Submission
Australia's Future Tax System

Presented by

Australian Institute of Superannuation Trustees

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Background

As part of the 2008 Federal Budget, the Government announced it would conduct a "root & branch" review of the taxation system, to be conducted by Dr Ken Henry, secretary to the Treasury.

This submission to the Henry review is made by the Australian Institute of Superannuation Trustees (AIST).

We welcome the opportunity to contribute to the review, and look forward to working with Government over coming months.

AIST

AIST is an independent, not-for-profit, member-based organisation. Its members are Trustee Directors and fund staff of corporate, public sector and industry super funds. AIST is a Registered Training Organisation which offers a range of services including professional development, events, compliance services and member support. It advocates on behalf of our members to relevant stakeholders. AIST members manage $450 billion in retirement savings on behalf of two-thirds of the Australian workforce.

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Introduction

In the late 1980s and early 1990s, the Australian Government recognised the risks to economic performance and standards of living emerging from the ageing of the population. The "three pillars" architecture was developed as a response to these risks, and we believe this was a visionary policy. We strongly support the philosophy behind the three pillars, and in particular the SIS regulation framework, and the Superannuation Guarantee system of compulsory contributions. While some valuable improvements to the system have been made over the intervening 20 years, the fundamental policy settings remain unchanged, we believe that social and demographic changes warrant the inquiry's attention.

We believe that a "root and branch" review of the tax system would not be complete without thorough consideration of the changed circumstances of the nation and the economy over the last 20 years, and the future risks which have emerged over that time, notably:

- Climate change and policy responses to it;
- Peak oil, and the resulting deep structural adjustments to the economy; and
- The current financial crisis.

Naturally, the concern which informs this submission is the adequacy and integrity of the retirement incomes system. If this review is to be a truly root & branch review, it is appropriate to investigate whether:

- the Age Pension has kept pace with the cost of living, particularly for those entirely dependent on it, and who do not own their accommodation.
- the likely outcomes from the current 9% superannuation guarantee are adequate, having regard to the fallout from the financial crisis.

Because, we believe that the retirement incomes system is so enmeshed with the broader economy, we will comment on aspects of the tax-transfer system external to it, but which impact on the viability of the desired outcomes from it. In particular, we believe that a long term assessment of the affordability of both health services and housing are crucial to any consideration of retirement incomes adequacy.

The financial crisis is likely to have deep and long lasting impacts on the confidence of the community in the financial system and superannuation in particular, and may also impact on attitudes to investment risk. It is well recognised that the complexity of the superannuation system is a major barrier to consumer engagement and confidence. Recent policy developments have assigned a major role to individual choice in driving economically optimal outcomes from the system, but confidence and engagement are necessary to deliver optimal choices. Further loss of confidence can be addressed in part by reducing complexity.

Finally, if the system is to be a truly universal retirement income system, there are a number of leakages in the current system which needs to be addressed.

Emerging social trends

As outlined above, AIST supports the three pillars architecture, and tax policy in superannuation, but we recognise the context of uncertainty in which those policy settings play out. Most obviously, many uncertain factors will impact on the capacity of the superannuation system to deliver those objectives, including investment returns, increases in mortality, and changing social norms and expectations concerning retirement.

While superannuation policy aims to deliver incomes commensurate with the costs retirees will actually face, other areas of policy will impact the level of those costs. We believe the two greatest such impacts will occur in housing and health.

Health costs

Australian Government spending on health is projected to increase as a proportion of
GDP from 3.8 per cent in 2006-07 to 7.3 per cent in 2046-47[1]. This projected increase shows why health funding is and will continue to be important for policy makers.

The particular mix of public funding and incentives for private health insurance will determine the income distribution effects and efficiency of health service provision.

Therefore, we urge the Government to take the following factors into consideration when formulating the review's response to health policy:

- The greater demand on health services by retirees compared with the general population. We strongly believe that health costs must be spread evenly across all ages, particularly given the constraints on retirement income.
- Retirees' typically low, fixed incomes leave them vulnerable to large out of pocket health costs. We urge Government to reduce that vulnerability across the full range of health services.

