The Senate

Select Committee on Superannuation

Superannuation and standards of living in retirement

Report on the adequacy of the tax arrangements for superannuation and related policy

December 2002

Commonwealth of Australia
ISBN 0 642 71202 6

This report was printed by the Senate Printing Unit, Parliament House, Canberra, ACT 2600.

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Terms of Reference

On 14 March 2002, the Senate referred the following matter to the Committee for inquiry and report by the last sitting day in September 2002:

> *The adequacy of the tax arrangements for superannuation and related policy to address the retirement income and aged and health care needs of Australians.*

(On 16 September 2002 the Committee sought and was granted an extension of time to present its report to 14 November 2002.

On 17 October 2002 the Committee sought and was granted an extension of time to present its report to 10 December 2002.

On 3 December 2002 the Committee sought and was granted an extension of time to present its report to 12 December 2002.)

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Preface

On 14 March 2002 the Committee commenced its inquiry into the adequacy of the tax arrangements for superannuation and related policy to address the retirement income and aged and health care needs of Australians.

The inquiry had its genesis in responding to community interest in how adequate superannuation would be under the present taxation regime.

The inquiry attracted considerable interest in the community, with the Committee receiving over 150 submissions. The Committee conducted eight public hearings in connection with the inquiry, the last of which was held in the form of a roundtable hearing on 8 October 2002.

One of the main issues arising during the inquiry was the identification of appropriate modelling assumptions to be used when projecting retirement incomes. The Committee was confronted with conflicting modelling advice on what projected retirement incomes could be expected by retirees who have had a full working life with superannuation contributions at the current maximum of nine per cent of wages. The Committee commissioned the Institute of Actuaries of Australia (IAA) to assist with resolving the different modelling outcomes.

A key feature of the IAA report was the identification of replacement rates of pre-retirement income as the most appropriate focus for assessing the adequacy of retirement incomes. Replacement rates are more robust and less subject to distortion by differences in modelling approaches than a dollar level.

The other issues which arose related to:

- The adequacy of superannuation, including:
  - the amount of income that would be needed in retirement;
  - the expenses likely to be incurred in retirement for health and aged care;
  - the levels of superannuation contributions and other measures that could cover expected expenses in retirement;
- The equity of the tax arrangements for superannuation, especially the overall fairness of the taxation regime for superannuation;
- The integration of superannuation with the social security system, including improving the coordination of superannuation with other social security measures; and
- The simplification of the superannuation system, including streamlining the operation of the system and improving member understanding.

The Committee found that:

- The available evidence demonstrates that the current arrangements for superannuation may not provide an adequate income in retirement for most people and that strategies need to be identified to address the shortfall;
- The current taxation treatment of superannuation produces some inequities which need to be addressed;
- The relationship between superannuation and the age pension and other social security measures could be better integrated;
- The superannuation system in Australia is very complex, not easily understood and requires simplification.

The Committee has made a number of recommendations for reform to the superannuation system and related areas. If implemented, the Committee considers that they will assist in improving standards of living in retirement, reduce budget outlays in the longer term, and instil greater confidence in superannuation as a retirement savings vehicle. However, as some of the matters raised in the report have the potential for significant impacts on the budget, the recommendations would have to be viewed in the light of the budget position at the time.

The Committee has also included a number of appendixes in this report which contain useful information about a variety of matters alluded to in the report. This information should be read as part of the report.

The Committee was appreciative of the many people and organisations which took the time to make submissions to the inquiry or to give evidence at the public hearings. In particular, the Committee records its appreciation to those who participated in the roundtable hearing held in Canberra on 8 October 2002.

I commend the report to the Senate.

Senator John Watson
Committee Chair

Executive Summary

Adequacy

Identifying and quantifying adequacy

1.1 The Committee found that there is a need to define the meaning of the term 'adequacy' of superannuation. In particular, there is a need to establish clearly articulated objectives for Australia's retirement incomes system, which include targets for representative groups of Australians.

1.2 In order to provide an adequate standard of living in retirement, the Committee notes the high degree of consensus expressed by witnesses at the roundtable that the desirable target for a person on average earnings is a replacement rate of 70-80 per cent of pre-retirement expenditure (which equates to approximately 60-65 per cent of gross pre-retirement income), a target which would need to be higher for those on less than average weekly earnings, and lower for those on high incomes.

1.3 The Committee found that, should this replacement rate be accepted, the available modelling shows that the current arrangements are unlikely to deliver these outcomes, and that other strategies are required to address the anticipated shortfall.

Closing the adequacy gap

1.4 The Committee considers that strategies to close the adequacy gap include more incentives for voluntary contributions, including expanding the government co-contribution concept by raising the threshold and improving coverage to lower to middle income earners, and widening access to superannuation as a savings vehicle by removing the work test for making voluntary contributions, lowering front-end taxes in the long term, providing a cost-effective savings vehicle, and permitting contribution of non superannuation assets to superannuation.

1.5 The Committee considered the evidence in favour of additional compulsory contributions by either employers or employees, but concluded that these could not be supported in the current economic climate.

Factors inhibiting adequacy

1.6 The Committee noted that a number of factors inhibit the effectiveness of the current contributions in delivering adequate retirement incomes, including the impact of front-end taxes, the impact of fees and charges and the impact of rising household debt.

1.7 Although the Committee received no compelling suggestions on how the revenue shortfall could be addressed if front-end taxes were removed or reduced, the Committee favours a gradual move away from front-end taxes. The Committee also re-emphasises the importance of transparent disclosure up front of fees and charges, and notes that there is a need to monitor the relationship between the effect of household debt and the ability of people to save for retirement.

Baby boomers

1.8 Given that the compulsory superannuation scheme has only been in operation since 1992, the Committee notes that most baby boomers will not have the benefit of a full working life under the compulsory superannuation system and, other savings aside, that their incomes in retirement are likely to fall well short of the consensus target level of 70-80 per cent of pre-retirement expenditure (approximately 60-65 per cent of gross pre-retirement income). The Committee considers that a number of its recommendations for change which apply to the wider community will also assist baby boomers to achieve an adequate income in retirement.

Other adequacy issues

1.9 The Committee notes that there are a number of arrangements which could impact on the adequacy of individuals' or groups' retirement incomes. These include:

- arrangements for the self-employed;
- member protection arrangements; and
- the $450 SG earnings threshold.

1.10 The Committee has identified in this report a number of strategies to assist people affected by these measures to improve the adequacy of their income in retirement, including examining the extension to the self-employed of the same contribution arrangements that apply to employees, and examining the removal of the $450 earnings threshold.

1.11 The Committee has also identified strategies to assist women and others with broken work patterns, to achieve an adequate income in retirement.

Equity

1.12 The Committee found that the current taxation arrangements applying to superannuation are not delivering equity to all Australians because of flat rate contributions and earnings taxes and end benefit taxes that encourage lump sums.

1.13 The Committee considers that equity in the superannuation system is best achieved through a whole of life approach to taxation concessions. The Committee suggests that, together with industry, the Government undertake a review of the appropriate benchmark for determining and measuring the impact of superannuation taxation concessions.

1.14 The Committee prefers to gradually move the taxation of superannuation away from the accumulation phase, that is at the front-end, in favour of end benefit taxation. However, not all members of the Committee are attracted to the suggestion of providing front-end rebates on individual contributions. Instead, the majority of the Committee prefers phasing out the contributions tax in the long term.

1.15 The Committee considers that by implementing the measures outlined in this report, there is scope to improve the ability of individuals, such as women and others with broken working patterns and baby boomers, to increase their retirement incomes.

1.16 The Committee considers that the surcharge is an inefficient tax which is costly to administer. It causes serious inequities for members of defined benefit funds. It also imposes costs on all members, irrespective of whether they are liable to pay the surcharge or not. For this reason, the Committee would prefer to transfer the administration of the surcharge to the ATO and to introduce a maximum 15 per cent cap on employer financed benefits in all defined benefit fund schemes.

1.17 In the context of the Committee's preference to remove or reduce superannuation taxes during the accumulation phase, the Committee considers that lump sum benefit taxes should be adjusted in order to provide for equity through the progressive tax system and to replace revenue lost through any reduction in front-end taxes.

1.18 In addition, the Committee considers that, while the current RBLs should be retained, the annual indexation applicable to the RBL thresholds should be limited.

Integration

1.19 The Committee found that Australia's public and private health and aged care system is well regarded, but, in the light of projected expenditure identified in the *Intergenerational Report* and other reports published in the last decade, the system faces significant challenges in the future as Australia's population ages.

1.20 The Committee believes that the Government could consider a number of strategies to address these challenges, including:

- identifying ways to make savings in health care costs, through further examination of options such as voluntary heath insurance through superannuation protocols; and
- monitoring community and residential aged care programs to ensure their effectiveness and sustainability.

1.21 The Committee notes that Australia has a modest universal age pension system which includes targeting through the assets and incomes tests. The Committee also notes that the costs associated with the system are expected to increase in the future, and that strategies need to be identified to deal with this anticipated development.

1.22 To address this, the Committee believes that there are a number of initiatives that the Government could undertake to enhance integration of the three pillars of the retirement income support system in Australia: compulsory employer SG contributions, voluntary superannuation, and social security measures. Specifically, as discussed in this chapter, the Committee believes the Government should:

- continue to strive for universal and adequate superannuation coverage, with a focus on assisting those who face the greatest challenges in achieving an adequate retirement income – the low and middle income earners;
- review current arrangements for access to the Commonwealth Seniors Health Card scheme to ensure that it focuses on those in greatest need of Government support;
- explore options to encourage workers to remain in the workforce beyond the current superannuation preservation age;
- monitor the uptake of complying annuities, to ensure that they offer an attractive investment option for retirees;
- consider the appropriateness of the current minimum draw-down limits for allocated annuities;
- develop a standard set of rules applying to income streams; and
- develop means by which those who wish to could draw an income stream from their owner-occupied housing assets for retirement income purposes, including health and aged care expenses.

Simplicity

1.23 The Committee accepts that there are some real and perceived complexities in Australia's superannuation system which need to be addressed in order to streamline the operation of the system and improve individual's understanding of their entitlements.

1.24 Some of these complexities include:

- the ongoing amendments to the legislative framework, specifically relating to transitional arrangements for older workers, the preservation age of benefits, and the tax and social security consequences of either cashing out, rolling over or purchasing a retirement income product;
- the 'grandfathering' of taxation provisions for superannuation when calculating superannuation entitlements;
- the arrangements governing who could make a contribution to a superannuation fund (i.e. the work test for making voluntary contributions);
- the proliferation and loss of monies in superannuation fund accounts; and
- the lack of understanding of superannuation in the Australian population generally.

1.25 The Committee has recommended that the Government consider the matters raised in this report in order to identify ways to make the superannuation system less complex and more comprehensible to the Australian people.

1.26 The Committee considers that the implementation of its major recommendations in Part III – Equity, together with the suggestions for simplifying the system in Part IV – Simplicity, would significantly reduce the complexity of the superannuation system, enhance member understanding, and assist with the efficient administration of superannuation funds.

Other issues

1.27 The Committee notes that, in order to improve the safety of superannuation, the Government has recently announced the requirement for all trustees of APRA regulated superannuation funds to obtain a superannuation trustee licence and has proposed a number of other measures designed to provide greater protection of employee retirement savings.

1.28 While the Government's initiative is to be commended, the Committee considers that there are some other issues which the Government should consider in a timely manner to ensure that people have confidence in the superannuation system and that they have adequate savings and incomes in retirement. These include:

- developing alternative savings vehicles, to maximise the potential for increasing national savings and to assist long-term savings for purposes such as health, housing and education;
- considering indexing Commonwealth funds superannuation benefits to the CPI or MTAWE, whichever is the higher, to maintain parity with community living standards for Commonwealth public sector and defence force retirees and considering linking the preserved benefit to the fund earning rate, rather than the CPI.

1.29 Finally, as some of the matters raised in the report have the potential for significant impacts on the budget, the recommendations would have to be viewed in the light of the budget position at the time.

Recommendations

Identifying and quantifying adequacy

1. The Committee recommends that the Government announce a clear statement of objectives for Australia's retirement incomes system, including target retirement incomes for representative groups. (para 2.19)

2. The Committee recommends that, having established the objectives or goals, the Treasury convene a panel of key stakeholders to identify, and where possible recommend, common modelling assumptions and techniques for projecting retirement incomes. (para 2.75)

Closing the adequacy gap

3. The Committee recommends that the Government:

- **extend the co-contribution concept by raising the threshold to people on average earnings, and improving the coverage to lower to middle income earners;**
- **remove the work test for making voluntary contributions for those under age 75; and**
- **permit the contribution of any non superannuation asset to superannuation income stream products, providing that, as far as possible, there are no adverse tax or age pension means test consequences. (para 3.41)**

Other adequacy issues

4. The Committee recommends:

- **examining the option of extending to the self-employed a framework for making superannuation contributions, with tax treatment similar to that which applies to employees making contributions; and**
- **examining the removal of the $450 earnings threshold for SG contributions. (para 6.46)**

Equity and tax concessions

5. The Committee recommends that, together with industry, the Government conduct a review of the appropriate benchmark for measuring the impact of superannuation tax concessions. (para 7.31)

6. The majority of the Committee recommends that, in the long term, the superannuation contributions tax be gradually removed and replaced with a new approach to taxing end benefits. (para 8.33)

7. The Committee recommends that, until such time as the taxation regime has moved to back-end taxes, which would ultimately enable Maximum Deductible Contribution limits (MDCs) to be removed, the Government review the scale of the annual MDC limits. (para 8.66)

Surcharge

8. The majority of the Committee recommends that, as part of a policy to move towards a more equitable system of end-benefit taxation, the surcharge be gradually removed in the long term (given the revenue implications this may be achieved through a staged reduction). (para 9.28)

9. The Committee recommends that:

- **a surcharge cap of the maximum rate of surcharge (currently 15 per cent) be implemented for members of private sector defined benefit funds; and**
- **the burden of administering the surcharge be transferred from superannuation funds to the Australian Taxation Office. (para 9.29)**

Whole of life equity measures

10. The Committee recommends that:

- **the current Reasonable Benefit Limits (RBLs) be retained, but that the annual indexation applicable to RBL thresholds be limited (para 10.12);**
- **the lump sum tax free threshold be gradually reduced to the annual equivalent of average weekly ordinary time earnings (AWOTE) and maintained at that level; and**
- **lump sum taxes on amounts in excess of the thresholds be gradually adjusted in line with the tax rate applicable to income streams. (para 10.24)**

Health and aged care

11. The Committee recommends that the Government consider proposals by which the superannuation system could be used to help meet health care costs in Australia, including dental health costs, which are expected to increase significantly in the next four decades. (para 11.62)

Income support

12. The Committee recommends that the Government:

- **continue to strive for universal and adequate superannuation coverage, with a focus on low and middle income earners (para 12.31);**

- **review the current arrangements for access to the Commonwealth Seniors Health Card scheme to ensure that it focuses on those in greatest need (para 12.47);**
- **examine options to encourage older workers to remain in the workforce beyond the superannuation preservation age, particularly on a part-time basis (para 12.67);**
- **monitor the uptake of complying annuities, to ensure that the restrictions imposed do not inhibit the attractiveness of complying annuities;**
- **consider the appropriateness of the current minimum draw-down limits for allocated annuities;**
- **develop a standard set of rules applying to income streams (para 12.103); and**
- **examine options by which those who wish to could draw an income stream from their owner-occupied housing assets for retirement income purposes, including health and aged care expenses. (para 12.115)**

Simplifying the superannuation system

13. The Committee recommends that more resources be allocated by Government agencies to assist people to prepare for retirement. (para 13.52)

14. The Committee recommends that the Government consider the matters raised in this report in order to identify ways to make the superannuation system less complex and more comprehensible to the Australian people. (para 13.55)

Other issues

15. The Committee recommends that, as means of increasing national savings and reducing the temptation for people to accumulate debt which is repaid with superannuation on retirement, the Government examine the introduction of a tax preferred medium to long-term savings vehicle which could be accessed prior to retirement for purposes such as:

- **health;**
- **savings for a home deposit; and**
- **education. (para 14.13)**

16. The Committee recommends that the Government consider indexing Commonwealth funded superannuation benefits to Male Total Average Weekly Earnings (MTAWE) or the Consumer Price Index (CPI), whichever is the higher, in order that recipients share in the increases in living standards enjoyed by the wider community. (para 14.28)

List of Abbreviations

ABA	Australian Bankers' Association
ACA	Australian Consumers' Association
ACOSS	Australian Council of Social Service
ACPSRO	Australian Council of Public Sector Retiree Organisations
ACTU	Australian Council of Trade Unions
ADF	Approved Deposit Fund
AICD	Australian Institute of Company Directors
AIR	Association of Independent Retirees
AIST	Australian Institute of Superannuation Trustees
AMA	Australian Medical Association
AMP	AMP Financial Services
APRA	Australian Prudential Regulation Authority
ASFA	Association of Superannuation Funds of Australia
ATI	Adjusted taxable income
ATO	Australian Taxation Office
AWE	Average weekly earnings
AWOTE	Average weekly ordinary time earnings
Cbus	Construction and Building Industry Superannuation
COTA	Council on the Ageing
CPA	CPA Australia
CPI	Consumer Price Index
CSHC	Commonwealth Seniors Health Card
CSS	Commonwealth Superannuation Scheme
DOFA	Department of Finance and Administration

DVA	Department of Veterans' Affairs
ETP	Eligible termination payment
FACS	Department of Family and Community Services
FPA	Financial Planning Association
GDP	Gross Domestic Product
IAA	Institute of Actuaries of Australia
ICAA	Institute of Chartered Accountants in Australia
IFSA	Investment and Financial Services Association
IFF	Industry Funds Forum
MBS	Medicare benefits schedule
MDC	Maximum deductible contribution
MTAWE	Male total average weekly earnings
NATSEM	National Centre for Social and Economic Modelling, University of Canberra
NIA	National Institute of Accountants
NICRI	National Information Centre on Retirement Investments Inc
NSA	National Seniors' Association
NSCF	Notional surchargeable contributions factor
OECD	Organisation for Economic Co-operation and Development
PBS	Pharmaceutical benefits scheme
PSS	Public Sector Superannuation (scheme)
PwC	PricewaterhouseCoopers
RIM	Retirement Income Modelling unit, Department of the Treasury
RBA	Reserve Bank of Australia
RBL	Reasonable benefit limit
PBS	Pharmaceutical Benefits Scheme
SATO	Senior Australians Tax Offset

SG	Superannuation Guarantee
TIA	Taxation Institute of Australia
SCOA	Superannuated Commonwealth Officers' Association
SISFA	Small Independent Superannuation Funds Association
SOS	Society of Superannuants

List of Tables, Charts and Figures

PART I - INTRODUCTION

Part I of the report provides an outline of how and why the matter of the adequacy of superannuation was referred to the Committee and how the Committee conducted its inquiry. It then provides an overview of the other five Parts of the report.

