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Further ASFA Submission to the Review of Australia's Future Taxation System

Following our previous submissions to the Review on 20th October 2008 and 26th February 2009, the Association of Superannuation Funds of Australia Ltd (ASFA) is pleased to provide a further submission.

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

While there has not been a formal call by the Review for further submissions on retirement outcome issues, ASFA understands it is still possible to address matters canvassed in the interim report. In particular, we understand the Panel would be interested in a further submission which does the following (with the summary ASFA position inserted in brackets for each dot point):

- Maps out any ASFA arguments that are at odds with the interim report (OECD, ASFA and indeed Harmer Review modelling indicates that current superannuation settings will not deliver acceptable retirement incomes for the bulk of the population, ASFA demonstrates that contributions of 12% or more generally will be needed).
- Addresses the impact of higher superannuation contributions on disposable income in the pre-retirement period, particularly for low to middle income earners (ASFA calculations indicate the additional contributions are affordable for low to middle income earners. For a person on average earnings an additional 1% going into superannuation leads to a reduction in disposable income of only \$411 a year, around \$7.90 a week. For a person on median income the reduction in disposable income is just \$5.90 a week).
- Provides commentary on why savings outside superannuation represent a less desirable outcome (ASFA's analysis indicates that given there is no preservation requirement for savings outside superannuation, a tax concession for such savings would amount to no more than a subsidy for current consumption and/or would encourage funds to flow to risky or inappropriate forms of savings).
- Provides stronger arguments on why the compulsory system should cover the self employed (ASFA provides evidence that a substantial proportion of the self employed do not make adequate provision for their retirement, and that compulsory contributions for the self employed apply in most developed countries. ASFA also provides legislative and practical details of how compulsory coverage of the self employed could be implemented).

- Provides stronger arguments on why the SG threshold of earnings of \$450 a month should be abolished (the administrative costs would be low for employers and would be low relative to the contributions for those benefitting. Some 200,000 to 300,000 persons, mostly women, would benefit).
- Describes the best model for soft compulsion (ASFA considers that the Commonwealth has adequate Corporations and Taxation powers to introduce soft compulsion, and a model for this is described in this submission).
- Analyses the equity of current superannuation tax concessions (ASFA sets out recent research indicating that current tax concessions are broadly equitable when considered on a whole of life basis and when receipt of the Age Pension by those on lower incomes is taken into account. The problems associated with very tight caps on contributions in a given year and/or taxation of contributions at higher than current rates are also identified).
- Sets out measures which would improve the equity of superannuation (ASFA recommends that the 15% contributions tax be rebated for those on incomes less than AWE, and that the co-contribution be extended to middle income earners).
- Responds to suggestions that the preservation age should be increased to the entitlement age for the Age Pension (ASFA does not support such an increase).
- Points out changes to government policies which would lead to better post-retirement policies (ASFA recommends that both income tax rulings and SIS regulations be amended, and consideration be given to social security means test concessions for individuals who take out products providing longevity cover).

The remainder of the submission provides more detailed responses on each of these matters. Particular attention is given to the legal, economic and social arguments for higher superannuation contributions. There are of course ASFA views on other superannuation, retirement income and taxation issues which were canvassed in the earlier ASFA submissions. The earlier ASFA submissions still stand. This submission also emphasises the need for the Panel to articulate a clear strategic vision for the future, rather than a series of individual measures with a very current budget cost focus.

THE NEED FOR A STRATEGIC VISION

The expectation is that the output from this Review will redefine retirement outcomes for all Australians both in the immediate future and for decades ahead.

Past strategic visions

The Review is in the tradition of previous substantial and substantive reviews of Australian taxation and regulation arrangements. For instance, in the 1970s the Asprey Report set the scene for a range of reforms, including into capital gains, income tax and taxation of goods and services.

The 1980s had the July 1985 Tax Summit, which followed the publication of the Draft White Paper, *Reform of the Australian Tax System*.

In the 1990s there was both A New Tax System (ANTS) and the Ralph Review of Business Taxation.

Superannuation policy also has had a number of significant turning points. For instance, in 1986 there was the Accord Mark II and the National Wage Case productivity claim which led to the first compulsory superannuation. In May 2006 the package of measures known as Simpler Super were announced.

How the interim report and 2009 Budget superannuation measures are being perceived

While each of the major reports and of measures referred to above differed markedly in content, they shared a common purpose in identifying major gaps or needs and then providing solutions. However, the interim report of this Review together with the May 2009 Budget announcements on superannuation and retirement have been perceived by many as not doing that. One typical comment is that the proposals appear to be “short-term tactics to address long-term strategic issues”.

More specifically, the 2009 Federal Budget introduced changes that have been interpreted by many as altering the long held philosophy that a combination of compulsory and voluntary superannuation contributions was the means by which all Australians could achieve an adequate and dignified retirement.

ASFA’s concern is that this perception that support for superannuation has been seriously curtailed will become increasingly common and that what will follow will be a lack of confidence in the superannuation system. This may not be the intention of the Panel, but it appears likely to be outcome if not remedied in the final report. Constant changes (especially adverse changes) to the system result in people leaving the superannuation system or making less use of it in favour of what is perceived to be a more stable alternative. This will even be the case when investments outside superannuation have higher levels of investment risk.

Tinkering with the system (together with speculation about future changes such as an increase in the preservation age) will discourage people from consolidating their long term saving in superannuation. While there is scope for improving the superannuation sector and outcomes for individual members, the combination of strong prudential and market conduct controls have meant that APRA regulated super funds have largely avoided the significant problems and catastrophic losses incurred by investors in certain non-super investments (Storm, Opes Prime, Westpoint).

