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Committee Secretary
Senate Standing Committee on Economics
Department of the Senate
PO Box 6100
Parliament House
CANBERRA ACT 2600

21 December 2016

Subject: **Superannuation (Objective) Bill 2016**

Dear Committee Secretary

Mercer welcomes the opportunity to comment on the above Bill dealing with the objectives for superannuation.

In principle support

Mercer strongly supports the policy decision to enshrine the primary objective and subsidiary objectives of the superannuation system in legislation, and to require new bills and regulations relating to superannuation to be accompanied by a statement of compatibility with those primary and subsidiary objectives.

Defining clear objectives is important in both the short and longer-term if the overall system is going to provide an adequate and secure retirement income for all Australians.

Objective should relate to overall retirement income and target adequacy

However, we do not agree that the primary objective of the superannuation system should be "to provide income in retirement to substitute or supplement the age pension". We believe this is too vague. Whilst recognising that supplementation and substitution of the age pension will occur, we need a clear and sensible line in the sand as to when superannuation income should move from supplementing the age pension to becoming a substitute for it. Similarly, some rationale and clarity around the rate of substitution is needed. We suggest some possible principles in the Attachment.

Furthermore, Mercer believes it is critical that the objectives are defined with a total retirement income perspective and a long-term view. To do this properly we recommend defining the

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objectives of both superannuation and the age pension simultaneously, with a key factor being the inclusion in the objective of a desired level of total income from both superannuation and the age pension.

Recommended primary objective

With this objective in mind, we recommend that the high level objective for the overall retirement income system should be:

> *to provide the vast majority of Australians[1] with an income throughout their retirement that enables their pre-retirement living standards to be maintained.*

Inclusion in the objective of a desired level of total income from superannuation and the age pension will provide a firm basis for policy decisions about the design of the age pension means tests, such as:

- at what point income from superannuation should move from supplementing the age pension to becoming a substitute; and
- the appropriate rate of substitution;

as well as informing decisions about the level of superannuation savings which should be compulsory (i.e. the SG requirements) and the level to which incentives should be provided to encourage people to voluntarily save through super.

We note that Australia would not be alone if the objective included a desired level of total income from both superannuation and the age pension – Switzerland is an example of a country which already does this (refer to Section 3 of the Attachment for details).

We have developed further the above ideas and concepts in the Attachment together with some comments about the subsidiary objectives mentioned in the Explanatory Statement to the Bill, as well as the objective included in the Swiss constitution.

Who is Mercer?

Mercer is a global consulting leader in talent, health, retirement and investments. Mercer helps clients around the world advance the health, wealth and performance of their most vital asset – their people.

[1] This objective deliberately uses the term “the vast majority of Australians” and not “all Australians” as we do not believe that the Government should support, either through superannuation tax concessions or the age pension, the maintenance of lavish or expensive lifestyles.

Mercer Australia provides customised administration, technology and total benefits outsourcing solutions to a large number of employer clients and superannuation funds (including industry funds, master trusts and employer sponsored superannuation funds). We have over $150 billion in funds under administration locally and provide services to over 2.4 million super members and 15,000 private clients. Our own master trust in Australia, the Mercer Super Trust, has around 230 participating employers, 213,000 members and $20 billion in assets under management.

Please contact me on [redacted] if you would like to discuss this submission.

Yours sincerely

[redacted]

Dr David Knox
Senior Partner

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ATTACHMENT - Objectives for Superannuation

Mercer strongly supports the proposal to enshrine the objective of the superannuation system in legislation, to serve as a guide to policy-makers, regulators, industry and the community about superannuation's fundamental purpose.

Section 1 below sets out our comments on the primary objective in the Bill. The Explanatory Statement sets out the subsidiary objectives to be set out in regulations and our comments on these objectives are set out in Section 2. Section 3 provides an example of a country where there is a legislated objective for the retirement income system which does incorporate the concept of adequacy.