Chapter 1

Introduction

Terms of reference for the inquiry

1.1 On 14 March 2002 the Senate agreed to establish the Select Committee on Superannuation. At the same time, the Senate referred the following matter to the Committee for inquiry and report by the last sitting day in September:

> The adequacy of the tax arrangements for superannuation and related policy to address the retirement income and aged and health care needs of Australians.

1.2 Because of the breadth and complexity of this inquiry, which required more public hearings than originally envisioned, and the pressures of other concurrent inquiries, including inquiries into five superannuation bills, the Committee sought, and received a number of extensions to its original reporting date.

Background to the inquiry

1.3 The inquiry had its genesis in responding to community interest in how adequate superannuation would be, under the present taxation regime.

1.4 Superannuation savings are currently taxed at three stages:

- on entry to the particular fund, where a contributions tax of 15 per cent applies on employer contributions and employee pre-tax contributions (commonly known as 'salary sacrifice');[1]
- on accumulation while in the fund, where a tax of 15 per cent applies to earnings at an effective rate of eight per cent due to the impact of dividend imputation and capital gains tax concessions; and
- on exit from the fund, where a benefits tax applies to lump sums at varying rates, depending upon the amount of the benefit, with a tax-free threshold of $112,405 (indexed).

1.5 With these taxation measures in place, the Committee sought to establish whether current levels of superannuation would be adequate to provide a reasonable standard of living in retirement for a growing number of years as people live longer.

1 In addition an extra contributions tax, or surcharge, of up 15 per cent applies to those on adjusted taxable incomes over $90,527.

Conduct of the inquiry

1.6 The inquiry was advertised in the national press - the *Australian Financial Review* on 5 April 2002 and the *Weekend Australian* on 6 April 2002, inviting interested organisations and individuals to lodge submissions. The Committee also wrote to a wide range of interested bodies and prominent individuals advising them of the inquiry and inviting submissions.

1.7 In the advertisement for the inquiry, the Committee indicated that the inquiry would focus on people's standards of living in retirement and the factors which contribute to that – including retirement incomes, contribution levels, and taxation arrangements for superannuation, and meeting the aged and health care needs of Australians.

1.8 The inquiry attracted considerable interest in the community, with the Committee receiving over 150 submissions, many of them supplementary submissions as people and groups provided responses to questions taken on notice at hearings. A list of the submissions received is at **Appendix 1.**

1.9 The Committee held eight public hearings in connection with the inquiry, the last of which was held on the form of a roundtable hearing on 8 October 2002. A list of the public hearings and witnesses who appeared is at **Appendix 2**.

1.10 A list of the documents tabled at the hearings or received as exhibits is at **Appendix 3**.

1.11 During the inquiry, the Committee did not seek to confine itself to examining government policy. Instead, because of the breadth and complexity of the inquiry, it sought to 'look outside the square' to identify issues and possible solutions. In doing this, the Committee drew on a number of resources. These included not only the evidence received during the inquiry, in the form of written submissions, oral evidence, tabled documents and exhibits, but also a variety of research papers, including those presented at the annual colloquium of superannuation researchers held at the University of New South Wales.

Main issues arising in the inquiry

1.12 One of the main issues arising during the inquiry was the identification of appropriate modelling assumptions to be used when projecting retirement incomes. The Committee was confronted with conflicting modelling advice on the outcomes that will be provided to retirees who have had a full working life with superannuation contributions at the current maximum of nine per cent of wages. The Committee commissioned the Institute of Actuaries of Australia (IAA) to assist with resolving the different modelling outcomes. The report from the IAA is at **Appendix 4.**

1.13 The other issues which arose related to:

- The adequacy of superannuation, including:

- the amount of income that would be needed in retirement;
- the expenses likely to be incurred in retirement for health and aged care;
- the levels of superannuation contributions and other measures that could cover expected expenses in retirement;

- The equity of the tax arrangements for superannuation, especially the overall fairness of the taxation regime for superannuation;
- The integration of superannuation with the social security system, including improving the coordination of superannuation with other social security measures; and
- The simplification of the superannuation system, including streamlining the operation of the system and improving member understanding.

1.14 In Parts II to V, the report addresses each of these issues in turn, together with, in Part VI, some additional issues raised during the inquiry.

1.15 It should be noted that during the inquiry, the Committee also completed inquiries into five superannuation bills, and that a number of the issues which arose in this inquiry were also addressed in the inquiries into the bills. The five bills related to the Government's proposals to:

- introduce quarterly Superannuation Guarantee (SG) contributions by employers;
- reduce the superannuation surcharge rates;
- allow superannuation contributions to be made on behalf of children;
- increase the deduction limit for personal superannuation contributions made by the self-employed;
- increase from 70 to 75 the age up to which working members of superannuation funds can make personal superannuation contributions;
- provide for co-contributions to be made by the Government towards the superannuation of low income earners;
- provide employees with a choice as to which complying fund or account receives the SG contributions made on their behalf by the employer.[2]

1.16 It should also be noted that this report is one of many Senate Committee and Government initiated inquiries, reports and announcements into various aspects of superannuation. These inquiries, reports and announcements have addressed a wide

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2 The five bills were addressed in the following reports: Senate Select Committee on Superannuation, *Report on Taxation Laws Amendment (Superannuation) Bill (No 2) 2002 and Superannuation Guarantee Charge Amendment Bill 2002*, June 2002; Senate Select Committee on Superannuation, *Provisions of the Superannuation (Government Co-contribution for Low Income Earners) Bill 2002 and provisions of the Superannuation Legislation Amendment Bill 2002,* September 2002; Senate Select Committee on Superannuation, *Provisions of the Superannuation Legislation Amendment (Choice of Superannuation Funds) Bill 2002,* November 2002.

range of issues**.** A chronology of superannuation policies, events and inquiries is at **Appendix 15**. A list of the 61 reports and papers presented by the various Senate Select Committees on Superannuation, and Superannuation and Financial Services, from 1991 – 2002, is at **Appendix 16**.

Acknowledgments

1.17 The Committee was appreciative of the many people and organisations which took the time to make submissions to the inquiry or to give evidence at the public hearings. In particular, the Committee records its appreciation to those who participated in the roundtable hearing held in Canberra on 8 October 2002.

PART II - ADEQUACY

Part II of this report concerns the adequacy of Australia's superannuation system. Two of the three pillars of the retirement incomes system are examined in this part. They are the compulsory SG system and tax advantaged voluntary contributions. Access to the third pillar, the age pension, is also considered. The age pension is also examined in Part IV - Integration.

The discussion on the adequacy of superannuation begins with an examination of suitable targets before considering what the system will deliver in a range of representative real life circumstances. Finally the Committee considers ways to improve the adequacy of the superannuation system.

Chapter 2

Identifying and Quantifying Adequacy

Introduction

2.1 A major focus of the inquiry was how people support themselves in retirement. The evidence received addressed the adequacy of standards of living in retirement, and the ways in which this can be achieved. Considerable evidence was also received on the ways in which the adequacy of retirement incomes is measured and quantified.

2.2 Following a brief background section on Australia's retirement incomes system, this chapter examines the following issues:

- the objectives of the Australian retirement incomes system;
- determining an appropriate target;
- what the current arrangements will provide; and
- access to Treasury's Retirement Income Modelling (RIM) unit models.

Background

2.3 Australia enjoys a world class retirement incomes system. The World Bank has broadly endorsed Australia's general approach to the provision of retirement incomes.[1] Australia's approach is based on a three pillar system – the compulsory Superannuation Guarantee (SG), tax concessions for voluntary superannuation contributions, and a means tested age pension. Each of these pillars will be examined later in this report.

2.4 Much of the debate on the adequacy of superannuation to deliver a sustainable and dignified level of retirement income centres on the level of the inputs into the superannuation system. In other words, much of the energy is focused on the inputs rather than the outcomes or targets that the system should achieve. In the following material the questions of what the targets should be, whether those targets are the same or different for different groups, and the role of the age pension and voluntary savings will be examined.

1 *Submission* 78, Treasury, p. 7.

Objectives of the retirement incomes system

2.5 Retirement patterns are not 'set in stone'. Commentators have identified that workers respond to the incentives they face and that changes in the relative attractiveness of work and retirement can influence individual decisions.[2]

2.6 Treasury informed the Committee that the policy objective of the retirement incomes system is to enable Australians to achieve a higher standard of living in retirement than would be possible from the publicly funded age pension alone. This is achieved through the three pillar approach of compulsory SG employer contributions, tax concessions for additional voluntary personal contributions, and the publicly funded and means tested age pension. Treasury noted that this approach has been broadly endorsed by the World Bank. Treasury also informed the Committee that the Government has not established any specific targets for retirement income levels or for aggregate levels of access to the age pension, because individual circumstances vary.[3]

2.7 The Committee was concerned that no targets or specific objectives for Australia's retirement incomes system have been identified, other than 'to enable Australians to achieve a higher standard of living in retirement than would be possible from the publicly funded age pension alone'. Accordingly, the Committee sought information on what the objectives and targets of the Australian retirement incomes system should be.

2.8 Dr David Knox of PricewaterhouseCoopers (PwC) outlined his views on the possible approaches to identifying objectives for Australia's retirement incomes system. In a detailed table he indicated that three possible objectives could be the provision of a **basic** income for all, an **adequate** income for all or a **replacement** income linked to pre-retirement income. For each of the three possible objectives Dr Knox identified the influence of the following factors or assumptions:

- retirement income goals or targets;
- incentives;
- contribution limits;
- benefit rules; and
- age pension participation.

2.9 The full table provided by Dr Knox is included **at Appendix 5.**

2.10 Dr Knox recommended the **adequate** approach as the most appropriate as, in his view, it would reduce future age pension costs, encourage long term saving and build upon the current three pillar retirement incomes structure. In his submission Dr

2 J F Quinn, 'The labor market, retirement and disability', article tabled by ACOSS during the public hearing on 9 July 2002.

3 *Submission* 78, Treasury, p.6. See also Committee Hansard, 8 October 2002, p. 672.

Knox stressed that it is important to set objectives and that one way of doing this would be to estimate the proportion of aged Australians who would receive a full, part or zero age pension.[4]

2.11 In its submission, the Institute of Actuaries of Australia (IAA) recommended that 'the Government articulate more clearly its national retirement incomes strategy, including key principles and objectives that underpin it'. The Institute considered that an appropriate objective should be to move to a position where the majority of Australians do not draw on the age pension. In the view of the Institute, this would also be consistent with one of the primary arguments for providing tax concessions for superannuation – namely the encouragement of self-provision for retirement for those able to do so.[5]

2.12 Access Economics submitted to the Committee that the link between superannuation targets and the age pension needs to be examined:

> The issue of retirement income targets was considered almost exactly 10 years ago, in 1992, by the then Labor government. The super guarantee was then expected ultimately to involve 12 per cent of earnings by 2002 and, based on a 40-year contribution life and retirement at age 65, this was expected to generate retirement income equal to 40 per cent of pre-retirement income. At that time, the government noted that about 75 per cent of people of age pension or service pension age were either full or part-rate pensioners, with about two-thirds receiving the full pension. The government stated at that time:
>
> … the current levels of self-provision in retirement are far too low.
>
> But it seems that the role of the super guarantee has been to reduce reliance solely on the full pension in retirement but not necessarily total reliance on the pension. That still seems to be set at around three-quarters of the retired population. Is that an adequate target? If the answer is no, what lower target is appropriate?[6]

Determinants and measures of living standards in retirement

2.13 Australia's retirement income system has many facets, including the interaction between compulsory SG contributions and the age pension. Many other factors are also involved, including the important issue of home ownership. It should be noted that the SG was designed to improve people's position in retirement, in conjunction with access to a means tested age pension or part thereof.

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4 *Submission* 110, PwC, Attachment 1.

5 *Submission* 74, IAA, p. 3.

6 *Committee Hansard*, 1 July 2002, p. 40.

2.14 Treasury made a very useful contribution to the debate on the adequacy of superannuation by outlining how it saw the drivers of income in retirement.[7] In summary, the Treasury indicated that a range of factors will influence retirement incomes:

- superannuation;
  - which is influenced by salary level and length of time in the workforce, interest rates, and fees and charges;
- other private savings;
- age pension access;
- the effect of taxation, including the Senior Australians Tax Offset;
- home ownership;
- access to Government benefits; and
- family relationships and social contact.

2.15 In view of all of these factors Treasury indicated that different replacement rates will be optimal for different individuals. A number of other submissions from industry peak bodies supported this approach.

Committee view – objectives of the Australian retirement incomes system

2.16 Recognising that a number of factors can influence the outcome, the Committee notes calls for the identification of a clearly articulated statement of high level policy objectives for Australia's retirement incomes system, together with the identification of targets for representative groups.

2.17 The Committee is concerned at the apparent absence of a clearly articulated statement of high level policy objectives for Australia's retirement incomes system. The Committee is also concerned to ensure that there is a greater focus on the outcomes of the retirement incomes system, rather than the current focus on the inputs. Current policy appears to focus on the SG and the age pension as proportions of wages and salaries rather than what people actually need in their retirement years.

2.18 The Committee notes that the Government has not set specific retirement income targets for the combination of superannuation, taxation, and age pension policy arrangements. The Committee considers that the lack of such targets causes difficulties within the community in planning for their own retirements and in maintaining realistic expectations.

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7 *Submission* 78, Treasury, pp. 4-6.

Recommendation

2.19 **The Committee recommends that the Government announce a clear statement of objectives for Australia's retirement incomes system, including target retirement incomes for representative groups.**

What is an appropriate target?

2.20 As noted above, there are many factors which contribute to people's income in retirement, with compulsory superannuation a major contributor. Much of the evidence to the inquiry sought to identify adequate retirement income targets for different cohorts of Australians.

2.21 When the SG was implemented in 1992, a replacement rate of 40 per cent of final income was the identified target at that time. This target was set to allow future communities to come to a judgement about whether the appropriate retirement saving rate should be higher.[8] In the early 1990s the Government of the day considered that the nine per cent contribution rate was not necessarily the final figure. This view is supported to some extent by the 1995 proposals by the then Labor Government to increase the contributions to 15 per cent by 2002 by providing a three per cent government co-contribution to match an employee contribution of three per cent. More detail of those proposals is included at **Appendix 6.**

2.22 Nonetheless the SG is only one of many inputs to the retirement incomes system. It is important to examine what the outcomes of the compulsory superannuation and aged pension systems are for people in their retirement years. These outcomes can be measured in terms of percentages of retirement income relative to working income (that is, replacement rates) or they can be expressed in flat dollar terms (that is, an amount in contemporary dollars, which an individual could expect in retirement).

2.23 This issue is examined below.

Replacement rates

2.24 Treasury advised the Committee that the approach its Retirement Income Modelling (RIM) unit takes is to use a replacement rate based on the ratio of average expenditure in retirement (including draw downs of capital) to expenditure in the last year of working life. Treasury also advised the Committee that the Government has not set explicit benchmark replacement rates.[9]

2.25 The IAA advised that, in its view, the most appropriate focus for assessing the adequacy of retirement incomes is the level of first year retirement income relative to the level of earnings immediately prior to retirement (and not an average over the

8 Statement by the Hon John Dawkins, MP, Treasurer of the Commonwealth of Australia, *Security in Retirement – Planning for Tomorrow Today*, 30 June 1992, p. 3.

