Institute of Actuaries of Australia

21 October 2008

AFTS Secretariat
The Treasury
Langton Crescent
PARKES ACT 2600

Email: AFTS@treasury.gov.au

Dear Sir/Madam

**Australia's Future Tax System**
**Preliminary Submission from the Institute of Actuaries of Australia**

**Purpose**

This paper provides the initial response of the Institute of Actuaries of Australia (the Institute) to the request for a submission to the review of Australia's tax-transfer system (Tax Review). Given the short time frame provided for this initial response this document provides a summary of some of the issues the Institute considers should be on the agenda. We will provide more detailed submissions to fit in with your developing timetable.

Please note that the Institute has provided a detailed submission to the Harmer Pension Review. Given the interrelationships between this and the broader Tax Review we have attached the executive summary from that submission.

**Introduction**

We commend the Government in establishing the Tax Review. We note that in introducing this review the Treasurer indicated that its primary objective is '…the long-term modernisation of our tax system to make it more competitive…'. Given the broad scope of the overall review and its long term ramifications, we believe that there are a number of key areas, including areas where the Institute can add significant value. At this stage we have identified the following key areas:

1. The changing demographics of Australia and our view that the Intergenerational report and other publicly available Government analysis potentially significantly underestimates longevity changes and the impact of ageing of the population.

2. The imbalance between State Government revenues and expenditures and an over reliance on inefficient taxes by the States that distort economic behaviours and outcomes.

3. There is a close link between the taxation treatment of private health insurance premiums (including rebates), future health insurance coverage and increases in health insurance premiums. This, in turn, has significant ramifications for longer-term public and private, State and Federal, health financing in Australia. This whole dynamic deserves careful consideration and examination.

The Institute of Actuaries of Australia
ABN 69 000 423 656
Level 7 Challis House 4 Martin Place
Sydney NSW Australia 2000
Telephone 02 9233 3466 Facsimile 02 9233 3446
Email: actuaries@actuaries.asn.au Web site: www.actuaries.asn.au

4. There are a number of taxation treatment anomalies between investment products and vehicles in the financial sectors that are potentially distorting consumer investment decisions and, in some cases, potentially ironically encouraging investment via less regulated and/or riskier investment vehicles. Clearer and simpler alignment (or differentiation where appropriate) of the taxation treatment of investment vehicles is required.

The Institute would like to stress the importance of a holistic approach to addressing the close links between the outworkings of demographic changes, the need to avoid taxes which distort economic behaviours and outcomes in these areas.

**Demographic Issues**

The Review's comprehensive August 2008 publication "Architecture of Australia's tax and transfer system" (Architecture Review) provides a detailed review of Australia's tax and transfer system. The Architecture Review highlights that the 'demographic challenge of an ageing population is also profound'[1]. The Treasury is well aware of the implications of the ageing population. The most recent Intergenerational Report (2007) provides a detailed analysis of the implications of the changing demography and in particular 'The demographic, economic and fiscal projections in this report assist the policy debate about the choices governments can make today to improve the wellbeing of current and future generations of Australians'[2]. This is an important source of information to the current review.

Our observation, based on the most recent analysis, is that we suspect that the Intergenerational Report significantly underestimates the impacts of the ageing population. Indications are that mortality rates are improving faster that anticipated. The Institute is still developing a more detailed fact based view on expected mortality improvements but there are indications that improvements may be exceeding past estimates. In particular, a recent review into the life expectancy of pensioners of four major public sector funds[3] has indicated that 25% of male former public servants currently receiving pensions are expected to live to over 100, based on current trends in mortality improvements. Further, male pensioners have the same life expectancy as female pensioners under some scenarios. Whilst this is a healthier subset of the general population it may be indicative of longer term trends.

The nexus been mortality, morbidity and general health means these mortality trends and developments have much wider ramifications than just pensioner longevity.

We are not yet in a position to be specific about the mortality improvements and how these may impact on demographic issues but we urge early consideration of mechanisms which might mitigate the economic and financial impacts of these trends. In particular

- It will be necessary to remodel the impact of the ageing population on the balance between capital, labour and land/resources taxes.
- It may be necessary for policy makers to consider increasing the pension age in line with increasing life expectancy and the ageing population.
- Government should consider initiatives that will encourage and reward older Australians for remaining in the workforce i.e. by not penalising them via loss of pension. This may include introducing a deferred age pension.

