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Dr Ken Henry AC
Chair, AFTS Panel
CO/- AFTS Secretariat
The Treasury
Langton Crescent
PARKES ACT 2600
By Email: AFTSubmissions@treasury.gov.au

Dear Dr Henry

**ISN Submission to the Australia's Future Tax System (AFTS) Inquiry**

Further to a meeting last week between Nick Coates and Sacha Vidler in my team and the Australia's Future Tax System secretariat, please find attached our initial submission to your inquiry.

We would welcome future opportunity to discuss the submission with the panel or the Secretariat. We are working closely with the Australian Institute of Superannuation Trustees, whose initial submission to your inquiry we also support, and anticipate having detailed proposals to put to the inquiry in the first quarter of 2009.

Please don't hesitate to contact myself (03 9657 4374) or Sacha Vidler if you have any questions.

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Yours sincerely

**David Whiteley**
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**Industry Super Network**

# Australia's future tax system

# Submission by Industry Super Network

October 2008

# Introduction

The Industry Super Network (ISN) is a division of Industry Super Holdings Pty Ltd, which is jointly owned by 38 super funds. ISN coordinates collective projects on behalf of a number of industry super funds with the objective of maximizing the retirement savings of five million industry super members.

We appreciate the opportunity to make a submission to this review.

We note the Terms of Reference of the inquiry and agree that ageing, climate change and globalisation are redefining our economy and society. There is consequently no better time to deeply analyse the extent to which our tax-transfer system is able to help us meet these challenges, and to consider the efficiency, equality and simplicity of the tax-transfer system as a whole, and the balance of taxation on returns from work, investment and savings and consumption.

We also note the release of *Architecture of Australia's tax and transfer system*. The complexity of the tax-transfer system as revealed by this document emphasises that policy change is often ad-hoc and always path-dependent. While a review such as this may not be able to immediately drive wholesale reform from the ground up, it can provide the philosophical underpinnings for incremental reform in coming years, guiding the overall system towards greater consistency and efficiency.

Our member funds, as not-for-profit superannuation providers, are at the coal face in relation to the challenge of ageing and its implications for retirement incomes policy. While recognising broader challenges, our submission focuses on this policy area.

Retirement incomes policy is largely defined by the tax-transfer system, and is also a significant part of it (as measured by revenue raised and transfers paid). As such, a 'root and branch' review of the tax-transfer system implies and includes a review of retirement income policy. Providing quality input to this review is therefore a high priority for ISN.

Along with other sponsor organisations linked to the not-for-profit superannuation sector, including the Australian Institute of Superannuation Trustees (AIST), we are developing a detailed retirement incomes policy platform. The platform will reflect our core principles, especially ensuring provision of adequate retirement income for low to middle income earners. Potential suggested reforms include restructuring the co-contribution, small increases to employer/employee contributions and making the tax on contributions progressive.

We are commissioning research to evaluate the macroeconomic and microeconomic trade-offs of the policies included in the platform and will deliver detailed policy suggestions to the inquiry in the first quarter of 2009.

We note and welcome the government's Pension Review, chaired by Dr Jeff Harmer. There is strong prima facie evidence, including a recently released report that many pensioners cannot afford to fill drug prescriptions (SMH, 22/10/08), that those wholly reliant on the public age pension are materially falling behind. We support an upwards revision of the base level of the age pension, and our early 2009 submission will include recommendations on the extent of recommended increase and how that increase might be funded.

In this submission, we would like to highlight two gaps in the current policy framework with broad implications: the lack of an official definition of adequate retirement income, and a lack of commitment to addressing glaring issues with competition in the superannuation market, particularly commission-based selling.

The following section provides some brief comments on retirement income policy as a whole.

# Retirement income policy

Australia has a history in retirement income policy dating back to 1900, as it has long been recognised that most people require some form of financial support to provide for their retirement.

Australian retirement income policy – often referred to as a 'multi-pillar' system – consists of a means-tested public age pension (dating back to 1908), compulsory concessionally-taxed workplace superannuation savings (which emerged between 1985 and 1992), and voluntary savings. The model has been lauded by foreign experts, including the World Bank (1994).

Strengths of the Australian system include the affordability for government of the public age pension (relative to systems in most other OECD nations) and the balance of risks and responsibility stemming from a combination of public provision and self-provision – effectively through deferring wages.

ISN strongly endorses the existing multi-pillar structure. Current financial and economic conditions highlight the very important ongoing role of the public age pension and healthcare as a safety net; while the imminent retirement of the baby-boomers underscores the need for enhanced self-provision to deliver desirable levels of comfort for future retirees. Concessional taxation of compulsory superannuation contributions and concessional taxation of earnings on both compulsory and voluntary savings are important incentives to help sustain this balance.