9 *Submission* 78, Treasury, pp. 5-6, 38.

duration of retirement as preferred by Treasury). The Institute advised that this ratio is usually referred to as the replacement rate; further, that replacement rates are more robust and less subject to distortion by differences in modelling approaches than a dollar level.

2.26 The IAA also submitted that it was not possible to set ‘a single optimum SG contribution rate that will provide an adequate or appropriate retirement income for the majority of retirees.’[10]

2.27 AMP Financial Services (AMP) submitted that the required replacement rate depends on an individual’s circumstances, such as family size, home ownership and life style aspirations in retirement, for example:

> … if the individual does not expect to own their home at retirement, then a higher replacement rate will be necessary.[11]

2.28 The Investment and Financial Services Association (IFSA) submitted that ‘the appropriate minimum replacement rate target for retirement incomes should be in the order of 75-80 per cent of late working life consumption expenditure, which approximates to 60 per cent of gross income.’[12]

2.29 The Association of Superannuation Funds of Australia (ASFA) took a different approach, indicating that its preferred approach was to use dollar outcomes as, in its view, these provide a more meaningful illustration which people can understand. The Association submitted that:

> Assessment of adequacy necessarily requires some value judgements to be made. However, both opinion polling and objective assessment of income requirements in retirement indicate that the current Superannuation Guarantee arrangements will not generate adequate retirement incomes for most individuals even when supplemented by the Age Pension.
>
> Opinion polling indicates that around 70% of respondents believe they would require at least $30,000 per year in retirement, with 30% wanting at least $50,000. A variety of research studies examining expenditure by those of retirement age indicate that a budget of at least $25,000 and preferably $30,000 per year is needed for a relatively modest but comfortable lifestyle in retirement. For those on relatively high incomes prior to retirement, needs and expectations will be somewhat higher than these amounts.[13]

2.30 Subsequently, ASFA recommended that the target for a minimum retirement income for a person on around average weekly earnings be initially set at $25,000 per year in today’s dollars, with this target rising to $30,000 for those retiring in 2030.

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10 *Submission* 74, IAA, p. 3.

11 *Submission* 64, AMP, p. 14.

12 *Submission* 70, IFSA, p. 2.

13 *Submission* 73, ASFA, p. 4.

ASFA indicated that, in terms of replacement rates, the target might be a replacement rate of 100 per cent for a person on social security prior to reaching retirement age, 60 per cent for a person on average earnings and 50 per cent or less for a person on $60,000 or more a year. Options for reaching those targets should be based on the assumption of an average of 30 years in paid employment – earlier policy assumptions as to an unbroken work career of 40 years are no longer valid.[14]

2.31 Subsequently at the Canberra roundtable discussion on 8 October 2002, Ms Smith from ASFA expanded on this issue in the following terms:

> I would like to make some brief comments about the replacement rate and targets and then the dollar amount that was used by ASFA. I would agree that if we are using net replacement rates the target should probably be in the order of 70 to 80 per cent. If we were using gross rates, the target is probably 60 to 70 per cent.
>
> …
>
> And transfers, including the pension arrangement. For lower income people the target may need to be higher than that 70 to 80 per cent. For people below or just above average weekly earnings, we may need to go for a higher target than 70 to 80 per cent just for the commonsense reason that there is a flat level below which it becomes very difficult for people to operate.[15]

2.32 In its written submission, the Australian Bankers' Association (ABA) submitted:

> ABA believes that a significant gap exists between the aspirations (and expectations) of Australians for their standard of living in retirement, and what the present system will actually deliver. Australians will achieve outcomes lower than in comparable OECD countries.[16]

2.33 The Australian Council of Social Service (ACOSS) said that it supported compulsory savings for retirement, but that there needs to be a balance between the savings for retirement and pre-retirement savings, and that the balance is wrong for low income earners. It advised the Committee that:

> Our starting point is the simple proposition that the purpose of long-term saving is to smooth expenditure across the life course. This point seems to have been overlooked in the present debate over the adequacy of future retirement incomes.
>
> In this debate, the wrong questions are being asked to produce the 'right' answer: that compulsory superannuation saving should be raised by either

14 *Submission* 73, ASFA, pp. 4-5.

15 *Committee Hansard*, 8 October 2002, p. 661.

16 *Submission* 51, ABA, p. 1.

> 3% or 6% above the present 9% of earnings. This is a one-dimensional discussion about retirement income targets, without reference to the extent to which people should sacrifice current expenditure to achieve them.[17]

2.34 ACOSS further submitted that, in its view, four key questions have not been properly addressed. These questions are:

> 1. What is the minimum level of income required to avoid hardship in retirement?[18]
>
> 2. Should compulsory saving be sufficient to achieve exactly the same living standard after retirement as that attained through working life, or is it acceptable for retirement living standards to be somewhat lower?
>
> 3. How should living standards be measured for the purpose of developing benchmarks for the adequacy of retirement incomes?
>
> 4. What priority should be given to saving for retirement over other long-term savings needs, such as home purchase, child rearing, and further education and training to upgrade skills?[19]

2.35 ACOSS continued:

> A good starting point for informed debate over retirement income needs is reliable data comparing future retirement *living standards* (as distinct from gross or disposable incomes) with those attained over working life.[20]

2.36 To address these questions, ACOSS advised the Committee that more research is needed:

> More research on retirement and pre-retirement living standards is needed to establish the adequacy of retirement incomes attained through the 9% Superannuation Guarantee and Age Pension. Further research is also needed to identify and quantify other long-term savings needs, especially 'life-cycle' savings needs such as child rearing, home ownership, and further education and training.[21]

2.37 Until that research is completed, ACOSS made a provisional assessment of the SG arrangements, and signalled the following broad directions for reform:

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17 *Submission* 65, ACOSS, p. 7.

18 See footnote in ACOSS submission: 'There is a common assumption that an Age Pension fixed at 25 per cent of average earnings is adequate for this purpose. This is unlikely to be so, especially for private tenants and single retirees who have run down their assets.' See *Submission* 65, ACOSS, p. 7.

19 *Submission* 65, ACOSS, p. 7.

20 *Submission* 65, ACOSS, p. 7.

21 *Submission* 65, ACOSS, p. 9.

- A compulsory retirement savings system is necessary to ensure that future generations achieve an adequate income in retirement. This should be its main objective. Easing future Age Pension and other fiscal costs should be a secondary consideration.
- The nine per cent SG saving requirement is close to the mark (though slightly too high) for middle income-earners, but it overshoots the mark in respect of low income-earners.[22]
- Although the SG fails to achieve comparable levels of income replacement for high income-earners, this is not an appropriate role for a compulsory savings regime. The SG nevertheless provides high income-earners with a decent absolute living standard in retirement, and they are in a strong position to save voluntarily to improve income replacement levels after retirement.
- It would be impractical to set different SG contribution rates for different groups in the population. The foregoing points suggest that the compulsory retirement savings requirement should be somewhat less than nine per cent of earnings.
- There is a strong case for broadening the scope of compulsory saving, and taxation support for saving, to long-term savings needs other than retirement. These long-term savings needs include home purchase, income maintenance while a parent withdraws from the paid workforce to care for a child, further education and training, and for low wage-earners the purchase of necessary assets such as cars and refrigerators (to help them avoid excessive debt levels).
- If a more broadly-based system of compulsory long-term savings were established along these lines, there would be a case for raising the SG level above nine per cent, *provided the proportion of earnings required to be set aside for retirement purposes does not exceed nine per cent* (indeed, it should be less than this, at least for low income-earners).
- On the other hand, those savings still earmarked for retirement purposes should be more strictly preserved for that purpose. The present system inappropriately encourages early retirement and allows large lump sum retirement benefits. A more rapid increase in the preservation age, and tighter restrictions on lump sum retirement benefits are likely to be resisted by many people approaching retirement age. Allowing people to withdraw a part of their compulsory savings

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22 See footnote in ACOSS submission: 'In respect of middle income-earners, this assessment is based on a presumption that a reasonable retirement income target for the *compulsory* savings system would result in a modest reduction in living standards after retirement. Those who wish to maintain *exactly the same* living standards after retirement as those enjoyed during working life (or more) could save voluntarily. Low income-earners are disadvantaged by the present superannuation system in three ways: they are forced to set aside an excessive proportion of their limited earnings for retirement, they receive little taxation support for this, and a large part of the resulting increase in their retirement income is clawed back under the Age Pension income test.' See *Submission* 65, ACOSS, p. 9.

for purposes other than retirement (within in a carefully structured long-term savings system) could ease that resistance.[23]

2.38 The Council on the Ageing (COTA) advised the Committee of the University of New South Wales Social Policy Research unit's estimate of the amount needed by different family types to achieve a 'modest but adequate' standard of living in retirement. The Council submitted that the standard is one which:

> … affords full opportunity to participate in contemporary Australian society and the basic options it offers. It is seen as lying between the standards of survival and decency and those of luxury as these are commonly understood.
>
> (and that)
>
> … the modest but adequate standard for a retired 70 year olds in 2001 is $13,260 per year for a single person and $19,500 per year for a couple. These levels, in turn, are about 30% and 15% higher respectively than the Age Pension.[24]

2.39 CPA Australia (CPA) commissioned the National Centre for Social and Economic Modelling (NATSEM) to examine the effectiveness of superannuation options in providing appropriate levels of income for people in retirement.[25] CPA Australia submitted that:

> The research clearly points to the fact that sole reliance on compulsory superannuation arrangements will not provide an adequate outcome for all Australians. Not surprisingly, an increase in the employer superannuation contributions (via a salary sacrifice arrangement), adding an employee superannuation contribution or reducing superannuation taxation, will all have a marked impact on people's living standards in retirement.[26]

2.40 PwC submitted that there is no universally agreed definition of adequacy when considering the level of retirement income, and that the influential 1994 World Bank Report *Averting the Old Age Crisis* noted that:

> The 'right' target replacement rate varies greatly, depending on the circumstances and preferences of each household and the rate of economic growth.[27]

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23 *Submission* 65, ACOSS, pp. 9-10.

24 *Submission* 63, COTA, pp. 15-16.

25 Superannuation Centre of Excellence, *Superannuation the right balance?* – Report prepared by Anthony King, National Centre for Social and Economic Modelling, University of Canberra, 2001.

26 *Submission* 43, CPA Australia, p. 5.

27 Cited in *Submission* 27, PwC, p. 2.

2.41 PwC submitted that no single replacement rate or objective applies to every individual or household. Given this variability, PwC recommended that 'there must be flexibility within a long term robust system which combines a mandatory level of minimum saving and a flexible level of voluntary saving, which is encouraged by the Government through both education and taxation support.' However PwC continued:

- this initial conclusion does not prescribe the appropriate mix between the mandatory and voluntary levels of savings or the minimum level of retirement income that should arise from the mandatory pillar;
- the World Bank Report suggests that the government might require savings or contributions that would replace about 60 per cent of the worker's gross average lifetime wage with a floor at about a third of the gross economy–wide average wage;
- in the Australian context, the age pension represents an income floor of about a quarter of the average wage. In addition, 60 per cent of the lifetime wage is about 42 per cent of the gross final year wage. Hence, in setting the minimum objectives of the Australian system we should develop from the age pension level (for those with no other income) to a total retirement income of about 40 percent of the final wage for the higher incomes;
- most analysts accept that within a Government supported retirement income system, there should be a higher level of replacement income for lower income earners than for higher income earners.[28]

2.42 Dr Vince FitzGerald of the Allen Consulting Group made the following remarks on the adequacy issue at the Canberra roundtable discussion on 8 October 2002:

> There is almost a consensus of what is a First World replacement rate. Almost all of the major OECD countries seem to have systems which, although they differ in some important structural respects, produce replacement rates on the most meaningful way to talk about those—that is, net or disposable income or expenditure, or fairly similar concepts—of 70 to 80 per cent of late working career income as an income produced in at least the early stages of retirement. That essentially amounts to evidence that around the OECD world people are looking for retirement income systems that protect their standard of living; in other words, systems that avoid any large drop in standard of living in retirement. Seventy to 80 per cent of net income or disposable income replacement—that is, after taxes and pensions and the like—would typically produce something like that when you also think about the changes in the expenditure patterns of people.
>
> You would imagine that over the last five or 10 years of working life a typical household unit—and I think it is best to look at household units rather than at individuals—would probably still have a mortgage, say, of $200,000 and the outgoings to service that mortgage would be something in

28 *Submission* 27, PwC, pp. 2-3.

> the order of roughly 10 per cent of income. Some other expenses you would expect to be a little bit less in retirement and you would expect people—although in many of these countries financial savings are fairly small outside pension funds or similar arrangements—to have a few other resources. That is where you get from that 70 to 80 per cent to a fairly similar standard of living—by considering these other factors: the reduced expenditure on things like a mortgage and travel to and from work or whatever and the existence of at least modest other savings to supplement the official retirement incomes of the system in those different countries.
>
> …
>
> Home ownership is the reason why having 70 to 80 per cent of disposable income replacement gives you a similar standard of living after retirement. In other words, if you have ceased paying the mortgage but still have the home to live in then that is one of the expenses that in some senses you have pre-funded by paying the house off before or at retirement—or in some combination. You have housing in retirement and it is extremely important for those numbers to add up to maintenance of standard of living.[29]

2.43 At the Canberra roundtable discussion on 8 October 2002, Dr David Knox, appearing in a private capacity, had the following to say on the adequacy issue:

> The 70 or 80 per cent is a good target, but we should recognise that it will not be a constant over different income levels. This has already been indicated. At lower income levels, where we will have lower home ownership on average, I would say the target should be closer to 90 per cent. At high income levels—shall we say three times the average wage—we could be looking at a 60 per cent to 65 per cent target from the system. Remember that many people at high income levels will have wealth and assets outside the super retirement income and pension system. So I think that rather than saying the target is 70 per cent to 80 per cent across the board, I would see a declining target with income rising. Seventy per cent to 80 per cent is around the middle, but 90 per cent at low incomes, perhaps declining down to 65 per cent from the system at high incomes.
>
> The other point I wish to make is that we need to recognise that even within the system and within the average there are individual circumstances. Whilst 65 per cent to 90 per cent is a good band to look at, there needs to be flexibility within the system to recognise changing circumstances, different family household make-ups et cetera.[30]

2.44 Mr John Maroney, a consultant for the IAA, made the following remarks at the roundtable:

> I support the general range of 70 per cent to 80 per cent, as is included in our report, as the net replacement level. Again, I stress the need for higher

29 *Committee Hansard* , 8 October 2002, pp. 660-661.

30 *Committee Hansard* , 8 October 2002, p. 663.

> percentage replacement for lower income earners, particularly those without owner occupied housing. The variability coming from investment fluctuation, volatility and quite a range of other factors is another key issue. There will be quite a range of dispersion around the averages in this area and that is something that needs to be taken into account in monitoring adequacy at a system level and at an individual level. It is something that the complexity of the system probably works against at the moment, and I note that that is on the agenda for discussion later on. That would be the general view I have on the adequacy issue.[31]

2.45 Ms Rubinstein from the Australian Council of Trade Unions offered the following views during the Canberra roundtable discussion on 8 October 2002:

> On the question of adequacy, like everyone here, we would have no disagreement with both the dollar targets and the replacement level targets. The issue for us has always been: 'Well, what do you need to get there?' I suppose it is analogous to saying that we talk less about the living standards that workers need and more about the actual amounts of money that people are seeking. In that sense, we have supported an objective for superannuation of 15 per cent as the minimum mandatory contribution level, leaving aside from where that comes. We have supported that for some time, and most certainly since the co-contribution scheme which the previous Labor government adopted but which has not been continued as a policy by this government. That is the particular interest that we have: is 15 per cent the right amount?
>
> Certainly, at much higher levels of income, that may be less of an issue. But as far as lower income workers are concerned, there are two issues that we think need to be taken into account. One is the point that has already been made—that the needs of low income workers are going to met by a higher replacement level in retirement, simply because there is a floor to that. There is a basic level of financial support that all people will require in retirement. But the second issue is that, for low income workers, for relatively unskilled and blue-collar workers, the availability of full-time work and permanent work is declining all the time. Workers are increasingly finding themselves in casual employment, in intermittent employment and in part-time employment—sometimes voluntarily, but this is increasingly not the case. Increasingly, casual work is becoming the norm in traditional male blue-collar occupations. By its nature, casual work is going to be somewhat more intermittent than full-time work. For that reason, for those lower income workers, the need for higher provision for retirement is going to be even more critical. It is why we think that 15 per cent by and large is going to hit the target, although that is something that we would be keen to see further work done on. It is not a fixed position; if some better position was put then we would of course be more than happy to look at it.[32]

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31 *Committee Hansard* , 8 October 2002, p. 664.

32 *Committee Hansard* , 8 October 2002, p. 669.