Home affordability

Home affordability has been declining since the mid 1990's[2], and is now at record lows. Many workers retiring over the medium term will continue to be homeowners, having been able to access the housing market prior to the increases in prices over the last decade. However, as those now under 40

[1] Intergenerational Report 2, 2007, p.49

[2] HIA-Commonwealth Bank Affordability Report

years old retire, from 2030 on, we believe there will be rapidly increasing incidence of rental housing among new retirees, as well as increased incidence of people entering retirement without having paid off their home, and using some of their superannuation to do so, reducing the savings available to fund retirement income.

Renting in retirement is a strong indicator of disadvantage, for the following reasons:

- Reduced capacity to save for a home during working life indicates lower retirement savings overall;
- For those on the full Age Pension, the pension is the same for homeowners and non homeowners. While rental assistance measures are available, we believe they are not sufficient to compensate retired renters, given increases in rents over recent years. In addition, while the liberalised means test for non-homeowners helps retired renters on middle incomes, it is of no assistance to the majority of non-home owning retirees, who fall below the means test;
- The home is itself an asset which can be used to generate income through a reverse mortgage;
- The home is exempt from the age pension assets test;
- The psychological continuity and sense of security arising from owning one's home;
- The low risk tolerance of low-income retirees, and the fact that home ownership eliminates a number of volatile costs associated with renting makes it a desirable investment from an overall risk perspective.

While we applaud measures to improve home affordability, such as the First Home Saver Accounts, we strongly urge the Government to consider ways to increase home ownership prospects for those entering retirement.

Macro economic factors

National savings

The current financial crisis has highlighted some of the risks associated with Australia's integration with the global financial system. In particular, Australia's continued dependence on foreign savings has meant that the Australian financial system will be directly affected by the crisis despite being well regulated and well capitalised. As international wholesale debt markets have frozen, a major source of funds for Australian lenders has been removed, which threatens to undermine economic growth more generally.

In this context, it is worth reflecting on how much more seriously Australia might have been affected by the crisis, had the superannuation reforms of the 1990s not occurred, and we did not have $1 trillion as national savings in the superannuation system. However, increasing national savings, once a policy priority, has been largely ignored during the Howard government years. Combined with more effective regulation of retail lending, increased superannuation contributions – particularly for middle income households – would increase private savings without compromising public savings.

Climate change and the Carbon Reduction Pollution Scheme

We recognise climate change as a major risk to economic growth, and hence to the capacity of the superannuation system to deliver adequate retirement incomes to Australians. Through the joint AIST/ACSI submission in response to the Green Paper, we have supported the Government's proposed Carbon Pollution Reduction Scheme (CPRS). We are working with trustees and other industry participants to integrate carbon risk into the investment process.

The Green Paper recommends that revenues generated by the auction of emission permits under the CPRS be used in part to compensate households for increases in energy and other costs arising from the scheme. We believe the need for compensation will be most acute among retirees, and particularly low income retirees.

We fully support compensation being paid as income support, rather than as price support for the affected industries, as the latter option would mute the price signal intended and fundamentally undermine the objectives of the CPRS. We believe this income support should be delivered to retirees through increases to the age pension.

The Green Paper also indicates the Government will subsidise or otherwise support the adoption by households of low-emissions technologies. We support this policy, but we note that retirees may have a lower capacity to engage with such measures than working people. This is due to lower capacity to borrow, more constrained budgets, and generally lower familiarity with new technologies.

We urge the Government to take these factors into consideration, both when designing incentives for technology adoption, and in achieving the appropriate balance between income support and those incentives.

Peak oil and structural economic changes

While oil prices have reduced as a result of the financial crisis, we believe concerns regarding peak oil are real, and that the current softening of price will reverse once the fallout of the crisis becomes clearer. More expensive crude oil will have major impacts on the economy, and a proper response will require major capital investments and significant structural adjustment across all sectors. It is also likely to require significantly higher investment in infrastructure, from both the public and private sector.

In this context, the importance of a large and growing pool of national savings becomes even more acute, and we believe that superannuation is crucial to delivering that pool of savings. However, it may become necessary to use tax incentives to ensure rapid deployment of capital to particular projects or technology developments than would be possible relying on market forces alone.

