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27 February 2009

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

Joint ISN/AIST Submission to the Australia's Future Tax System (AFTS) Inquiry

Further to our earlier submissions to the AFTS inquiry, please find attached our joint submission responding to the Retirement income Consultation Paper released in December 2008.

We would welcome the opportunity to discuss our submission further with the Panel or the secretariat. Please do not hesitate to contact Sacha Vidler if you have any questions.

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Yours sincerely

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Australia's Future Tax System Inquiry

The retirement income system

Submission by

Industry Super Network
&
Australian Institute of Superannuation Trustees

February 2009

About ISN and AIST

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.

The Australian Institute of Superannuation Trustees (AIST) is a national not-for-profit organisation whose mission is to promote and protect the interests of Australia's $450 billion not-for-profit superannuation sector. AIST's membership includes the trustee directors and staff of industry, corporate and public-sector funds, who manage the superannuation accounts of nearly two-thirds of the Australian workforce. As the principal advocate and peak representative body for the not-for-profit superannuation sector, AIST plays a key role in policy development and is a leading provider of research.

This submission was coordinated by Sacha Vidler of ISN and Andrew Barr of AIST; Geraldine Pace of ISN provided research assistance. Access Economics were engaged as consultants. The project was overseen by a steering committee consisting of Cath Bowtell and Grant Belchamber of the ACTU, Peter Burn of AiGroup, David Whiteley of ISN, Nick Coates (formerly) of ISN, and Fiona Reynolds and Sandy Grant of AIST. The AiGroup and ACTU are also making independent submissions to the AFTS on retirement income.

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Summary

This document and the attached *Simulations Report* constitute the joint submission on retirement incomes to the Australia's Future Tax System (AFTS) review by the Industry Super Network (ISN) and the Australian Institute of Superannuation Trustees (AIST), both organisations that represent not for profit superannuation funds.

ISN and AIST have developed the submission in close consultation with the superannuation funds they represent, as well as employer and union peak bodies – the AiGroup (AiG) and the Australian Council of Trade Unions (ACTU) – to incorporate the perspectives and insights of all key stakeholders in the not for profit superannuation sector. We note that AiG and the ACTU are also making independent submissions to the AFTS on retirement income.

The submission is research-driven, informed by detailed modelling of the impact of potential policy changes on the full spectrum of age and income groups, as well as consideration of cost to Government over the long term.

ISN/AIST strongly support Australia's multi-pillar retirement income system, which is based on shared responsibility between individual and Government to mitigate risks while offering effective incentives. However, we believe the system does need some significant reforms.

This submission develops themes introduced in ISN's interim submission to AFTS in October 2008 – that Government should adopt an explicit definition of adequate retirement income to guide the wide range of policies oriented to achieving this aim; and that efficiency and investment performance are key determinants of the system's ability to deliver adequacy and must be addressed as part of the Government's current reform effort.

Our focus in developing policy options going forward is on low and middle income households, to ensure that the benefits from reform are concentrated on areas of greatest need and serve to balance the relatively high benefits that the "Better Super" reforms of 2006 had for higher-income households.

We are also, like the AFTS review panel, more focussed on long term challenges, particularly demographic change and the need to increase national savings, than short term challenges, notably the global financial crisis and associated economic downturn. We recognise that the Government must take current financial conditions into account when implementing reform, but would remind the Government that many important reforms to the retirement income system – with a legacy that will last for generations – were implemented in the midst of the last deep recession. Explicit planning for the long term sends an important message to households and businesses: that we will come out of this in time and, if reform continues, can be better placed for the future.

Retirement income policy is a very important component of the overall tax-transfer system, with the age pension system and the superannuation system being, respectively, the largest expenditures and tax expenditures in the Government budget. Government should adopt an explicit definition of adequate retirement income to guide policy. This definition should be a range consistent with community standards, bounded by levels of consumption broadly recognised as adequate. Work on costing consumption levels suitable for this purpose has already been done by the Social Policy Research Centre (SPRC) at the University of New South Wales. The SPRC was commissioned by Westpac and the Association of Superannuation Funds of Australia (ASFA) to develop two budget standards for healthy, active retirees: a 'modest but adequate' standard and a 'comfortable/affluent' standard. In the absence of more recent research, we recommend these standards be used as effective boundaries on the adequate range.

Such a definition of adequacy would guide policy by emphasising that the first goal of policy should be to ensure all Australian retirees – through the pension and their superannuation and other savings – have a real opportunity to enjoy at least a modest standard of living in retirement. The second goal is to encourage as many workers as possible, through workplace and voluntary savings, to move higher in the range towards a comfortable/affluent standard of living in retirement. We would see supporting individuals achieve a standard of living higher than this as a much lower priority.

We would also encourage the review panel, in considering the long term fiscal sustainability of the key expenditures and tax expenditures, to recognise that leaving post-retirement tax treatment beyond the scope of analysis constrains potential reforms, and makes needed rebalancing more difficult.

A powerful determinant of the adequacy of retirement incomes, yet one which rarely receives attention, is the efficiency of the superannuation system and its ability to deliver strong returns net of fees and commissions over the long term. Modelling by our consultants, Access Economics, indicates that a 0.75% increase in annual performance would increase superannuation assets by 19% of GDP by 2041, and improve total retirement benefits (including the public pension) by 7.4% for a worker on average income (relative to the modest retirement income benchmark). ISN/AIST strongly support the efforts of Nick Sherry, Minister for Superannuation and Corporate Law, to raise awareness about these issues and implement a range of measures to stimulate competition on fees and net investment performance in the superannuation industry. We see banning commissions on retirement saving and income products as the first and most important step in this process.

We believe reform of the age pension is necessary to improve the base standard of living of those in retirement. We recommend that the base rate be increased, with the most urgent need faced by those solely reliant on the pension, especially single people and non-home owners. We have modelled an increase in the base level of the pension equal to the one-off payment made by the Government in December 2008 as part of the Economic Security Package announced in November. This improves adequacy for low to middle income workers by over 5% relative to the modest benchmark.

We also believe the impact of the current structure of means-testing of the age pension needs to be reviewed. The age pension currently acts as a safety net for low income earners, but also boosts the retirement income of many previously middle and high income workers with considerable assets. Meanwhile, the existing taper rate of the age pension (although substantially less stringent since "Better Super" in 2006) continues to act as an effective tax on savings for those in the taper range. The Government must closely consider this issue in order to get the balance right between maintaining strong incentives to save and keeping the system affordable via appropriate targeting.

On the issue of incentives to save, an important component of the current retirement income system is the 15% tax on employer superannuation contributions. This rate is concessional for those on high marginal rates, but confers no benefit, and can even be detrimental, for those on low incomes and low marginal tax rates. We have evaluated several options to address this issue, including changes to the co-contribution scheme, a progressive tax (equal to an individual's marginal tax rate minus 15%) on superannuation contributions and a simpler structure, stepping from 0% tax for low income earners to the current 15% for middle and high income earners.

We also have evaluated and recommend a maternity linked Government contribution – a super "baby-bonus". We also recommend the panel review the exemption on compulsory superannuation contributions for those earning less than $450 per month. These measures would potentially provide significantly better treatment for low income earners, and especially women, who typically have more broken work patterns than men and make up the bulk of those in part-time work.

An important gap in the retirement income system is the exemption from compulsory contributions to superannuation for the 1.3 million owner operators in unincorporated enterprises, or 'self-employed'. Within this group, those in the sub-category of dependent contractors are treated legally as normal employees in relation to superannuation contributions. For dependent contractors, the issue is one of enforcement of existing law, and we recommend the Government resource the Australia Tax Office as necessary for it to achieve this task. For independent contractors, the issue is whether they would benefit, as other workers do, from the requirement to save for retirement partially through superannuation, instead of, as is often the case, through investment in their businesses, which may not constitute a saleable asset of significant value. We recommend the Government review the current exemption in relation to the self-employed with a particular view to the risks of under-saving due to a reliance on reinvestment in one's own business.

As the population ages, a higher proportion of people are moving into retirement and retirees are living longer on average. However, as the private market for lifetime annuities in Australia is very underdeveloped, the associated longevity risk is largely borne by the Government through the age pension (which provides income to all retirees if and when they have run down their own retirement savings).

We consequently suggest that the Government create a funded annuity product with genuine longevity coverage by offering an extension of the existing public pension which retirees could access by investing a lump-sum from their retirement savings. The delivery of the product would benefit from economies of scale and scope available due to the Government's administration of the existing pension, its lower cost of capital, and its optimal ability to pool inflation and longevity risk. Access Economics estimates this would, at negative overall cost to Government (due to reduce pension cost), significantly improve average retirement incomes, especially for older retirees.

ISN/AIST believe that in order to move to a system which provides comfortable retirement income based on increased self-provision there is a need for increased superannuation savings, particularly for those who have not experienced the full 9% contribution for much of their working life. While further modelling needs to be undertaken, it is our view that contributions of up to 12% are necessary.

However, we recognise that there is not consensus among unions and employer groups about how additional contributions would be paid for. Further, while there is a necessity for those currently in the workforce to make higher contributions now, it is also acknowledged that in the immediate term it is unlikely that a government would seek to impose additional costs on employers or compel employees to allocate an additional one per cent of their wages to savings rather than consumption.

This report recommends a number of low cost measures that ensure greater equity in the taxation of superannuation and in improving the efficiency and competitiveness of the superannuation system. It also recommends the Government increase the base level of the age pension and carefully review the tapering of the pension to ensure the system remains targeted and sustainable. If these measures were introduced quickly, then the immediate need to increase contributions is reduced.

The retirement income system is a part of the wider tax-transfer system. This submission and the analysis on which it is based has, of necessity, assumed that the wider tax system remains unchanged from current settings. This assumption is particularly unrealistic while a major tax review is underway. Naturally, we may need to reconsider the recommendations in our submission to the panel in light of significant tax reform potentially flowing from the AFTS process.

Recommendations

Recommendation 2.1. Government adopt an official definition of adequate retirement income consisting of a range bounded by budget standards consistent with community standards of adequacy, such as the ASFA/Westpac 'modest' and 'comfortable' standards, to act as a benchmark against which the combination of public policy and individual provision can be assessed.

Recommendation 3.1.1: Implement measures to improve the net performance of the superannuation industry, including banning commission-based selling of retirement saving and income products.

Recommendation 3.2.1: The Government increase the base rate of the pension by at least the level of the one-off payment in December 2008.

Recommendation 3.2.2: The Government offer lifetime annuities utilising the administrative structure of the public pension, the Government actuary and possibly the investment expertise of the Future Fund in competition with private sector providers.

Recommendation 3.2.3: Review the means-testing of the pension and related benefits with a view to balancing sustainable support for those most in need, and the need to minimise distortions, including from EMTRs on saving.

Recommendation 3.2.4: The Government should review the level of the bonus received for deferring receipt of the pension and the treatment of income from personal exertion under the pension income test.

Recommendation 3.3.1: Government address the lack of concessionality of the superannuation contribution tax for low income earners as a matter of urgency.

Recommendation 3.4.2: That a $1500 superannuation baby bonus contribution be paid to a woman's superannuation account when they have a child.

Recommendation 3.4.3: ISN/AIST recommends the $450 per month exemption be reviewed.

Recommendation 3.4.4: Self-employed (dependent contractors) – Greater resources be given to the ATO enforce current law in relation to contracts for labour, including giving the ATO capacity to assess compliance in the absence of a complaint.

Recommendation 3.4.5: Self-employed (independent contractors) – The Government review the current exemption in relation to the self-employed with a particular view to the risks of under-saving for retirement due to a reliance on reinvestment in one's own business.