[1] Architecture of Australia's tax and transfer system August 2008 page xi

[2] Intergenerational Report 2007 page viii

[3] Point of View: Pensions for Longer Life, Mercer 2008

- Government should also consider reducing the current high effective tax rates for older Australians earning an income. This may involve removing the income test on pensions and then taxing pensioners' total incomes on a similar basis to pre retirees.
- Government may need to consider placing more restrictions on early access to self funded superannuation benefits.
- Consideration of settings to encourage effective pre-funding, self-funding and/or earmarking of funding of long-term care costs.

Many of the issues related to policies for an ageing Australia are included in our submission to the Harmer Review, the Executive summary of which is attached to this submission.

**Inefficient State Taxes**

There is an imbalance between State Government revenues and expenditures which leads to over reliance by the States on inefficient taxes which inhibit efficient use and pricing of labour, capital and assets in the community (e.g. payroll tax) and other indirect taxes such as those on general insurance premiums which likely discourage many households from fully protecting their assets and result in other anomalous outcomes.

As an example, in the case of insurance taxes, the Insurance Council of Australia in its submission to the Federal Government on the 2008 Budget provided a detailed assessment of the effects of the high level of premium taxes and fire levies. We support the conclusion that these are inefficient taxes because they distort price signals in the market. In some cases these taxes have increased premiums by over 30%. The Insurance Council's conclusion is that:

> *'removing State taxes on insurance will result in an additional 300,000 households across Australia taking out contents insurance and an additional 69,000 households taking out building insurance. This represents a decline in the non insurance population for contents and building of 14% and 34% respectively'*[4]

The community at large has an interest in widening the pool of insureds and reducing the number of uninsured (and under insured) citizens. The abovementioned taxes operate in a way which drives behaviour in a direction counter to that which would benefit the community as a whole.

**Health Financing System**

We would make the observation that the recent debate over the changes to the Medicare Levy Surcharge thresholds and potential changes to the 30% rebate reinforce some of the instabilities that exist in Australia private health insurance and broader health financing system.

The current system of providing substantial tax concessions and a legislated premium charging basis (community rating) that does not take into account the age and state of health of members can become very unstable if there are changes made to the tax basis. In effect if tax concessions are reduced or removed then the first people to leave the private health insurance system will be those younger healthier members who currently provide much of the stability in the premium rates. The community rating approach will only work whilst there is a cross section of the community represented in the system. Any ageing in the membership of private health insurance funds could lead to a steady increase in the health insurance premiums. This would create a downward spiral in membership and could lead to the eventual collapse of the private health insurance system.

[4] 2008 FEDERAL GOVERNMENT BUDGET SUBMISSION, ICA 2008 page 3

At this stage we have no specific suggestions regarding the taxation of the private health insurance industry. However, we note that the issue cannot be divorced from consideration of the holistic stability and structure of the mix of public and private provision of health services in Australia, tax and cost misalignments between State and Federal levels of government and the impact of our ageing population as noted above.

**Savings Vehicle Taxation Anomalies**

Over recent decades there have been a number of changes to the taxation of saving vehicles that have removed some previous significant inconsistencies. However, a number of other anomalies have been introduced along the way (including some that now mean previously advantaged investment vehicles are now disadvantaged) and there are new emerging issues that should be reviewed.

Some examples include:

- It appears as though capital gains within superannuation investments in Life Company Statutory Funds may now be taxed at a higher rate than that which applies to capital gains in non-statutory funds superannuation vehicles. This anomaly arises because of a discretion that the Australian Tax Office (ATO) has regarding classification of these investments. The implication is that superannuation investments in Statutory Funds will be penalised and an informed public will move their assets to other vehicles.

  We believe that this effect may ironically work against the broader government objectives of protecting superannuation investments. Statutory funds are closely regulated by APRA and have greater capital adequacy requirements than do other pooled vehicles that invest superannuation funds. This issues arguably involves a taxation penalty for investing long term funds in a highly regulated environment.

- A similar situation arises for non-superannuation investments in via life insurers and friendly societies. In both cases capital gains are fully taxed at the corporate rate whereas individuals investing via unit trusts typically can access the benefit of concessional taxation of capital gains.

These are meant as just two examples. Whilst these are of examples acting against life insurance entities there are of course others adversely affecting other types of entities. The key issue is that a clearer and simpler alignment (or differentiation were appropriate) of the taxation treatment of investment vehicles is required so that consumer choice is based more clearly on balancing fees, performance and investor protection and not due to underlying taxation arbitrage.

If you require any further information or would like to discuss any aspect of this letter, please do not hesitate to contact our Chief Executive, John Maroney (+ 61 2 9233 3466; email: john.maroney@actuaries.asn.au).