2.46 Mr Davidson from ACOSS provided a different perspective, preferring to address the broader issue of living standards rather than replacement rates:

> I will make some comments on adequacy generally and then turn briefly to the retirement age issue. To start with the basics in regard to adequacy, the purpose of saving is to defer expenditure. We should therefore aim to achieve living standards close to those we enjoyed previously—that is the purpose of saving. For that reason, we do not find it particularly helpful to set arbitrary flat dollar benchmarks or to survey people about what level of income they would like in retirement, unless we complete the picture by also asking people about their income and living standards prior to retirement and how much of their income they think they should forgo in order to achieve a certain level of income in retirement. A retirement income benchmark should be based on a proportion of living standards over the course of working life—that is, the average living standard attained over the course of retirement compared with the average living standard attained by an individual or household prior to retirement or at least during working life.
>
> If we go to living standards rather than income, we take into account a set of factors that are not often taken into account when retirement income benchmarks are discussed in Australia. These go to the different expenditure needs of retirees—that is, they have smaller households, they generally have lower housing costs and they have lower costs relating to employment. In regard to compulsory saving for retirement, we believe that the basic principle should be to set a living standards target somewhat below, but not substantially below, the average living standards enjoyed throughout the course of working life. The reason for that, of course, is that people can voluntarily top up their compulsory savings and there is no point in overshooting and securing for people, through the compulsory system, a higher living standard post retirement than that which they enjoyed previously. That would be the wrong way to go in the compulsory system. If people want to do that, they can do it voluntarily.
>
> The only research we are aware of that compares living standards, as distinct from income or expenditure, pre and post retirement is that recently conducted by NATSEM. Single people saving nine per cent of earnings over 40 years and couples with children saving nine per cent of earnings over 40 years in the case of one partner and, I think, roughly 30 years full-time equivalent in the case of the other partner—to take account of child rearing and withdrawal from the labour force—were achieving around 100 per cent of previous living standards in the case of middle-income earners and around 110 to 120 per cent in the case of low-income earners. Here I am referring to singles and couples with children. It was lower in the case of couples without children, because their living standards were relatively high during the course of working life as they did not have the extra expense of children.
>
> We would not like to draw too many conclusions from a single piece of research. We think that more research that looks at actual living standards pre and post retirement is essential before we can progress this debate in any

> sensible direction. But there are some results from the study—and I am referring to the core scenario; there are a number of alternative scenarios as well—that are quite striking. One is that nine per cent looks to be about right for most in the middle, and looks to be too high for those around the bottom end. There was also previous research by RIM using an expenditure benchmark that tended to suggest that nine per cent was overshooting the mark for those at the bottom end.[33]

What will the current arrangements provide?

2.47 In order to assess the level of retirement incomes that will be available in future under current policy settings, the Committee requested the Treasury to model various personal life time experiences. The modelling assesses the combined effect of the superannuation system, the taxation system, and the age pension, on a range of real life examples.

2.48 Treasury submitted that:

> Analysis undertaken by Treasury's Retirement and Income Modelling Unit indicates that current policy will deliver substantially higher replacement rates for senior Australians, as a group, over the longer term. The Superannuation Guarantee (SG) system in conjunction with the Age Pension is projected to provide a spending replacement rate for an individual on median earnings of 72 per cent after 30 years of contributions and 77 per cent after 40 years.[34] These replacement rates are conservative in that no allowance is made for superannuation contributions above the SG or for additional private savings outside of superannuation. Replacement rates for women with interrupted careers are also calculated.[35]

2.49 In addition, the Committee sought some specific 'cameo' modelling of individual hypothetical circumstances from the Treasury. One of these scenarios was for a single male, retiring in 2032 at age 65 following 30 years of work at average earnings (100 per cent of AWOTE). Superannuation was taken as an income stream and supplemented with the age pension. The result showed that this person would receive a first year retirement income of $28,308 in 2001-02 dollars (CPI deflated). This represents a net replacement rate of 60 per cent of pre- retirement earnings, and includes 95 per cent of the age pension. **Table 2.1** shows a summary of projected retirement incomes at 75 per cent, 100 per cent and 150 per cent of AWOTE. The Treasury 'cameo' of these particular scenarios is included at **Appendix 7**.

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33 *Committee Hansard* , 8 October 2002, pp. 679-680.

34 See footnote in Treasury's submission: 'These replacement rates are based on individuals retiring in 2032. For individuals retiring under a fully mature SG system in 2042, the SG in conjunction with the Age Pension is projected to provide a spending replacement rate of 82 per cent, after 40 years of contributions.' See *Submission* 78, Treasury, p. 2.

35 *Submission* 78, Treasury, p. 2

Table 2.1: Projected retirement income for a single male, retiring in 2032 at different AWOTE

Retirement age Career length (years)	70 25	70 30	70 40	65 25	65 30	65 40
0.75 x AWOTE* (parameters in $2001-02 (CPI deflated))						
Final salary	50,711	50,711	50,711	50,711	50,711	50,711
Full age pension (average)	18,709	18,709	18,709	19,266	19,266	19,266
Private income including drawdowns (pa)	9,629	12,333	16,634	8,447	10,818	14,592
First year retirement expenditure	24,925	26,844	29,898	24,085	25,768	28,330
Average retirement expenditure $2000-01 (CPI deflated)	26,617	28,419	31,235	26,260	27,773	30,134
Average pension as percentage of maximum pension	100%	98%	96%	99%	97%	94%
Replacement ratio - first year retirement expenditure	65%	70%	78%	63%	67%	74%
1 x AWOTE* (parameters in $2001-02 (CPI deflated))						
Final salary	67,617	67,617	67,617	67,617	67,617	67,617
Full age pension (average)	18,709	18,709	18,709	19,266	19,266	19,266
Private income including drawdowns (pa)	12,953	16,596	22,452	11,362	14,558	19,694
First year retirement expenditure	27,284	29,871	33,918	26,155	28,308	31,681
Average retirement expenditure $2000-01 (CPI deflated)	28,828	31,210	35,003	28,116	30,113	33,318
Average pension as percentage of maximum pension	98%	96%	93%	97%	95%	90%
Replacement ratio - first year retirement expenditure	57%	63%	71%	55%	60%	67%
1.5 x AWOTE* (parameters in $2001-02 (CPI deflated))						
Final salary	101,422	101,422	101,422	101,422	101,422	101,422
Full age pension (average)	18,709	18,709	18,709	19,266	19,266	19,266
Private income including drawdowns (pa)	19,599	25,123	34,086	17,193	22,038	29,900
First year retirement expenditure	31,931	35,890	42,870	30,039	33,220	38,984
Average retirement expenditure $2000-01 (CPI deflated)	33,159	36,755	43,061	31,757	34,780	39,828
Average pension as percentage of maximum pension	94%	91%	86%	92%	89%	82%
Replacement ratio - first year retirement expenditure	49%	55%	66%	46%	51%	60%

* AWOTE is currently $927.60 per week (seasonally adjusted) or $48,389.80 per annum.

Scenario: single male; retirement year: 2032; benefit taken as life pension; CPI: 2.5%; wage inflation: 4%; projected fund earning rate: 7%; tax indexation: CPI; life expectancy:83 (84 if retiring at 70).

Source: *Submission* 78, Treasury, p. 40.

2.50 ASFA indicated that outcomes which are lower than Treasury projections may be more realistic. In this context Ms Smith from ASFA noted in the hearing on 10 July 2002:

> If you look … at a fully mature system, someone with average earnings of $40,000 who puts aside nine per cent for 30 years—based on our calculations of average earnings rates of about six per cent—will end up with a retirement income of $19,000. Again, that is assuming an age pension.[36]

2.51 ASFA disagreed with the Treasury findings in the strongest possible terms. In particular ASFA questioned the key underlying assumptions that Treasury used in the modelling. Mr Clare from ASFA highlighted the key areas as follows:

> We would be the first to admit that the modelling issues are not entirely straightforward—there are some technical aspects—but we will try this afternoon to do our best to explain it in the simplest terms possible. You have already identified one of the major differences between the Treasury approach and the ASFA approach in terms of the use of the deflators—the average weekly earnings adjustment that we make and the CPI adjustment that Treasury makes. Over a short period, there is not a great difference between the two but, when we are talking about periods of 30 or 40 years, the difference between the two measures—about 1.5 per cent a year, which is a common assumption between the both of us—accumulates to a very substantial amount. It is the function of the 30 to 40 years.
>
> As to what is the appropriate adjustment factor to use, Treasury claims, through the press release that was issued by Senator Coonan, which you may be aware of, that the Treasury approach is the standard one and that ASFA is using a non-standard approach. However, other very respected researchers use the same approach as we do. I have looked at a number of publications from the National Centre for Social and Economic Modelling. They use the average weekly earnings adjustment both of living expenses and of tax scales. In a way, Treasury are the odd one out in terms of the contemporary researchers, even though they have claimed otherwise in material they have released. I can give you the references for that material from NATSEM. As you would be aware, Anne Harding and her colleagues are world renowned microsimulation modellers and are subject to peer review by academic researchers around the world.
>
> As time has gone on, we have had more ventilation of what Treasury are doing, but, until very recently, it has been very much a black box in terms of some of their projections of adequacy. The more we see of those projections, the more the inconsistencies that appear to be in that model. In some ways, it goes back to that judgment about how you assess living standards in absolute terms. Do you assess them in terms of the living standards that applied when a person commenced their working career, and say that they should be very grateful that in 30 or 40 years the age pension

36 *Committee Hansard*, 10 July 2002, p. 199.

> will generate increases in the standard of living that they will share in, or do you assess living standards relative to their last year of employment?
>
> They (Treasury) basically build in future increases in living standards that come from the age pension throughout the entire retirement period. Again, this is not a very standard approach.[37]

2.52 Ms Smith from ASFA subsequently explained further major points of difference with the Treasury assumptions:

> There was one particular flaw that we highlighted, you might remember: they had assumed that someone on average earnings by the year 2030 would be on the top marginal tax rate. Because of that, we said, 'Your post-retirement income looks good because of the fact that the pre-retirement income has gone down by that percentage.' They said they had remodelled using our figures of average weekly earnings and had got the same replacement rate. The reason they got the same replacement rate is that, in their calculations, they used a fictional annuity product. They used an annuity product which they assumed was taxed quite heavily. In the real world, annuity products are not taxed. I am saying that there has to be some care in what is being factored into the remodelling.[38]

2.53 Ms Smith and Mr Clare from ASFA responded to questioning about whether Treasury had assumed that current tax concessions for post-retirement products will not exist in 30 or 40 years as follows:

> That is one assumption. In their paper, in their modelling, the post-retirement products that they use are fictional products; they do not relate to the real world.
>
> They are products that you would be unable to purchase in the market, because they have rates of return which are much higher than the sorts of products they are talking about. They have invented these imaginary income streams which are better than what people can actually achieve in the market. That leads to some distortion.[39]

Reconciliation of the Treasury and ASFA modelling

2.54 The Committee considered that the reconciliation of the differences between the Treasury and ASFA projections was of major importance in assessing the adequacy of the current retirement income system. Accordingly the Committee commissioned the IAA to assess the differing approaches.

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37 *Committee Hansard*, 8 August 2002, p. 587.

38 *Committee Hansard*, 8 August 2002, p. 589.

39 *Committee Hansard*, 8 August 2002, p. 589.

2.55 In its report to the Committee,[40] the Institute advised that 'it is very important to realise that there is a high degree of inherent variability in the range of retirement incomes that individuals will receive, both in absolute dollars and net replacement rates'. The Committee notes this point and accepts that it follows that any hypothetical 'cameos' are simply illustrative of the possible results of the respective superannuation and social security systems – but still important in providing a framework for the debate to move forward.

2.56 The Institute found that that most significant difference in the assumptions leading to the respective results was in the use of deflators to bring future dollar values back to 2001-02 values. ASFA used the wage based average weekly ordinary time earings (AWOTE) while the Treasury used the price (inflation) based Consumer Price Index (CPI). This means that the Treasury result is inflated relative to the ASFA result by the 1.5 per cent per annum difference between projected CPI and AWOTE growth for the 30 period. On the same basis, under the Treasury approach, the 1.5 per cent difference over 30 years inflates the age pension results relative to the ASFA result and also has the effect of assuming a person on average earnings will pay 25 per cent more tax than today in 30 years time.

2.57 The Institute considered that the use of the AWOTE deflator was the most appropriate for long term projections, like the current adequacy inquiry, while the CPI was more appropriate over shorter timeframes. Accordingly the Institute considered that the Treasury and ASFA sponsored research findings were not comparable.

2.58 In terms of replacement rates, the Institute found that the net of tax retirement replacement rates from the Treasury and ASFA models were quite close. This was the most significant finding of the assessment and provided the Committee with a sound basis for proceeding with much more confidence. Specifically, the Institute found that the net retirement replacement rate for the specific cameo scenario in the Treasury model was 60 per cent and 57 per cent in the ASFA one. The full report of the IAA is included at **Appendix 4.**

Committee view – determining an appropriate target

2.59 The Committee notes that there was a high degree of consensus in the evidence presented to the Committee about the replacement rate concept as the best means of presenting future retirement incomes in terms that people can understand.

2.60 The Committee also notes that there was a high degree of consensus that the desirable net replacement rate for a person on average earnings should be of the order of 70-80 per cent of pre-retirement expenditure (approximately 60-65 per cent of gross pre-retirement income). Witnesses also agreed that this target range needed to be

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40 Institute of Actuaries of Australia, *Superannuation and Standards of living in retirement – Modelling assumptions*, Report to the Senate Select Committee on Superannuation, September 2002. See **Appendix 4.**

higher for those on less than average earnings (about 90 per cent for those on median earnings) and could be smaller for those on high incomes.

2.61 In considering what the current arrangements will provide, the Committee notes that the different approaches to modelling of projected retirement incomes used by Treasury and ASFA (based on the potential results of the current nine per cent SG and age pension provisions), produced different results in dollar terms, but very similar results in net replacement rate terms. The Committee considers that care should be taken with using dollar figures, as this may lead to misleading expectations because of the fluctuating purchasing power of the dollar over time, with wages growth and the impact of inflation.

2.62 The Committee also notes that the Treasury 'cameo', which has a replacement rate of 60 per cent for the single male, retiring at age 65 after 30 years of work on average earnings, falls short of the consensus target rate of 70-80 per cent (approximately 60-65 per cent of gross pre-retirement income).

2.63 The Committee also notes that relatively few people achieve average earnings which calls into question the validity of using average weekly earnings (AWE) as the appropriate assumption for modelling projected retirement incomes. The Committee understands that the median income is about 75 per cent of AWE, and that this level of earnings would be more appropriate for modelling purposes.

2.64 The Committee considers that the most important factors influencing the ability of a person to self fund an adequate retirement are the level of funding through quantum of contributions and the duration of those contributions. The Committee observes that no matter how well educated a person is, if there is insufficient income and saving during a person's life, an individual's expectations of a standard of living in retirement may not be achieved.

2.65 The Committee notes that the effect of more widespread casual and part-time work, broken work patterns, and early retirement or retrenchment have made the concept of a 40 year full time career obsolete. Accordingly, the Committee considers that the benchmark for an average working life, and therefore the ability of a male to accumulate superannuation contributions, is now approximately 36 years, and less for females.[41]

2.66 The Committee also notes that the Institute of Actuaries consider that the most appropriate measure of the adequacy of long term retirement incomes is the first year of retirement net replacement rate. Accordingly the Committee is persuaded that the first year of retirement net replacement is the most appropriate adequacy benchmark.

2.67 The Committee notes that the available modelling demonstrates that the net replacement rate of income in retirement for the median income groups from a 30 year career under the compulsory SG system are not sufficient to meet the consensus target

41 *Committee Hansard*, 17 July 2002, p. 336.

replacement rate of 70-80 per cent for average earners and 90 per cent for those on median earnings. By contrast, Treasury modelling produced a first year net replacement rate of about 60 per cent of final working life expenditure for those on average earnings, and 67 per cent for those on median earnings.

2.68 The Committee acknowledges that the results of any modelling in this area that seek to provide outcomes decades into the future are subject to many factors that could change the outcome. Nonetheless the Committee can only make assessments on the basis of the best available contemporary advice it receives.

2.69 Therefore the Committee concludes that, should the consensus replacement rates be accepted, the likely outcomes of the SG, taken together with the age pension, will not meet the benchmark targets of adequacy for the majority of people on or below average incomes.

Access to RIM models

2.70 Some commentators have indicated that it is very difficult to develop options to address adequacy and improve equity without access to common modelling tools. For example, IFSA submitted:

> Consideration of front-end tax impacts, and their removal, requires open access to the models used by the Commonwealth. The current debate on front-end tax removal is incomplete without a full fiscal analysis of the changes in revenue amounts and timing, and of future savings to outlays – and this analysis requires the data and models used by RIM.[42]

2.71 The Committee sought the views of the Treasury about providing wider access to RIM modelling. The Treasury responded in the following terms:

> The resources of RIM are currently more than fully occupied doing quantitative analysis of ageing, retirement income and personal income tax policies for the Government, and cannot be redirected to work in collaboration with private organisations.
>
> There would be a considerable cost in supporting the external use of RIM models because of their complexity. The use of RIMHYPO and RIMGROUP requires an understanding of superannuation, taxation and social security policy – and this combination is not common, and takes a long time to teach. RIMGROUP is so complex that it can take six months to gain proficiency in its use, and RIM is not in a position to do extensive training and support. If the models were to be made commercially available, it could take RIM a year to acquire and train staff who could support external users. To recoup costs, fees for the models would need to be high.