Economic modelling

ISN/AIST have considered a range of policy changes to the current retirement income system. Several of these are estimated to have large positive impacts on the adequacy of retirement incomes. Figure S.1, below, shows the dollar contribution (in 2009 dollars) of each measure to average retirement income in 2041. The measures with significant potential impacts include:

- improving superannuation system efficiency to increase net investment performance by 0.75%;
- increasing the pension consistent with the December 2008 one-off payment;
- a public funded annuity scheme operated using the administration of the public pension; and
- increasing compulsory contributions

ISN/AIST have also considered several measures with smaller impacts on average, but which improve the targeting of retirement tax-transfers. Figure S.2, below, shows the percentage benefit on retirement incomes by lifetime income decile in 2041 of these measures, which include:

- concessional contributions tax for low income earners;
- super baby-bonus;
- raising the co-contribution threshold; and
- removing the $450/month superannuation guarantee exemption

Figure S.1 Average impact of policy options on adequacy in 2041 (2009 dollars)

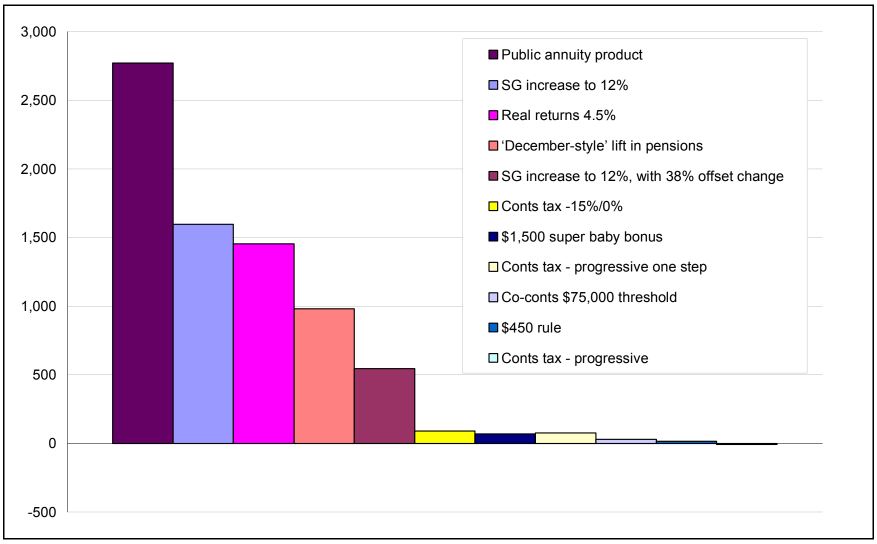
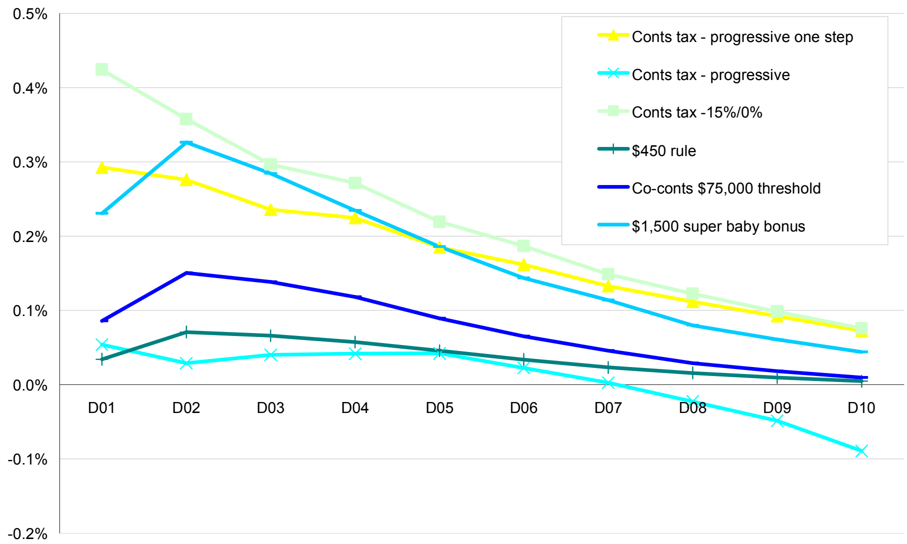
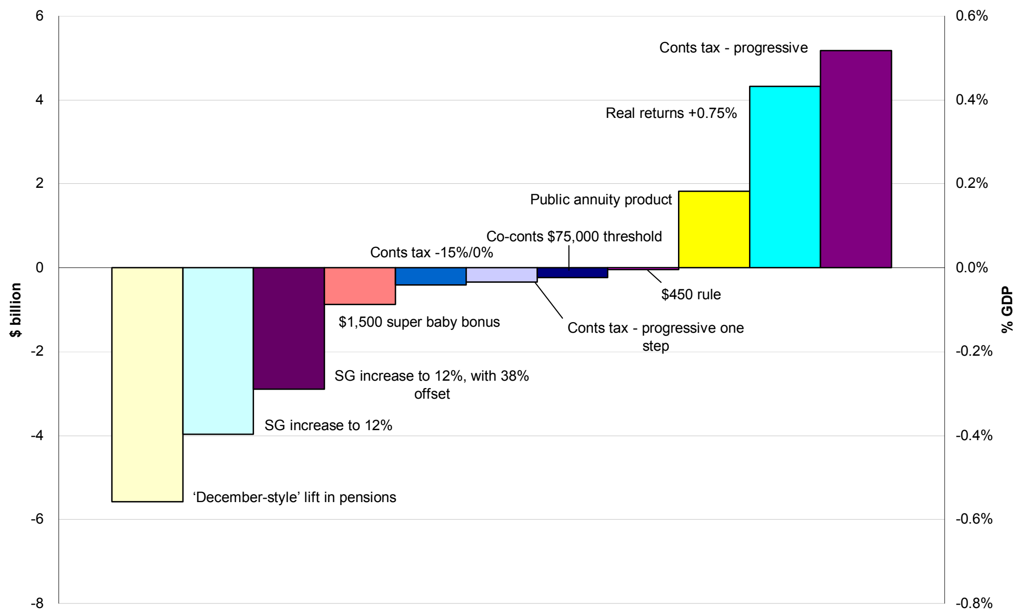


Figure S.2 Distributive impact of targeted policy options – percentage impact on a pre-retirement consumption benchmark by lifetime income decile



ISN/AIST have also modelled the cost to Government of each of the proposals. Figure S3, below, shows the estimated cost to Government in 2041 in billions of dollars (converted to 2009 values) and as a percentage of GDP.

Figure S.3 Cost to Government of considered policy measures



More detailed analysis is included in the relevant sections on the potential policy measures, and the summary of costs and impacts in Section 4, below, and, finally, in the attached report by Access Economics, *Retirement Incomes Policy: Simulations Paper*.

1 Introduction

In May 2008 the Australian Government announced a review of the Australian tax-transfer system, including the retirement income system. In a parallel process, the age pension is also being reviewed. In December 2008, the tax system inquiry, headed by Dr Ken Henry, released a consultation paper on the retirement income system calling for submissions from the public by the end of February 2009 (AFTS, 2008). This document is the combined submission of the Industry Super Network (ISN) and the Australian Institute of Superannuation Trustees (AIST).

ISN and AIST represent a large proportion of the not for profit sector of the superannuation industry. Not for profit superannuation funds are governed by representative boards of trustees, including employer and worker representatives. In developing the submission, ISN/AIST have also been guided by these stakeholders, through representation on our project steering committee of the Australian Council of Trade Unions (ACTU) and the Australian Industry Group (AiGroup), as well as direct consultation with other employer associations including the Australian Hotels Association and the Master Builders' Association. We note that AiG and the ACTU are also making independent submissions to the AFTS on retirement income.

ISN/AIST strongly support the multi-pillar structure of the Australian retirement income system which shares risks and responsibility between Government and individuals through a combination of public provision and incentivised self-provision and non-incentivised self-provision (i.e. voluntary saving outside of super). Current financial and economic conditions highlight the very important ongoing role of the public age pension and public healthcare as a safety net; while the imminent retirement of the baby-boomers underscores the need for enhanced self-provision to deliver adequate income for future retirees, without compromising financial sustainability.

ISN/AIST considered the adequacy, equity and sustainability of the system in the face of increased strains on the system from population ageing. This submission develops two important themes introduced in ISN's interim submission to the tax review in October 2008:

- that Government should officially define adequacy to guide retirement income policy; and
- that the efficiency and investment performance of the superannuation system are important determinants of retirement income adequacy.

The submission also seeks to address important challenges for the system, including:

- the lack of balance in superannuation tax incentives, with lower relative benefits received by low income earners and net detriment for very low income earners;
- potential gaps in adequacy when the system matures; and
- the need for transitional arrangements while the system matures to support those who have not benefited from compulsory superannuation for much of their working lives.

Finally, the submission recognises the important role the retirement income system has in achieving higher levels of national savings. Current financial conditions emphasise the increased vulnerability to international shocks that can emerge due to reliance on foreign capital.

To the greatest extent possible, given the tight time-frame, this submission reflects positions informed by the most recent data and detailed analysis. ISN/AIST commissioned Access Economics to conduct new modelling of projected adequacy based on current policy settings, as well as analysis of a number of proposals considered by the steering committee. The consultant's report is attached at Appendix B.

Projecting the performance of the system decades into the future necessarily requires that assumptions are made about a number of factors, some of which, such as the responsiveness of savings behaviour to tax incentives, are only partially understood. To this end, this submission and attached analysis represent an important contribution to the process of improving Australian retirement income policy.

The submission first discusses the definition of adequacy, then the consultant's projections of the 'base case', then the analysis of various policy options, and then the sustainability of the system. Appendix A contains answers to the questions in the consultation paper, with references to the text of the main document.

2 Defining adequate retirement income

The retirement income system is a large and important component of the tax-transfer system. However, there is no official Government policy on what constitutes adequate retirement income (Rothman and Bingham, 2004). In recent working papers, Treasury's Retirement Income Modelling (RIM) group has expressed the view that the system, when current policy settings mature, will provide adequate retirement incomes for a large majority of people across the income distribution (Rothman, 2007). An implicit (relative) definition of adequacy appears to be in operation.

The Government's reluctance to announce an explicit definition of adequacy may be derived from a concern that such a policy would imply Government responsibility for all individuals achieving that level of retirement income. Retirees might demand, for example, that the Government set the public pension at that level; a change which could compromise public finances.

However, one of the strengths of the three pillar system, which ISN/AIST strongly supports, is the joint and overlapping responsibility between the individual and the Government for achieving adequate retirement income:

- responsibly for the 1st pillar safety net rests with Government, which bears the associated funding, inflation and longevity risks;
- responsibility for the 2nd pillar is shared between Government and individuals. Compulsion and tax concessionality are the product of Government regulation while contributions are connected to an individual's earned income and it is individual account holders (at least in accumulation accounts) that make investment choices and bear associated investment risks; and
- the 3rd pillar is left to individual discretion, although with the support and encouragement of Government through concessional tax treatment of voluntary super contributions.

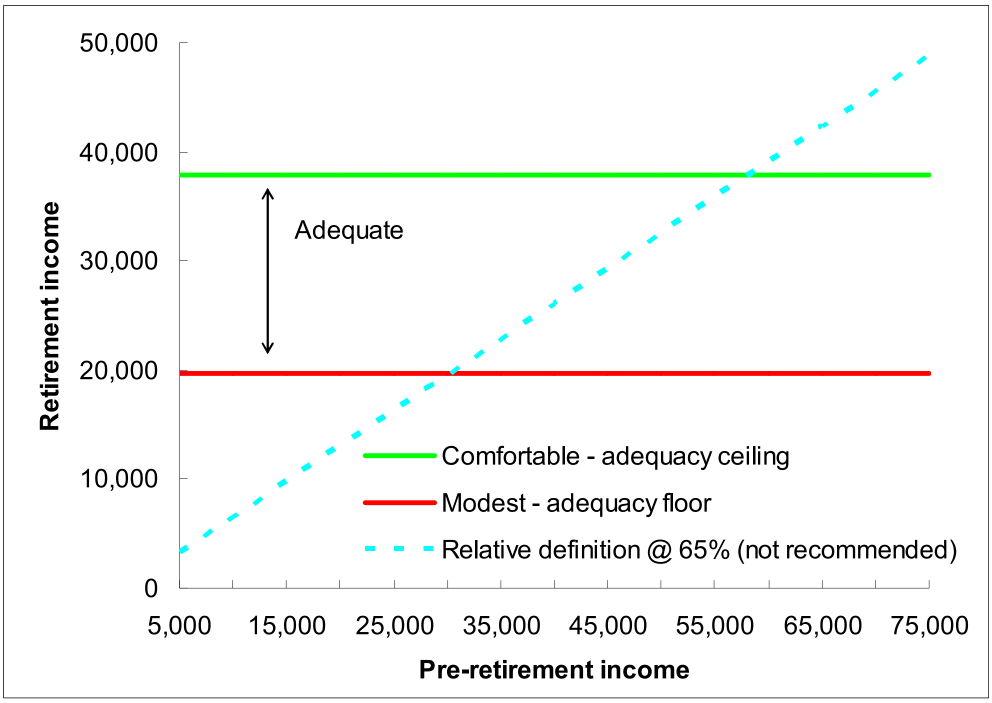
Much of the tax transfer system is oriented to achieving adequate retirement income. We believe the Government should adopt an official definition of adequacy to guide retirement income policy.

The term 'adequate' means sufficient or appropriate for a task or purpose. The question then becomes 'what is the task?' An individual will have their own consumption needs as well as unique preferences in relation to the important trade-offs involved in determining retirement income – such as the extent to which consumption is deferred during working life. This is the usual justification for a relative measure of adequacy, which treats an individual's pre retirement income or consumption as the appropriate benchmark for evaluation of post retirement income. However, by basing the benchmark on individual income, a relative definition of adequacy implies that the Government has almost no responsibility to support the retirement incomes of those who had very low incomes before retirement, but a significant obligation to support individuals with very high incomes in retirement.

To the extent that the definition of adequacy influences public policy and therefore the flow of direct or tax expenditures – which must be financed by the taxpayer generally – a consensus view of adequacy is called for.

Estimates of the consumption needs for retirees associated with 'modest' and 'comfortable' lifestyles were commissioned from the Social Policy Research Centre (SPRC) by ASFA/Westpac in 2004 and have been indexed to price changes for the basket of goods subsequently (ASFA/Westpac, 2008). In the absence of superior or updated research, these would appear to be entirely reasonable boundaries for the adequate range. Figure 2.1, below, shows the modest and comfortable retirement standards for September 2008

Figure 2.1 Budget standards measure of adequacy



(ASFA/Westpac, 2008) with a relative measure for comparison. The relative measure implies very low retirement income is adequate for low income workers, while relatively high retirement income is inadequate or high income earners. ISN/AIST do not support use of a relative measure.

