expanding the scope of "simple superannuation advice" may provide consumers with more relevant and accessible advice.

The consumer benefit from expanding the availability of "intra fund advice" is likely to be significant given QUT's<sup>5</sup> recent survey of fund members. QUT found that consumers are significantly more likely to engage in positive investment behaviours after obtaining advice<sup>6</sup> than before, or without, obtaining advice; a conclusion consistent with ANOP's findings that those members that avail themselves of financial advice "consistently show higher levels of awareness and involvement in key aspects of super"<sup>7</sup>.

In the interests of making advice more affordable and more accessible, simple personal advice on superannuation interests ("intra fund advice") should be facilitated. "Intra fund advice" is simple personal advice and should be limited to advice and recommendations provided to current members in relation to their current superannuation account. It should exclude complex advice and any advice interaction that involves comparing superannuation with other financial products being considered by the member.

##### Guiding principles - advice:

The system should provide incentives to encourage people to seek financial advice. Financial advice for retirement planning should be broadly accessible to retirees and workers. The tax effects should be neutral between advice paid for by commission and advice paid for on a fee for service basis.

ASFA recommends that:

- A tax deduction should be available for advice paid for on a fee for service basis. Alternatively a tax rebate could be available.

2 QUT Financial Literacy Research (2008)

3 ASIC Report 121(MR 08-85) dated April 2008 "Australian Investors at a glance"

4 ANOP Research Services Pty Ltd "2007 National Survey of 25-69 Year Olds in the Workforce: Report on Attitudes to Superannuation in Late 2007". Prepared for the Association of Superannuation Funds of Australia ("ASFA"), November 2007, Summary Table 7.3

5 QUT Financial Literacy Research (2008)

6 QUT Financial Literacy Research (2008);

7 ANOP Research Services Pty Ltd "2007 National Survey of 25-69 Year Olds in the Workforce: Report on Attitudes to Superannuation in Late 2007". Prepared for the Association of Superannuation Funds of Australia ("ASFA"), November 2007, Key Research Results

- A fee for service arrangement for preparation of an initial financial plan is currently not tax deductible. Tax deductibility would assist consumers' access to financial advice and improve tax neutrality between payment by fee for service and payment by commission from the product issuer.
- It is our view that the availability of the tax concession should not be capped. Capping introduces unnecessary complexity and acts as a disincentive.

We also note that simplification of the tax treatment of contributions and benefits would reduce the need for complex advice on structure issues, and therefore potentially reduce the cost of the advice retirees and workers need to make retirement planning decisions. For example:

- Workers in middle income brackets wanting to contribute more to super need advice on whether they are better off making contributions from pre or post tax income or by spouse contributions.
- The different tax treatment of death benefits (depending on whether the benefit is paid to a spouse /financial dependant or to non-dependant adult children) means people seek advice on re-contribution strategies.
- The different taxation regimes before and after retirement create complex "transition to retirement" strategies where a person still working after age 60 moves the bulk of their assets into the tax-free retirement phase and starts an allocated pension, salary sacrifices as much as they can of their salary into a super fund and lives off the allocated pension payments (which are made tax free). This can reduce their personal marginal tax on salary.
- The different taxation regimes on investment returns & capital gains tax before and after retirement create arbitrage strategies where a person with a self managed super fund can delay sale of assets in their fund until after they retire, avoiding paying capital gains tax on the sale.

## 5.1.2 Financial Literacy

### Guiding principles:

Financial literacy is critical to enabling individuals to understand the importance of saving for retirement.

At younger ages, literacy must focus on maximising contribution benefits available to individuals, particularly for those who do not participate in the system. Further, individuals can benefit from targeting a certain living standard in retirement by making additional contributions.

At older ages, literacy must focus on transitioning from 'saving earnings' to 'spending savings'. Awareness of income needs, life expectancy, health and care are critical.

### Tools for superannuation fund members

ASFA recommends that:

- All Australians receive an annual projection (called a "Retirement Income Estimate<sup>8</sup>") with their superannuation statement which gives them an indication of the income they can expect in retirement from both their superannuation and the relevant Age Pension. Industry wide standards should be introduced for all superannuation projections.
- Industry wide standards be introduced for the use of life expectancy in projections, and other information given to superannuation fund members. This will allow people to more readily understand and plan for their longevity risk.
  - For example, life expectancy figures need to allow for mortality improvements. Perhaps ASIC could mandate a certain improved life expectancy table be used for all projections and member discussions.
  - Where an average life expectancy is shown the member must also be shown the likelihood of 'beating the odds' by living to certain ages beyond the average expectancy. Some projections indicate a 10% chance of living to age 100 for a 65 year old.
- Government funds initiatives through the Financial Literacy Foundation to educate prospective retirees about what they can expect in retirement and how they can influence the outcome.