What the Panel should do in the Final Report

While the Global Financial Crisis has made the budgetary climate not particularly favourable for the immediate implementation of measures, the interim report of the Review appears to have carried this through into the longer term and presented a very modest vision for the future.

A focus on the future is particularly important when superannuation and retirement incomes are concerned. Public statements from Panel members indicate that the Review shares this view. It can take several decades before the benefits of superannuation reforms take full effect or deliver their full benefits. It also is necessary for a retirement income system to deliver outcomes consistent with future expectations and living standards.

ASFA's strategic vision for future retirement income policy is reproduced in Attachment A. The specific proposals set out below are consistent with that strategic vision.

It is important for the Panel to set goals for superannuation and the retirement income system. This would:

- Allow the success or otherwise of the system to be measured.
- Provide a framework for deciding if and when changes to the system are needed.
- Put a clear context around the taxation concessions for superannuation.

Setting goals for the system would bring about much greater accountability in terms of the development of policies and delivery of retirement benefits to the community.

COMMENTARY ON THE FINDINGS AND RECOMMENDATIONS IN THE INTERIM REPORT

1. LEVEL OF COMPULSORY SUPER AND THE COVERAGE OF THE SUPERANNAUTION GUARANTEE

1.1 Panel's recommendation to leave SG at 9%

The interim report asserts rather than demonstrates that both the coverage and the rate of the SG should not be extended.

It is claimed (at page 11 of the Report) that the Superannuation Guarantee, together with the Age Pension, is expected to provide the opportunity for people on low to average wages with an average working life of 35 years to have a substantial replacement of their income. Figures of replacement rates of about 73% for a worker on median income and about 63% for a person on average earnings are given.

However, these replacement rates are boosted artificially by using only the CPI to deflate increases in the Age Pension received after a person retires. This is not a meaningful approach given that the Age Pension moves in line with increases in average wages so as to retain a link to community living standards. An individual receiving the Age Pension, say, 20 years after retirement does not perceive the Age Pension as being worth substantially more than it was when it was first received 20 years earlier.

The perception is and will continue to be that the Age Pension has done no more than keep up with community standards. This certainly has been the perception of individuals and the community in the context of the recent review of the Age and Carers Pensions. If that report has attempted to dismiss concerns about the level of the Age Pension by relating the current level of the Age Pension to the level of wages 20 or more years ago the review findings would have been dismissed out of hand. Such reasoning should not be applied in the context of the wider review of taxation and retirement income to claim that current settings will generate adequate retirement incomes for most individuals in the decades following their retirement from the paid labour force.

A more relevant set of numbers are those making use of a wages deflator. The technical reasons for doing this have been well explored in both reports from the Institute of Actuaries and in the Senate Committee report that examined the adequacy of superannuation. ASIC uses a wages deflator in its Fido calculators, and this is both international and domestic best practice.

In practical terms, using a wages deflator allows appropriate allowance to be made for future increases in the general standard of living. This is very important when projections are being made over long periods.

Using this more appropriate methodology, replacement rate numbers are substantially lower at around 61% for an individual on median earnings and only around 52% for a person on average earnings. At 1.5 times average earnings the replacement rate plummets to only 42.6%. These replacement rates are low compared to the 60% to 70% of gross (pre-tax) income replacement rates generally sought in overseas countries and by financial planners in Australia for those at or slightly above average earnings.

The sensitivity of these claimed replacement rates to the particular assumptions used in the Treasury modelling is also brought out by examination of OECD comparative figures for replacement rates. These show that for a median income earner the Australian system when mature is projected to generate a retirement income of 59.2% of lifetime earnings, compared to an OECD average of 71.8%. Shifting the goal posts does not make Australia a champion performer in terms of retirement income provision.

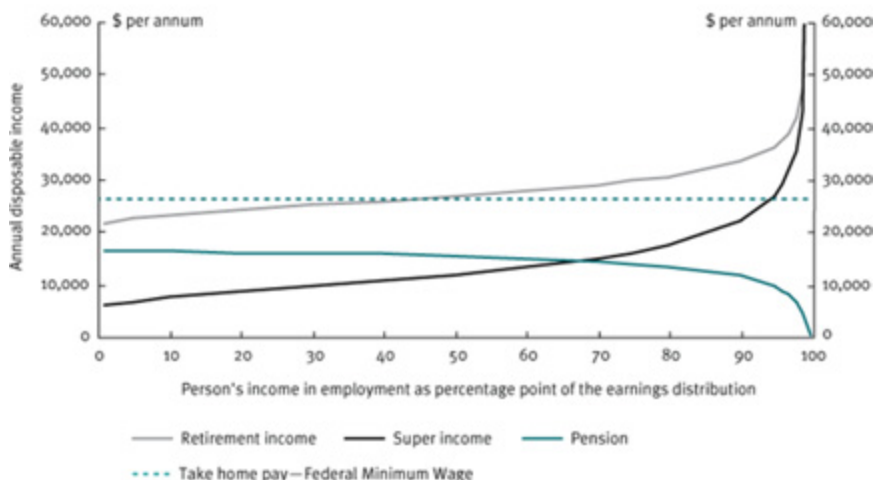
Turning to the absolute level of retirement incomes that will be generated, an individual who was on average earnings (\$60,000) retiring on \$24,500 (52% of after tax employment income) in their first year of retirement does not perceive this as involving a replacement rate of 63% on the basis that future Age Pension increases will lead to an average retirement income of \$29,700 being received over the course of retirement. There is no empirical evidence that any retiree has ever perceived adequacy in such terms.