Yours sincerely

**Greg Martin**
President

# Institute of Actuaries

# Submission to the Pension Review

# EXECUTIVE SUMMARY

September 2008

The Institute of Actuaries of Australia
ABN 69 000 423 656

Level 7 Challis House 4 Martin Place
Sydney NSW Australia 2000
Telephone 02 9233 3466 Facsimile 02 9233 3446
Email: actuaries@actuaries.asn.au Web site: www.actuaries.asn.au

# 1 Executive summary

1.1 Australia's population is projected to grow and to age over the next 40 years. From 2007 to 2047[1] the proportion of the population aged 65 and over will nearly double to 25%, whilst the proportion aged 85 and over will nearly quadruple to 5%.

1.2 A range of initiatives, which improve work-force participation and productivity will be required to meet the challenges of our ageing population.

1.3 Society, as a whole, will benefit from measures designed to encourage older Australians to support themselves financially for longer and to a greater extent than is currently the case, through a combination of work and savings and/or family support.

1.4 Currently, people are retiring well before the Age Pension age. The average age at retirement for people aged 45 years or more and who retired in the last five years was 61.5 years for males and 58.3 years for females[2], which is substantially lower than the Age Pension age of 65 for males and 63.5 for females. This is also reflected in a significant reduction in workforce participation rates for Australians over age 55. For example, male workforce participation rates reduce from 90% for 25-54 year olds to 66% for 55-64 year olds[3].

1.5 In addition, the Asset and Income tests for the Age Pension, personal tax rates and tax offsets are very complicated and impose a financial penalty on continued work beyond Age Pension age.

1.6 This submission puts forward the following options to encourage people to work longer and which would also improve the long term financial sustainability of the Age Pension:

(a) Age Pension reform options are to:

- (i) Phase in an increase in the Age Pension age;
- (ii) Increase the amount of the Single Age Pension as a percentage of the Couples' Pension;
- (iii) Introduce the option of a deferred Age Pension;
- (iv) Remove the Income test and simplify all mature age tax offsets;
- (v) Retain home equity exemption from the Asset test and extend this to include home equity release schemes which meet retirement and health costs.

(b) Other related reform options are to:

- (i) Standardise "retirement ages" in superannuation legislation;
- (ii) Further discourage early access to superannuation benefits.

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[1] Intergenerational Report 2007 p6

[2] Australian Bureau of Statistics, 1301.0 - Year Book Australia, 2007

[3] Productivity Commission, Workforce Participation Rates – How does Australia Compare? Staff Working Paper 2006

1.7 Although these options work well together as a package, they can also be considered independently of each other.

### Increase Age Pension age

1.8 The Age Pension age for Australian males – 65 – has not changed in a century. Now, as life expectancies and general health and capacity to work at older ages increase, and the workforce ages, it is time for Australia to adopt a more dynamic approach which links pension age and life expectancy and health and capacity to work.

1.9 The first step in such a change could be for Australia to gradually raise the Age Pension age from 65 to 67 between 2025 and 2032. An early announcement of this change would minimise the impact on Australians already nearing retirement.

1.10 Other nations, including the US, the UK, Germany and Denmark, are already moving their Age Pension age to 67 or 68.

1.11 After announcing such changes, Australia should regularly review the Age Pension age, adjusting it in line with changes in life expectancy and general health and capacity to work. Age-based superannuation rules should also be reformed and then adjusted in line with these changes.

1.12 Together, these reforms would:

(a) Change the community's focus from the single age of 65;

(b) Erode preconceptions about when workers are "too old" to work;

(c) Continue the encouragement of increased labour force participation rates at older ages;

(d) Increase workers' superannuation savings for retirement;

(e) Improve the long term sustainability of the Australian retirement income system.

### Increase the Single Age Pension as a percentage of the Couples' Pension

1.13 Comparisons indicate that the Age Pension for couples may be just adequate when measured against a poverty level but in itself, would be well below a "modest" level. Further, the current rate for the Single Age Pension (25% Male Total Average Weekly Earnings) at just 60% of the Couple Age Pension, does not provide a commensurate standard of living for a single person compared to that of a couple.

1.14 If the Single Age Pension was increased from its current level of 25% to 30% Male Total Average Weekly Earnings, this would provide a more comparable level of financial support to that paid to a couple. This would provide 72% of the Couple Age Pension excluding Rent Assistance or 75% of the Couple Age Pension including Rent Assistance.

### Deferred Age Pension, remove Income test and simplify mature age tax offsets

1.15 Either in conjunction with, or in place of, any increase in the Age Pension age, a further option would be to introduce a deferred Age Pension, remove the Income test and simplify the complicated system of existing “mature age” tax offsets into one simpler “mature age” tax offset. Under this approach:

(a) A person’s entitlement to all or part of the Age Pension would be determined each year by the Asset test;

(b) A person eligible for all or part of the Age Pension could choose to either “take” or “defer” their Age Pension.