Defining adequacy as a range puts a floor (and a ceiling) on Government responsibility for retirement incomes. We believe the range of adequate retirement incomes defined by these standards is broadly consistent with the range of shared responsibility between the individual and the Government.

This implies that retirement income policy should enable, if possible, even individuals on low lifetime incomes to bridge the gap between the age pension and the modest benchmark with their own savings, and strongly encourage and support individuals on a wide range of incomes to achieve the comfortable standard. Lifestyles beyond that level in retirement may be desirable; however, it is difficult to justify an unlimited obligation on Government to support individuals achieve them.

Recommendation 2.1. Government adopt an official definition of adequate retirement income consisting of a range bounded by budget standards consistent with community standards of adequacy, such as the ASFA/Westpac 'modest' and 'comfortable' standards, to act as a benchmark against which the combination of public policy and individual provision can be assessed.

3 Policy issues and solutions

ISN/AIST have reviewed a number of policy options to improve adequacy, including initiatives targeting those on lower incomes, women and those in or near retirement who have only been in the superannuation system for a fraction of their working lives.

Policies have been reviewed in terms of their contribution to adequacy, their distributive or 'equity' impact, cost to Government and for administrative simplicity and ease of implementation.

Time constraints have prevented further optimisation of policy options and only offered limited scope for consideration of the impact of behavioural change flowing from policy modification, which would be an important source of benefit over time in most cases.

3.1 Efficiency, net investment performance and adequacy

The majority of policy options reviewed by the steering committee and modelled by Access Economics involved either an increase in superannuation contributions, or a change in Government expenditure or tax expenditure. In such cases there is an indirect or direct trade-off between current and future expenditure. The main exception was an analysis of the impact on retirement income of alternate rates of return (net of fees and charges) on capital invested in the superannuation system.

Policy measures which improve the efficiency of the superannuation system can have a dramatic impact on net performance. The variation in performance by sector within the industry gives some indication of the improvement in aggregate performance which could possibly be achieved though systemic reform. The not for profit sector of the superannuation system has consistently outperformed the retail sector of the system by 1-2 per cent. For the last 12 full financial years, the retail sector has delivered net returns after inflation of around 1.8 per cent p.a., compared to 3.5 per cent p.a. for the not for profit sector (APRA, 2007; 2008a; 2008b). The rate of return on retail funds during this period has been lower than the rate of return on risk free assets.

Access Economics modelled a number of rate of return scenarios. The base case assumed real return of approximately 3.75%.[1] Alternate scenarios included real return at a slightly lower rate – 3.0%, a significantly lower rate – 1.5% pa, and at a higher rate – 4.5% p.a.

The analysis points to the powerful impact efficiency and performance have on the effectiveness of the retirement income system to deliver adequate retirement incomes. Increasing the rate of return to 4.5% real would increase assets by 19.1% by 2041. It provides an average improvement of $1,450 (in 2009 dollars), a 7% improvement relative to the modest benchmark. The distribution of benefits is proportional to assets, ranging from around 5% for the lowest decile of lifetime earners, up to around 8.5% for the highest decile. By contrast, a return at the lower end of the spectrum, of 1.5% real, would reduce assets by 43% relative to the base case.

ISN/AIST note and applaud the efforts of Nick Sherry, Minister for Superannuation and Corporate Government, to implement a range of measures to stimulate competition on fees and net performance in the superannuation industry.

Recommendation 3.1.1: Implement measures to improve the net performance of the superannuation industry, including banning commission-based selling of retirement saving and income products.

3.2 The public pension

3.2.1 Base level

In October 2008 the Prime Minister and Treasurer announced a $10.4 billion Economic Security Strategy, which included $4.8 billion in additional payments to pensioners described as "an immediate down payment on long term reform" (PM, 2008).

What form that reform might take is the subject of the Harmer review currently underway. Increasing the pension, especially for those solely reliant singles, is an important transitional measure to help in the short to medium term to assist those who have only been in the superannuation system for a fraction of their working lives.

ISN/AIST has analysed the impact on adequacy of a permanent increase in the public age pension equivalent to the one off payments in December 2008 of $1,400 (for single pensioners). Access Economics estimate this measure would increase the cost of pensions by 0.3% of GDP immediately, rising to 0.5% of GDP by 2041. The measure would provide a 5% improvement in retirement income against the modest benchmark on average. The

[1] The RIM group uses a real rate of return of approximately 4.5% p.a. (7% nominal with inflation of 2.5%) before earnings tax and fixed administration charges, which is comparable to the base case depending on assumptions around these variables (e.g. an administration fee of $80 on an average account size of $30,000 costs around 27 basis points, and effective tax of 8% on nominal return of 7% would cost around 56 basis points).

distributional analysis shows a flat 5.4% benefit from decile 1 through 5, trailing off to 4% by decile 10.

This change to the pension brings the base level of retirement income closer to the 'modest but adequate' budget standard benchmark. A pension at this level still requires a significant level of private retirement saving in order to reach an adequate retirement income. The estimated lifetime earning deciles generated by Access Economics show that the lowest lifetime decile, on average, earned around $8,200 in wages and salary income p.a. (in 2005-06), or close to $300,000 over a 36 year working life, generating under our proposed contribution tax structure (see below) superannuation savings of $27,000, which could generate a private pension of $1,600. An equivalent level of voluntary saving would enable very low income workers to achieve a total retirement income approaching the modest benchmark.

Recommendation 3.2.1: The Government increase the base rate of the pension by at least the level of the one-off payment in December 2008.

3.2.2 Pension extension/public annuity

The market for lifetime annuities in Australia is under-developed. The limited products available are poorly priced in part due to existing accounting rules which effectively require investment in risk free assets. Such products are also difficult to incentivise via the tax-transfer system, in the absence of post retirement taxation.[2] The private sector therefore offers individuals little opportunity to use their accumulated savings to independently cover themselves against the inflation, investment and longevity risks inherent in retirement.

By default, the Government – via the public pension – bears the downside of these risks for all retirees, which become more pressing with increased age as retirees run down their retirement savings. Indeed, the very low uptake up of lifetime annuities products results in more rapid run down of retirement savings than is desirable.

ISN/AIST suggest that the Government provide a lifetime annuity product to rectify this gap by selling increases in the public pension. Retirees would pay a lump sum to the Government in return for a pension, indexed to wage growth, determined on an actuarially fair basis. The administration would be managed by Centrelink, and fund management could be outsourced or conducted by a Government agency, such as the Future Fund.

This Government annuity 'product' would have a number of benefits over those currently available. The Government has greater capacity to invest assets in a risky portfolio against long term liabilities of this kind, and it has the lowest possible default risk and cost of capital. By utilising the existing social security administration, the product would also benefit significantly from economies of scale and scope for extremely cost-effective delivery.

Allowing purchase of an increase in the public pension would also offer flexibility to those who take advantage of the Pension Bonus Scheme. Tax free lump sums paid as part of that scheme could be reinvested to increase the level of pension.

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[2] One alternative might be to allow assets in lifetime annuities to be exempted from the public pension assets test.

If the product was fairly priced, which is the intention, the initiative would be revenue neutral from the outset. In the long term, public finances would benefit from the partial transfer of longevity risk; in effect a partial replacement of unfunded public pensions with funded pensions. Fair pricing (and an absence of product options) could minimise the risk of precluding the development of the private annuities market.

The modelling of the impact of such a product is, of course, dependent on the level of uptake, and sensitive to the behaviour that would occur in the absence of the scheme (particularly the rapid rundown of assets). If a reasonable uptake is assumed, our modelling suggests this initiative could have a very powerful impact on aggregate retirement income adequacy, particularly through boosting incomes of those who live beyond average life expectancy, at which time most other forms of retirement savings wealth may be run down.

Access Economics estimates an average improvement over retirement of 14.1% against the modest benchmark by 2041. Pension costs would be reduced slightly (0.05% of GDP) by this time.

Recommendation 3.2.2: The Government offer lifetime annuities utilising the administrative structure of the public pension, the Government actuary and possibly the investment expertise of the Future Fund in competition with private sector providers.

3.2.3 Targeting

As mentioned previously, ISN/AIST strongly endorse the multi-pillar system with shared risks and responsibilities. We observe, however, that there is a tension between the income supplement role played by the age pension for retirees who were on middle and even high deciles of lifetime earnings, which could be labelled 'middle class welfare', and the sustainability of the system in the long term.

ISN/AIST has reviewed the possibility of tightening the means and asset tests on the age pension as a way of improving the targeting of the pension and reducing the overall budget impact of the recommended increase.

Access Economics analysed the contribution each of the three pillars makes to retirement income across the lifetime earnings distribution. An interesting feature of this analysis is that on average individuals on the highest lifetime decile receive a significant proportion (around 12%) of retirement income from the public pension over their entire retirement. This finding is driven partly the assumption of (arguably irrationally) rapid drawdown of assets in the decumulation phase. The modelling suggests that tightening the means-test by 5% results in a saving to Government of 0.01% of GDP by 2041.

However, ISN/AIST recommend a cautious analysis of the means-test. The first pillar in the three pillar system provides a base level of income for those without any savings. It also provides partial protection against inflation, longevity and investment risks for those who have some savings but are not fully self-sufficient. The importance of this role – especially in relation to investment risks – is particularly notable in periods of extreme volatility on financial markets.

Effective marginal tax rates (EMTRs) are also an important issue to consider in relation to means-testing of the pension. The implied EMTR is already quite high for those within the taper range. Leaving aside deeming rules which often result in those with retirement accumulations being excluded by the income test, the assets test also provides a strong disincentive to save. Additional savings of $1,000 reduces pension income by $1.50 per fortnight in the taper range. This sounds trivial, but over 25 years of retirement, $1.50 per fortnight (from a risk free source indexed to wage growth) is worth perhaps $760, discounted to present value (see Table 3.1), resulting in an effective tax on this saving of 76%.[3]

Table 3.1 The effective marginal tax rate resulting from the assets test on the pension for those within the taper range

Saving		$1000.00
Pension reduction - per fortnight	-$1.50	
per annum	-$39.00	
PV over 25 years @ 2% p.a.[4]		-$760.00
Net increase in wealth		$240.00
Effective marginal tax rate		76%

Whether this acts as a deterrent to saving is unclear due to the potentially large interval between the saving and the incidence of the tax. However, the current rate of tapering certainly results in savers within the taper range getting very little improvement in retirement income from their additional savings.

A range of other reforms may be possible and should be considered by the review to contain the cost of the pension and limit some problematic incentives currently in place. Much of the work of financial planners for those approaching retirement revolves around ensuring that the client can achieve at least a part age pension to gain the Health Care Card. Several not for profit funds report that this apparently small benefit leads to distorted retirement planning, effectively undermining the intention of having a pension which gradually tapers to zero.

Generous treatment of the family home under the age pension means test reflects a strong tradition of home ownership in Australia and the recognition of its contribution to quality of life in retirement and importance in family estates. Nonetheless, it also can generate significant distortions, by, for example, encouraging retirees without dependents to continue to live in large, valuable houses appropriate for families with children. If the wealth held in family homes could be partially converted (through sale and reinvestment) to an annuity with covers longevity risk (as discussed above) without sacrificing partial pension benefits, the individual and community would be better off.

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3 This analysis obviously also ignores the initial tax on that saving (15% as a super contribution or personal marginal rate for most other savings).

4 2% pa is an approximation of the risk free rate minus wages growth. (For simplicity, the period between the saving and retirement is ignored; effectively an assumption that the discount rate applied to the value of the pension at retirement is equal to the investment returns possible on the saving.)

Recommendation 3.2.3: Review the means-testing of the pension and related benefits with a view to balancing sustainable support for those most in need, and the need to minimise distortions, including from EMTRs on saving.

3.2.4 Flexibility – timing and employment

The income test on the public pension provides a powerful disincentive for those eligible for a pension to continue a reasonable level of paid work. A first step has been taken towards introducing flexibility around taking the pension, through the Public Pension Bonus, which offers some reward for deferment of the pension.

However, at a accrual rate of 9.4% of the public pension for each year of deferment and seemingly without adjustment for the additional tax paid while continuing in the workforce, the bonus does not appear to offer fair compensation for deferment. Official statistics on the Public Pension Bonus suggest that less than 5% of those eligible for the scheme participate (FaHCSIA, 2008).

The development of transition to retirement products offers flexibility around phasing retirement for those with a reasonable level of retirement savings. It would be appropriate that similar flexibility be introduced to the conditions around the pension.

It is better to induce people willing and able to work past 65 to do so rather than to lift the pension age with a view to forcing that action. There are many people who struggle to work to 65 already, either by virtue of their health or lack of commercially attractive skills.

Of the 1.9 million retired people in 2007 who had worked in the last 20 years 32% reported the main reason for retiring was personal health or physical abilities (ABS, 2009). Aside from personal health, the other commonly reported main reasons that men retired included being retrenched or made redundant(10%) and reaching the eligibility age for an age (or service) pension (8%). The other main reasons that women retired were caring responsibilities (15%) and to spend more time with family/retirement of partner (13%) (ABS, 2009).