Given these needs, and investment needs arising from climate change abatement and adaptation, we believe a root & branch approach to tax reform needs to consider existing and future incentives for major infrastructure investments in the context that most of the capital required will be delivered either through public investment, or from superannuation funds.

Choice and complexity of superannuation

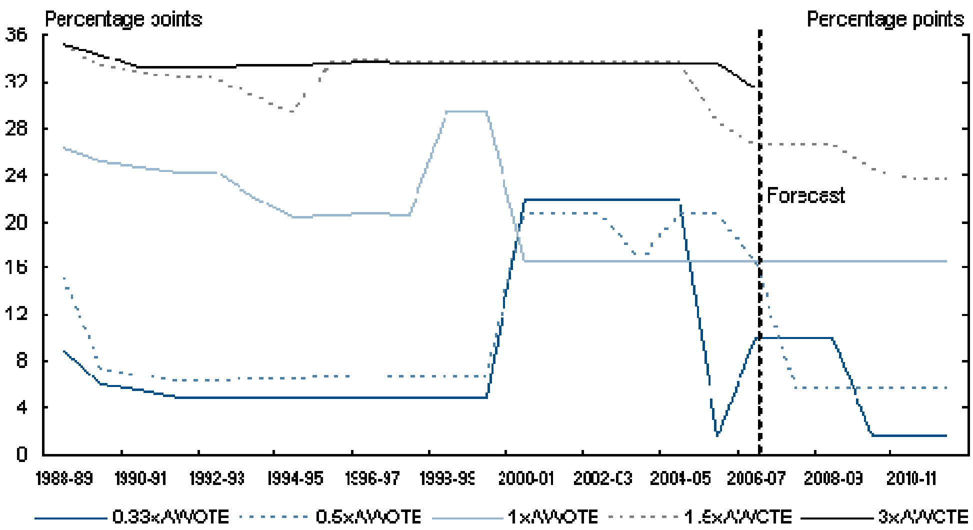
Since the introduction of the Superannuation Guarantee in 1992, the commercial landscape in the superannuation industry has changed dramatically. In particular, the Howard Government pursued a policy of introducing choice into the industry, with the intention of creating a consumer market for superannuation.

The economic rationale behind this policy agenda was that individual choice would support rational consumer behaviour, driving down fees and costs, and weeding out underperforming funds.

Evidence of the success of this program is mixed at best. It is certainly the case that the disclosure limb of the framework has failed to create effective awareness of the risks and benefits of various products for most consumers, and that access to non-conflicted, fee-for-service advice is very limited. If anything, these two factors have combined to reduce consumer engagement and confidence, from the low level existing before.

We believe that the current financial crisis has the potential to further erode confidence, which will only lead to a greater imbalance between the theoretical objectives of the disclosure and choice model, and its practical outcomes. As discussed in the introduction, complexity of the superannuation system, particularly complexity of taxation, compounds the confidence problem.

The following chart from the Architecture paper[3] illustrates the nature of the problem consumers are facing.



[3] Chart 7.13: Effective marginal concession on superannuation contributions

We believe simplification of superannuation taxes would significantly improve the prospects of effective communication with, and understanding by, consumers. It would also offer scope for advice to be targeted more toward improving contribution levels and enhancing investment outcomes, and less toward tax minimisation. Both these outcomes would improve the prospects for confidence and engagement, and would provide practical traction for the consumer choice theory.

We note that the Minister for Superannuation and Corporate Law has already announced a number of measures aimed at addressing these shortcomings, as part of his proposal to "renovate the house". We believe the superannuation industry itself has a significant contribution to make toward achieving adequacy, and that a reduction of costs, removal of conflicts within the predominant financial advice model, and improved disclosure are key elements in a more cost effective system.

While the removal of tax for over 60 year olds introduced with the Better Super reforms in 2007 have simplified the tax system, they have done so at the cost of making the overall system more regressive. In any event, in terms of confidence, the area where the problem is most acute is at younger ages, where people need to consider the benefits of additional contributions. As the chart above illustrates, changes in Government policy over time are the primary driver of the complex messages consumers perceive.