Accordingly replacement ratios of the type used in the interim report are very abstract, and do not give a true indication of the extent of austerity in retirement that most Australians will face on the basis of current Age Pension and compulsory superannuation settings. For a person employed at \$60,000 a year a claimed replacement rate of 63% may sound attractive, but the reality of an income of \$24,500 a year in retirement is far less attractive.

A more meaningful way of looking at prospective of retirement incomes is to look at the projected level of incomes in dollar terms. This was done in the Pension Review Report. Chart 1 for Chapter 2 of that Report is reproduced below. The chart provides estimates of absolute levels of income in retirement that are consistent, when adjusted for years in the paid labour force, with modelling undertaken by ASFA.

An important message to be drawn from the Chart is that only 2% to 3% of retirees are expected to have retirement incomes in excess of \$40,000 a year even when the SG system is fully mature. The bulk of retirees are expected to have retirement incomes of less than \$30,000 a year. As well around 90% of retirees are projected to be in receipt of a full or near full Age Pension.

Chart 1 Retirement incomes—contribution of the Superannuation Guarantee and Age Pension (modelled results under full superannuation guarantee)



Source: Pension Review modelling.

Despite setting out relative low retirement incomes in absolute terms, the projections in the Chart are optimistic in that they are based on 40 years of full time work and two years of part time work. This is likely to be longer than most Australians, particularly women, will be in paid work in the future even when the Age Pension eligibility has increased.

Both the Pension Review and Treasury modelling are in effect “best case” scenarios based on a limited set of assumptions. There is little acknowledgment of the volatility of investment returns, or the quite different labour market patterns which will be experienced in practice.

Using a more realistic assumption of 35 years in the paid labour force, a person on median earnings is projected to receive only about \$23,000 a year in total, taking into account both the Age Pension and compulsory superannuation. For a person at the 75th percentile of earnings the annual retirement income is not that much higher, at around \$26,000 a year. As well, as noted above these figures are based on very long periods in the paid labour force.

Plausible levels of average financial (income generating) assets outside of superannuation do not materially alter these projected results. For instance, the sustained increase in retirement spending associated with \$50,000 in non-superannuation savings is only around \$2,000 a year.

Accordingly, the replacement income targets inherent in the conclusions of the Review’s interim report are very low, both in absolute terms and as a percentage of pre-retirement income. They are below the levels consistent with meeting the needs and expectations of the Australian community.

Opinion polling conducted for ASFA by McNair Ingenuity Research in September 2008 found that less than 10% of those aged 25 to 69 considered that a minimum retirement income of less than \$30,000 would be sufficient to maintain an adequate lifestyle in retirement. Most (60%) expected that they will need at least \$40,000 a year in retirement.

ASFA considers that the Review Panel should revisit its conclusions on replacement rates. For most employees, including those on low to middle incomes, contributions of around 12% of wages would strike a more reasonable balance between before and after retirement incomes.

ASFA’s recommendations on adequacy

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 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 perceived difficulties around an increase to the SG (including political considerations and employer concerns), so if this is not possible then our next preference is for a compulsory additional personal contribution.

Our third preference is for a “soft compulsion” personal contribution where individuals would be able to opt out from making additional contributions if they so chose.

1.2 Panel’s implicit rejection of soft compulsion

At page 11 the report makes a one-line reference to proposals in submissions for the use of soft compulsion to increase the effective rate of contributions. Despite the fact that it would lead to higher retirement incomes, soft compulsion appears to have been dismissed out of hand on the basis that it would lead to a reduction in the pre-retirement income of employees.

If the same argument were adopted there would be no grounds for compulsory superannuation at all. While the report nominally supports a three pillar system, with one of those pillars being compulsory superannuation, this emphasis on the impact of compulsory contributions on current living standards could be (and has been) interpreted as a lack of support for the compulsory superannuation pillar.

The four good reasons for adopting a system of soft compulsion are set out in Box 1.

- Soft compulsion actually works
- It does not cost the government much
- Employees and the community more generally think it is a good idea
- It is not hard or costly for employers to implement

Soft compulsion has a sound basis in behavioural finance. Soft compulsion both stops people delaying decision making because of the complexity of the task and gets around the human foible of putting off until tomorrow what you do not want to do today.

There is a considerable body of evidence available from both overseas and Australian cases that when properly presented soft compulsion leads to the great bulk of those covered going along with the default rate of contributions. There are numerous examples of soft compulsion working well in the United States and the United Kingdom. A number of Australian public sector and corporate superannuation schemes also involve soft compulsion arrangements put in place voluntarily by employers.

ASFA calculations indicate that the budgetary costs of increased contributions to superannuation through soft compulsion would be relatively modest, albeit with some sensitivity to the discount rate used. For those on low to middle incomes the amount of income tax revenue foregone is quite small given that superannuation contributions are taxed at 15%. For those on higher incomes the impact of the additional superannuation savings is both an increase in private retirement income and a reduction in Age Pension expenditures. Higher income earners who already have in place adequate retirement savings plans also would be more likely to opt out from soft compulsion compared to lower income earners.

The impact of soft compulsion on disposable incomes during working years

For a person on average earnings an additional 1% going into superannuation leads to a reduction in disposable income of \$411 a year, around \$7.90 a week. For a person on median income the reduction in disposable income is only around \$5.90 a week. Given this amounts to the cost of only around 2 or 3 cups of coffee a week (depending on where you get your takeaway coffee) these amounts are very affordable for most

individuals. For those severely cash constrained, the option of opting out from the additional contributions would be available.