(c) If the person “takes” the Age Pension there would be no further reduction to the Age Pension as a result of any earned income, however, the tax rates that would apply would be the same as that applied to any other member of the community. That is, any person taking the Age Pension would not receive a “mature age” tax offset.

(d) If the person “defers” commencing all or part of their Age Pension, they would receive an increased Age Pension when subsequently commenced. However, they would receive the “mature age” tax offset during the deferral period, which would reduce the tax payable on any income earned during the deferral period and they would also retain all other pension rights during the deferral period, such as the Pensioner Concession Card.

(e) The period of deferral would be totally at the person’s choice and there would be no limit on the deferral period.

(f) The rate of increase to their Age Pension entitlement could be determined on an actuarial and financially neutral basis (i.e. on a ‘no loss’ basis for the Government and individual). Initial work suggests that equivalence in value would support a rate of increase of around 5% to 8% for each year of deferral. Based on a 7% per annum increase, the full Age Pension for a single (homeowner) would increase in deferral from:

   (i) $14,368 per annum from age 65 to

   (ii) $20,000 per annum from age 70 to

   (iii) $28,000 per annum from age 75.

(g) The current and complicated system of tax offsets should be simplified so that all offsets that apply to older people are combined into one “mature age” offset that applies to self-funded retirees only, which includes Age Pensioners in deferral.

(h) The scheme would replace the current, but restrictive, lump sum Pension Bonus system. However, a person could continue to access a lump sum up to the maximum of the existing Pension Bonus scheme, for example up to $33,409 after five years for a single, instead of the increased Age Pension.

1.16 The key advantages of this approach are that it is provides a voluntary option for increasing both the average retirement age and the level of the Age Pension, whilst removing the financial penalty for working beyond Pension age.

1.17 In addition, the advantages of means testing are retained whilst the disadvantages are minimised by removing the Income test (e.g. high administration costs).

1.18 A deferred Age Pension should be cost neutral for the Government and can be integrated with variable and casual work patterns, which are often the case for many older workers.

1.19 Consideration should also be given to extending the exemption that applies to homes under the Asset test to home equity release, that is, where the home equity is released into some form of protected savings account where it can only be used for funding health, retirement or aged care.

### Standardise "retirement ages" in superannuation legislation

1.20 There are many different age based rules in the superannuation system for contributions and benefits which deliver a very confused message about "retirement age".

1.21 These should be harmonised in order to reflect a clearer message that working beyond age 65 is to be encouraged, whilst the use of retirement savings prior to 65 is discouraged.

1.22 Initiatives could include

(a) Enabling all superannuation contributions by an employer, employee or self-employed person to be made at any age provided that the person is no more than 10 years older than the Age Pension age;

(b) Gradually increasing the tax-free age for superannuation benefits towards the Age Pension age;

(c) Alternatively, you could include lump sum superannuation withdrawals prior to Age Pension age, in excess of certain limits, in the assessment of assets under the Age Pension test for a limited number of years.

### Conclusion

1.23 Increasing longevity is both a problem and an opportunity for Australia. Increasing longevity and the ageing population are both projected to have a significant impact on the economy. Increasing longevity is also expected to increase the number of years of healthy active life. In fact, more than 70% of the overall increase in life expectancy is an increase in healthy life expectancy[4] .

[4] Australian Institute of Health and Welfare, 2008, www.aihw.gov.au/life_expectancy/hale./cfm, 21/08/08

1.24 This makes an increasing average retirement age both possible and desirable in order to improve the quality and standard of living in retirement, as well as reducing the fiscal impact of the ageing population. Once inactive, older people are unlikely to shift back into active work (less than a 5% chance[5]), hence the need to encourage people to remain active in the first place.

1.25 We note that removing financial disincentives to work longer is only one part of the solution and changing the attitudes of both employers and older workers is the other. The Government will also have a wider role to play in regards to raising awareness, providing information and providing education in order to help change attitudes.

1.26 It is noted that the summary above considered the position of the general population who are experiencing improving longevity and health, and work in physically less demanding jobs compared with many in days gone by. In implementing changes such as those above, it will also be important to ensure that those who continue to work in physically demanding jobs and/or suffer health issues that inhibit or prevent longer working lives, retain fair and reasonable assess to retirement or equivalent “disability” options relevant to their situation.

[5] OECD, Ageing and Employment Policies, Live Longer, Work Longer, 2006 p36