Section 1 – Primary Objective

The primary superannuation objective in the Bill is:

> *To provide income in retirement to substitute or supplement the age pension*

The need for a broader perspective

For the development of sound future policies, it is important that agreement is reached on the objective of the overall retirement income system as well as the objectives of each pillar within the system, together with an agreed understanding of the integration and relationships between each pillar.

The Australian retirement income system is commonly considered to have three pillars, namely:

1. the means-tested age pension;
2. the compulsory superannuation guarantee (SG) system for employees; and
3. the voluntary superannuation system for the self-employed and for additional contributions by employees.

We are concerned that the primary objective in the Bill does not provide any indication of, or reference to, the desired outcome of the total system, namely the level of income which superannuation (or superannuation plus the age pension, for those eligible) should provide. The proposed objective is so vague that it could be argued that any level of superannuation would meet the proposed primary objective. It therefore provides little if any guide to policy makers as to the level of superannuation savings which should be compulsory (i.e. the SG requirements) or the level to which incentives should be provided to encourage people to voluntarily save through super.

In Mercer's view it is essential for the objective of the overall retirement income system to include a desired level of income (or the concept of adequacy) in order to provide meaningful guidance to policymakers.

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Secondly, we note that the proposed objective makes it clear that superannuation should be designed to provide income in retirement. We strongly agree with this emphasis which we expect will support the direction of superannuation policy towards encouraging retirees away from lump sums and towards income products. On the other hand, it is worth recognising that many retirees have a need for capital (or lump sum payments) for a range of purposes during their retirement years. Therefore continued access to some capital from superannuation during retirement is a desirable outcome and should be recognised.

In our view the objective should highlight the concept that the income from superannuation and the age pension should be designed to last the whole of the person's retirement period, resulting in the need to consider longevity protection[2].

Therefore Mercer proposes that the objective of our total retirement system should be:

> *to provide the vast majority of Australians with an income throughout their retirement that enables their pre-retirement living standards to be maintained.*

Note the inclusion of the phrase "throughout their retirement" to highlight that the objective must have a long-term perspective.

The exception (from 'the vast majority') would be for those Australians with considerable wealth and/or income for whom it is unreasonable to provide taxpayer support through superannuation at a level that allows them to maintain their pre-retirement living standards from their superannuation income. That is, it is reasonable to impose a limit on the extent to which the Government supports the provision of retirement income.

Mercer's suggested approach

The primary purpose of the age pension should be to alleviate poverty amongst older Australians. That is, it should be focused on those with limited means. As an individual's means increase, whether through income or wealth or a combination thereof, it is reasonable that the provision of the age pension reduces.[3]

This approach is broadly consistent with the primary objective in the Bill:

> *To provide income in retirement to substitute or supplement the Age Pension*

However the Bill's objective represents a very high level objective and does not help clarify at what point the age pension should be reduced as superannuation income increases. In other words, at what point does the supplementation become substitution? And what should guide the rate of substitution?

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[2] We have made further comments on the issue of management of longevity risk in Section 2 below.

[3] There would be some advantages in a universal, non-means tested pension (including greater simplicity, lower administrative costs and reduction of disincentives to savings as well as earning other income). However given the current circumstances we have assumed continuation of a means-tested age pension for the purpose of this submission.