Compulsion is the best guarantor of prudent savings behaviour for those at younger ages. As outlined below, our approach to superannuation adequacy is a modest but broad-based increase in compulsory contributions. It would replace the current co-contribution scheme, which, while useful for it would replace the current co-contribution scheme, which, while useful for those who can afford to participate, is not a realistic answer to lifting savings rates across the spectrum of low-income workers.

Tax incentives for additional contributions do have an impact in improving savings for higher income earners, and we believe the current tax-deductibility and salary sacrifice provisions are an appropriate incentive for this group.

Outline of the proposed AIST adequacy proposal

AIST is developing a comprehensive policy position in conjunction with other bodies, to inform a review of superannuation adequacy, based on just principals and reflecting new research. The following section is a provisional contribution which aims particularly to articulate the principles which we believe should drive policy in this area.

As discussed in the introduction, we support an extension of the three pillars architecture, while recognising the need for a review of policy settings. A summary of our approach to reform of each of the three pillars is summarised below:

- Age Pension – The cost of living for retirees continues to rise more quickly than the general cost of living, particularly as a result of rising health costs. Changes to the Age Pension over recent years, have extended the means test, rather than increasing the basic rate. Our position is that the rate of the Age Pension should be increased, while the eligibility age should be capped at 65 for both men and women. Budgetary pressures on the Age Pension, should they arise, should be addressed through tightening the means test, so that the Age Pension remains an effective safety net for those least able to fund their own retirement income.

- Compulsory superannuation– There is considerable debate over the adequacy of the compulsory component of superannuation funding, and it is here that we believe significant reform is required. While some recent research suggests that the compulsory limb may be adequate, we note that much of that research was based on the more favourable asset values and economic outlook prevailing 12 to 18 months ago. Where research is based on more conservative projections of fund returns[4] those conclusions rest on unrealistically high assumptions of voluntary contributions.
- Voluntary superannuation – Incentives for higher income earners to contribute to superannuation have in recent years been enhanced through removal of the superannuation surcharge, introduction of the transition to retirement rules and tax free super for those over 60.

Our proposal for reform will focus primarily on changes to the compulsory pillar. These can be grouped into increasing compulsory contributions while remediating the regressive tax changes introduced by the Howard Government, and plugging leakages in the current system.

Increasing compulsory contributions

We do not believe the current 9% mandatory contribution is sufficient to deliver adequate retirement incomes for most Australians. While we note that significant incentives apply for voluntary contributions, these have been demonstrated to be of limited effect among low income earners.[5]

While we support an increase in contributions to 15% in the long term, we recognise such a policy is unlikely to gain community support in the shorter term, particularly given the likely impacts of the financial crisis on growth, business profitability and the labour market.

We also believe that public perceptions and attitudes to superannuation have changed over the last fifteen years to reflect the system's status as a civic right, rather than as an employment benefit. In light of this, there is an expectation that all sectors of the community should contribute toward increases in contributions.

We propose that the current 9% contribution be increased to 12% by 2012, as follows:

- 1% from employers, by increasing the SG rate to 10%;

[4] Access Economics: The AMP Superannuation Adequacy Index Report, July 2007

[5] AIST Co-contributions research

- 2% as a contribution of mandatory member contribution and government co-contribution;

The 2% member and Government contribution would operate as a 2% Government contribution for those on low incomes, while those on higher incomes should be required to pay the 2% employee contribution themselves. The 2% Government contribution would phase out over the middle income range, and be replaced by the 2% employee contribution. The Government contribution would replace the co-contribution for low income earners, and we suggest that the phase out points be linked to either the existing co-contribution thresholds, or the income tax thresholds for the 30% and 40% rates.

We note that the current co-contribution system includes an administrative facility whereby information is exchanged by ATO and funds for the purpose of assessing eligibility for the co-contribution. This system could easily be adapted to administer the proposed phased contributions.

The superannuation industry itself stands to benefit from increased contribution levels, and we propose that a further contribution to adequacy should be made by the industry, by way of reduced fees and charges. Joint AIST/ISN research has already demonstrated the capacity for this contribution.[6] That research concludes that for a worker on average income, every half percent increase in annual fees reduces the member's replacement rate by approximately 6.5%.