The general population appear to understand this arithmetic implicitly if not explicitly. A strong majority (78%) of respondents in the 2008 McNair Ingenuity survey commissioned by ASFA supported putting an extra 1% into super each time they received a wage increase or started a new job, up to a maximum of 3%. Support for putting an extra 1% into super each time they received a wage increase (which for most people is annual) or started a new job was highest among females and respondents under 40 years. This very strong support for such a measure from those facing the greatest relative demands on their income indicates that the Review concerns about the impact of soft compulsion on pre-retirement consumption opportunities have been overstated.

The practicalities of soft compulsion

What is being proposed would involve minimal employer burden. The adjustment to contribution rates would occur when employees are hired or receive a salary increase. Wage payments and superannuation payments need to be set or adjusted at these times in any event.

ASFA suggests that the appropriate legislative basis for implementing soft compulsion would be for the Commonwealth to make use of the Corporations power to legislate a new standard condition of employment. Consequential amendments to the Commonwealth industrial relations legislation would also be required so that payment of increased superannuation contributions rather than wages was consistent with any applicable award or industrial agreement.

An alternative approach would be to build upon the Choice of Fund legislation to require employers to put in place soft compulsion arrangements for both new and existing employees. Again, amendments to industrial relations legislation would be needed to bring about consistency of increased salary sacrifice contributions with any industrial relations requirements.

There is also a strong case for more general industrial relations provisions which would permit or require employers to provide salary sacrifice arrangements into superannuation even if this led to the payment of cash wages below the amount specified in an award or agreement.

1.3 SG and the self employed

For self-employed people, ASFA has recommended that:

- a compulsory contribution be gradually introduced for self employed people;
- 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 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 eligible); and
- the contribution would be assessed as part of the tax return process.

One argument that has been put forward against introducing compulsory superannuation contributions by the self employed is that there are self employed persons who consider the value of their business to be their retirement savings. However, there are significant divides amongst the self employed. ABS data indicates that the better off self employed tend to have more superannuation, more business net worth, more investment properties, and higher holdings of shares. The less well off self employed tend to have little of each of these.

Anecdotal evidence from funds suggests that those self employed who have more in superannuation are also better at building up equity in their business and otherwise accumulating retirement savings.

For those self employed who have a business which has a significant sale value independent of the proprietor's continued involvement, an option would be to provide an opt-out mechanism from compulsory superannuation (by way of declaration on the individual's income tax return) that they have business assets that would qualify for the 'CGT rollover exemption for small business', that is, a saleable business or business premises.

Why the self employed should be covered by compulsory superannuation

The self employed make up a substantial proportion (over 10%) of the paid labour force in Australia. In 2006 there were around 830,000 individuals aged 25 to 64 whose principal source of income was from their own unincorporated business. The number of self employed is growing strongly with this figure up 6.5% on the 780,000 self employed in 2004.

On average the self employed are less likely to have superannuation than employees. Around 26% of the self employed have nil superannuation. In the case of self employed females, over 31% have no superannuation. In contrast, compulsion works and only around 4% of wage and salary earners have no superannuation (presumably part timers below the threshold for the Superannuation Guarantee or the survey respondent not knowing about their superannuation).

The bulk of superannuation assets of the self employed is held by a relatively small number of individuals. The degree of concentration in the holding of superannuation assets is much higher than for wage and salary earners.

At the other end of the distribution of superannuation assets, around 26% of the self employed (around 210,000 persons) have no superannuation and a further 53% had less than \$40,000. While 36% of wage and salary earners achieve a superannuation balance of more than \$100,000 in the run-up to retirement, only around 18% of the self employed do so.

Many of the self employed currently do not achieve significant savings either in the form of equity in their business, or retirement savings in superannuation or otherwise. The net result is that a large proportion of recent retirees from the ranks of the self employed qualify for a full or part Age Pension. 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 self employed five years earlier. The data indicate that 51% of this group were receiving some Age Pension, with 30% receiving the full Age Pension.

Overseas practices in regard to the self employed

Australia is actually very unusual in terms of the current treatment of the self employed compared to most developed countries. According to a recent OECD study (OECD SOCIAL, EMPLOYMENT AND MIGRATION WORKING PAPERS No. 84 PENSION SCHEMES FOR THE SELF-EMPLOYED IN OECD COUNTRIES) countries which have compulsory coverage of the self employed in earnings related pension or retirement savings arrangements include Canada, Finland, Iceland, Norway, Sweden, Austria, Czech Republic, Hungary, Korea, Portugal, Slovak Republic, Switzerland, Turkey, and the United States. Countries which have special separate schemes for the self employed include Belgium, France, Germany, Greece, Italy, Luxembourg, Poland and Spain.

The OECD paper observes that recent reforms overseas have generally involved more closely integrating arrangements for the self employed within overall pension and retirement savings arrangements, including increasing the required rate of contributions by the self employed. The paper notes that because more and more people, at least for part of their career, are self employed pension systems need to be adapted to allow this new environment to be fully integrated into the pension system.

Clearly most other developed countries have found that there are no significant practical or policy problems in introducing compulsory coverage of the self employed. Introducing such arrangements in Australia is both feasible and desirable.

ASFA's recommendations on the self employed

ASFA strongly recommends that the Review reconsider its approach to the self employed. Expansion of the compulsory system would lead to a considerable improvement in retirement incomes and less reliance on the Age Pension for a substantial proportion of the self employed.