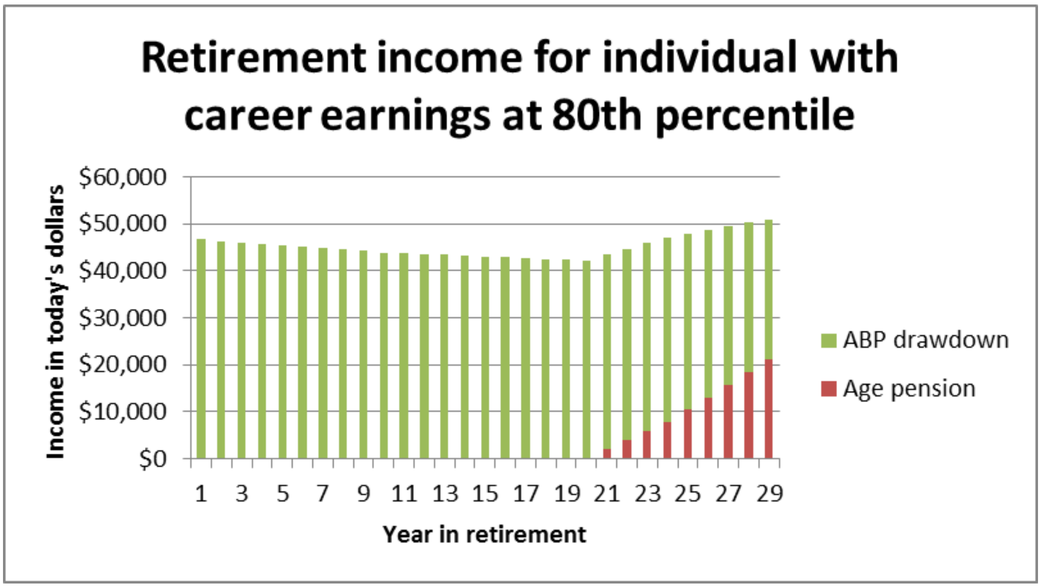
We suggest that the following principles would help determine appropriate outcomes:

1. the primary purpose of the age pension is to alleviate poverty amongst the aged

2. where the age pension is means tested:

    - the age pension should not be reduced until a single person's income exceeds 40% of the average wage[4]
    - the rate of substitution should be such that there is a clear increase in an individual's future retirement income (allowing for the age pension, superannuation and tax) from additional superannuation contributions

As an example of the complementary roles of superannuation and the age pension, let us consider an individual who earns income at the 80th income percentile[5] throughout their working career from age 20 to age 67 (the future pension eligibility age). The following graph shows their level of retirement income (in today's dollars) assuming they withdraw from their account based pension at the minimum rate[6] each year.



The graph indicates that this retiree will not receive any age pension from the Government until age 88, or their 21st year in retirement. Life expectancy at age 67 for someone entering the workforce at age 20 today is likely to be about 24 years. Therefore it is reasonable to expect that some of these individuals will be receiving a part pension in the future.

[4] A higher percentage would be used for a couple.
[5] This is equivalent to an income of about $100,000 in today's dollars.
[6] Research indicates that this is the most common behaviour amongst retirees.

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This modelling allows for the legislated increase in the SG to 12% in 2025, some allowance for additional salary sacrifice contributions in line with current experience, as well as the new asset test rules introduced from January 2017.

In today's dollars, this individual has a projected final superannuation balance of $1.036 million (of which 10% is assumed to be taken as a lump sum) and concessional contributions in their final year of employment of $17,635.

The purpose of this example is to recognise that even at above average incomes for an entire full time career, a part age pension is likely to be paid in the later years of retirement. That is, income from superannuation provides substitution for the age pension well up the income scale and does not cease at median or average incomes.

Who is superannuation for?

In addition, the objective in the Bill does not provide any indication of the desired breadth of coverage of superannuation. For example, should superannuation policy be aiming to support retirement incomes for:

- all Australians of working age?
- all Australians of working age with a capacity to save?
- all Australians in paid employment?

We note that the current SG system covers most wage and salary earners but does not cover:

- contractors and other self-employed workers
- those on social security benefits or receiving paid parental leave payments (in most cases)
- those out of the workforce or doing small amounts of paid work (less than $450 per month from any employer) but who are not eligible for any social security benefits e.g. many non-working spouses caring for children

The legislating of superannuation's objective provides an opportune time to review whether the objective should embrace the ideal of providing superannuation for all Australians, which would then guide policy decisions on (for example) the breadth of SG coverage and level of incentives for those outside the workforce.

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Section 2 – Subsidiary objectives of the superannuation system

We agree it is preferable to express the objectives of the superannuation system in legislation via a reasonably brief primary objective plus a number of subsidiary objectives, as proposed by the Government, rather than to try to include all the desirable elements in a single objective.

We are largely in agreement with the subsidiary objectives proposed in the Bill, subject to the following comments.