Leakages from the superannuation system

Universality is a key component of the vision behind the introduction of compulsory superannuation in the late 1980s and early 1990s. However, a number of leakages persist, which compromise the integrity of that vision, and we urge the Government to block those leakages in order for the system to fully achieve its objectives.

$450 monthly earnings threshold

This is a particularly pernicious leakage, as it affects those whose superannuation savings are already likely to under-provide for their retirement, most notably women, and casual or part-time workers.

There is substantial anecdotal evidence that unscrupulous employers employ a number of part-time employees in preference to a full-time worker, specifically so that each worker's earnings will fall below the $450 threshold, and the superannuation guarantee contribution can be avoided.

The reasons most commonly advanced in defence of the threshold is the administrative burden imposed on employers and funds in processing many small payments, and an alleged contribution to the lost members problem. We believe that, to the extent these arguments are valid at all, the

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[6] AIST/ISN Superannuation Adequacy - a Critical Review of Recent Industry Papers, *Sacha Vidler, 2007*

Government's proposed universal clearing house will alleviate these administrative burdens.

We also note that the co-contribution system and the information exchanged by funds and the ATO, along with the universal clearing house, could form the basis of an effective system to monitor, and enforce payment of superannuation guarantee contributions more generally.

Self-employed people

Currently superannuation is not compulsory for self-employed persons. We believe the security of self-employed people in retirement will become a significant problem in future years. While it is certainly true that some self-employed people successfully turn their businesses into profitable enterprises proposition is not axiomatic.

AIST research shows that a significant proportion of people in the busy mid-life years generally lack the time, energy and inclination to attend to their financial security in retirement. We can only expect this to be even more the case for a harried self-employed shopkeeper or tradesman. In fact many responses to our focus groups indicated that tradesmen imagined that their book full of satisfied clients would turn into saleable goodwill at retirement, when in fact the assets of their business amounted to "a clapped out ute full of clapped out tools".

We recognise the legal and political difficulties involved in bringing the self-employed within the compulsory superannuation framework. However, we believe that a universal retirement system should include all workers, and urge the Government to investigate appropriate legal and taxation structures through which the self-employed can enjoy a more secure retirement.

There is another aspect to the question of self-employed workers which we believe requires urgent action. Over recent years, there has been a marked increase in the number of dependent contractors, notably in the building industry. Under this arrangement, employers engage workers as self-employed persons on contract, rather than as full employees. This allows the employer to avoid paying superannuation guarantee payments, although the worker is technically an ordinary employee under current law. This arrangement not only robs the worker of superannuation, but also removes the protections afforded them under industrial legislation.

We believe this abuse of the system should be eliminated through improved policing, and if necessary, tightening of the law.

Women

Women are the single largest disadvantaged group in relation to superannuation. This disadvantage stems from a number of factors, including:

- Periods of absence from the paid workforce for family reasons, during which superannuation contributions lapse;
- The deleterious impact these breaks have on women's prospects of career advancement, with lower wages and hence contributions on re-entering the workforce;

- The generally lower wages of women compared to men.

The Productivity Commission has recently released its report from the Inquiry into Paid Maternity, Paternity and Parental Leave. AIST welcomes the recommendations in the report for a national paid maternity leave scheme, incorporating compulsory superannuation contributions.

Not only will the proposal provide superannuation through a period maternity leave, it will also improve the likelihood of women returning to the workforce following their leave, thus minimising the impacts on their career development.

However, the payments and superannuation contributions are linked to the minimum wage, and our submission called for payments equivalent to average wages.

Other measures

There are a number of other measures which we believe would enhance the equity and adequacy of the superannuation system, and which will be covered in our adequacy research and report, These include:

- Legislating for more frequent payment of superannuation contributions
- Shifting the age for access to tax free benefits from 60 to 65
- Tightening the age pension means test over time
- Restrict access to transition to retirement income streams to genuinely part-time workers only
- Measures to more effectively encourage deferral of commencement of the age pension