If the Review continues with its recommendation that the self employed not be subject to compulsory superannuation arrangements, ASFA agrees with the suggestion in the interim report that the scope of the Superannuation Guarantee could be extended to include with greater clarity and certainty arrangements that are close in nature to a formal employer-employee relationship.

More specifically, ASFA recommends that contracts be regarded as wholly or principally for labour (and subject to the Superannuation Guarantee) when the contractor is remunerated wholly or principally for their personal labour and skills. It should not be a requirement that the contractor must perform the work personally, or that payment is made by reference to hours worked rather than completion of the contract. It should be sufficient if the entity making the contract is aware that the contract is principally for personal labour and skills and that the identity of the person performing the skills is known.

Accordingly, the Superannuation Guarantee should still apply to the person performing the work even if the contract is with a trust or partnership. As well, the Superannuation Guarantee should apply even where the person is free to hire other people to perform the work in cases where the person performs the work themselves and this is known to the entity making payments under the contract.

1.3 Panel's recommendation to leave SG threshold at \$450 a month

For those working a series of low-paying jobs, the panel's recommendation that SG continue not to apply where earnings in a given job are below \$450 per month will mean those affected will have little chance of achieving adequacy. Currently around 200,000 to 300,000 people, mostly female, miss out on contributions because of the threshold. The panel noted in the interim report that a number of submissions argued for the abolition of the \$450 threshold. However, the report asserted that applying the SG from the first dollar of income may not be appropriate or cost-effective in many cases. Specific reference was made to the need to ensure that compliance costs to the employer are outweighed by the benefits to the employee.

ASFA suggests that examination of actual employer administrative costs would support the complete abolition or substantial reduction in the threshold. For instance, for an employee earning \$300 in each month of a SG quarter, a 9% contribution would equate to \$81. The actual administrative cost to an employer of making a contribution would be far less than this. Administration costs for small employers will also be reduced when the Clearing House proposal announced by the Government comes into effect.

In fact, there are likely to be higher compliance costs for employers from there being a threshold. Paying super on every dollar of wages involves less monitoring and compliance effort than checking that wages paid are below \$450 in a calendar month, particularly if wages are paid on a weekly or fortnightly basis with varying numbers of payments between months depending on the cycle of payments. ABS figures indicate that currently around 53% of those earning under \$200 a week in the main job are provided with superannuation by their employer. The bulk of persons in such job are female.

Administration costs and net benefit are also likely to be positive for the beneficiaries of the superannuation contributions. It is often the case that an individual will have multiple jobs, particularly in industries such as office cleaning, hospitality or retail. As well, almost all adults in employment will have an existing superannuation account from a time when they earned more than \$450 a month. Again it is not unusual for a person to have spells of full-time or near full-time employment punctuated by periods of part-time or casual employment. This is particularly the case for women with family or other care responsibilities.

Removing the \$450 threshold would also remove a potential bias against the employment of those earning just above the threshold, leading to greater labour market efficiencies and productivity gains.

2. TAX ASSISTANCE AND FAIRNESS OF CONCESSIONS

The Panel has stated that there will be final recommendations in the December report maintaining tax assistance to superannuation but improving the fairness of concessions for contributions, including by broadening access to them and limiting generous salary sacrifice concessions.

We also understand that the Panel will be examining the tax assistance (or lack thereof) for savings (i.e. capital) in the pre-retirement years.

ASFA considers that a priority for the Panel should be addressing inequities in the tax treatment of contributions by low income individuals. This would have an unequivocal and positive impact on equity. On the other hand, as will be discussed below, further tightening caps on concessions and/or attempting to remove tax benefits for certain groups would have both uncertain and potentially detrimental equity and efficiency impacts.

2.1 Restatement of ASFA's recommendations to address tax inequity

ASFA addressed the tax inequity issue for lower income earners in our 29th February submission to and we reiterate here our previous recommendations:

- 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 2008 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 advantaged contributions to super. If salary sacrifice were more broadly available then this measure would not be required. ASFA also emphasises that any assessment of the overall equity of the treatment of superannuation needs to take into account the tax treatment over the entire life course of superannuation and also the receipt of the Age Pension.

Such a whole of life approach was adopted by Dr George Rothman of the Retirement and Intergenerational Modelling and Analysis Unit in the Department of the Treasury in his July 2009 paper, *Assessing the Equity of Australia's Retirement Income System*. That paper demonstrates that the cost to government of tax concessions for superannuation and Age Pension expenditures is remarkably steady from income deciles 1 to 10. The author concludes that using this more comprehensive approach, the retirement income system after the 2009 Budget is found to be more equitable, both vertically and by gender, than many would have expected.

Accordingly, it can be argued that the current system of tax concessions and Age Pension provision is not so broken that it needs fundamental changes. That said, tax concessions for superannuation do not provide significant assistance for low income earners. Another July 2009 research paper by David Tellis of Treasury indicates that some 1.6 million individuals currently receive no tax concession on their supposedly concessional superannuation contributions. ASFA's recommendations in regard to the lower paid reproduced above address this shortcoming.

2.2 Tax treatment of non-superannuation savings

Clearly there are a host of issues related to the taxation of the range of savings and the tax treatment of income from capital. Certain investments receive preferential tax treatment relative to other investments. Some forms of saving (principally through the family home) are exempt from capital gains tax. Capital gains tax concessions (relative

to current income) also give rise to lower effective tax rates on negatively geared shares and property. On the other hand, interest income from forms of savings such as bank deposits are taxed relatively harshly, particularly when the impact of inflation on real returns is taken into account.