Need for restricted access and tax concessions

In our view it is important for the subsidiary objectives to also draw out the need for restrictions on access to superannuation, so that it is used for the intended purpose of providing income in retirement, but that these access restrictions need to be counterbalanced by tax concessions. Without such tax concessions, there would be no incentive for voluntary superannuation saving due to the restrictions on access. As noted in the 2010 Henry Report on Australia's Future Tax System:

> *"Superannuation is the main form of lifetime saving outside the family home. There is a bias in the current taxation system against long-term saving, particularly lifetime saving such as superannuation. There are at least two reasons for taxing superannuation more favourably than other saving (with the exception of housing) to reduce this bias.*
>
> *The first reason is that taxing superannuation earnings, like the earnings on most forms of savings, means that the effective rate of tax on the real value of saving increases the longer an asset is held…This effect is more pronounced in superannuation than other savings as superannuation saving is generally held for a longer time. This justifies a more favourable tax treatment.*
>
> *The second reason is that superannuation is a form of deferred income. People should be taxed on superannuation at the rate that would apply if their income had been spread over their entire life rather than merely over their working life. This is an income-smoothing argument. As a person's retirement income is generally lower than their income while they were working it should be taxed at a lower rate."*

Provision of insurance

Another issue which does not seem to be adequately catered for in the proposed objectives is the provision of death and disability insurance within superannuation. While the inclusion of insurance in superannuation does add a significant layer of complexity and cost, the rates negotiated by super funds are generally considerably lower than members could obtain individually and, for most people, the cover provides valuable protection and helps reduce Australia's chronic underinsurance problem.

In our view insurance within superannuation provides a valuable cost-effective service within the group arrangements and should be supported by the objectives adopted.

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Measuring success

We note a number of the proposed objectives will be difficult to measure. The Productivity Commission's work on assessing the efficiency of the superannuation system may be of some assistance in developing appropriate methodology.

Nevertheless, if future Governments are required to justify future legislative changes against the enshrined objectives, this may reduce the chances of inappropriate and/or knee-jerk legislative change occurring in future. That is, Governments would need to justify why a particular change should be introduced if it was inconsistent with the previously agreed objectives.

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Section 3 – Swiss Retirement Income System Objective

Switzerland is an example of a country which does set a target level of overall retirement income.

Article 111 from the Swiss Constitution states:

> *"The Confederation shall take measures to ensure **adequate financial provision** for the elderly, surviving spouses and children, and persons with disabilities. These shall be based on three pillars, namely the Federal Old-age, Survivors' and Invalidity Insurance, the occupational pension scheme and private pension schemes." (emphasis added)*

Furthermore Article 113 from the Swiss Constitution (reproduced below) includes at paragraph 2a a principle that a combination of both the old age insurance and occupational pensions should enable an individual ***"to maintain his or her previous lifestyle in an appropriate manner***".

> ***Article 113 Occupational pension scheme***
> *1 The Confederation shall legislate for an occupational pension scheme.*
> *2 In doing so, it shall adhere to the following principles:*
>> *a. the occupational pension scheme, together with the Old-age, Survivors' and Invalidity Insurance, enables the insured person to maintain his or her previous lifestyle in an appropriate manner.*
>> *b. the occupational pension scheme is compulsory for employees; the law may provide for exceptions.*
>> *c. employers shall insure their employees with a pension institution; if required, the Confederation shall make it possible for employees to be insured with a federal pension institution.*
>> *d. self-employed persons may insure themselves on a voluntary basis with a pension institution.*
>> *e. for specific groups of self-employed persons, the Confederation may declare the occupational pension scheme to be compulsory, either in general terms or for individual risks only.*
>
> *3 The occupation pension scheme is funded from the contributions of those insured, whereby employers must pay a minimum of one half of the contributions of their employees.*
> *4 Pension schemes must satisfy the minimum requirements under federal law; the Confederation may provide for national measures to resolve particular difficulties.*

Hence, it is possible to introduce the concept of adequacy into any objectives. Whilst this term, in itself, is subjective it would be possible for the objective of the overall retirement income system in Australia to recognise both the concept of adequacy and the inevitable relationships between the three pillars present within Australia's system.