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42 *Submission* 70, IFSA, p. 12.

> There would also be potential for conflicts of interest to arise if government officials were to work on issues identified by external organisations without the agreement of the government.[43]

Committee view – access to RIM modelling

2.72 The Committee notes that the modelling of retirement income scenarios, and options for reform, is a very complex area. The Committee has spent considerable time, and received much evidence, on the basis of different assumptions and modelling techniques. This has made consensus much more elusive than it would have been if common benchmarks and tools had been adopted by the key stakeholders. The Committee is aware that productive and worthwhile public debate can be stifled where one party can dismiss proposals and options simply because of disagreements over modelling outcomes.

2.73 The Committee notes that the public sector is not the sole repository of expertise in public policy relevant to the discussion of retirement income issues. The submissions and the evidence clearly demonstrate a very high level of understanding from industry groups.

2.74 The Committee therefore considers that, having established the objectives or goals for Australia's retirement income systems, there is a need for all key stakeholders to identify common modelling assumptions for projecting retirement incomes. At the very least, the Committee considers that RIM models should be provided to key groups so that they can model proposals for change using the same basic assumptions and modelling techniques.

Recommendation

2.75 **The Committee recommends that, having established the objectives or goals, the Treasury convene a panel of key stakeholders to identify, and where possible recommend, common modelling assumptions and techniques for projecting retirement incomes.**

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43 *Submission* 142, Treasury, p. 8.

Chapter 3

Closing the Adequacy Gap

Introduction

3.1 The previous chapter noted evidence to the inquiry that there is a shortfall in the ability of the nine per cent superannuation guarantee (SG) contribution, together with the age pension, to deliver appropriate target retirement incomes for many representative groups of Australians.

3.2 This chapter considers whether more contributions are necessary and if so, from what source, including the role played by:

- additional compulsory contributions;
- voluntary contributions, including Government co-contributions; and
- increasing the access to superannuation as a long-term savings vehicle.

Additional compulsory contributions

3.3 The first pillar of the retirement income system, the compulsory employer SG, began from 1 July 1992. The level of compulsory employer contributions has grown from a minimum of three per cent of earnings to nine per cent by 1 July 2002.

3.4 A number of submissions to the inquiry called for additional compulsory contributions to close the adequacy or expectation gaps, that is the gap between what people desire in retirement and what the current systems will actually deliver. Some submitted that any additional contributions will help address the gap, and that the reduction of the contributions tax can have the same effect as an increase in contributions. Some also suggested that increasing the compulsory employer component would be necessary, while others favoured introducing compulsory employee contributions.

3.5 For example, the Australian Bankers' Association (ABA) submitted that it would be difficult to respond to the gap issue without increasing contribution levels, either voluntary or compulsory, and that the international experience suggests that compulsory contributions could come from the employee:

> In ABA's view, it is difficult to achieve a satisfactory response to the adequacy issue without increased contributions from individuals, whether voluntary or compulsory — or both.
>
> On the question of going further with compulsory contributions, it should be noted that virtually all of the major OECD countries have some system of mandatory contribution for retirement, in most cases through 'social

security' systems producing defined benefits.[1] Whether in North America or in Europe, all of these systems differ from Australia's Superannuation Guarantee in requiring a *sharing* of the burdens between employees and employers. The 9 per cent Superannuation Guarantee employer contribution in Australia is already a substantial employment on–cost. This suggests that any increment to the compulsory level should preferably be as an employee co–contribution, ideally with the impact on take–home pay softened by phasing (small steps over a period when most people's pay is likely to increase) and, say income tax cuts.

There is a public policy case that can be made out for further compulsory contributions, and it is worth noting that opinion surveys have found that compulsory superannuation is now widely accepted.[2] Many people appear to be grateful that someone has obliged them to put something away for their old age.

The precise means through which increased contributions are achieved are a matter for more detailed assessment, including by the Government's experts. However in ABA's view, the precise mix of means is less important than a firm commitment to set goals and identify measures which will effectively achieve them.[3]

3.6 In **Table 3.1** below, the ABA also demonstrated the need for additional contributions over varying working lives to achieve the target replacement rate of 75-80 per cent of pre-retirement income:

Table 3.1: Employer contributions (including 9 per cent SG) for person on AWE to achieve 75-80 per cent disposable income replacement[4]

	Years of work		
	40	**35**	**30**
Contribution Rate	12%	14%	17%

Source: *Submission* 51, ABA, p. 13.

3.7 **Table 3.1** suggests that additional contributions of about three per cent of salary, over and above the nine per cent SG contribution, are needed over an

1 See footnote in ABA submission: See *Retirement Income Systems: The Reform Process across OECD Countries*, Organisation for Economic Co-operation and Development (OECD) Working Paper AWP 3.4, 1998. *Submission* 51, ABA, p. 17.

2 See footnote in ABA submission: ASFA (based on an address by Philippa Smith to FPA Conference, November 2001) cites research indicting 95 per cent support. *Submission* 51, ABA, p. 17.

3 *Submission* 51, ABA, p. 17.

4 See footnote in ABA submission: 'Based on modelling presented in a statement published by a group of experts, the 'Retirement Futures Forum' early last year. The statement was released by D. Chessell, V FitzGerald, B. Fraser, S. Grant, D. Knox, M. Robertson, S. Ryan, I. Silk, P. Smith and G. Weaven, 19 March 2001 (via the office of Industry Fund Services).' See *Submission* 51, ABA, p. 13.

uninterrupted 40 year career to achieve the desired outcome of 75-80 per cent of pre-retirement income for a person on average earnings. For a more realistic 35 years of work about 5 per cent additional contributions are needed.[5]

3.8 Like the ABA, IFSA also considered that there is scope to increase employee contributions while ensuring that real take home pay does not fall through some future tax cut being directed to retirement savings.

3.9 Mr Willis from the Australian Industry Group also called for an additional three per cent in compulsory contributions to close the adequacy gap, but from employees and not employers:

> we are very cognisant that that is not widely supported, at least publicly, at this time. It is nonetheless a position we have advocated for at least 12 years. We believe the merits of the proposition on equity considerations are unarguable. We believe that people should be required to contribute to their own retirement income. We accept that there are significant political and economic difficulties associated with the implementation of such a policy. We do not come to this committee with a specific strategy or a time line over which that should be introduced but we do strongly support the principle and commend it to the committee and to the parliament.[6]

3.10 By contrast, the Industry Funds Forum (IFF) and the Australian Council of Trade Unions (ACTU) considered that the compulsory SG should be increased to 15 per cent.[7] In addition to supporting an increase in compulsory contributions from nine to 15 per cent, the ACTU also envisaged that the additional contributions could be shared:

> The ACTU recommends that the Committee consider options for this to occur, including through the taxation system, direct employer contributions, member co-contributions or a combination of some or all of these.[8]

3.11 In addition to recommending an increase in the SG to 12 per cent, ASFA also focused on options involving the removal of the contributions tax as ways of improving adequacy.[9] ASFA submitted that:

> Action by both individuals and government will be necessary. ASFA considers that important steps in improving adequacy of retirement incomes and equity will be to remove the contributions tax and to increase contributions. For a 35 year old individual on $40,000 per year (around AWE), removing contributions tax and increasing contributions to 12 per

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5 *Submission* 51, ABA, p. 13.

6 *Committee Hansard*, 17 July 2002, p. 329.

7 *Submission* 28, IFF, p.2. *Submission* 57, ACTU, p. 1.

8 *Submission* No.57, ACTU, p. 2.

9 Suggestions to increase adequacy through a reduction or removal of superannuation taxes are addressed later in this report in Part III – Equity.

> cent of wages would increase the retirement savings, in today's dollars, from $207,000 to $292,000. This is a very substantial increase which would go a long way to meeting retirement expectations of such an individual.[10]

Voluntary contributions

3.12 Further to the suggestions for additional compulsory contributions, from either the employer or the employee, many submissions also called for improving incentives for voluntary contributions, either independently or in conjunction with a Government co-contribution, to address the shortfall in reaching desirable retirement incomes.

3.13 In its written submission to the Committee, the National Institute of Accountants (NIA) advised that: 'Individuals must be educated on the importance of making greater personal contributions and should be given greater incentive to do so'.[11]

3.14 In its written submission to the Committee, the AMP submitted that Australians are willing to make voluntary contributions to boost their retirement incomes:

> Recent figures indicate that Australians are voluntarily contributing to their retirement savings. It is estimated that in 2000-01, 44% of total contributions to superannuation were voluntary employee contributions, up from 23% in 1995-96 (APRA 2002). Data also suggests that the proportion of employees making voluntary superannuation contributions rises with income.[12]

3.15 The following table provided by the AMP demonstrates the level of voluntary contributions by various income groups.

Table 3.2: Voluntary contributions to super by income - 2000[13]

	Annual income	**$1 - $19,999**	**$20,000 - $39,999**	**$40,000 - $59,999**	**$60,000 - $79,000**	**$80,000 - $99,999**	**$100,000 +**
% making contributions		8.6%	23.7%	43.9%	48.5%	44.0%	39.5%
Of this group, the level of weekly contributions	Under $20	35.7%	28.3%	13.2%	7.6%	8.4%	6.5%
	$20 - $39	21.7%	35.1%	25.9%	12.4%	10.1%	10.0%
	$40 to $59	10.0%	12.7%	26.8%	23.6%	16.8%	9.6%
	+ $60	11.5%	8.4%	21.3%	43.4%	51.3%	61.1%

Source: ABS 6360.0, cited in *Submission* 64, AMP, p.18.

3.16 The AMP also submitted that:

10 *Submission* 73, ASFA, p. 5.

11 *Submission* 59, NIA, p. 3.

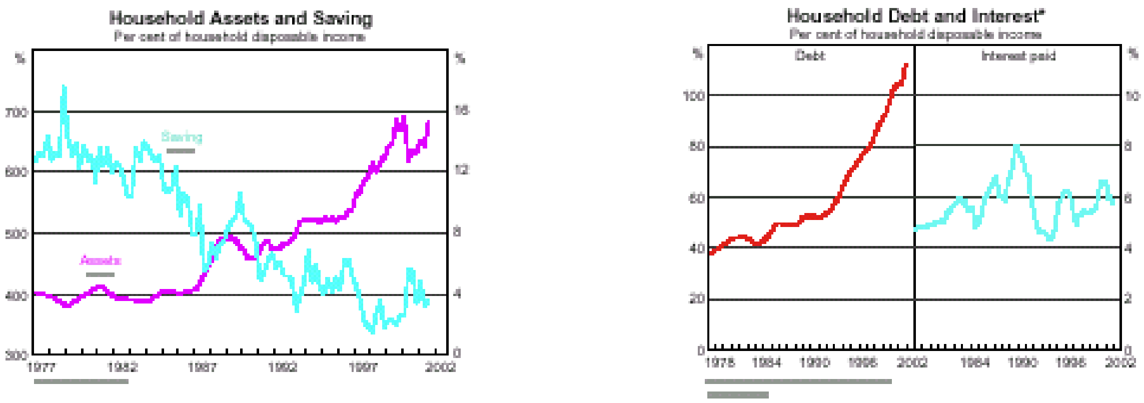
12 *Submission* 64, AMP, p. 18.

13 *Submission* 64, AMP, p. 18.

> By encouraging those who can, to make additional contributions, should go some way to addressing the expected pressures on future Government Budgets in relation to aged pensions, aged care and health expenditures. If the future expenditure issues are not addressed, then it will be the younger generations who will be under pressure to fund retirees needs. Introducing measures that encourage baby boomers (as well as younger generations) to fund their own retirements today should be supported, as it also allows the cost of these incentives to be spread across today's tax payers.[14]

3.17 While there appears to be an ability to save, the need for incentives to increase voluntary long-term superannuation savings is reflected in Australia's low household savings record. The following charts demonstrate the downward trend in household savings and the upward trend in household debt.

Chart 3.3: Household Assets and Savings and Household Debt and Interest[15]



Source: RBA tables cited in *Submission* 70, IFSA, p.7.

3.18 According to IFSA, the message from these Reserve Bank of Australia (RBA) charts is that Australians are saving about a third as much of their income as they did 25 years ago, while the value of their household assets as a percentage of disposable income has increased by 70 per cent.

3.19 The IAA submitted that it was necessary to provide incentives for individuals to make voluntary contributions to superannuation in the following terms:

> The IAA considers that the national debate should move away from a focus on increasing the level of compulsory SG contributions. Rather, Government and industry commentators should focus on how best to target incentives for voluntary saving for retirement and better integrate the superannuation and social security systems. A desirable outcome from the retirement income system would be compulsory SG superannuation (in conjunction with the Age Pension where required) that provides a foundation retirement income for all. This should be combined with

14 *Submission* 64, AMP, p.18.

15 Cited in *Submission* 70, IFSA, p. 7.

> appropriate incentives for voluntary saving that provide the flexibility for individuals to achieve retirement incomes that reflect their personal circumstances and expectations.[16]

3.20 CPA made the following comments about incentives for voluntary contributions:

> It is apparent that the pillar of voluntary savings is not supporting the pillars of the safety net of the age pension and compulsory superannuation system. Australians seem to be taking comfort in compulsory contributions and are not actively planning and providing for their own retirement. According to a recent Australian Bureau of Statistics (ABS) survey, only 25% of workers aged between 15 and 54 years make voluntary contributions. (ABS 2000, Table15).
>
> Policy reform clearly needs to focus on providing adequate incentives for Australians to make superannuation contributions. Public confidence in, and public awareness of, superannuation are also essential issues.[17]

3.21 Another suggestion raised in evidence to the inquiry to provide additional incentives to save was through Government co-contributions matching voluntary member contributions. For example Dr Vince FitzGerald submitted:

> The mention of co-contributions prompts me to comment, having been implicated in the research that IFSA sponsored. The idea of co-contributions as a supplementary mechanism within the system has found favour at different times and in different forms with both sides of politics. If you are stuck with a system where the overall architecture is much like the one we have now—with taxes all over the place and difficulties in targeting—and your concern about equity was really about the situations of people on low to middle incomes, then co-contributions are not a bad thing to look at. In that research, we found that dollar for dollar matching is an extremely generous incentive; in fact, you can induce people to make a bit of an effort themselves. We are not talking about the people right down the poverty end but about the battlers—if that is still an acceptable term—who have to make a bit of an effort to save.
>
> According to the research and modelling we did, $1 for $2 would allow you to either extend the coverage of the co-contribution well towards average earnings—certainly past median earnings—or to go a certain distance on the same or a smaller budget while also inducing a substantial flow of additional private contributions. That mechanism is one of the variants that is available. If you do not believe we can address all these equity issues by a big bang or a roll-up or a transition model, it offers an opportunity to look at

16 *Submission* 74, IAA, p. 3.

17 *Submission* 43, CPA, p. 5.

> some of the middle income adequacy and equity issues and target such a thing, which would not disturb the rest of the system.[18]

3.22 Mr Davidson from the Australian Council of Social Service considered that any proposed Government co-contributions should apply to compulsory SG contributions as well as voluntary contributions:

> We oppose a general reduction in the contributions tax because the people who will benefit the most from it per dollar contributed are by definition those on higher incomes. I think that is very clear. Matching contributions are much more equitable than the present system and would be more equitable still if they applied to compulsory as well as voluntary contributions. One of the problems with restricting them to voluntary contributions is that the most income constrained groups in the population will not benefit: by definition, they still will not save more and, therefore, will not receive the concession. There will be a certain amount of leakage to the partners of high income people. Having said all of that, matched contributions are certainly much fairer than the present tax treatment, but we would prefer matched contributions to apply to the compulsory as well as the voluntary contributions. In that way, they are an equity measure for the bottom end as well as being an incentives measure.[19]

3.23 The ACTU also supported the thrust of this approach, indicating that it supported measures to assist low and middle income earners increase their retirement savings.[20]

3.24 The AMP made the following additional suggestions:

> The Government could increase the take up of voluntary saving by adopting two measures. First, is an incentive program along the lines of the co contribution, and second, making it easier for anyone, whether working or not, to make a voluntary contribution.[21]

3.25 In addition, the AMP also suggested extending the Government co contribution, currently available to those with an assessable income below $32,500, to those with an assessable income of $60,000:

> Extending the co-contribution to those with an assessable annual income of $60,000 (the highest income tax threshold), would provide an incentive for employees to make additional superannuation contributions.

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18 *Committee Hansard*, 8 October 2002, p. 700.

19 *Committee Hansard*, 8 October 2002, pp.700-701.

20 *Submission* 57, ACTU, p. 3.

21 *Submission* 64, AMP, p. 17.