Lifting the pension age would simply increase the number of such people being inadvertently "retired" and receiving New Start or disability pensions. We therefore encourage the review to consider the treatment of income from personal exertion under the pension income test.

Recommendation 3.2.4: The Government should review the level of the bonus received for deferring receipt of the pension and the treatment of income from personal exertion under the pension income test.

3.3 Superannuation contribution tax-transfer treatment

The level of access to workplace superannuation and the level of concessionality received by the taxpayer vary across different employers and individuals. While most employers pay the minimum 9% contribution some pay considerably more, and some offer incentives for extra voluntary saving. Some employers allow salary sacrificing while others do not.

Workers on high marginal personal tax rates get considerable benefit from the 15% contributions tax. However, as is noted by the retirement incomes consultation paper, low income earners get no benefit. For very low income workers, the 15% tax will be punitive relative to the tax treatment of earned income (particularly after family allowances and other transfers).

ISN/AIST considered a number of options for addressing the lack of concessionality for low income earners, all involving introducing more than one rate of contributions tax. All the options considered would operate using the existing administrative framework of the co-contribution. Super funds would pay 15% contributions tax on behalf of all employer contributions and submit relevant information to the ATO, which would reconcile these records with an individual's tax return. Rebates for eligible members would be provided to the fund(s) and credited to the member's account(s).

The initiatives considered to redress the lack of concessionality for low income earners, are:

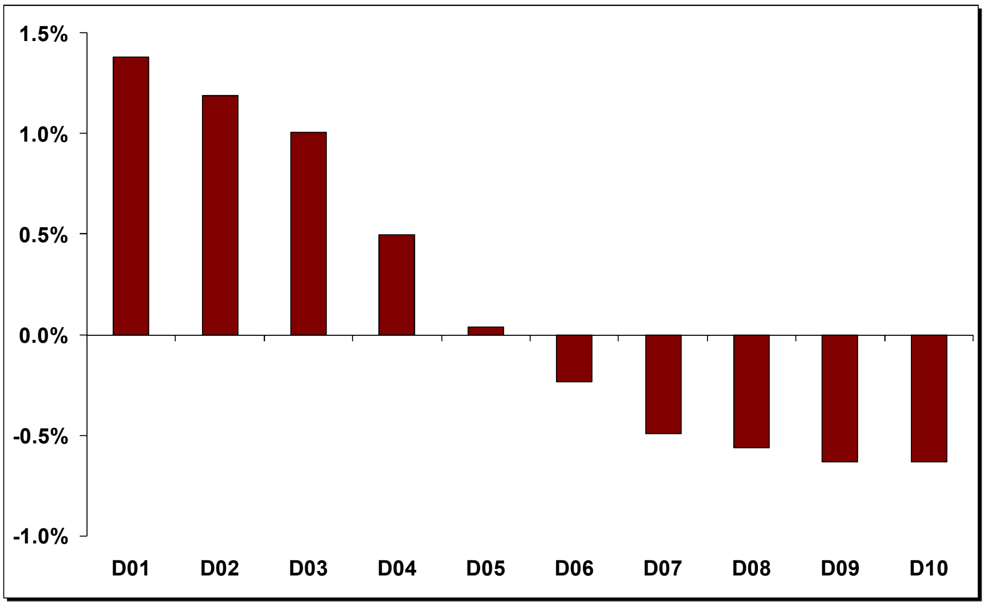
1. A progressive contributions tax with marginal contributions taxed at 15% below marginal personal income tax (with no negative taxes);
2. A single step contributions tax, with 0% contribution tax for low income earners and 15% for others.
3. A two step contributions tax, with -15% contribution tax corresponding to the personal income tax free threshold, 0% corresponding with the first income tax bracket, and 15% for higher tax brackets.

Consideration of these options highlighted a number of complexities with introducing a split level contributions tax. The adopted structure should ensure that taxpayers do not face lumpy (dis)incentives around contribution tax brackets. The tax treatment should also be based on total remuneration including super (as with the co-contribution) to ensure consistent treatment regardless of the level of employer contributions and voluntary contributions (i.e. individuals should not be able to salary sacrifice down to a lower tax bracket).

In terms of impacts, the progressive model (option 1 in the list above) shows strong positive benefits for low income earners and negative effects for higher income earners. This reform is estimated to save 0.3% of GDP in Government revenue initially, rising to 0.45% by 2041. It is neutral in term of average levels of adequacy.

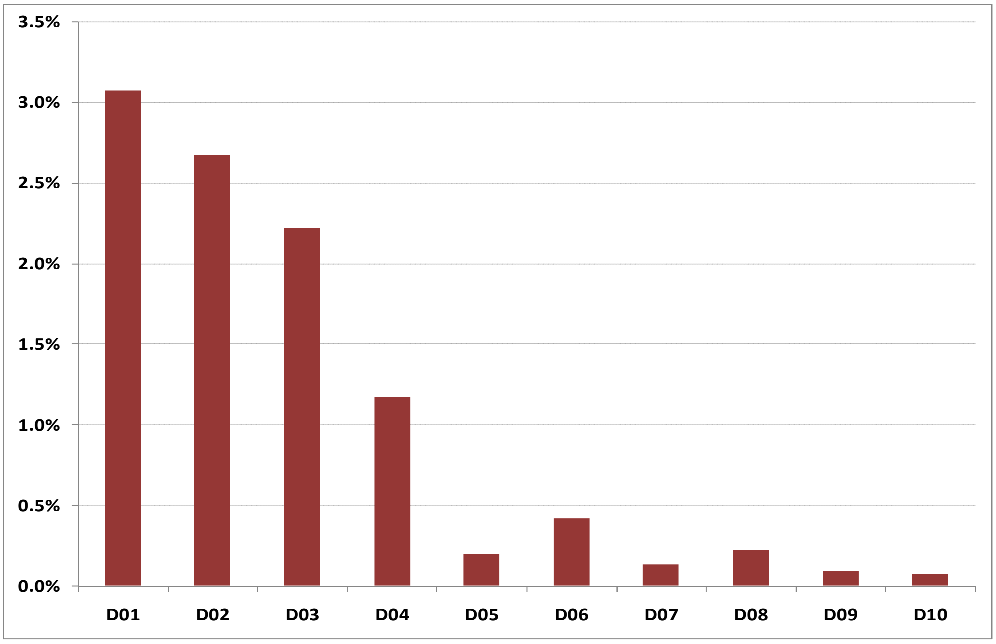
Feedback from funds on this proposal included that having a tax on contributions of more than 15% (even for a small minority of members) would involve additional administrative burden, and that the contributions tax should be lower then 30%, in order to remain concessional relative to the company tax rate, which is the EMTR on many high income earners.

Figure 3.3.1 Percentage impact on adequacy of progressive contributions tax across lifetime income distribution



By contrast, the two step progressive model (option 3) has large positive impacts on adequacy for low income earners and small positive impacts for high income earners. It is estimated to have a positive effect on adequacy in aggregate and costs the Government 0.06% of GDP initially, falling to 0.03% of GDP by 2041 through reduced cost of pensions. Option 2 have a similar but less pronounced impact to option 3.

Figure 3.3.2 Percentage impact on adequacy of progressive contributions tax (capped at 15%) across lifetime income distribution



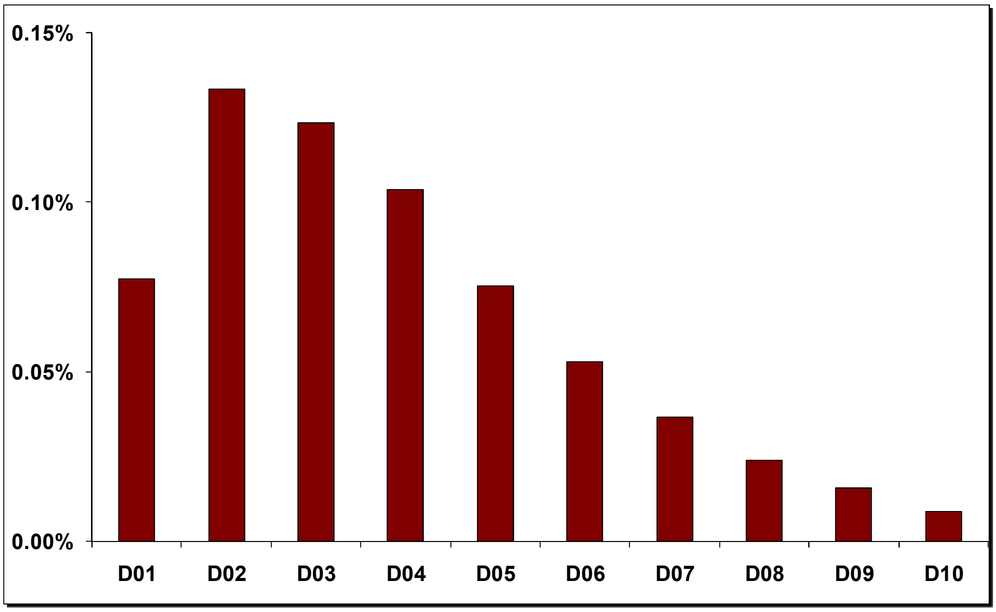
For low income earners, the tax treatment of contributions is also shaped by the co-contribution scheme. AIST has conducted research into take-up of the co-contribution which indicates, as might be expected, that many who are eligible to participate do not have the disposable income to do so (AIST, 2008). Nonetheless, not for profit funds report reasonable take-up of the co-contribution and reasonable response rates to direct marketing campaigns encouraging its take-up. This suggests that take-up will improve over time as awareness increases, even without policy change.

ISN/AIST also considered making changes to the co-contribution scheme to enable greater participation among low income earners.

1. A grant of $500, plus a matching Government co-contribution of $1:$1 to maximum of $1,000. The total benefit is unchanged at $1,500; the $500 grant plus the $1,000 co-contribution sum. The taper rate would operate in the same manner as it does currently.
2. Increase of the top income threshold to $75,000 to enable greater participation by middle income earners.

The initiatives have small estimated aggregate impacts – 1.2% and 0.5% respectively – however, both initiatives have (similar) redistributive effects, reflected in the percentage benefit shown in Figure 3.3.3, below.

Figure 3.3.3 Percentage impact of extending the top co-contribution threshold to $75,000 across lifetime income distribution



Our preferred option from both sets is option 3 of the first list (it has been incorporated in our combined policy simulations), as it also incorporates elements of the intentions around the co-contribution options.

Recommendation 3.3.1: Government address the lack of concessionality of the superannuation contribution tax for low income earners as a matter of urgency.

3.4 Compulsory superannuation

3.4.1 Compulsory superannuation contribution levels and savings offsets

ISN/AIST modelled an increase in compulsory contributions from the current 9% to 12% and 15%. The impact such changes have on adequacy is sensitive to the degree to which the increase in compulsory savings is offset by a decrease in other savings. Similarly, the distributional impact on adequacy of compulsory savings is dependent on the rate of this offset across the income spectrum.

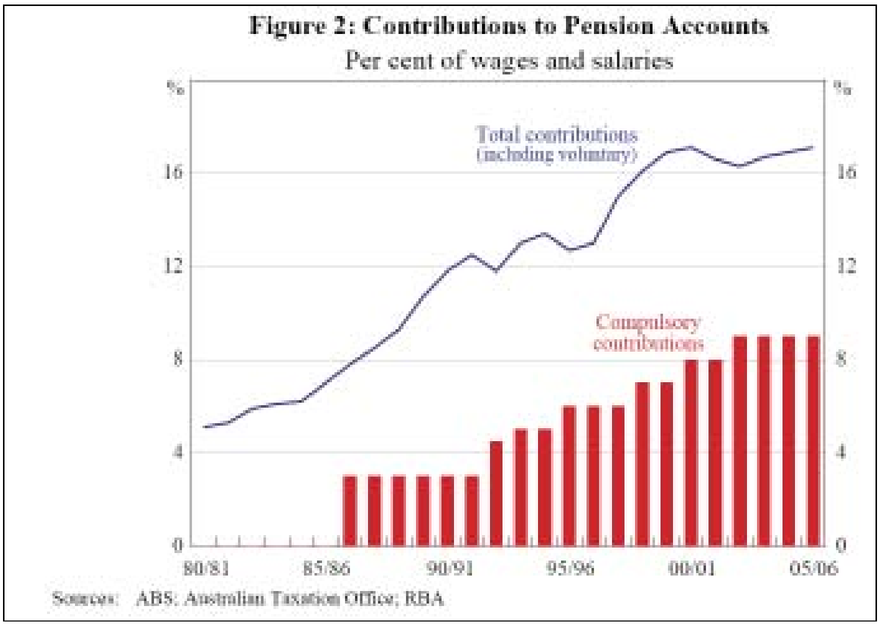
The issue of savings offsets is subject to much debate. The traditional view is informed by the lifecycle theory of saving, which, in its purest form, assumes people are well-informed and rational, and consequently save (and borrow) to smooth consumption over their lifetime. For people who behave in this manner, more compulsory saving would be fully offset by reduced voluntary saving because less of the latter is required to reach their pre-determined saving target.