## 5.1.3 The effect of superannuation tax concessions on decisions

### **ASFA's current policy**

#### Simplification of taxation

ASFA supports reform of taxation of superannuation so as to reduce current complexity and increase the fairness of arrangements.

ASFA will support provisions which do not impose undue compliance and administration costs on superannuation funds and their members.

<sup>8</sup> Please refer to ASFA's submission to ASIC on Consultation Paper 101 – Superannuation Forecasts on 31 October 2008.

ASFA supports realistic timetables that would allow any affected funds to adjust their accounting and investment practices if this were required in any reform.

When changes are made to the taxation of superannuation, ASFA supports taking into account the accrued rights and expectations of individuals by the use of transfer values and/or other transitional arrangements. ASFA does not support "Grandfathering" of accrued rights and expectations when changes are made to the taxation of superannuation. While this method satisfies some aspects of equity criteria, it introduces other anomalies between individuals of the same and different generations. It also adds to the complexity and confusion confronting the system today.

ASFA has concerns with 'one-off' levies which purport to only impact on the higher paid. Poor design of these levies generally results in increased administration costs that are borne by all members. They also impact on low income earners receiving relatively small retirement and other lump sums that, for levy determination purposes, push them over the levy threshold.

#### Guiding principles:

In simple terms, the tax benefits provided by the superannuation system are designed to incentivise saving and regulations have been introduced to ensure the system is used in the intended spirit. Recent changes to the system have simplified the tax treatment of superannuation, particularly in retirement. Further simplifications to the regulations should also be considered, which reduce barriers to the aging population, businesses and innovation.

#### Simplifying investment returns tax?

As discussed in Section 3.2.1, ASFA was considering recommending the extension of the superannuation investment returns tax (at 12%) across the board for both pre-retirement and post-retirement investment returns.

Whilst we think that this measure has merit for the following reasons:

- it would reduce administration costs in the industry (and ultimately member costs) as only one tax regime will be in operation, and
- it would solve some of the complexities described raised in 5.1.1 above;

we have decided not to recommend this measure. The reason is that this would make the tax outside of superannuation cheaper than superannuation tax rates for many Australians which would discourage continued use of the retirement incomes system in retirement. Without wholesale changes to the general taxation rules for retirees we cannot see that this would work.

#### Simplifying contributions

The Consultation Paper points out the difficulties for individuals in making decisions on how to make their contributions due to the differences in treatment of before-tax and after-tax contributions. This is mainly an issue for lower income earners, who pay a relatively high rate of tax on before-tax contributions (compared to their marginal tax rates) and as such maybe better off making part of the contribution from after-tax salary.

If the tax on SG and other pre-tax contributions for lower income earners is reduced, much of this complexity is removed. The complexity would be completely removed if for all income levels, before-tax contributions are more tax effective than after-tax contributions (however with the co-contribution in operation this may not be possible).

ASFA made some recommendations in Section 3.2.3 above which will assist in this regard, namely:

- Rebate (via the co-contributions system) the 15% contributions tax on SG and any other pre-tax contributions for low income earners – say below Average Weekly Earnings (currently around \$58,000 p.a.). This figure should be indexed.
- Expand co-contributions to middle income earners – for example lift lower co-contribution limit from \$30,342 to a higher income eg. \$50,000 so that it phases out at \$80,000 (limits continue to be indexed).

#### Simplifying death and disability payments

In ASFA's previous submission section 4.1 we recommended that:

- death benefits paid after age 60 (or age 65 if the "tax free" age is changed) be exempt from tax.

This will greatly simplify administrative procedures for superannuation funds and thereby reduce costs.

In ASFA's previous submission section 4.2 we recommended that

- All Total and Permanent Disablement Benefits paid in income stream form to be tax free regardless of the age of the recipient. Tax on lump sum benefits remains before age 60 (or 65).

This will greatly simplify the process for seriously ill people to be able to access their benefits.

### The Self Employed and part time workers

Due to the fact that self employed people are outside the SG system, a number of complexities exist.

Employers may be more incentivised to employ “contractors” where they think that they can reduce costs by not having to pay SG.