> The co-contribution could remain capped at $1,000 for those on less than $20,000, reducing by $0.025 per extra dollar of income, up to the $60,000 threshold.[22]

3.26 Similarly, ASFA made the following comments about expanding the recently implemented co-contributions in respect of low income earners:

> …having in place a mechanism for delivering a targeted co-contribution is nearly as important as the characteristics of the co-contribution itself. In ASFA's view, there are grounds for expanding the number of potential recipients of the co-contribution, while at the same time focussing more closely on low to middle income family units.
>
> ASFA suggests that the co-contribution could be refined by focussing on singles and couples where the family income is modest. It also would be more effective in achieving retirement income objectives if the payment were made available to a wider range of low to middle income earners so as to encourage their efforts at saving and greater self reliance.
>
> For instance, including individuals with taxable income of up to $40,000 would double the number of potential recipients to a little less than 600,000 individuals. ASFA appreciates that such a dollar for dollar co-contribution would have a cost of up to $300 million a year. If the cost in the current Budget context were a significant concern then consideration could be given to a co-contribution rate which was less than dollar for dollar.[23]

3.27 In addition ASFA also submitted that moving beyond the year 2002-03, 'it would be desirable to have a rate of co-contribution which encouraged and supported significant additional member contributions further up the income range of low to middle income individuals and families, and which provided dollar for dollar assistance.' In support of this ASFA submitted that:

> … additional contributions be encouraged and supported as part of a process of mutual obligation, rather than being mandated. A possible way of doing this would be by way of personal contributions matched by a government contribution. For equity reasons middle income earners with a salary in the range $30,000 to $60,000 might be a particular target of government assistance. This group receives no assistance from the government's co-contribution, although the Committee will note that in the previous section ASFA was recommending that the upper limit for the co-contribution be increased in the next financial year to $40,000.
>
> Another reason for focussing on individuals on $30,000 or $40,000 to $60,000 per year is that those on lower incomes already are benefiting from the Age Pension, and some of them at least will benefit from the soon to be introduced co-contribution. At the other end of the scale, upper income

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22 *Submission* 64, AMP, p. 17.

23 *Submission* 73, ASFA, p. 62.

earners have greater capacity to make contributions without the need of a co-contribution.[24]

Widening access to superannuation as a savings vehicle

3.28 A number of submissions called for the widening of access to superannuation, including through changes to the employment and age-based tests. For example the AMP submitted:

> Taking in to account the Government's recent election commitments relating to voluntary superannuation (first child tax rebate, super for children, increasing the age for voluntary contributions from 70 to 75), access to superannuation will be much improved. Although access will still be restricted to certain groups.
>
> The Government should widen access to super even further, allowing anyone between the ages of 18 and 75 to make undeducted voluntary contributions, regardless of their employment or spouse status.
>
> This would avoid complex rules being designed to classify who can and cannot make contributions.
>
> It would also simplify the fund trustees' role in determining who could and could not make voluntary contributions, particularly in relation to satisfying work test criteria.
>
> This will be beneficial for older workers who might wish to move in and out of the workforce once they have retired from full time work, but wish to save more for their retirement.[25]

3.29 IFSA noted that, following the 2002 Budget announcements, very few people are now prevented from making personal contributions to superannuation. In its submission, ISFA made the following points about the employment nexus:

> Rather than stating who may not contribute, superannuation regulations contain multiple categories of people who can. This seems to result in complicated systems and costly administrative processes, all of which come at cost to fund members saving for their retirement. All can be traced to the original employment nature of superannuation – the employment nexus.
>
> The obvious and simple solution – to remove the employment nexus from personal superannuation contributions – warrants exploration. It would not be difficult to assess who would benefit, who (if anyone) might lose, and to scope the costs and benefits to superannuation fund members, superannuation funds, and retirees. Assessing Commonwealth fiscal cost

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24 *Submission* 73, ASFA, pp. 62-64.

25 *Submission* 64, AMP, pp. 17-18.

> and benefit might be more involved, but it would allow reasoned consideration of the issue.[26]

3.30 IFSA also considered that non superannuation monies should also be permitted as contributions to income stream products to assist people achieve adequate superannuation incomes:

> The tax rules also effectively exclude non-superannuation savings from allocated retirement income stream products. The design of these products facilitates the orderly drawdown of capital across retirement, and limits inappropriate tax deferral. As such, these products are important to help retirees achieve adequate income across their whole retirement, and this exclusion militates against adequacy.
>
> It seems to be difficult to quantify the fiscal benefit of this exclusion, if any, and as such it is hard to justify its continuance. The exclusion is not present in social security rules for asset test exempt annuity products, for the reason that retirement income streams meet the policy objectives of retirement incomes policy no matter what the source of the purchase price.
>
> …
>
> The rules excluding non-superannuation monies from retirement income stream products should be removed. If it is appropriate to retain some limitations in order to prevent misuse of this access, these could be implemented in conjunction with removal of the existing impediments.[27]

3.31 In its submission ASFA noted that it could be argued that the occupational link for superannuation is in such disarray that the pretence of maintaining it should be abandoned.[28] The Institute of Chartered Accountants in Australia (ICAA) also recommended a separation from the employment nexus to encourage all Australians with disposable income to invest for retirement.[29]

Committee view – closing the adequacy gap

3.32 The Committee notes that the current available evidence demonstrates that the SG and age pension alone will not provide an adequate income in retirement for most people. The Committee also notes the variety of suggestions to address the shortfall between the expectations and reality of incomes in retirement.

Contribution levels

3.33 The Committee notes the calls for additional compulsory contributions to close the adequacy gap, either with or without additional voluntary savings. The Committee

26 *Submission* 70, IFSA, p. 14.

27 *Submission* 70, IFSA, p. 15.

28 *Submission* 73, AFSA, p. 53.

29 *Submission* 31, ICAA, p. 2.

is particularly conscious of the evidence before it advocating an increase in SG contribution levels above the current nine per cent level.

3.34 The Committee notes that there is no consensus among the major groups about the level to which these compulsory SG contributions should go, nor the source of the additional compulsory contributions to fill the identified shortfall.

3.35 The Committee considers that the current economic and employment climates are difficult ones in which to contemplate additional compulsory employer contributions. The Committee is also reluctant to propose compulsory member contributions because of the immediate reduction in living standards that would result. Against that background, the Committee is not satisfied that employers or individuals could afford or support additional compulsory contributions in the current economic circumstances. Accordingly the Committee supports incentives to save in superannuation through voluntary tax effective contributions as the means to fill the adequacy gap.

3.36 The Committee recalls that prior to 1983 the incentives to make compulsory contributions to superannuation were much more generous than they are today. Before 1983 there were no contribution, earnings, or surcharge taxes and only five per cent of lump sum benefits were subject to tax at the person's marginal tax rate. Even so, the record shows that superannuation coverage extended to only some 40 per cent of the population – and these were mainly public sector (where fund membership was compulsory), male, and high income earners. It is clear from this experience that tax incentives alone may not be sufficient to generate significant new voluntary contributions, although the spread of compulsory superannuation has lifted the level of contributions due to increased awareness and understanding of superannuation, as evidenced in paragraph 3.14. The Committee also notes that the existing SG laws do not ensure that salary sacrificed contributions are encouraged, as some employers are able to reduce their contributions.

Co-contributions

3.37 The Committee is therefore attracted to the notion of revisiting the co-contribution concept as a means of boosting voluntary savings. The Committee has received a number of worthy proposals to extend the current arrangement so that more people would be able to make contributions without significant impacts on the Budget bottom line. These include proposals to extend co-contributions to the middle income group where there is more scope to make a voluntary contribution, for example to those on AWOTE, and ensuring that the co-contribution concept assists the less fortunate in society. In addition, the Committee has been informed that the level of voluntary contributions (and presumably the ability to make additional contributions) rises with income. The additional savings that this extension will encourage will also assist in correcting Australia's low household savings record.

Superannuation and employment

3.38 The Committee acknowledges that recent policy developments have reduced but not removed the nexus between employment and access to the superannuation system. For example the Committee notes the developments to provide non working spouses and children with access to superannuation. The Committee also notes that the age limit for older Australians to make personal contributions to superannuation has recently been raised to 75 years. Furthermore, the Committee supports removing the work test for making voluntary contributions.

Increasing access to superannuation

3.39 The Committee notes that non superannuation assets currently are excluded as contributions to superannuation income stream products. The Committee considers that, subject to equity considerations, every chance should be taken to allow people to maximise their income in retirement through topping up their assets from non superannuation money, providing that, as far as possible, there are no adverse tax or age pension means test consequences.

3.40 The Committee also notes that the Government's proposal for superannuation contribution splitting between spouses.

Recommendation

3.41 **The Committee recommends that the Government:**

- **extend the co-contribution concept by raising the threshold to people on average earnings, and improving the coverage to lower to middle income earners;**
- **remove the work test for making voluntary contributions for those under age 75; and**
- **permit the contribution of any non superannuation asset to superannuation income stream products, providing that, as far as possible, there are no adverse tax or age pension means test consequences.**

Chapter 4

Factors Inhibiting Adequacy

Introduction

4.1 As reflected in the previous chapter, increasing contributions and widening access to superannuation as a savings vehicle were some of the ways in which evidence to the inquiry suggested that the shortfall between the expectations and reality of incomes in retirement could be addressed. However, much of the evidence to the inquiry suggested that there were a number of factors which reduce the effectiveness of the current contribution arrangements, impact on the adequacy of incomes in retirement, and reduce incentives to save.

4.2 This chapter discusses the impact of:

- front-end taxes;
- fees and charges; and
- rising household debt.

4.3 Discussion of the superannuation taxation arrangements, including the annual and whole of life taxation measures, is included in Part III – Equity.

The impact of front-end taxes on adequacy

4.4 The introduction of front-end or accumulation phase taxes, including superannuation contributions and earnings taxes from 1988, resulted in reducing the compounding effect of interest on savings and acted as a break on the growth. This situation was extended from 1996 with the introduction of an additional front-end tax, the surcharge tax, on high income earners.

4.5 Despite these developments, in evidence to the inquiry, Treasury indicated that superannuation remains a tax preferred savings vehicle:

> Notwithstanding Australia's approach of taxing superannuation at all three stages (ie contributions, earnings and benefits), research undertaken by Treasury's Retirement and Income Modelling Unit indicates that superannuation is a tax preferred investment over a working lifetime for persons in all marginal tax brackets. … The aggregate size of the tax expenditure associated with superannuation is projected at approximately \$10.3 billion in 2002-03.[1]

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1 See footnote in Treasury's submission: *Budget Strategy and Outlook 2002-03,* Budget Paper No. 1, 14 May 2002. For methodology and other related issues see: Appendix B: Superannuation Benefits, *Tax Expenditures Statement 2001.* See *Submission* 78, Treasury, p. 15.

> The taxation of superannuation can affect the adequacy of retirement incomes in a number of ways. In a direct sense, the concessional taxation treatment of superannuation increases the amount of a contribution which is available to be invested (after tax) compared with alternative forms of saving – for example, shares or property acquired out of after tax income. This advantage continues during the accumulation phase of superannuation reflecting the concessional tax rate applying to investment earnings on superannuation account balances. The concessionality of superannuation also has an indirect impact on the adequacy of retirement incomes to the extent that it encourages individuals to undertake retirement savings.[2]

4.6 The Committee notes that a number of submissions to the inquiry recommended the abolition or phasing out of front-end taxes as a means of boosting adequacy. COTA also supported this approach but in doing so, expressed a desire to maintain revenue to fund current age pension payments. COTA submitted that:

> … contributions and earnings taxes reduce superannuation accumulation, and thence pay-outs and retirement incomes. Shifting taxation to the benefits stage would leave more money accumulating in superannuation for longer, and have very positive effects on benefits. This is a desirable outcome, as long as net Commonwealth revenue is not diminished, nor disrupted by the changeover. Revenue is required to maintain the existing Age pension and finance the range of community services currently available to seniors and other members of the community.[3]

4.7 ACOSS expressed its concern that the complexity of the system of taxing superannuation does not provide incentives to save. The Council submitted that:

> From the standpoint of savings incentives, it is the *concessionality* of the tax treatment at each stage, not the *number of times* superannuation savings are taxed, that matters. The present system is highly concessional at each of the three stages. However, transparency is also important. People will only be encouraged to save voluntarily on a large scale if they understand how the tax concessions work. The present system is both complex and opaque.[4]

4.8 AMP submitted that one way of addressing the complexity of the system of taxing superannuation, and to boost retirement savings, would be for the Government to consider a move from front-end to benefit stage taxation. AMP estimated that by implementing a benefit tax, someone on average earnings could add an extra nine per cent to their superannuation over 10 years, or 12 per cent over 20 years.[5]

4.9 In its submission, CPA provided a copy of research that it had commissioned from the National Centre for Social and Economic Modelling (NATSEM). In this

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2 *Submission* 78, Treasury, p. 15.

3 *Submission* 63, COTA, p. 26.

4 *Submission* 65, ACOSS, p. 14.

5 *Submission* 64, AMP, p. 4.

report, NATSEM indicated that a straight abolition of the 15 per cent tax on employer superannuation contributions, and also of the superannuation surcharge, would have a similar effect on retirement living standards to an additional 3 per cent employee contribution to superannuation.[6]

4.10 In its submission to the inquiry, the IAA modelled the impact of front-end taxes on a target level of end benefits of 60 per cent of gross income before retirement. The results are presented in **Table 4.1.**

Table 4.1: Examples of a 20 year old male on a current salary of $30,000 retiring at age 65 or age 70[7]

	Retire @ 65	**Retire @ 70**
With current taxes	19.3%	15.5%
No contributions tax	16.4%	13.2%
No investment tax	16.9%	13.4%
No cont/investment taxes	14.4%	11.4%

Note: The projections show that the contribution rates required for a male on a current salary of $30,000 to achieve the target retirement benefit.
Source: *Submission* 74, IAA, p. 10.

4.11 According to the IAA, **Table 4.1** demonstrates that if a male retires at age 65, the elimination of contribution and investment taxes on superannuation would reduce the required contribution to provide the target retirement benefit from 19.3 per cent to 14.4 per cent of salary. Retiring later gives more years to contribute and leaves less time in retirement to receive the benefit. As a result, the required contribution rate reduces significantly for males retiring at age 70 rather than age 65.[8]

4.12 The IAA suggested that one means of reducing the impact of taxes on adequacy worthy of consideration would be the capping of taxes as a percentage of Gross Domestic Product (GDP). The IAA indicated in its submission that although this would be difficult to implement, a cap would maintain existing revenue in real terms while limiting future increases.[9]

4.13 In response to a question from the Committee on the effect of front-end taxes on adequacy, Dr Hazel Bateman, of the Centre for Pensions and Superannuation at the University of NSW, provided the following information:

6 *Submission* 43, CPA, p. 6.

7 *Submission* 74, IAA, p. 10. The IAA notes that 'For the purposes of illustration, we have assumed a target retirement benefit that is sufficient to provide (in present day value) a lump sum of $100,000 plus a pension equal to the Age Pension. The examples assume that, based on an investment earning rate of 6 per cent p.a. and inflation of 4 per cent p.a., the equivalent lump sum present value of the Age Pension for males is $140,000 at age 65 and $114,000 at age 70.'

8 *Submission* 74, IAA, p. 10.

9 *Submission* 74, IAA, p. 12.

> …under the current superannuation tax regime (of a 15% contributions tax and a net earnings tax of 8%) with administration charges and insurance premiums of 2% of assets per annum, a gross contribution rate of 17.7% is required to generate the same retirement income as a 9% net contribution rate. Including lump sum taxes, the gross contribution rate increases to 19.9%.[10]

The impact of fees and charges on adequacy

4.14 In November 2002 the Committee reported on the provisions of the Superannuation Legislation Amendment (Choice of Superannuation Funds) Bill 2002. A large body of evidence was provided to the Committee during that inquiry on the impact of fees and charges on account balances. Most of the evidence to that inquiry suggested that fees and charges have an adverse impact on fund balances and retirement incomes, and that entry and exit fees prohibited portability and consolidation of accounts. Suggestions to address these issues included a cap on fees and charges or prohibiting entry and exit fees.

4.15 In its report on Choice of Superannuation Funds, the Committee commented on the impact of fees and charges, noting that Treasury uses an assumed fee of 1 or 1.2 per cent in its modelling of projected retirement incomes, a figure which is significantly lower than many retail funds offer. In its report, the Committee indicated the fees charged by funds should reflect the underlying cost of the service, but that a cap on fees and charges would not be without its practical problems. The Committee also noted that in its consultation paper on portability, the Government leaves open the option of regulating exit fees.