However, there is now increased recognition among economists that levels of financial literacy, understanding and rationality vary widely among consumers, as do access to financial markets and financial products. These can all influence savings behaviour, and make the impact of compulsory savings unclear. For example, it is plausible that higher awareness of the importance of retirement savings resulting from an increase in compulsory saving can lead to an increased preference for voluntary saving. This might reduce the level of offset, even passed zero, resulting in an increase in other savings. In support of this idea, industry super funds report that participation in the co-contribution scheme, on average, leads to an increase in voluntary contributions over and above that required to optimise scheme participation.

A Reserve Bank of Australia (RBA) working paper has used macro-economic techniques – looking at aggregate savings patterns before and after compulsory super – to arrive at an estimated aggregate offset of 38% (Kohler and Connolly, 2004). One of the authors has revisited the issue of offsets subsequently, and come up with a lower range of values – from 10-30% – by comparing the savings habits of workers inside and outside of the compulsory super system (Connolly, 2007). This is the best available research on this question in Australia, assuming that the analysis controlled for differences in income between the test and control groups. Connolly further observes that voluntary contributions over time appear independent of increasing SG contributions (see Figure 3.4.1, below).

It is very likely that average offset levels hide important differences across the population. It is plausible that superannuation fund members on higher incomes with higher assets will be more likely to be target savers (being better informed or advised and having better access to a variety of financial products) than low income, low asset members, and therefore be more likely to offset additional compulsory with less voluntary savings.

Figure 3.4.1 Voluntary and compulsory contributions to superannuation accounts over time



Source: Connolly, 2007: 4 (reproduced)

Internal analysis by two major not for profit funds provide some evidence that voluntary savings levels vary by age, gender and income, but, interestingly, are not obviously sensitive to the level of standard workplace contributions – whether higher or lower than the standard 9%. Modelling income-sensitive offsets was beyond the scope of the preparation of this submission, but will be considered in the future research by ISN/AIST on this issue.

Access Economics' modelling include scenarios with no behavioural change (i.e. zero offset) and a 38% offset. A scenario with a 10% offset (the bottom of Connolly's estimated range) was included in the combined policy simulation.

Without behavioural change, an increase in the SG to 12% and 15% is estimated to provide an increase against the modest benchmark on average of 8.1% and 16.3% respectively by 2041. With behavioural change (a 38% offset), the average estimated improvements against the modest benchmark are 2.8% and 5.5% respectively. The great difference in impact between these two scenarios highlights the need for more conclusive research on savings offsets.

Estimation of the distribution of these impacts on adequacy is similarly vague. Benefits are proportional to assets (and therefore correlated with income) under the assumption that offsets are even across the income distribution. However, as mentioned, we find it more plausible that offsets vary with income. Further research and modelling is required to effectively estimate the distributional impact of further increases in compulsory contributions. (See section 3 of the attached report for more analysis of potential increases in compulsory contributions.)

3.4.2 Maternity linked contribution

Women have lower participation rates, more part-time work, more broken periods of work, and lower average wages than men. The cumulative impact of these factors results in women having lower superannuation savings than men. This disadvantage is compounded by the fact that their average retirement savings needs are greater than those of men on average because of their longer life expectancy.

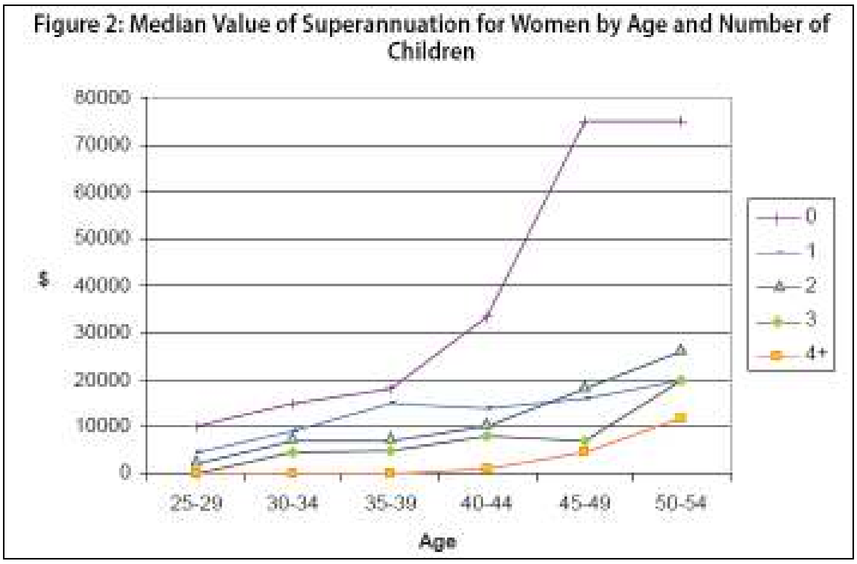
Childbirth and child rearing responsibilities constitute one of the primary reasons for breaks in workforce participation for women.

Research by Parr et al (2007) shows that the number of children is a strong determinant of superannuation balances, with women who have more children having lower superannuation balances than women with less children or no children (see Figure 3.4.2, below). All else equal, this results in overall lower retirement savings for families with children.

Given the relationship between current fertility levels and future dependency ratios, it appears inequitable that women who take time out of the workforce to have children have poorer retirement outcomes. The prospect of diminished capacity to accumulate retirement savings acts as a disincentive for couples having children.

To examine ways to rectify this imbalance, ISN/AIST modelled the effect of introducing a maternity linked superannuation bonus contribution for women. This was modelled as a $1500 contribution paid to women's superannuation accounts when they have a child.

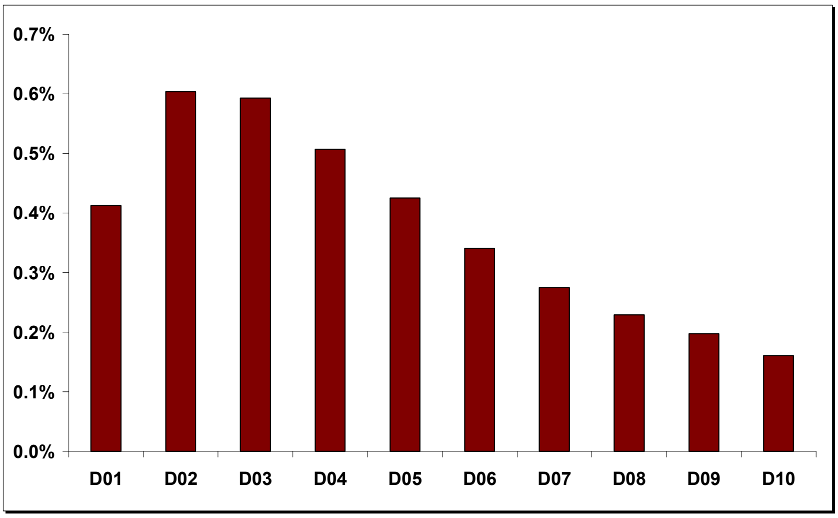
Figure 3.4.2 Superannuation assets for women by age and number of children



Source: Parr et al, 2007: 12 (reproduced)

This policy would be quite easy to administer and implement. It could integrate with current taxation system infrastructure which assesses eligibility for the Maternity Payment, and payments could be made direct to superannuation accounts as occurs with the co-contribution. We would expect the contribution would be subject to the same means-testing provisions that apply to the Maternity Payment.

Figure 3.4.3 Percentage impact on adequacy of $1,500 super 'baby-bonus' across lifetime income distribution



This initiative would require that a superannuation account be created for mothers who have not previously been in the superannuation system. By default, if no choice was made, this might be to a low cost fund such as AusFund. While this would carry a small administrative cost it would have the advantage of raising awareness around retirement saving.[5]

This policy could results in improved adequacy outcomes for all lifetime income deciles, with our modelling showing deciles 2, 3 and 4 receiving the most benefits (see Figure 3.4.3 above). The initiative results in total superannuation assets being an estimated 2.6% higher in 2040-41 than what they otherwise would be. The targeted nature of this measure means that superannuation assets of beneficiaries are likely to increase by a percentage much greater than 2.6%, which is averaged across the whole population. The annual cost of this measure is estimated to be 0.1% of GDP in 2041.

Recommendation 3.4.2: That a $1500 superannuation baby bonus contribution be paid to a woman's superannuation account when they have a child.

3.4.3 $450 per month exemption

Under current Superannuation Guarantee (SG) arrangements employers do not have to make contributions for an employee who earns less than $450, before tax, in a calendar month.

This exemption was introduced to minimise the administrative cost for employers of remitting small superannuation contributions, and the cost to superannuation funds and members of having multiple, low balance accounts. We believe this exemption is appropriate only in a minority of cases, including casual employment.

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[5] Evidence from the US suggests that being given a retirement savings account, in itself provides a stimulus for people to save voluntarily for retirement (Madrian and Shea, 2001, cited in Connolly, 2007: 4).

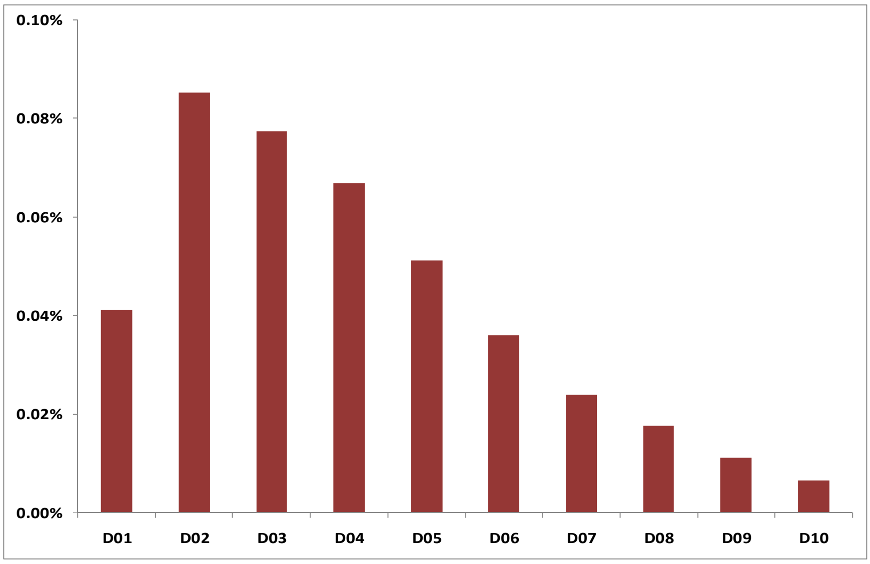
Low income workers and those who work only periodically have as much need as other workers to accumulate retirement savings. In industries where working for several employers is common, such as retail, hospitality and nursing, many employees are excluded from the SG system by the fact that the $450 threshold applies only to a single employer, and not on a combined income level. For employers, the exemption creates a distortion in incentives for employers, because it can involve a comparatively high cost of employment of workers marginally above the threshold.

In the choice of fund environment, the administrative rationale for retaining this exemption is less compelling, as workers are able to nominate the super fund of their choice. Many workers who earn less than $450 per month for a given period will earn greater than the threshold in other periods and so will already be a superannuation account holder.

Modelling by Access Economics shows that the aggregate impact of this measure is small, resulting in total superannuation assets 2010-41 being 0.326% higher than if no policy change was implemented. However, industry experience suggests it is likely to be quite concentrated, resulting in significant improvements for those individual workers who are most disadvantaged by the current exemption. The modelling supports this intuition, with distributional analysis estimating the adequacy benefit is concentrated among low income earners.

The cost to government of removing the exemption would be minimal (0.003% of GDP in 2041) flowing from a very slight increase in aggregate contributions. The costs to employers and compliance costs have not been modelled.

Figure 3.4.4 Percentage impact on adequacy of progressive contributions tax (capped at 15%) across lifetime income distribution



Recommendation 3.4.3: ISN/AIST recommends the $450 per month exemption be reviewed.

3.4.4 Self employed exemption

Currently almost 1.3 million Australian workers are 'self-employed' – working as owner managers of unincorporated enterprises – consisting of 310,000 who work on contract and 956,900 who work without a contract (ABS, 2009: 27). Workers who are self-employed are currently exempt from the requirement to make SG contributions on their own behalf.

This exemption was implemented partially as a response to the different income, asset accumulation and working patterns which often occur amongst the self-employed. The exemption is also pragmatic in that monitoring the compliance of the self-employed with compulsory superannuation obligations would be quite difficult. Finally, the exemption reflects the view that many self-employed people would prefer to retain discretion over the timing and use of their savings.

This exemption poses two significant issues for retirement incomes adequacy.

The first issue concerns whether a worker is 'legitimately' self-employed or is engaged under an arrangement that is essentially an employment relationship but which does not have superannuation contributions paid on their behalf. A distinction is sometimes made between dependent and independent contractors. The definition of 'self-employed' for SG purposes depends on the legal structure of the business, and the nature of contractual relationships between the business and clients.

The ATO has established that if a contract between a client and a self-employed contractor is solely or principally for the contractor's labour, then the relationship is considered an employment relationship. In this case the client is obliged to make superannuation guarantee payments for the contractor, even though they may quote their own ABN. This ruling was implemented to prevent employers engaging workers as self-employed contractors in order to avoid superannuation guarantee obligations. The employment of contractors principally for labour is concentrated in certain industries, such as construction and commercial cleaning.