We recognise, however, that the system has evolved iteratively, and it may be possible to achieve better integration and consistency between the pillars. We support the inquiry Panel considering this issue, and in determining our policy platform, we will consult with industry stakeholders, including financial planners, on potential areas of inconsistency caused by the interaction of different elements of the system.

Since the widespread introduction of workplace superannuation in the 1980s, Australian superannuation assets have grown rapidly to over $1 trillion. Reserve Bank of Australia (RBA) staff estimate that the majority of these assets are savings that would otherwise not have occurred (Connolly and Kohler, 2004).

While national savings rates have fallen during the same period, the consensus view is that this has been driven mainly by an increase in personal and corporate borrowing made possible by a combination of financial liberalisation and low interest rates. We believe that this trend has plateaued. Increases in superannuation savings in future, especially from workplace contributions, will provide a needed boost to national savings.

Continued reliance on foreign savings has made the Australian financial system particularly vulnerable to the current global financial crisis, despite having a well capitalised and well regulated banking sector. A significant potential advantage of increased superannuation contributions is a positive expected impact on national savings, which we will detail in our 2009 submission.

## Adequate retirement income

There is an ongoing debate on the level of adequacy of current retirement income arrangements. In the last 18 months, several interested parties have released papers on this issue, including AMP, Treasury's Retirement Income Modelling (RIM) Group, the Association of Superannuation Funds of Australia and the Investment and Financial Services Association.[1] The debate lacks clarity because each of the parties uses its own definition of adequacy *and there is no official definition*.

We believe a review of retirement income policy must begin with a review of the level of adequacy of current arrangements. We suggest there is an underlying contradiction between having a wide range of retirement income policy measures, and not having a base level or benchmark towards which that policy aims. The Henry inquiry is an opportune juncture for the Government to address this gap in the framework of retirement income policy.

All policy interventions involve trade-offs. It is difficult to effectively evaluate the costs and benefits of measures designed to, for example, increase superannuation balances at retirement for low income earners, in the absence of a plausible measure of success of the policy. A recent conference paper released by Treasury's RIM Group finds 'no aggregate savings shortfall or saving gap' (Rothman, 2007: 19), but it is difficult to see how this conclusion can be reached without some definition of adequacy, albeit implicit.

Rothman uses an unspecified relative definition of adequacy. However, a relative definition of adequacy will falsely categorise retirees in or near poverty as having adequate retirement income if their circumstances were similarly dire prior to retirement, while, paradoxically, classing retirees living very comfortably as being on inadequate incomes if they experience a substantial drop in income when leaving the workforce.

In recent years, some industry groups have proposed a measure of adequacy involving measurement of the absolute cost of consumption goods of the retired, such as the Westpac-ASFA Retirement Standard.[2] We think there is merit to this approach. Many industry fund members are on low to middle incomes but aspire, not unreasonably, to a comfortable retirement. Projections of the adequacy of these members' retirement incomes should be based on the actual costs of living in retirement, rather than their pre-retirement income. We believe the inquiry panel should give this approach due consideration.

## Competition in the superannuation market

Retirement income policies are responses to market failures that result in individuals being either unable or unwilling to fully provide for their own retirement.

The Superannuation Guarantee (SG), which requires employer contributions of 9% of employee's income as retirement savings, is the important second pillar of Australian

[1] See (Access Economics, 2007); (Rothman, 2007); (Clare, 2007) and (Allens Consulting, 2007).

[2] http://www.superannuation.asn.au/RS/default.aspx

retirement incomes policy. It addresses problems of myopia (excessive discounting of future costs and benefits), inertia and information asymmetry (stemming from the opacity and complexity of financial products) that have historically caused under-saving.

However, myopia, inertia and information asymmetry remain factors in the newly created market. One way they are being expressed is in the low level of engagement and analysis of superannuation products by superannuation fund members. Since choice of fund was introduced in 2005, individuals have been able to choose their fund in most workplaces, and portability has been greatly improved, allowing consolidation of most balances.

However, only 10% of workers exercise their rights to choice of fund (Ernst & Young, 2008: 5). Most workers join the default fund in their workplace, despite substantial and enduring differences in performance between individual funds and fund sectors (APRA, 2007). Account proliferation continues, with recent analysis indicating that around four million Australians have four accounts or more and are consequently exposed to substantial additional fees or lost income as a result (Clare, 2007b and ISN calculations).