4.16 Further, in its report on Choice of Superannuation Funds, the Committee emphasised the importance of a standardised disclosure regime, which has been consumer comprehension tested, to allow valid comparisons to be made between funds. The Committee also considered that the disclosure regime should allow employees to compare funds based on the projected end benefit, rather than the overall cost of the fees and charges.[11]

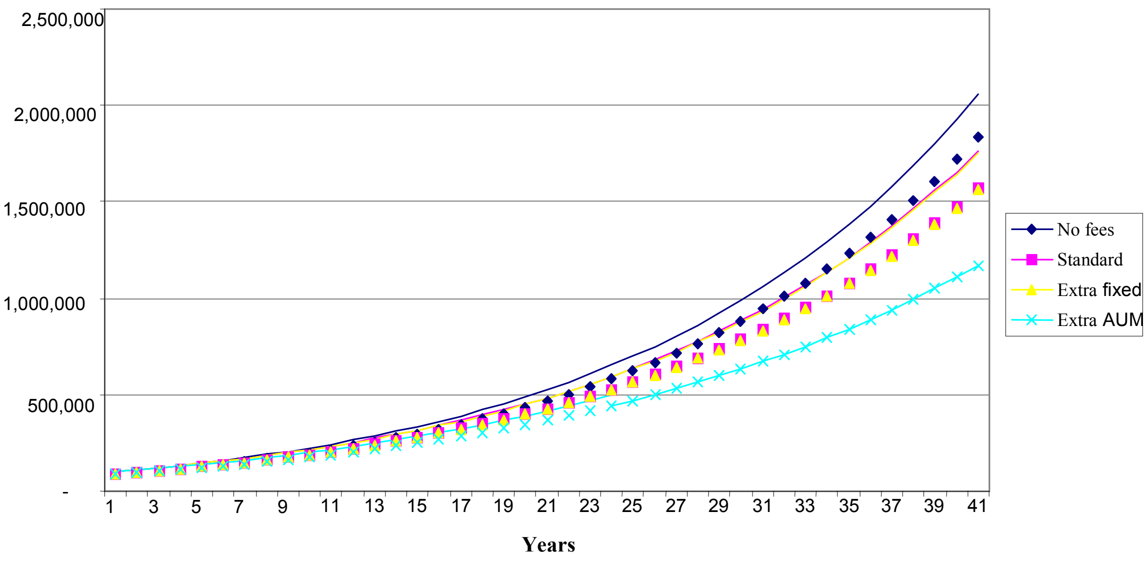
4.17 The impact of fees and charges on the adequacy of retirement incomes was also a major issue raised during this inquiry into the adequacy of superannuation, where similar evidence was provided.

4.18 The Committee cites below a graph provided by Sunsuper on the effect of fees on the balance of a fund over 40 years, based on an initial balance of $100,000:

10 *Submission* No.104, UNSW, p. 1.

11 Senate Select Committee on Superannuation, *Provisions of the Superannuation Legislation Amendment (Choice of Superannuation Funds) Bill 2002*, November 2002, pp. 63, 81-82.

Chart 4.2: Effect of Fees – Accumulation over 40 Years



Source: *Submission* 128, Sunsuper, p. 3.

Assumptions:
Interest of 6 per cent after tax before fees
Inflation of 3 per cent per annum
15 per cent tax on contributions
Initial annual contribution of $5,000
Standard fees - $1 per week and 0.5 per cent per annum asset fee
Extra fixed is extra $1 per week. Extra fee for assets under management is 1 per cent per annum.

4.19 Sunsuper indicated that the graph shows that over a 40 year period, based on an initial balance of $100,000 and the assumptions listed above, an extra management fee of one per cent per annum would reduce the fund balance in its 40th year from $1,759,000 to $1,314,000, a difference of $445,000.[12]

4.20 Cbus indicated in its written submission that there is an argument that since superannuation contributions are compulsory that the fees that are charged by providers of superannuation funds should be subject to regulation.[13]

4.21 The Committee notes proposals by the ALP to prohibit certain types of fees and cap others.[14]

The impact of rising household debt on adequacy

4.22 A number of submissions made the connection between rising household debt and the availability of superannuation to repay that debt. For example, Ms

12 *Submission* 128, Sunsuper, p. 3.

13 *Submission* 42, Cbus, p. 10.

14 Senate Select Committee on Superannuation, *Provisions of the Superannuation Legislation Amendment (Choice of Superannuation Funds) Bill 2002*, November 2002, p. 91.

Wolthuizen from the Australian Consumers' Association made the following remarks at the Canberra roundtable discussion on 8 October 2002:

> The debt burden is something we are seeing and certainly having reported to us, particularly where consumers are using their home equity to fund their lifestyle either through accessing a line of revolving credit attached to their mortgage or using their home as security for other credit to fund things such as school fees, health costs or lifestyle costs and thereby gradually increasing their debt burden. This is really a mentality that puts off the day of reckoning. Our theory is that that day of reckoning is retirement—that is, when the impact on the end benefit that people will receive from their superannuation if a large or substantial proportion of it is used to pay off debts incurred over the course of their working life is determined.[15]

4.23 However, Mr Gallagher from the Treasury considered that the level of household debt had more of a relationship with housing equity than superannuation balances:

> I think the relationship between financial deregulation, award superannuation and the SG is largely coincidental. It would be incorrect to blame the rise in household borrowing on the superannuation guarantee. If you look at the national balance sheets—which I think are the best way to look at this issue, and I also have in mind remodelling—the superannuation guarantee assets are about $75 billion. The rise in borrowing by households has been $365 billion—that is, there is a very large order of magnitude difference between what we have seen in terms of superannuation guarantee savings and the rise in household borrowings. Therefore, I think it is useful to look at the issue of financial deregulation. There are a number of factors that you think might have influenced the rise in borrowing in households. Perhaps one is that … loan devaluation ratios have changed, the need for deposits has changed and, very importantly, people have been able to borrow against their own housing equity in taking a loan. If you look at the national balance sheets, the line of housing equity and the line of rising household borrowing, they have a very similar gradient. I think it would be useful in this issue to look at the access to lending in terms of a person's own housing equity. I will leave it at that.[16]

Committee view – factors inhibiting adequacy

4.24 The Committee notes that there are a number of factors which reduce the effectiveness of the current contribution arrangements, impact on the adequacy of incomes in retirement, and reduce incentives to save. They include front-end taxes, fees and charges, including death and disability insurance premiums, and rising household debt.

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15 *Committee Hansard*, 8 October 2002, p. 683.

16 *Committee Hansard*, 8 October 2002, p. 682.

Impact of front-end taxes

4.25 Evidence cited by the Committee suggests that the impact of front-end superannuation taxes can have the same effect as a three per cent increase in contributions. Nonetheless the Committee also notes that the reduction or removal of front-end taxes would have a very significant effect on revenue.

4.26 During the inquiry the Committee sought suggestions from witnesses on how to make up any possible revenue shortfall if front-end taxes were to be reduced or removed, but did not receive any compelling suggestions on how this could be achieved. Although, as will be discussed in Part III – Equity, suggestions were made to cushion the Budget by phasing in any front-end tax reductions, or by introducing a withholding tax. As will also be discussed in Part III – Equity, the Committee would prefer a gradual move away from all front-end superannuation taxes so that, in the long term, tax would only be applied to the end benefit and has recommended that the contributions tax be gradually phased out.

4.27 The Committee notes that capping taxes at a proportion of GDP was suggested by the IAA as a means of maintaining current levels of revenue. However the Committee considers that the implementation of such a cap, and the consequences for end benefit tax, would negate any benefit.

4.28 The Committee believes that there is a basic mis-match of revenue flow and budgetary need inherent in the current arrangements. That is taxes are brought forward and spent well ahead of the retirement of people who will have future health and social security calls on the budget. This matter is also addressed in the Part III - Equity section of this report.

Impact of fees and charges

4.29 The Committee notes the important impact of fees and charges on the level of retirement incomes. In some cases a one per cent difference in fees and charges, all other considerations remaining the same, can produce a 25 per cent reduction in retirement income over 40 years.

4.30 The Committee notes that the nine per cent Superannuation Guarantee (SG) is somewhat illusory, because leakages from the employers' SG contributions, such as contributions tax, death and disability insurance premiums, fees and charges, lower the employers' investment on behalf of employees, so that the fund member does not actually receive the full nine per cent because of these leakages.

4.31 However, as an alternative to increasing the level of SG contributions, the Committee notes that one possible option could be the introduction of a compulsory national death and disability insurance scheme, under which all employers would contribute a flat amount for minimum levels of cover for all employees. The Committee notes that obtaining appropriate insurance cover at a reasonable cost is becoming harder, and that such a scheme could assist those on low incomes, and allow more money to be invested for generating retirement incomes.

4.32 The Committee considers that every effort should be made to make the impact of fees and charges, however described, as transparent as possible to the fund member. In particular, the Committee considers that fees and charges should be disclosed in such a way that the member can be aware of the impact on those fees and charges on the end benefit, rather than the overall cost of the fees and charges.

4.33 The Committee notes the announcement by the Parliamentary Secretary to the Treasurer, Senator the Hon Ian Campbell, that the Government has commenced discussions with the regulators and industry to design a disclosure system which would provide more information about fees and charges.[17]

4.34 The Committee considers it unfortunate that the regulations for product disclosure statements were inadequate in their failure to provide meaningful fee disclosure for consumers. With the regulations subsequently disallowed, there is now a further gap in the financial services regulatory framework which needs to be addressed. The Committee urges the Government to form the next disclosure regime on the basis of broad consultation and consumer testing.

Impact of rising household debt

4.35 The Committee is also concerned about the effect of the rise in household debt on the ability of people to save for retirement. The Committee considers that this relationship should be closely monitored, and if the level of debt becomes a problem for retirement income policy, remedial action should be considered. Remedial action could take the form of limiting access to lump sums, or expressed another way, promoting access to income streams relative to lump sums.

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17 Announcement by Senator the Hon Ian Campbell at the ASFA Annual Conference, Brisbane, 15 November, 2002. Reported in *Australian Financial Review,* Saturday 16 November, 2002, p. 8.

Chapter 5

Adequacy for Baby Boomers

Introduction

5.1 The Committee was concerned that the impending retirement of the large 'baby boomer' generation raised important adequacy questions. This is because this cohort is the last that will not have the benefit of a full working life under the compulsory superannuation system and, other savings aside, is therefore likely to fall well short of the target level of 70-80 per cent of pre-retirement expenditure in retirement. They are also likely to fall short of the current Treasury projection of 60 per cent of pre-retirement expenditure for those on average earnings in the wider population.

5.2 The Committee sought suggestions from key witnesses about how to address this issue.

Options to improve adequacy

5.3 A number of the proposals to improve the adequacy of retirement incomes generally, as discussed in the previous chapters, will also have the potential to assist the baby boomers to achieve adequate incomes in retirement. These include reducing front-end taxes, contributing non-superannuation assets to superannuation, removing the work test for making voluntary contributions and expanding the co-contribution concept.

5.4 Elaborating on the first two of these suggestions, IFSA pointed out that they do not seek to find new money but maximise what someone has available to contribute.[1]

5.5 In addition ISFA suggest that the removal of the surcharge, the removal of the annual deductible contribution limits, and the recognition of growth pensions would also assist the baby boomer cohort in the adequacy context.[2]

5.6 Mr Kelly from NATSEM contributed to the baby boomer issue at the Canberra roundtable discussion on 8 October 2002, indicating that it was more important to encourage the 'baby boomers' to stay in work as a means of boosting their retirement savings:

> I have also looked at increasing the superannuation guarantee to 15 per cent and I have found that it does not make a substantial difference because

1 *Submission* 70, IFSA, p 2-3.

2 *Submission* 70, IFSA, p 2-3.

> people are still taking early retirement, which almost negates it. So the priority is to encourage people to stay in employment and to look at ways for them to do so. The superannuation accumulation phase is more important than whether it should be nine or 15 per cent.[3]

5.7 AMP provided the following suggestions to assist baby boomers:

- promoting voluntary savings measures;
- extending the co-contributions, with appropriate changes to end benefit tax arrangements to require that the benefits of the co-contributions are taken as income streams and not lump sums;
- breaking the nexus between employment and superannuation.[4]

5.8 In its supplementary submission, AMP advised the Committee that:

> To help baby boomers meet their retirement goals, voluntary saving measures should be promoted.
>
> Firstly, AMP supports the proposal to extend the co-contribution to middle income groups (up from the $32,000 limit). …
>
> If the Government wanted to provide additional incentives for baby boomers compared to what is offered to the rest of the population, consideration could be given to easing the eligibility for the co-contributions for this group, or by increasing the level of co-contribution (such as having the maximum contribution eligible for the co-contributions being, say, $1,500 for people between 40 and 50 and $2,000 for people over 50). This is similar to the recent changes introduced in the US where the amount people can put into their Individual Retirement Account or 401(k) is higher for people aged over 50.
>
> The effect of this policy would also flow through to women rejoining the workforce or older self-employed people playing catch-up with their retirement savings.
>
> …
>
> AMP propose that any new incentives provided to baby boomers by the Government (for example, the co-contribution) be contingent on people having to take that proportion of money as an income stream at retirement.

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3 *Committee Hansard*, 8 October 2002, p. 690. In a paper presented at the Tenth Annual Colloquium of Superannuation Researchers in July 2002, *Projecting the impact of changes in superannuation policy: a microsimulation approach,* Mr Kelly et al indicated that according to NATSEM modelling, increasing the SG to 15 per cent in 2003 would not impact on age pension outlays until 2025.

4 *Submission* 64, AMP, pp. 16-17.

> AMP also notes that the current proposal to enable a couple (or de facto) to split superannuation contributions provides a strong incentive to take a lump sum at retirement. The intent of the policy is to enable a single income family to take advantage of two superannuation tax free thresholds and RBLs (2 x $105,843 and 2 x $562,195). Yet the policy effectively reduces any incentive to take the superannuation benefit as an income stream, because it enables a family to take over $200,000 as a **tax free** lump sum at retirement.
>
> AMP also suggests that the nexus between employment and superannuation be broken for the purpose of making undeducted (personal) contributions so that any adult (18 to 75) can contribute to superannuation.[5]

5.9 In response to questions from the Committee about whether there should be any special arrangements to help boost the savings of those currently aged over 45, ASFA submitted that it 'would not favour a differential superannuation tax based on the age of the member' and that its preference is for measures that impact on the entire population.' ASFA submitted that:

> This would introduce a whole new layer of complexity to record keeping and accounting. It also needs to be kept in mind that funds do not have records of the age of some fund members, and there is no independent validation of the birth dates that are recorded. In addition not all persons aged over 45 are relying on compulsory superannuation alone. Around 40% of the population had superannuation prior to the SG, with a fair proportion of these in relatively generous defined benefit schemes and/or have a substantial proportion of their superannuation benefits payable as a lump sum of which only 5% forms part of their taxable income in the year the benefit is taken.
>
> While ASFA in general welcomes any measure that would improve adequacy of retirement incomes its preference is for measures that impact on the entire population that is receiving the benefit of superannuation contributions.[6]

Committee view – adequacy for baby boomers

5.10 Given that the compulsory superannuation scheme has only been in operation since 1992, the Committee notes that most baby boomers may not have the benefit of a full working life under the compulsory superannuation system and, other savings aside, that their incomes in retirement are likely to fall well short of the consensus target level of 70-80 per cent of pre-retirement expenditure (approximately 60-65 per cent of gross pre-retirement income). They are also likely to fall short of the current Treasury projection of 60 per cent of pre-retirement expenditure for those on average earnings in the wider population.

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5 *Submission* 127, AMP, pp. 2-3.

6 *Submission* 108, ASFA, p. 18.

5.11 The Committee also notes, however, that a number of the proposals to improve the adequacy of retirement incomes generally also have the potential to assist the baby boomers to achieve an adequate income in retirement. These include gradually reducing front-end taxes (a targeted reduction in the contributions tax for those over 40 would be particularly helpful to baby boomers), contributing non-superannuation assets to superannuation and removing the work test for making voluntary contributions. In addition, the expansion of the co-contribution concept, with appropriate changes to end benefit tax arrangements to require that the benefits of the co-contributions are taken as income streams and not lump sums, and providing incentives to extending an individual’s working life, are also likely to assist.

5.12 The Committee is aware that the Senior Australians Tax Offset (SATO),[7] which was introduced in the 2001 Budget, is also considered to be a relevant transitional arrangement affecting the ‘baby boomers’. This is because the non indexation of SATO will see it effectively phase out after 15 years as the indexation of the age pension rebate overtakes the frozen SATO level.

7 The SATO provides additional tax rebates to ‘self-funded retirees’ so that couples can receive $58,000 per annum and pay no tax.

Chapter 6

Other Adequacy Issues

Introduction

6.1 During the inquiry, a number of other arrangements were identified which could also impact on the adequacy of individuals' or groups' retirement incomes. These include:

- arrangements for the self-employed;
- member protection arrangements; and
- the $450 Superannuation Guarantee (SG) earnings threshold.

6.2 The arrangements for people with broken working patterns are also discussed.

The self-employed

Current treatment of self-employed persons

6.3 The SG scheme applies to all employers in respect of their full-time, part-time and casual employees, with only limited exemptions. The definitions of 'employee' and 'employer' are quite broad under the SG legislation, and include for instance members of a company board or its directors, and can also include persons working under contracts, depending on their circumstances. There is no legislative provision however to require self-employed persons to make superannuation contributions on their own behalf on a regular or systematic basis. Often, it is considered the proceeds of the sale of a business by a small owner-operator will be used by that individual to fund their retirement.