The ATO has reported that non-compliance with superannuation obligations is more prevalent in some sectors than in others. In particular they identify that employers in the hairdressing and beauty, engineering design and consulting, and building and industrial cleaning are at a higher risk of not meeting their superannuation obligations. Many of these industries also (quite legitimately) employ labour via contract arrangements with self-employed contractors.

Non profit funds in relevant industries, including CBUS which has many members in the construction industry, report that there is considerable non-compliance in payment of SG to dependent contractors despite the legal obligation. In many instances this non-compliance is not reported to the ATO and so is unrecorded as the ATO generally only investigates compliance following a complaint. Due to resource constraints the ATO is also prevented from investigating the complaints it does receive in a timely manner.

Recommendation 3.4.4: Self-employed (dependent contractors) – greater resources be given to the ATO enforce current law in relation to contracts for labour, including giving the ATO capacity to assess compliance in the absence of a complaint.

The second issue related to the self-employed exemption applies to those who are operating genuine, viable businesses in an unincorporated structure. Anecdotal reports from several not for profit super funds suggest that unincorporated owner operators, notably in the retail, building trades and transport industries often do not plan for retirement in a timely or diversified manner. A common but naïve expectation is that owner operators, by continuing to reinvest in their businesses, might be generating a saleable asset to support their retirement in lieu of contributions to the superannuation system, or other diversified financial investment. Overvaluation of internal assets is common. Finally, the risk of business failure is heightened if the business also represents the principal form of retirement savings.

Analysis of the SEARS data set suggests voluntary retirement saving by the self-employed does increase (as with other workers) as they approach retirement. However, while there is provision for small business owners to roll up to $500,000 from the sale of business assets into super, in practice this provision would be applicable to only a small minority of the self-employed. Rebates from voluntary super contributions (equal to the difference between the income tax rate are currently returned to the taxpayer in cash. We suggest these be paid into the superannuation fund, as is the practice in the UK.

ISN/AIST would argue that the needs of self-employed workers to prepare for retirement are no different to those of other workers. We recognise that there may be practical difficulties in the introduction of compulsory super for the self-employed, such as adjustment for varied cashflow (including years with negative income) and difficulties separating business and personal income and assets. Our view is, however, that neither of these issues are insurmountable, and the fundamental similarity of the need between the self-employed and other workers, demands equal treatment in the retirement income system.

Recommendation 3.4.5: Self-employed (independent contractors) – the Government review the current exemption in relation to the self-employed with a particular view to the risks of under-saving for retirement due to a reliance on reinvestment in one's own business.

4 Summary of impacts and costs

4.1 Individual policies evaluated

The following four charts summarise the modelling output of the main policy options considered. The first two charts show the dollar impact (in 2009 dollars) on retirement income in 2041 for the large aggregate impacts (Figure 4.1.1a) and smaller more targeted impacts (Figure 4.1.1b) across the lifetime income distribution.

The second two charts show the percentage impact (in 2009 dollars) on retirement income in 2041 for the large aggregate impacts (Figure 4.2.1a) and smaller more targeted impacts (Figure 4.2.1b) across the lifetime income distribution.

Figure 4.1.1a Dollar impact in 2041 on retirement income of policies across the lifetime earnings distribution - with large aggregate impacts (2009 dollars)

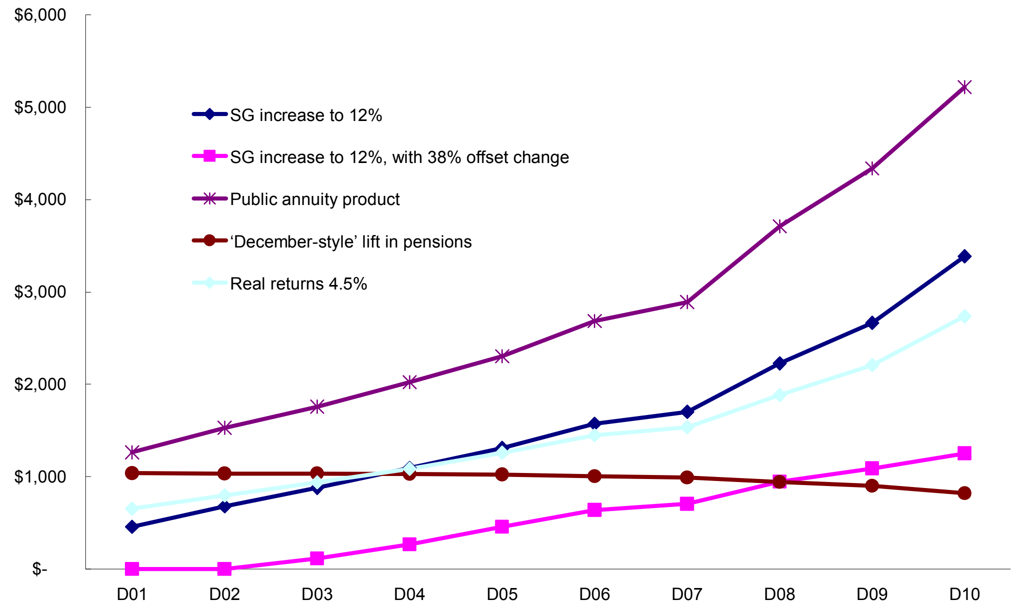


Figure 4.1.1b Dollar impact in 2041 on retirement income of policies across the lifetime earnings distribution - with targeted impacts (2009 dollars)

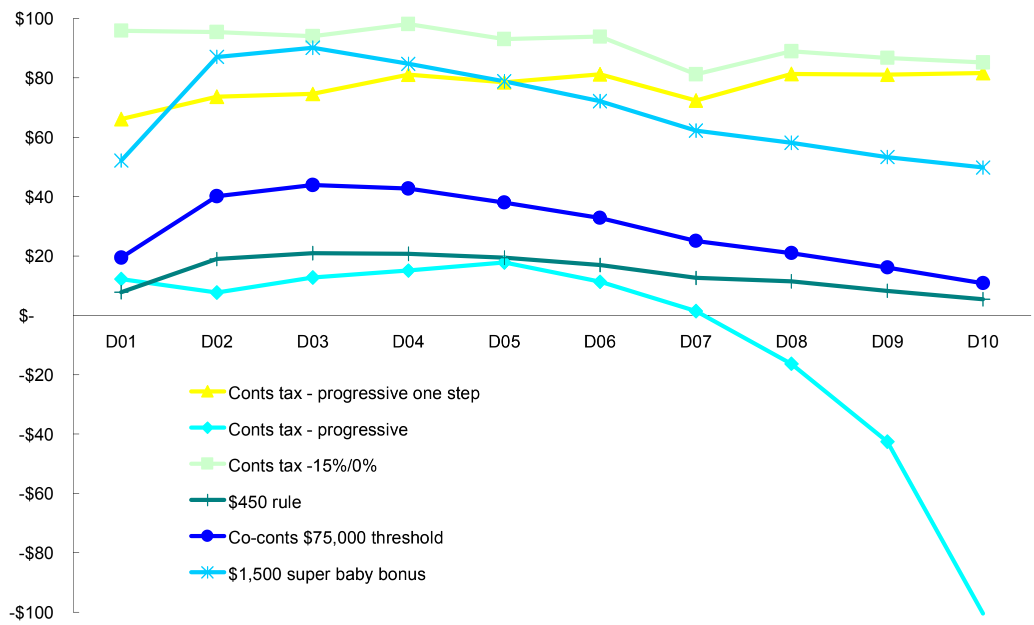


Figure 4.1.2a Percentage impact in 2041 on retirement income of policies across the lifetime earnings distribution - with large aggregate impacts (2009 dollars)

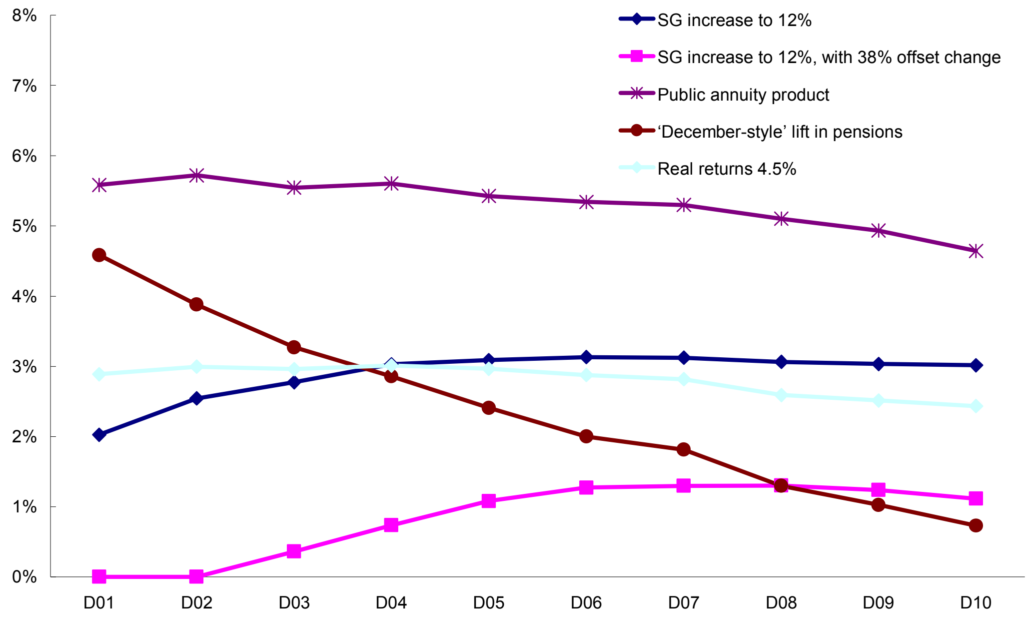
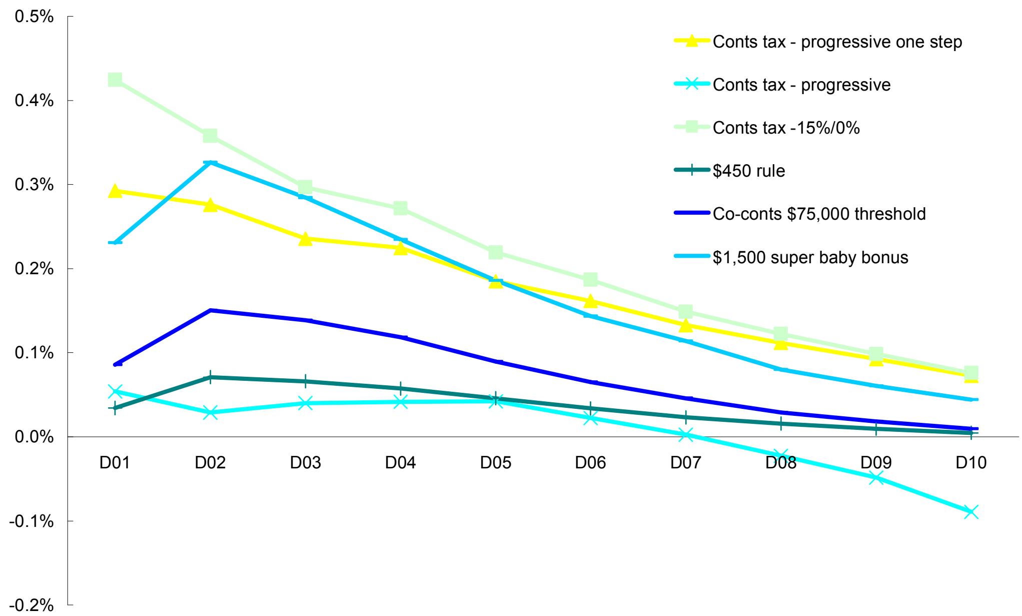


Figure 4.1.2b Percentage impact in 2041 on retirement income of policies across the lifetime earnings distribution - with targeted impacts (2009 dollars)



4.2 Combined impact of recommended policies

The final two charts show the modelled impact on adequacy of a combination of policy suggestions, in dollar and percentage terms. The policies in the first mix are: (i) measures to improve net investment performance by 0.75%, (ii) a 'December-style' life in pensions, (iii) a two step contributions tax, (iv) a public annuity product, (v) a $1,500 super baby bonus and (vi) removing the $450 SG exemption. The second mix includes all those in the first mix, plus a 1% increase in compulsory contributions with a voluntary 10% offset.