A particularly pernicious aspect of the current Australian superannuation market is the role of commission-based selling. Superannuation is a complex product, and it interacts with the tax-transfer system in complex ways. Many people would benefit from sound and impartial financial advice with regard to saving for retirement. However, the financial planning groups with the highest market share remunerate their planners through upfront and trailing commissions on assets committed by members to superannuation funds and other financial products.

This form of remuneration *precludes recommendation of funds that do not pay commissions to planners.* As a consequence, none of the 30 leading financial planning groups recommend industry funds, despite these being superior, as a group, to retail funds that pay commissions. Two thirds of these financial planners are connected to one of the large private financial conglomerates (Rainmaker, 2007).

The most recent modeling undertaken by SuperRatings (to 30 June 2008) demonstrates that on average belonging to an industry super fund over a 40-year working life could mean having $118,476 or 23% more at retirement measured in today's dollars (SuperRatings, 2008).[3] In terms of aggregate savings, ISN estimates that Australian superannuation assets are $52 billion lower than they might have been had retail fund assets been held in better performing not-for-profit funds over the past 12 years (see Table 1, below).

The superannuation market is a creature of regulatory intervention. We strongly advise the inquiry to acknowledge the powerful affect differing fund performance has on member benefits and aggregate superannuation savings, and to analyse how this market functions, given its importance to delivery of positive retirement incomes for most Australians.

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[3] Assumptions: starting account balance $50,000, initial salary $50,000; 2.5% inflation rate; 3.5% salary increase per annum; 9% superannuation guarantee contributions; no additional salary sacrifice or voluntary contributions; 15% contributions tax; employer asset sizes accumulated at 11.6% per annum; investment return of 7.225% as per ASIC model (gross of taxes and fees at 8.5%) but with taxes of 15% deducted; explicit costs deducted from members' accounts (eg member fee) subject to a 15% tax allowance; contribution fees, entry fees, exit fees, additional adviser fees are excluded from calculations; starting age 25 and retirement age 65; employer asset size $150,000.

We recommend as solutions to this issue: (i) an end to all sales commissions on superannuation; and (ii) an extension of the fiduciary obligation on super fund trustees requiring them to act in the best interests of their members to the relationship between financial advisers and their customers.

**Table 1 Historical opportunity cost, 1997-2008**

| Financial year ending June | Industry fund return on assets | Retail fund return on assets | Industry fund out-performance | Retail fund assets – average ($m) | Annual lost savings ($m) | Lost savings compounded to 2008 |
|---|---|---|---|---|---|---|
| | | | | | | |
| A | B | C | D | E | F | G |
| | | | = B – C | | = D * E | = F * (1 + 6.31%) ^ (2008 – A) |
| | | | | | | |
| 1997 | 11.70% | 8.00% | 3.70% | 58,662 | 2,170 | 4,256 |
| 1998 | 6.60% | 5.80% | 0.80% | 80,303 | 642 | 1,185 |
| 1999 | 6.50% | 4.80% | 1.70% | 86,910 | 1,477 | 2,563 |
| 2000 | 9.00% | 7.70% | 1.30% | 114,302 | 1,486 | 2,425 |
| 2001 | 3.20% | 2.20% | 1.00% | 138,248 | 1,382 | 2,122 |
| 2002 | -5.00% | -5.00% | 0.00% | 157,538 | 0 | 0 |
| 2003 | -1.80% | -2.70% | 0.90% | 166,434 | 1,498 | 2,034 |
| 2004 | 12.40% | 10.10% | 2.30% | 185,741 | 4,272 | 5,457 |
| 2005 | 12.10% | 10.30% | 1.80% | 218,249 | 3,928 | 4,720 |
| 2006 | 12.60% | 11.40% | 1.20% | 263,342 | 3,160 | 3,572 |
| 2007 | 14.2% | 12.5% | 1.70% | 334,327 | 5,684 | 6,042 |
| 2008 | -5.75% | -10.79% | 5.04% | 354,698 | 17,873 | 17,873 |
| | | | | | | |
| **Average** | **6.31%** | **4.53%** | **1.79%** | | | |
| **Total** | | | | | **43,574** | **52,250** |

Source: Years 1997-2006, APRA (2007), *Insight*, Table 7, p38, grossed up to reflect all retail entities, not just those with greater than $100m in assets; Year 2007, APRA (March 2008), *2007 Annual Superannuation Statistics*, Table 8; year 2008, APRA (2007-2008), *Quarterly Superannuation Statistics*, Table 11; **Column G, ISN calculations**.

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