Self-employed people can often choose whether to remain self-employed or incorporate and become an employee. Superannuation considerations could influence this decision. Some self employed people do not understand whether they are employed or self employed and as such find it difficult to know whether SG applies to them.

ASFA recommends that these complexities are reduced by:

- extending SG to the self employed (refer Section 2.1.1)
- for small business owners, simplify the CGT rules on the sale of businesses to encourage the transfer of lump sums to superannuation.

Many people have multiple or serial causal jobs. These people are likely to remain below the \$450 per month limit and therefore never receive superannuation. As outlined in 2.1.2 ASFA recommends the following:

- Remove the \$450 minimum annual earnings test for SG payments. A minimum dollar payment such as \$10 should still apply for practical purposes.

### **5.1.4 Decisions in retirement**

#### Integration of the Age Pension and Taxation Systems for older Australians

Section 2.1 of ASFA's previous submission outlined the rationale for combining the social security and taxation system for Australians aged 65 and older, and administering them as related arrangements.

For most retirees their income is a mixture of earned income, self-funded retirement income and Centrelink benefits. For this reason it makes sense to have these areas administered together. This could assist in reducing much of the current complexity of the system for Australian retirees.

ASFA stands by our recommendation in our previous submission to:

- Simplify the tax/welfare position of an individual by administering the impact of age pension, superannuation and tax as related arrangements for those aged 65 and older.

So for example depending on a schedule of relevant income, a payment is made to a person over 65 (i.e. Social Security), or a payment is taken from the person (i.e. tax).

We understand the complexity of integration of these two systems when the tax system is an individual system and the social security system is largely based on couples. As such if the system cannot be completely integrated, at least a single administrative unit could be created where the tax and social security situation of older Australians is managed by the same staff.

#### Encouraging earned income in retirement

Currently when an Age Pensioner receives earned income (eg. from a part-time job), they pay tax and also lose a portion of their Age Pension. This discourages retirees from receiving earned income and hinders the ability of a person aged over Age Pension age to transition gradually to retirement.

Treating earned income favourably for tax and social security means testing would remove the current disincentive for people receiving Age Pension to be in paid employment. Increases labour force participation for older Australians, and allows people who want to live on more than the Age Pension alone to boost their income.

- ASFA recommends that earned income is treated favourably in terms of Centrelink means testing in retirement.

#### Ability for older Australians to make super contributions

The work test requires individuals aged between 65 and 74 to work 40 hours in 30 consecutive days during the financial year to be eligible to contribute to super. Those aged over 75 are not permitted to make superannuation contributions. With longer life expectancies and the trend towards part-time work in retirement such rules should be modified. With the increasing trend to a gradual transition to retirement, these rules impose unnecessary complexity to individuals and increase the cost of administration of super.

ASFA recommends:

- that the work test for eligibility to make superannuation contributions at older ages be removed.
- that a common age be agreed of 75 for cessation of all contributions (SG, personal, salary sacrifice).

These measures recognise that people are working longer and so may wish to contribute longer, and remove red tape which will encourage engagement with super for older people.

#### Reduce the complexity of Centrelink assessment process

Currently retirees experience constant asset testing which is expensive and intrusive. Testing less frequently, perhaps as part of the tax return, would save an enormous amount of government administration costs – not to mention reduce stress and complexity for retirees.

ASFA recommends:

- The income test is removed and retirees are tested on assets only.  
We understand that some adjustments to the assets test may be required as a result – for example there would need to be a lump sum equivalent for non-account based income streams or deferred “longevity insurance” guarantees purchased in retirement.
- Assets are tested annually by Centrelink as part of the tax return process. If a person does not put in a tax return, they must provide Centrelink with a schedule of assets at the end of each financial year..
- To reduce costs and complexity - bring dates for social security updates and indexation in line with tax i.e. change from 1 March and 1 Sept – twice a year -to just once a year.

## **6. A SUSTAINABLE RETIREMENT INCOME SYSTEM**

### **Q6.1 – Role of the Age Pension**

**The Age Pension serves two roles, as a safety net for individuals who are unable to sufficiently save for their retirement and as an income supplement for many individuals who do save. What should be the role for the Age Pension and means testing in a future retirement income system and what impact does this have on its sustainability into the future?**

#### **6.1.1 Safety net or supplement?**

The Consultation Paper (p9 “Setting the retirement income parameters”) discusses the differences between an Age Pension which is intended:

1. to supplement retirement income; or
2. as a safety net for those unable to save.