Figure 4.2.1 Dollar impact in 2041 on retirement income of combined recommended policies (2009 dollars)

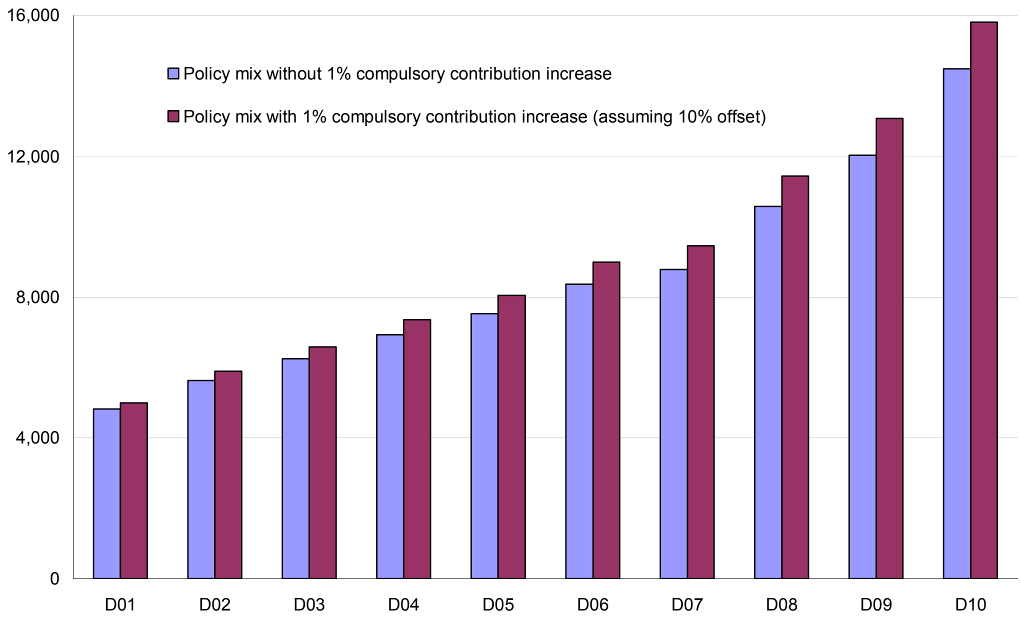
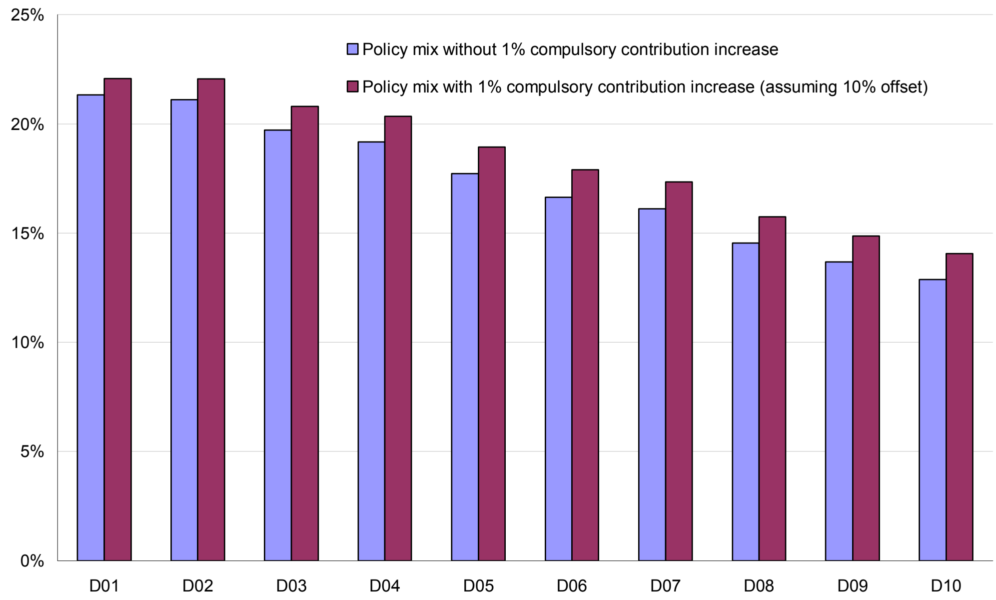


Figure 4.2.2 Percentage impact in 2041 on retirement income of combined recommended policies



5 Sustainability

Australia's multi-pillar retirement income system compares favourably with other OECD nations on key measures of fiscal sustainability. Nevertheless, the pressure of population ageing continues to mount. The sustainability of any proposed changes to the system also needs to be considered. ISN/AIST have addressed these considerations by commissioning long-term macroeconomic modelling to assess the impact of various policy proposals, as discussed in earlier sections of this submission and outlined in Appendix B.

ISN/AIST consider the following issues to be central to discussion of the sustainability of the retirement incomes policy mix.

5.1 The efficiency of the superannuation system

Mandating private contributions to retirement incomes through the SG and incentives for voluntary additional superannuation savings has a strongly positive impact on overall sustainability. Higher levels of superannuation and voluntary savings will, all other things equal, progressively reduce the demands on the age pension, especially the proportion of full age pensioners, as the system matures.

However, as we have emphasised in section 3.1, the benefits gained from increased compulsory and voluntary super savings are a function not just of the level of contributions achieved, but the efficiency of the system which manages those accumulated savings. Small variations in net returns have significant impacts on the effectiveness of superannuation as a contribution to adequacy and as an offset for age pension costs.

Given that these benefits can be obtained at virtually no cost to Government, we strongly recommend they be pursued as a first priority.

5.2 Post retirement tax treatment

The concessional tax treatment of superannuation savings are the largest tax expenditure. The equity and sustainability implications of pursuing further superannuation concessions instead of alternative proposals must not be ignored.

While the recent "Better Super" reforms have been excluded from issues under consideration by the panel, some of the measures included in this package are expensive, with the benefits being received mainly by individuals at the higher end of the income scale.

The transition to retirement provisions have been most beneficial for those over 60 years with large super account balances and higher incomes. The extended taper for the aged pension means also reducing the money available for those most in need of Government support. Analysis by CPA Australia (Morrison and Kelly, 2008) and ASFA (Clare, 2007) has indicated that these policy changes overwhelmingly benefited higher income households. It is unclear whether these measures, including making all super tax free for those over 60, are equitable or fiscally sustainable in the long run.

5.3 The balance between the first, second and third pillars

The level of contributions to superannuation and voluntary savings (i.e. pillar two and three of the retirement incomes system) (is pillar 2 super – including voluntary saving into super and pillar 3 voluntary outside of super or is pillar 2 the SG? And pillar 3 voluntary both in super and outside of super?) is often raised as a key variable influencing the sustainability of the system overall. While increasing contributions can be expected to increase super accumulations and therefore decrease future age pension expenditure, the effectiveness of this as a policy lever is not limitless.

Increased super contributions come at the expense of current consumption and other savings, and for low income households trading off additional current consumption for additional future retirement income and other forms of saving – including for a house – is not necessarily optimal. The trade offs depend in part on the starting level of consumption, lumpiness of short-term and medium term expenditure (for which non-retirement saving is very important) and also on expectations on future income and expenses and capacity to save.

The concessional tax treatment of superannuation savings carries opportunity cost in terms of its fiscal impact. The equity and sustainability implications of pursuing further superannuation concessions instead of alternative proposals should not be ignored. The recent "Better Super" reforms are expensive, with the benefits being received mainly by individuals at the higher end of the income scale.

The transition to retirement provisions have been most beneficial for those over 60 years with large super account balances and higher incomes. The extended taper for the aged pension means also reducing the money available for those most in need of Government support. Analysis by CPA Australia (Morrison and Kelly, 2008) has indicated that policy changes overwhelmingly benefited higher income households.

Davidson and Guest (2007) have undertaken projections of how much benefits tax would have been as a % of GDP, to give an indication of the revenue foregone. Depending on the contribution rate scenario, their estimate of the cost of earnings tax foregone is between triple and quadruple the base case at 1.8% to 2.25% of GDP by 2040. For benefits tax, the estimate is for a tripling of the tax expenditures (see Table 5.3.1). It is unclear whether these measures are equitable or fiscally sustainable in the long run.

Table 5.3.1 Projections of superannuation taxes

Table 3: Projections of Superannuation Taxes

	Base Case					
	Contributions tax		*Earnings tax*		*Benefits tax*	
	Our' calcs.	*IAA(2006)*	*Our' calcs.*	*IAA(2006)*	*Our' calcs.*	*IAA(2006)*
			(per cent of GDP)			
2004	0.50	0.50	0.20	0.20	0.05	0.05
2025	0.45	0.51	0.43	0.45	0.21	0.19
2040	0.42	0.49	0.63	0.59	0.33	0.33

	Higher contribution rates: Scenario 1		
	Contributions tax	*Earnings tax*	*Benefits tax*
		(per cent of GDP)	
2025	2.07	0.85	0.39
2040	1.94	1.81	0.81

	Higher contribution rates: Scenario 2		
	Contributions tax	*Earnings tax*	*Benefits tax*
		(per cent of GDP)	
2025	2.75	1.00	0.48
2040	2.58	2.25	1.03

Source: Davidson and Guest, 2007: 12 (reproduced)

5.4 Risk sharing between the state and the individual

The allocation of risk between the state and the individual has important impacts on the costs, equity and effectiveness of the retirement income system. The main risks which are relevant to this inquiry are investment risk, longevity and potentially spiralling healthcare costs.

The success of superannuation and other private savings in offsetting age pension expenditures is dependent on the ongoing performance of investment markets, in particular equity markets. The GFC provides a salient lesson that investment returns do not necessarily follow a steady upward progression, and so assessments of savings adequacy are contingent on investment performance. While the current event is unusual, it is not without precedent, and its severity and duration remain uncertain. Because households have a finite working life and investment horizon, their ability to recover from events such as the current crisis is limited. The age pension fulfils an important safety net role in this regard. One lesson for Government is that private investment savings will not necessarily insure against future age pension expenditure.

The age pension also serves an important function in helping individuals deal with longevity risk. Given the very limited range of products provided by the private sector to manage longevity, the default position for retirees is to manage their asset draw-downs as best they can, in the knowledge that should they outlive their assets the age pension will provide a safety net. There is scope for Government to enable retirees to manage longevity risk more effectively, and cheaply. Our proposal outlined in section 3.2.2 is one way Government can assist individuals to manage longevity more effectively, without detracting from sustainability.

Finally, as is recognised in the second Inter-Generational Report (Treasury, 2007) health care costs represent a large expenditure item for retirees. Health care expenditure increases with age and so rising health care costs impact retirees disproportionately.

5.5 Age pension eligibility parameters

Age pension expenditures have the potential to be a significant limiting factor in achieving system sustainability.

Given the significant ancillary benefits available via the Health Care Card, many retirees seek to structure their affairs to gain at least a part pension. While the maturation of the superannuation system will reduce the proportion of retirees fully reliant on the age pension, the majority of retirees are still expected to receive at least a part pension in 2040-41.

The means test and the taper rate, as well as the overall pension level, are thus important issues in determining whether future Governments will be able to sustain age pension expenditure. We trust the review is cognisant of the tensions between ensuring the public age pension continues to provide an effective safety net and not undermining public finances nor providing strong disincentives to save.

5.6 Fertility

Fertility, and to a lesser extent immigration, can contribute to improving the sustainability of policy measures such as the age pension by reversing or halting the predicted deterioration in dependency ratios.

While a comprehensive examination of these issues is beyond the scope of our submission, we have drawn attention to the anomaly which exists in relation to fertility and superannuation. Namely the fact that women's reduction in workforce participation due to children results in poorer retirement income outcomes for them, though it results in improved outcomes for the population overall. We have proposed a maternity linked superannuation bonus contribution as a means to at least partially redress this anomaly; we encourage the review panel to be alert other situations where such anomalies or misaligned incentives exist and so constrain sustainability.

6 Concluding remarks – an ongoing policy process

The retirement income system is a part of the wider tax-transfer system and is formed not only by the elements which deal explicitly with retirement income, but by the interactions of those elements with the wider system.

In the development of this submission, it has been necessary for ISN/AIST to assume that all relevant parts of the wider tax system are unchanged. The assumption of 'no policy change' is particularly unrealistic while a major review of the tax structure is taking place. The analysis and recommendations may need reconsideration in light of large scale tax reform flowing from the AFTS inquiry.

The modelling used to support this submission has highlighted areas that are very important for determining the impacts of policy changes but are as yet are not well understood. These include the behavioural responses to certain incentives and whether the sensitivity of those responses differs according to an individual's characteristics, including financial literacy, household income, age and gender. The understanding of how people manage their finances as they move into retirement is another area that needs detailed work. Both ISN and AIST conduct and commission research and consider this submission a part of their ongoing contribution to public debate to improve retirement income policy.

In relation to the crucial policy question of the appropriate level of superannuation contributions, ISN/AIST believe that in order to move to a system which provides comfortable retirement income based on increased self-provision there is a need for increased superannuation savings, particularly for those who have not experienced the full 9% contribution for much of their working life. While further modelling needs to be undertaken, it is our view that contributions of up to 12% are necessary.

However, we recognise that there is not consensus among unions and employer groups about how additional contributions would be paid for. Further, while there is a necessity for those currently in the workforce to make higher contributions now, it is also acknowledged that in the immediate term it is unlikely that a government would seek to impose additional costs on employers or compel employees to allocate an additional one per cent of their wages to savings rather than consumption.

This report recommends a number of low cost measures that ensure greater equity in the taxation of superannuation and in improving the efficiency and competitiveness of the superannuation system. It also recommends the Government increase the base level of the age pension and carefully review the tapering of the pension to ensure the system remains targeted and sustainable. If these measures were introduced quickly, then the immediate need to increase contributions is reduced.