Previous attempts at tax preferred savings outside the superannuation system have not been particularly successful. For instance in the 1997-98 Budget the then government attempted to increase private savings through a savings rebate on net personal income from savings and investments (eg. unearned income less allowable deductions and net business income).

The saving rebate was fundamentally flawed in that savings were not required to be preserved or maintained for any period. As well, there was no requirement to change behaviour to attract the rebate. The lack of preservation also meant that the rebate led to no significant or sustained increase in savings. Not surprisingly, the rebate lasted only a year before it was abandoned as a policy failure.

A very real problem with most measures which attempt to encourage or support non-preserved savings are that they lead to no real increase in savings. In effect, such measures simply reduce the tax paid by those with the most savings. This is not necessarily an equitable outcome.

Consequences of shifting tax concessions from superannuation to non-superannuation savings

The macro economic consequences of a shift in voluntary savings from super to outside super also would be material. These non-super savings because of a lack of preservation and associated liquidity considerations generally would not have the long term horizon typically applied by superannuation funds. As a result, shifting tax concessions from super to other forms of saving would lead to less funds being available for longer term investments.

It is also noteworthy that one of the advantages of the current arrangements is that capital has been available from super funds to companies who have sought capital raisings during the global financial crisis (GFC). The availability of these funds is likely to be reduced if voluntary saving shifts away from super.

A shift in voluntary savings away from superannuation also would be likely to lead to an increased misallocation of resources within the Australian economy as some of the voluntary savings will be used on expanding the principal residence or on less diversified investments (eg negative geared property) than would occur through the super system.

Any actual or perceived deficiency in the tax treatment of other forms of savings does not mean that the tax concessions should be withdrawn or limited in regard to superannuation. In particular, unless there is a clear tax advantage in savings through super compared to most other forms of non-super savings there will be a switch in voluntary savings away from super due to the preservation rules associated with super. This is particularly relevant in the context of the concern expressed in the Interim Report about leakage from the super system prior to the pension eligibility age and the suggestion to increase the preservation age to link it to the pension age.

2.3 Dimensions of equity

Equity within the tax system is a fundamental characteristic of a sound and robust tax system. Equity also needs to be understood by the community so that the overall system has community support. An equitable system should also ensure that a particular group is not favoured excessively nor excluded from the available taxation support.

It is also noted that equity comes in many forms, including inter and intra generational, as well as over the lifetime of an individual.

Saving for retirement through superannuation raises some particularly difficult issues as such saving is not conducted for the short term. Indeed it is spread over many years and decades through which the financial conditions of individuals (and hence their capacity to voluntarily save for retirement) can vary considerably.

The evidence available on those who make large superannuation contributions

One of the grounds relied on in the interim report in claiming that there is a case for limiting salary sacrifice concessions and for the May 2009 Budget decision to reduce the concessional contribution caps is the claim that high contributions are made almost exclusively by the wealthy. There also are perceptions that there is a large number of wealthy people abusing the concessions.

However, particular caution should be applied to point estimates of superannuation contributions and member incomes. These estimates often are very dependent on the particular sample survey, and may involve not many cases in the sample given that the incidence of high superannuation balances and/or relatively high superannuation contributions are quite low in the community. Unfortunately there is not a large proportion of the Australian population with large wealth and/or incomes.

There also are apparent inconsistencies in the Treasury estimates, no doubt due to the different data bases and estimates being drawn on. The various estimates also frequently are averages. An average figure can be severely distorted by only one or two records in the sample with very high levels of contributions or account balances.

For instance, it is claimed at page 12 of the report that employees on incomes of 2.5 times AWOTE (around \$150,000 a year) contribute on average 10% of wages in salary sacrifice contributions. This amounts to some \$28,500 in contributions including standard employer contributions at 9% of salary. The provenance of this estimate is not clear. For instance, the ABS 2007 Survey of Employment Arrangements, Retirement and Superannuation indicates that only 6% of those surveyed had incomes of \$100,000 or more a year. Of those falling within that category only 32.5% made salary sacrifice contributions of \$5,000 or more a year. On the basis of these numbers it seems implausible that the average salary sacrifice contribution for those earning \$150,000 a year is \$15,000.

Accordingly the conclusion in the interim report that employees on \$150,000 a year can expect an income replacement rate from the three pillars of about 95% does not appear to be supported by the data. If anything, the data suggests that the bulk of this higher

income group are not saving adequately for retirement given that only a minority make significant salary sacrifice contributions.

The Interim Report also appears to contain what could be interpreted as internal inconsistencies. For instance, in Table 4.3 at page 29 it is claimed that the average contribution rate (including both SG and salary sacrifice) for those on remuneration of between \$140,000 and \$160,000 is 15% of remuneration.

Even the much lower figure appears to be suspect, as are many of the other numbers in Table 4.3. While the exact source of the numbers in the table is not given, reference is made to projections being based on 2005-06 data. This could be unit record data from the ABS Survey of Income and Housing. It is also possible that unit record data from the ABS Survey of Employment Arrangements, Retirement and Superannuation were used.

Even if results from both surveys were used it is unlikely that there was a sufficient sample size to generate the level of detail in Table 4.3. Averages (means) also are not very meaningful when small numbers of observations are involved, with potential large differences between patterns of contributions within income bands.

More specifically in the ABS survey of Income and Housing there were only 9 observations of total superannuation contributions of between \$25,000 and \$50,000, with an average account balance of \$237,000. There were 14 observations of total contributions exceeding \$50,000, with an average account balance of \$355,000. There was only one observation of an account balance of over \$800,000 which received contributions of more than \$50,000. .