The pure form of Option 1. above would mean a universal Age Pension that all people receive, and this would mean a lower compulsory savings (SG) rate and fewer tax incentives for additional savings would be required.

Option 2. means the Age Pension ensures a minimum level of income for the duration of retirement. This is the system we have currently.

It is ASFA’s view that equity must be considered in the context of overall retirement incomes, including access to superannuation and the Age Pension. The community funds retirement income support for both superannuation and the Age Pension recipients, and some will benefit from one or other or partly from each. The Age Pension supports those who have not received tax concessions for super and it tops up the income of those with only modest super benefits.

As such, ASFA’s view is that the primary focus of the Age Pension should continue to be a safety net funded by the government. Whilst not being designed to supplement retirement income for all Australians, the Age Pension should continue to play an important role in topping up the income of those with only modest super benefits.

Please refer to section 1.1.5 for a detailed discussion of ASFA’s view of the role of the three pillars.

ASFA supports a guaranteed minimum retirement income provided by government on a means tested basis to provide for protection against poverty and recognises that for many, this is an important part of their overall retirement income.

ASFA believes that government involvement in the financing and provision of the safety net provision is essential.

#### **6.1.2 Age Pension and means testing – impact on sustainability**

##### Age Pension costs are sustainable

Despite Australia’s ageing population profile, the current Age Pension system will remain affordable well into the future. As a result government policies relating to superannuation are more focused on improving incomes in retirement than on restraining aggregate government expenditures on the Age Pension.

The Intergenerational Report 2007 projects expenditure on income assistance for the aged to rise to only 4.4 per cent of GDP by 2046-47. Given this level of future spending, expenditure on the Age Pension is very affordable going forward and there will

not be a need to curtail its availability or its amount due to budgetary pressures.

In addition, there is strong support for the basic structure of the current Age Pension across the political spectrum. Moreover, there is strong community acceptance of a flat rate Age Pension financed by a progressive income tax paid by current income earners. Equally, there is strong community acceptance of the Age Pension being more or less a universal entitlement (subject to means testing) rather than a measure of last resort. This is consistently shown by social attitudes surveys in Australia.

Government policies relating to superannuation as a result tend to be more focused on improving incomes in retirement than on restraining aggregate government expenditures on the Age Pension. Given the targeted and fiscally affordable nature of the Age Pension, Australia has not experienced the economic and political pressures that have built up in a number of other developed countries. Those countries with generous employment earnings related systems of retirement income financed out of general revenue are seeing massive increases in costs as their populations' age.

In Australia, the pressures have been more around the adequacy of the Age Pension. The complexity of benefits administration and the disincentives for private retirement savings due to the means test have also been issues. In regard to the World Bank criteria for a sustainable system, the Australian Age Pension is financially sound and can be maintained over a foreseeable horizon under a broad set of reasonable assumptions.

#### Should the Age Pension age be increased?

The average retirement age is around 62.5 years for men, and around 60 for women, with quite a bit of variance about these ages. Given that life expectancies continue to increase on the face of it there appears to be a case for increasing the eligibility age for the Age Pension. If 65 were the right eligibility age for men 50 years ago, then shouldn't it logically be higher now? However, the logic of this argument breaks down if an increase in the eligibility age for the Age Pension does not have much impact on when people leave the paid labour force.

Currently just over 50 per cent of those reaching Age Pension age actually get some Age Pension due to the operation of the means test. This compares to somewhere between 30 and 40 per cent of those aged 64 being entitled to income support from the government that is not activity tested (such as by having to look for work). Given that disability rates increase quite sharply for people aged in their late 60s with even relatively high levels of take-up of the disability support benefits for those aged in their early 60s, increasing the Age Pension age might not have a big impact on individuals or government expenditures. Social security benefits paid might have a different label, but still would be paid in most instances. There would also be a shift in the burden of costs, with workers compensation payments presumably still payable until individuals reached the higher Age Pension eligibility age. There would be other insurance cost implications as well, including in regard to the premium rates for various personal liability and salary continuance products.

Increasing the eligibility age for the Age Pension would certainly lead to some decrease in government costs. It would also lead to higher living standards for at least a proportion of those aged 65 and over, albeit at the cost of some retirement leisure. Although there currently is no compulsory retirement age in most jobs in Australia, changing the eligibility age for the Age Pension could change the mindsets of both individuals and employers. This would open up some opportunities for individuals who want to work past age 65 but currently are encouraged or pressured not to do so.