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Appendix A. Retirement Income Consultation Paper – Q & A

	The retirement income system
Q1.1	**In considering the future of Australia's retirement income system, which objectives are relevant in setting retirement income policy? Does the current system of the Age Pension and compulsory and voluntary savings meet these objectives? If not, how should the system be changed to meet these objectives?**
	The overall purpose of Australia's retirement income system is to enable all Australians to have a secure and dignified retirement. The retirement incomes system, taken as a whole, should meeting the following objectives: ▪ Adequate – ensure retirees have sufficient income to enable them to meet their consumption needs. ▪ Sustainable – in light of projected workforce participation, population, economic growth etc ▪ Equitable – both between individuals within a given age cohort but also between generations ▪ Simple and efficient To the extent that the definition of adequacy influences public policy a collective view of adequacy is called for. ISN and AIST support the adoption of a stated benchmark or objective to measure adequacy. We suggest this benchmark be in the form of an income range, bounded by the Modest and Comfortable budget standards published by ASFA based on research conducted by the Social Policy Research Centre. Refer to Section 2 for a more detailed exposition of our position on an appropriate adequacy benchmark ISN and AIST strongly believe the multi-pillar structure of the Australian retirement income system, which shares risks and responsibility through a combination of public provision and incentivised self-provision, is the most appropriate framework to meet Australia's retirement income policy objectives. While we believe the current framework is appropriate, this submission proposes several potential policy changes, designed to enhance and improve the capacity of the retirement incomes system to meet the objectives outlined above. These policies are outlined in further detail in Sections 3 and 4 of this submission.

	A broad and adequate retirement income system
Q2.1	**As the SG system matures, it will become a greater part of an employee's retirement income. What are the implications for individuals partially or fully excluded from the mature SG system (the self-employed, individuals with broken work patterns such as carers, women and migrants), and how can the retirement income system best accommodate these groups?**
	ISN and AIST believe additional measures need to be adopted to supplement the SG system for workers who, for various reasons, will not benefit fully from the mature SG system. Addressing these "adequacy gaps" should be a policy priority In particular we advocate the implementation of the following measures: ▪ Government address the lack of concessionality of the superannuation contribution tax for low income earners ▪ That a $1500 superannuation baby bonus contribution be paid to a woman's superannuation account when they have a child. ▪ That the $450 per month exemption from the SG be removed, with the sole exception of one-off casual engagements [wording?]. ▪ That greater resources be given to the ATO enforce current law in relation to contracts for labour, including giving the ATO capacity to assess compliance in the absence of a complaint. ▪ That the exemption from compulsory superannuation contributions for the self-employed be reviewed These measures are outlined in greater detail in Sections 3 & 4 of this submission. While these measures will greatly assist in improving retirement incomes adequacy for key groups, the role of the age pension serves as a safety net, especially for low income earners, must also be recognised. In order to strengthen the capacity of the age pension to fulfil this function, ISN and AIST recommend that the government: ▪ Increase the base rate of the pension by at least the level of the one-off payment in December 2008 ($1,400 for singles and XX for couples). ▪ Offer lifetime annuities utilising the administrative structure of the public pension, the government actuary and possibly the investment expertise of the Future Fund in competition with private sector

	providers. ▪ Manage the powerful incentives created by the means-testing of the pension, including high effective marginal tax rates for those within taper ranges. ▪ Review the level of the bonus received for deferring receipt of the pension and the treatment of income from personal exertion under the pension income test. Again, refer to Sections 3 & 4 of this submission for further detail.
Q2.2	**Noting that the adequacy of the Age Pension is being considered by the Pension Review, what is an appropriate concept of adequacy for the retirement income system? Should it be to ensure there is a minimum level of income in retirement, to replace a proportion of income earned prior to retirement, or some other alternative?**
	ISN and AIST support the adoption of a stated benchmark or objective to measure adequacy. We do not support the adoption of a replacement rate measurement of adequacy, as such measures imply very low retirement incomes are adequate for low income workers, while relatively high retirement income are inadequate for high income earners. We believe the most appropriate approach is to define an adequate income range, based on research such as that utilised in formulating the Westpac-ASFA Retirement Standard. Defining adequacy as a range puts a floor (and a ceiling) on government responsibility for retirement incomes. For equity and efficiency reasons we believe that there should be an upper income ceiling which is supported by a concessionally taxed retirement income system. It is not efficient for the system to provide generous concessions to people who have the capacity and inclination to save for their retirement without those concessions. Section 2 outlines in further detail our approach to defining adequacy. We would stress that achieving adequacy depends not just on the contributions made to the superannuation system, but also the efficiency with which those funds are managed. In particular small differences in net returns over the accumulation and drawdown phase can have a significant impact on retirement income achieved. This issue is addressed in depth in Section 3.1.
Q2.3	**What should the role of the government be in assisting individuals to meet their retirement income expectations in relation to the support provided by the Age Pension, the level of compulsory savings and incentives to make**

additional savings? Should the role of government change as an individual's income increases over their working life?

One of the core strengths of the three pillar system, which ISN and AIST strongly support, is the joint and overlapping responsibility between the individual and the government for achieving adequate retirement income:

- responsibly for the 1st pillar safety net rests with government, which bears the associated funding, inflation and longevity risks;
- responsibility for the 2nd pillar is shared as compulsion and tax concessionality are the product of government regulation while contributions are connected to an individual's earned income and it is individual account holders (at least in accumulation accounts) that make investment choices and bear associated investment risks; and
- the 3rd pillar is left to the individual's discretion, although with the support and encouragement of government through concessional tax treatment of voluntary super.

ISN and AIST believe this allocation of responsibility between individuals and government is broadly appropriate, however the following policy enhancements would address areas where the current system falls short:

- The role of the age pension as a safety net be strengthened by increasing the base rate of the pension by at least the level of the one-off payment in December 2008 ($1,400 for singles and XX for couples).
- The ability of retirees to manage longevity risk be enhanced by the government offering lifetime annuities utilising the administrative structure of the public pension, the government actuary and possibly the investment expertise of the Future Fund in competition with private sector providers.
- The powerful incentives created by the means-testing of the pension, including high effective marginal tax rates for those within taper ranges, be reviewed.
- The level of the bonus received for deferring receipt of the pension and the treatment of income from personal exertion under the pension income test. be reviewed
- The lack of concessionality of the superannuation contribution tax for low income earners be addressed
- Measures to improve the retirement incomes adequacy of key groups who are currently fully or partially excluded from the SG be implemented, including:
    - $1500 superannuation baby bonus contribution paid to a woman's

	superannuation account when they have a child. ○ Removal of the $450 per month exemption from the SG ○ Review of the exemption from compulsory superannuation contributions for the self-employed. These policy measures are outlined in further detail in Sections 3 & 4 of the submission.
	An acceptable retirement income system
Q3.1	**Do the settings of the retirement income system, such as the level of SG and access to concessions, adequately consider the needs and preferences of individuals both before and after retirement?**
	ISN/AIST believe that in order to move to a system which provides comfortable retirement income based on increased self-provision there is a need for increased superannuation savings, particularly for those who have not experienced the full 9% contribution for much of their working life. While further modelling needs to be undertaken, it is our view that contributions of up to 12% are necessary. However, we recognise that there is not consensus among unions and employer groups about how additional contributions would be paid for. Further, while there is a necessity for those currently in the workforce to make higher contributions now, it is also acknowledged that in the immediate term it is unlikely that a government would seek to impose additional costs on employers or compel employees to allocate an additional one per cent of their wages to savings rather than consumption. This report recommends a number of low cost measures that ensure greater equity in the taxation of superannuation and in improving the efficiency and competitiveness of the superannuation system. It also recommends the Government increase the base level of the age pension and carefully review the tapering of the pension to ensure the system remains targeted and sustainable. If these measures were introduced quickly, then the immediate need to increase contributions is reduced. The level of compulsory contributions are discussed in Section 3.4.1.
Q3.2	**Is the current level of superannuation income tax concessions appropriate and sustainable into the future? Are the current concessions properly targeted, and if not, how should they be reformed?**

	ISN and AIST believe the lack of tax concessionality within the super system for low income earners must be addressed by the Government. This issue is addressed in Section 3.3. While the recent "Better Super" reforms have been excluded from issues under consideration by the panel, some of the measures included in this package are expensive, with the benefits being received mainly by individuals at the higher end of the income scale. This matter is addressed in depth in Section 5.2
	A robust retirement income system
Q4.1	**At what age should an individual be able to access their superannuation and at what age should they become eligible for the Age Pension?**
	ISN and AIST believe the current preservation and access rules for superannuation and the age pension are appropriate and do not need to be changed. We encourage the review panel to consider options to increase the flexibility around retirement age. These issues are discussed in Section 3.2.
Q4.2	**What is the role of individuals in dealing with investment and longevity risk in accumulating and drawing down their retirement income? Do financial markets provide the means to deal with these risks? If not, is there a role for government to address these shortcomings?**
	The allocation of risk between the state and the individual has important impacts on the costs, equity and effectiveness of the retirement income system. Section 5.3 discusses this allocation in detail. Given the very limited range of products provided by the private sector to manage longevity, the default position for retirees is to manage their asset draw-downs as best they can, in the knowledge that should they outlive their assets the age pension will provide a safety net. There is scope for government to enable retirees to manage longevity risk more effectively, and cheaply. To this end ISN and AIST recommend that the government offer lifetime annuities utilising the administrative structure of the public pension, the government actuary and possibly the investment expertise of the Future Fund in competition with private sector providers. This proposal is explained and examined in Section 3.2.2 of this submission.
	A simple and approachable retirement income system
Q5.1	**In what ways does the retirement income system impose undue complexity and cost on retirees and workers? How could this complexity be reduced?**

	Financial products are complex, the age benefit eligibility rules are complex and the tax system is complex in a variety of ways that have a bearing on the retirement income system. To make optimal decisions in this context is difficult even for experts. Many people rely on rules of thumb or avoid relevant decision-making because the process of researching decisions even superficially is too daunting. The goal of simplifying the system for individuals is desirable but may not be obtainable. More proximate and achievable goals are: • To ensure effective defaults are in place, including products (including retirement saving and income products) with low fees and appropriate levels of diversification and risk profiles; and • To ensure that financial advice is not conflicted by remuneration structures based on sales commissions.
	A sustainable retirement income system
Q6.1	**The Age Pension serves two roles, as a safety-net for individuals who are unable to sufficiently save for their retirement and as an income supplement for many individuals who do save. What should be the role for the Age Pension and means testing in a future retirement income system and what impact does this have on its sustainability into the future?**
	ISN and AIST believe the age pension should continue to serve this dual role in any future retirement income system. We believe that effectiveness of the pension in fulfilling these functions can be improved by the government implementing the following measures: ▪ Increasing the base rate of the pension by at least the level of the one-off payment in December 2008 ($1,400 for singles and XX for couples). ▪ The government offer lifetime annuities utilising the administrative structure of the public pension, the government actuary and possibly the investment expertise of the Future Fund in competition with private sector providers. ▪ Managing the powerful incentives created by the means-testing of the pension, including high effective marginal tax rates for those within taper ranges. ▪ Review the level of the bonus received for deferring receipt of the pension and the treatment of income from personal exertion under the pension income test.

	Section 3.2 discusses these measures in detail, including fiscal impacts.
Q6.2	**In what ways does retirement income policy affect workforce participation decisions and what, if any, changes might reduce disincentives to work? Does the sustainability and cost of the retirement income system affect the workforce decisions of younger generations of workers?**
	Retirement incomes policy has important implications for workforce participation decisions of individuals, especially those aged 50yrs and older. Age pension eligibility age and tax free access to superannuation age serves as a benchmark for people about when is an appropriate or normal time to retire. It is unclear as yet what impact transition to retirement policy is having on retirement decisions of workers, in particular whether it is encouraging people to stay in the workforce for longer, albeit on a part time basis. The sustainability and cost of the retirement incomes system does not greatly influence the workforce decisions of younger generations in the current period, though it may have a greater impact as population aging progresses further. Younger generations of workers expect that superannuation and voluntary savings will play a greater role in funding their retirement income, however they still expect the age pension to be available as an income supplement and/or safety net. Sustainability issues are discussed in Section 5 of our submission.
Q6.3	**What impact could financial intermediation have on the effectiveness of retirement income policy?**
	Financial intermediation can have both positive and negative influences on the effectiveness of retirement incomes policy. In particular, financial intermediation can result in innovative product development and more choice and flexibility being provided to consumers. That noted, much of the need for intermediation, in particular for financial advice, is driven by the complexities of the current retirement income system. This complexity makes it difficult for consumers to understand the options available to them, and to make informed decisions. This lack of understanding places advisors and other intermediaries in a very strong position, and mean that competition has not necessarily developed in a manner which benefits consumers. The persistent underperformance in net returns of retail superannuation providers relative to other superannuation funds suggests that intermediation is currently not working in the best interests of consumers. The adequacy and efficiency impacts of system net performance are explored in Section 3.1. It also must be recognised that in some areas product choice for consumers is

	limited. In particular, very few products are provided which enable consumers to manage longevity risk. In this area there is a role for government to facilitate more directly the offering of products which enable consumers to manage longevity risk, as outlined in Section 3.2.2.

Appendix B. Modelling Report – Access Economics

See enclosed.