Given the very low number of observations in the ABS survey together with the average account balances that are actually involved, publicly available data provide a very questionable basis for relatively strong public policy decisions, such as that to halve the caps on concessional contributions, as was announced in the May 2009 Budget.

Other data from specific funds confirms the impression given by the ABS unit record data. For instance, one public sector fund, the 8th largest in Australia with around 550,000 members, has approximately 2,000 members with contributions in the current year over the new caps, with an average account balance of \$247,000.

A survey sample of retail fund members comprising some 10,000 employees found that of the over 50 year old age bracket who were contributing more than \$50,000 to super, the average account balance was \$206,500. 26% of this group were women. The under 50 year old age bracket who were contributing more than \$40,000 to superannuation had an average account balance of \$151,500, of which 30% were women.

In fact, the total number of persons making substantial salary sacrifice contributions is not that large, relative to the number of people with incomes over \$100,000. In 2007 around 125,000 people made salary sacrifice contributions of over \$20,000, compared to some 600,000 individuals with income of over \$100,000 a year. If anything the various figures indicate that salary sacrifice arrangements are not being enough by the higher paid, rather than the arrangements being unduly used by the wealthy.

2.4 The diversity of superannuation schemes

Focussing on annual actual or notional superannuation contributions ignores the range of superannuation arrangements present within the Australian community. The characteristics of both a scheme and its members need to be taken into account, not just what might be contributions in regard to an individual member in a given year. The superannuation contributions surcharge comprehensively failed on both equity and practical grounds because of such factors. There would be a real hazard of this happening again if any further measures attempting to severely limit concessional contributions or increasing the tax on such contributions.

Australia already is unusual in terms of international practice in regard to the contributions tax that is applied. While some analysts have argued that progressive income taxation should be applied to superannuation contributions, such recommendations have been based on unrealistic assumptions about the patterns of superannuation contributions, and also on the assumption that all individuals are members of accumulation superannuation funds.

Some of the diversity in funds and between members includes:

- Defined benefit and defined contribution schemes – For example, DB schemes use notional contributions for the contribution caps whereas DC schemes use actual contributions which can raise inequities.
- Special schemes such as for the military, police etc – In these cases, the contribution rates are often higher than normal to allow for the special circumstances and earlier retirement ages.
- Taxed and untaxed benefits – these benefits are treated differently and inequities arise.
- The treatment of untaxed schemes – Many Commonwealth public servants and some State public servants are not subject to the contribution caps whereas most State public servants are subject to these caps. This can, and has, led to inequities between members of various public sector schemes, and between members of certain public sector schemes and others in the community more generally.

2.5 The limitations of annual contribution caps

Given the great diversity in the superannuation arrangements, Australian workers are not treated equitably by annual caps of concessional contributions. This is the case with the caps imposed in the May 2009 Budget, and the problem would be exacerbated by any further reduction in the caps. In particular, many Australians now aged 40 or over have not had the opportunity to receive superannuation contributions throughout their working career. The ability to make additional contributions should not be unduly restricted in their later years of employment, when some of them will have the opportunity to save for their retirement years at more substantial levels of contributions.

Equitable taxation concessions should enable all Australians to contribute to their preserved superannuation benefits (i.e. their future retirement income) in a manner that is fair across all situations whilst also providing incentives to encourage the desired behaviour. The best way to proceed may be to average contributions over a number of years or enhancement or retention of the current higher transitional caps for those aged

50 and over. Many individuals, particularly women, do not have the opportunity or capacity to smoothly accumulate their superannuation savings over a number of decades.

The impact of any further tightening of salary sacrifice concessions

There would be important practical and equity issues in any further reductions in the caps on concessional and non-concessional contributions. The caps announced in the May 2009 Budget already are coming very close, or have gone below, the annual employer contributions that are required for some employees due to the Superannuation Guarantee or the operation of other legislative or industrial relations provisions. Further tightening of the caps would also raise considerable equity and practical issues in regard to the notional contributions involved in defined benefit schemes. The array of problems and inequities that were associated with the Superannuation Surcharge would resurface. Fundamentally, the level of actual or notional contributions in any given year has little to do with whether an individual is receiving equitable tax treatment.

In addition to having a significant impact on community confidence in the stability of superannuation arrangements, the reduction in caps already has had a number of detrimental consequences. It has:

- damaged the ability for under-funded members to make catch-up contributions in the years before they retire;
- thrown into question the strategy of many employers to contribute more than 9% to their employees through their corporate funds; and
- precluded many members of corporate, public sector and defined benefit funds from making any salary sacrifice contributions.

The recent (and any further) reduction also significantly increases the likelihood of unintended breaches of the cap, due to the complexity of the application of the caps:

- in salary sacrifice decisions by members of defined benefit funds, or where employers subsidise fund costs;
- where trustees decide to distribute surplus to members.

Members entitled to defined benefits or employer subsidies for costs have their concessional contributions calculated on “notional” employer contribution rates. Distributions of surplus also count as notional concessional contributions. While such distributions are not common this year, they are likely to occur in the future. Despite the seeming simplicity of the caps, notional concessional contributions are **not** easy for members to understand. Miscalculations are inevitable. The reduction of the caps increases the number of affected members and, importantly, the new caps are likely to affect members whose income does not attract the top marginal tax rate.