That said, there are other options that could be effective in lifting retirement living standards and limiting government costs. Making the Pension Bonus Scheme more attractive to individuals and promoting the Scheme more effectively might be one such option (please refer to section 6.2 below). Another might be to provide additional support and training for older workers.

In section 4.1.1 above ASFA recommends that the Age Pension age remain at 65.

#### Means testing

In section 5.1.4 we recommended the following:

- the income test is removed and retirees are tested on assets only (we understand that some adjustment to the assets test may be required as a result).

In designing the change, the impact on government costs and therefore sustainability would need to be carefully considered. Ideally it would be cost neutral.

There is also the question of indexation of the means testing threshold. Currently these are indexed at CPI. ASFA recommends that:

- The Centrelink means testing thresholds are indexed to AWOTE.

In section 4.2.3 we discussed either asset testing a portion of the equity in the family home, or alternatively making assets released from the family home exempt from asset testing.

Whilst the first measure may reduce the Age Pension cost to government and therefore improve the sustainability of the system, it would be politically very difficult to implement.

The second measure would have a minimal impact on government costs (as people avoid downsizing where it will reduce out pension entitlements) but would change behaviour in a positive way. Please refer to the above section for a more detailed

discussion.

#### Pension bonus scheme

The current Pension Bonus scheme provides inadequate incentive to defer taking the age pension. Provision of a lump sum bonus is not consistent with the principle of encouraging retirement income. The current bonus is not perceived to provide "fair" value for the foregone age pension income.

ASFA recommends:

- That the pension bonus system be reconfigured to provide a higher pension for those opting to defer commencement of the age pension.

The aim would be to keep the cost of the Age Pension the same, but allow a higher payment the longer an individual delays the commencement of the pension.

Work by the Institute of Actuaries shows that the level of pension would roughly double for every ten years by which it is delayed. A ceiling dollar figure should be considered.

If costed correctly, this would not have an impact on the sustainability of the system. It would however be of enormous benefit to retirees who would not experience such a drop in their living standards when they run out of assets and commence an Age Pension later in life.

#### **Q6.2 – Workforce participation**

**In what ways does retirement income policy affect workforce participation decisions and what, if any, changes might reduce disincentives to work? Does the sustainability and cost of the retirement income system affect the workforce decisions of younger generations of workers?**

The arithmetic of compound interest and the operation of the Superannuation Guarantee means that more years in the paid labour force increases retirement incomes, especially if the onset of retirement is delayed.

Providing a supportive, indeed encouraging, environment for individuals to work past age 65 makes a lot of sense. This applies in both an individual and collective sense. Paid work provides a sense of purpose for many individuals and contributes to overall productivity and community living standards.

Due to the impending skills shortage with the baby boomers reaching retirement and due to increasing life expectancy, the system should be designed to encourage people to continue working beyond age 65 if they are able to. People who are unable to continue working should be supported.

To encourage workforce participation by older Australians:

- We need transparent, well understood incentives for continuing to work.
- We need transparent, well understood incentives for delaying taking the Age Pension whether working or not.

ASFA has already made a number of recommendations in this regard as follows:

- In section 5.1.4 we recommended removing means testing of income in retirement
- In section 5.1.4 we recommended that the work test for eligibility to make superannuation contributions at older ages be removed.
- In section 6.1. we recommended that the pension bonus system be reconfigured to provide a higher pension for those opting to defer commencement of the age pension.

#### **Q6.3 – Financial intermediation**

**What impact could financial intermediation have on the effectiveness of retirement income policy?**

The SG system was designed as compulsory saving to force those who were income and credit restrained to save for their retirement.

However in practice the easy availability of credit in recent years and the strong Australian desire to own a home has meant that many individuals are retiring with a mortgage. Their superannuation is then used to pay this mortgage out which reduces the individual's retirement benefit.

The restriction on income during their working lifetime due to the 9% SG has lessened such peoples' ability to pay off their mortgage.

We acknowledge that a compulsory additional contribution will increase the problem, however with a soft compulsion system an individual could "opt out" of the additional contribution and use the additional income to pay off their mortgage.

## **APPENDIX A**

The ASFA projections in section 2.2.2 assume the following:

Post fee and tax investment return 7% p.a.

Inflation 2.5% p.a.

Salary Growth 4% p.a.

Life expectancy to age 88 exactly.

Further details are available on request.

Letter sent on 26 February 2009 to:

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