2.6 ASFA’s recommendations on concessional contribution caps

ASFA notes that the reduction of the caps was a budget measure. ASFA accepts that the Global Financial Crisis has necessitated a number of short-term measures to raise Government revenue (such as the temporary reduction in the co-contribution). A reduction in the caps as a temporary measure might be justified on this basis.

At the previous levels applying, the caps struck a balance as follows:

- they went a long way towards limiting excessive contributions by high income earners;

- they allowed those in “catch-up mode” in their later years to contribute larger amounts towards their retirement, and
- they did not hamper many of the more generous contribution structures in defined benefit, corporate and public sector funds.

The reduction of the caps, particularly for the over 50s, has already significantly reduced the ability of under-funded members to catch-up in later years. Middle income earners typically have limited capacity to save until they reach this age bracket (when their mortgage is paid and children are post-school age).

ABS figures show that of the 1.25 million persons making salary sacrifice contributions to superannuation in 2007, only around 30% have superannuation account balances in excess of \$150,000. Over 60% of those making such contributions are aged over 45, accounting for 78% of salary sacrifice contributions.

For adequacy of retirement incomes in the long term, ASFA recommends that the previous caps are reintroduced at a suitable time. At the very least, additional flexibility in the caps for people over age 50 is required to permit adequate levels of catch-up funding.

In the future, there may be a number of ways of managing tax concessions that are more sophisticated than annual contribution caps. Such methods would not involve the reintroduction of the flawed Reasonable Benefit Limits.

3. PRESERVATION AGE

3.1 Proposed increase in the preservation age

ASFA is concerned by the proposal in the Interim Report to increase the preservation age and we welcome the announcement by Prime Minister Rudd that the superannuation preservation age will not be changing.

Currently, the preservation age for those born after 30 June 1964 is 60. Increasing this age would disadvantage a number of groups:

- people who work in physically demanding jobs who may be physically unable to continue working in the same jobs after the age of 60. Requiring such people to retrain and obtain a different type of work is not always practical, particularly given the difficulties older people have in getting a job. Increasing labour force participation also requires an increase in the supply of jobs for older workers.
- people who need to leave work due to ill health
 - this is one of the major reasons given for early retirement
- people who need to leave work to care for a family member
 - this is another major reason cited for early retirement
 - this issue mainly affects women who are more commonly carers.

The income alternatives for the above people if they are aged less than Age Pension age are mainly:

- superannuation
- disability benefits
- unemployment benefits.

Currently some 400,000 Australians aged 55 to 64 are drawing on superannuation. The great bulk of these recipients are either not in the labour force or unemployed.

Delaying access to superannuation for a number of years would therefore only increase reliance on other government benefits for these groups. This both increases the cost to the government and is also potentially humiliating for those who have been hard-working, productive citizens all their working lives.

Any proposal to introduce differential ages for lump sums and income streams would introduce more confusion. Requiring a person in ill health to take out a life annuity to access their superannuation before preservation age also would be manifestly inequitable, given that such persons often will have reduced life expectancy.

4. LONGEVITY

4.1 Restatement of ASFA's recommendations for 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.

Post retirement products form a substantial part of the overall superannuation system. One set of estimates suggests that in 2008 there was nearly \$300 billion (around 30% of total superannuation assets) in the post retirement component of the superannuation sector. A large part of this (\$115 billion) was in public sector funds, around \$75 billion was in Self Managed Superannuation Funds, nearly \$90 billion was in retail retirement products, with \$13 billion in retirement products offered by industry funds.

While a number of public sector funds provide (or even require) benefits in the form of a lifetime pension, almost all other retirement products are in the form of account based products. With these, the account holder has the benefit of all the investment earnings together with preferential tax provisions. However, if the individual lives longer than they expect and/or their draw down the investment at too fast a rate then they can run out of money in their old age (or even not very old age).

Voluntary takeup of lifetime annuities in Australia is very low, with only about 1% of retirement assets in such superannuation products – driven mainly because of concessional social security means testing that was applied to such annuities. Since those concessions were withdrawn new sales of life annuities have dropped to only \$10 million in aggregate a year.

There is no doubt that the current Australian post-retirement income market is not as developed as it could be. Reasons for this include:

- the lack of long term government indexed bonds with which to back longevity insurance products;
- taxation disincentives for life annuities compared to other retirement products; and
- a desire by Australians to retain access to their capital.

Allowing access to lump sums provides flexibility for events outside normal retirement income needs. Such flexibility is likely to be a necessary feature of a retirement income system.

The government could play a crucial role in setting better rules for financial products providing retirement income. The introduction of “new generation” retirement products would enable retirees to retain the investment risk (as they do now through account based pensions) but share the financial risks of individual longevity through pooling. Such products are well established in other markets.

As noted above, the government could do this through setting more appropriate tax and regulatory rules for income streams. We are also moving to a situation where there will be more government debt. It would not be unreasonable for some part of this to be in government bonds which have an interest rate linked to movements in the CPI.

In the absence of any requirements for retirees to take retirement income products which deal with longevity, it may now be the time to introduce incentives to take them up. For instance, a meaningful but not overly expensive option for government might be to provide an Age Pension means test concession for retirees who invest more than, say, 25% of their superannuation savings in a longevity insurance or lifetime income stream product.

Attachment A

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.

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.

Setting a retirement income goal

ASFA believes that all Australians should be delivered 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 findings 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.

A floor for retirement incomes is “modest”. 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.

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.

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 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 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.

Delivering better retirement income products

The great bulk of retirement income streams provided in Australia are either in the form of defined benefit pensions from 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 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. When better income stream products are available, income stream products will be used more.