6.4 There are two main tax concessions currently available to self-employed or 'substantially self-employed' persons to encourage them to make contributions to superannuation on their own behalf (or for the benefit of their dependants) while working, or when exiting a business.

6.5 The concessions available for the self-employed are as follows:

- A full tax deduction on a specified amount of contributions, as well as a partial deduction (75 per cent) for an additional amount of contributions up to the individual age-based maximum deductible contribution (MDC) limit.
  - The amount which is fully deductible was raised from $3,000 to $5,000 per annum effective from 1 July 2002.
- An exemption from income tax and capital gains tax where a small business owner uses the proceeds from the sale of their business for the purposes of retirement. In these circumstances, the monies are considered in effect to be an

'eligible termination payment' (ETP). Eligibility requirements apply to this tax concession and there is a lifetime retirement exemption limit of $500,000 for any individual.

– The retirement exemption applies to disposals on or after 1 July 1997.[1]

6.6 Once their moneys are placed within a superannuation fund or equivalent, the same taxation arrangements apply for the self-employed as for employed persons on withdrawal of their monies.

6.7 A 'substantially self-employed' person may also qualify for the concessions even though they have received a small amount of employer superannuation support in any one financial year. Eligibility requirements, pertaining to the portion of income derived from employment falling below a certain threshold during the year (the 10 per cent rule), must however be met for this to occur.

6.8 Superannuation coverage amongst self-employed persons is much lower than for employed persons. ASFA has reported for instance that nearly 65 per cent of owner managers of unincorporated enterprises have either no superannuation or are currently not making contributions.[2]

Options for change

6.9 Of the views put to the Committee on this issue, most supported additional measures to further encourage savings by the self-employed. Recommendations ranged from options to ensure the tax treatment of superannuation contributions by the self-employed are brought into line with the tax concessions currently provided for employees, to provision for indexation of the tax free threshold for superannuation contributions by the self-employed.[3] The issue of compulsion for contributions by the self-employed was also raised and supported by various witnesses and submissions to the inquiry.[4]

6.10 Supporters of change to the current arrangements to align the treatment of the self-employed with that of employed persons argued that the current tax treatment for the self-employed is significantly less favourable. Superannuation contributions made by employers on behalf of employees are fully tax deductible up to age-based limits. In contrast, for the self-employed, only a relatively low portion of contributions is fully deductible, with the remainder generally qualifying for a 75 per cent deduction.

6.11 For example, in its written submission, ASFA argued that the arrangements for the self-employed should be brought into line with those which apply to employed persons. ASFA submitted that, in its view, there was no reason to continue to discriminate against a particular group in the labour force in this way, although fiscal

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1 *Submission* 78, Treasury, p. 12.

2 *Submission* 73, ASFA, p. 61.

3 See for example *Submissions* 43, CPA, p. 7.

4 See for example *Submission* 73, ASFA, p 61. See also *Submission* 31, ICAA, p. 3.

implications may have provided the original rationale for the different treatment of the two groups. Up until recently, the threshold which was fully tax deductible for the self-employed had not been adjusted over time (there is no provision to index this amount).[5]

6.12 Further, ASFA suggested it was necessary to increase the incentives for the self-employed to make contributions to superannuation so as to raise the level of superannuation coverage for this group. This would be done by making contributions fully deductible for the self-employed, up to the limits that apply to employees. In the longer term, ASFA also suggested it may be appropriate to give consideration to possible mechanisms for compelling superannuation contributions by the self-employed and/or providing greater tax incentives (beyond tax deductibility for voluntary contributions).[6]

6.13 CPA also supported removing the existing limit to the amount of monies which are fully tax deductible for the self-employed, up to the taxpayers' aged-based deduction limit. CPA indicated:

> This measure would ensure that self-employed workers are given the same advantages as employers.[7]

6.14 In addition, as a longer term measure, CPA recommended consideration be given to reforming the current age-based deduction limits, in order to better reflect Australia's changing working and lifestyle patterns. This issue is discussed in more detail at Part III – Equity. The issue of breaking the current employment nexus with superannuation was also canvassed by the CPA.

6.15 In its submission, Supermaster recommended the self-employed be compulsorily required to make contributions equivalent to rates required under the SG, with some qualifications:

> Phase in a requirement for all income earners not receiving at least 9% employer support to personally contribute at the same rate.
>
> Probably a minimum age of say 40 and minimum income level should apply. Tax deductibility should be at a flat 30%, identical with the company tax rate.[8]

6.16 Mr Lorimer from the Small Independent Superannuation Funds Association Ltd (SISFA) also recommended a compulsory system of superannuation for the self-employed:

5 *Submission* 73, ASFA, p. 61.

6 *Submission* 73, ASFA, p. 62.

7 *Submission* 43, CPA, p. 7.

8 *Submission* 40, Supermaster, p.11

> We would take a similar position for self-employed people. In other words, we would encourage a compulsory system of superannuation at the employee and self-employed levels.[9]

6.17 Mr Hopley from the Institute of Company Directors similarly advocated the introduction of compulsion for self-employed people to contribute to superannuation:

> We believe there is a lack of equity at the moment in that self-employed people are not required to make super guarantee contributions on their own behalf.[10]

6.18 Mr Hopley also provided details on how a compulsory system of contributions for the self-employed might work. He recommended a phased introduction of compulsory contributions, but noted there would be some difficulties:

> The difficulty I see is enforcement and the timing issue with regard to the contribution level. That is the major issue because it is the same as how you actually collect your taxation from somebody who puts in an annual tax return and those sorts of things. I would anticipate that we would apply it in exactly the same way as we apply the current taxation system, with quarterly returns and self-assessment—the Medicare collection is done in exactly the same way.[11]

6.19 A number of submissions called for the alignment of self-employed and employee arrangements. For example, the Institute of Chartered Accountants in Australia (ICAA) submitted that:

> …the self-employed are at a disadvantage to other employed persons, as employers are able to claim a deduction for 100% of contributions up to the age-based limit. Employed persons are able to salary sacrifice up to the age-based limit and take full advantage of the 15–30% tax rate applied to contributions, while the self-employed are unable to do so due to the discounted deduction rules.
>
> We recommend the removal of the limitation on contribution deductibility for self-employed persons to provide equity to those in employment relationships.[12]

6.20 The issue of self-employed workers was also raised by Cbus in its submission. Cbus noted:

> Many employees in the building and construction industry move between periods of self-employment and paid employment and may not necessarily make sufficient superannuation contributions while self-employed.[13]

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9 *Committee Hansard*, 10 July 2002, p. 267.

10 *Committee Hansard*, 9 July 2002, p. 185.

11 *Committee Hansard*, 9 July 2002, p. 189.

12 *Submission* 31, ICAA, p. 3.

6.21 Remedies which were recommended by Cbus to assist the self-employed included:

> That low income earners be able to claim a tax deduction for employee contributions.
>
> That low income earners with limited superannuation assets (small accounts) be able to claim a rebate of the superannuation contributions tax which would be paid into their nominated superannuation fund.[14]

6.22 AMP Financial Services (AMP) recommended that in order to increase savings by the self-employed:

> … the tax free threshold on superannuation contributions (set to rise to from $3,000 to $5,000) should be indexed to average earnings. This allows the threshold to move automatically year to year, rather than on an ad hoc basis.[15]

6.23 The AMP also made the following comments on the ability of small business owners to support their retirement from the proceeds of a business sale:

> Encouraging this group to save more is important. Relying on the sale of a business for retirement income has a high level of risk associated with it, as it relies on the business being successful, and the expected value of the business being realised on sale.[16] As a result, self-employed people are more exposed than employees to the risk of retiring with less funds than anticipated.[17]

6.24 On the issue of the ability of small business owners to support their retirement from the proceeds of a business sale, Treasury explained in a supplementary submission that:

> … the law encourages small business owners to use the proceeds of the sale of their business for retirement purposes by disregarding a capital gain where the proceeds of the sale of an asset are rolled-over into a

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13 *Submission* 42, Cbus, p. 8.

14 *Submission* 42, Cbus, p. 13.

15 *Submission* 64, AMP, p. 15.

16 See footnote in AMP submission: 'Many self-employed persons rely on their business to provide for their retirement rather than contributing to a superannuation fund, and usually reject the notion of compulsory superannuation on this basis. This position has been entrenched with the policy changes allowing the use of a business as the source of retirement income, with the capital gains on the sale of a business being tax free (up to certain limits) if the funds are used for retirement purposes. See *Submission* 64, AMP, p. 15.

17 *Submission* 64, AMP, p. 15.

> superannuation fund and used for retirement (up to a lifetime limit of $500,000).[18]

6.25 Whilst Treasury made no comments in relation to changing the current arrangements for the self-employed as part of this inquiry, Treasury did address this issue as part of their submission to a previous inquiry conducted in June 2002. At that time Treasury indicated that bringing the self-employed into line with the employee limits would have budgetary implications.[19]

Member protection

6.26 Although not a major issue in evidence to the inquiry, the issue of protecting small account balances from erosion due to the effect of fund fees and charges, did arise.

6.27 The development of member protection strategies became necessary as a result of transitional issues associated with the introduction of compulsory superannuation through the SG. One of these transitional issues was the erosion of small account balances through the impact of fees and charges. This was in the nature of a transitional issue where many people were new to superannuation and contribution levels were low. Accordingly, from 1 July 1995, funds that wanted to accept new members were required to protect account balances of less than $1,000 from the impact of fund fees and charges where they exceeded fund interest. For these purposes 'fees and charges' comprise entry and exit fees, periodic administration charges, and asset fees. Charges for tax, insurance, and for investment losses are not protected.

6.28 While it is up to the individual fund how they do this, in general these small account protection costs are subsidised by members with larger account balances. These cross subsidies can be quite large, especially when fund earnings rates are low or even negative. For example, Mr Luke from Sunsuper submitted during the Canberra roundtable discussion on 8 October 2002:

> One of the major problems with member benefit protection is that people can have 50 different accounts and they get member benefit protection on each account. Somehow, there needs to be some roll-up, because we are all bearing an enormous cost in providing member benefit protection for people under that $1,000. Lots of different providers can have it. The cost to us as an organisation was about $8 million in the last year in forgone fees. That is out of a total fee income for us of around $26 million to $27 million, so it is an enormous amount of money and, in a bad year, it can affect you.[20]

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18 *Submission* 142, Treasury, p. 8.

19 Senate Select Committee on Superannuation *Report on Taxation Laws Amendment (Superannuation) Bill (No.2) 2002 and Superannuation Guarantee Charge Amendment Bill 2002*, June 2002, p. 9.

20 *Committee Hansard*, 8 October 2002, p. 705.

6.29 In response to Committee questioning about people's desire to consolidate their superannuation into fewer accounts, Mr Luke said that 'people do not care. They have superannuation all over the place and they do not put it together.[21]

6.30 Similarly, Ms Doyle from the AMP also advised the Committee that people with small account balances could consolidate their accounts, but that they don't care enough to do so:

> I suggest that at the moment it is quite easy for members to accumulate their balances if they want to. Given that there is a lot of money in RSAs, ERFs and those sorts of things, it really comes down to people not caring enough about wanting to get their balances together, because most of the public offer funds allow members to accumulate their balances. I would be surprised if there was a corporate fund that would not allow rollovers as well.
>
> As for people being able to say, 'I had employment money here, here and here over my lifetime,' and being able to touch on those funds and then say, 'I want to roll up my balances and put them into my current fund,' there is not really a problem in trustees enabling people to do that. It comes down to issues such as people not caring enough to accumulate those balances, rather than there being restrictive trustee rules or anything like that which prevent people from accumulating those balances.[22]

$450 earnings threshold

6.31 Another transitional arrangement that has remained in place since the introduction of the compulsory SG is the contributions earnings threshold of $450 per month. Employers are not required to pay contributions in respect of any employee who does not earn $450 in any month. However, many awards and other workplace arrangements require the employer to make payments irrespective of the earnings of the employee.

6.32 The earnings threshold was introduced to minimise the employer administration effort in highly casual areas of employment, such as in seasonal agriculture. This was considered necessary when the compulsory superannuation arrangements were new, administration and payroll systems were somewhat embryonic by contemporary standards, and the contribution levels were relatively low.

6.33 In commenting on the level of the earnings threshold in the relation to the growth in the level of the SG, Dr Anderson from ASFA advised the Committee in the hearing on 8 August 2002 that it was currently consulting with its members to determine their views on the potential to lower the threshold in order to reflect the increased level of employer contribution:

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21 *Committee Hansard*, 8 October 2002, p. 705.

22 *Committee Hansard*, 8 October 2002, p. 705.

> The reason we said that we may be able to lower it was that, if you did your sums, you could say: 'We started at three per cent, and put it at $450. Can we use the same assumptions now we are at nine per cent?[23]

6.34 Ms Smith from ASFA also pointed out changing employment patterns are also relevant, because people can have income from a variety of employers, and the threshold applies in respect of each employer, where there is more than one, rather than an individual's total income:

> … with changing work patterns, what was reported to us … was the increased frequency for people in casual work to have multiple employers. What they are doing is patching together an income from a variety of employers.[24]

6.35 COTA expressed the view that the current $450 minimum threshold for contributions should be abolished. COTA indicated that:

> Employees with a portfolio of part-time and casual jobs may not make any Superannuation Guarantee contributions at all as their employment with each employer does not put them over the monthly threshold of $450 at which contributions are required. As the Superannuation Guarantee is an employer cost, extension of the 9% contribution to these workers would not reduce the individual incomes of these, often low income workers. There is little justification for not extending the Superannuation guarantee to all workers, irrespective of income.[25]

6.36 The National Seniors' Association (NSA) was also critical of the impact of the current $450 threshold on those with broken working patterns, in particular women, and suggested a remedy to address the concerns for employees aged 50 years or more:

> Superannuation regulations work against people engaged in part-time work. Employers are not required to contribute superannuation towards employees earning less than $450 a month. This is a problem for older workers who are either unable to find full-time work after being made redundant or choose to make a gradual transition into retirement. It also makes it near impossible for people taking up 'portfolio employment' or several part-time jobs with different employers to accumulate superannuation.
>
> To address this, NSA recommends allowing maximum entitlement to superannuation for casual employees over 50 who may be earning less than $450 per month taxable income from any single employer but more than $450 per month in total from several employers.[26]

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23 *Committee Hansard*, 8 August 2002, p. 601.

24 *Committee Hansard*, 8 August 2002, p. 602.

25 *Submission* 63, COTA, pp. 17-18.

26 *Submission* 60, National Seniors Association, pp. 4-5.

6.37 The Women's Economic Policy Analysis Unit, of Curtin University of Technology provided an example of how the current $450 earnings threshold impacted in circumstances where women work in more than one part-time job. The Unit explained in its submission that a woman could receive the same lifetime earnings by working in two part-time jobs, one of which has earning of less than $450 per month, or in one full time job. The difference in lifetime superannuation, however, is that the two part-time jobs attract 20 per cent less superannuation than the one full-time job.[27]

Committee view – other adequacy issues

Self-employed

6.38 The Committee notes that the weight of evidence supports the extension of the arrangements available to employees to the self-employed. The Committee notes that, although there might be budget implications, no policy objections were raised to the alignment of the taxation treatment for superannuation contributions of employees and the self-employed.

6.39 The Committee considers that the nature of work should not affect the tax treatment of contributions to superannuation. Indeed the Committee is aware that the different tax treatment of employer, employee pre and post tax, and self-employed contributions adds significantly to the complexity of the superannuation system.

6.40 The Committee has considered the extension of the compulsory SG system to the self-employed as advanced in some of the evidence. On balance the Committee does not support this extension at this time. This is because of the uncertain and volatile nature of the income of the self-employed. The Committee considers that the question of adequacy of retirement incomes for the self-employed is best addressed through appropriate tax arrangements for voluntary contributions and sale of business assets.

Member protection

6.41 The Committee notes that the effect of cross subsidies of the cost of fees and charges between members of superannuation funds in order to maintain the member protection rules can be quite high. In addition the Committee notes that, while there is a great deal of cross subsidisation, the genuine low account holder feels aggrieved that he or she is meeting a tax commitment while there is no addition to his or her balance.

6.42 The Committee is aware that the member protection rules add considerably to the complexity of fund administration including the effect they have on determining the annual crediting rate. The Committee also notes that superannuation funds are able to transfer inactive small accounts to an Eligible Rollover Fund that are

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27 *Submission* 75, WEPAU, p. 28.

established for the primary purpose of ensuring that administration fees do not erode small account balances.

6.43 The Committee is aware that the average superannuation fund member currently has about three accounts and that there are barriers that prevent many people from merging those accounts. The Government is currently examining proposals to facilitate account consolidation and associated portability. The Committee considers that those arrangements will provide some opportunity for minimising the effect that administration fees have on multiple small accounts, however their effectiveness is likely to be hampered where substantial entry and exit fees apply. The Committee believes that effective arrangements for account consolidation will substantially reduce the cost of member benefit protection, which should be retained to protect the small accounts that remain.

Earnings threshold

6.44 The Committee considers that the existence of the $450 contribution threshold was necessary as a transitional arrangement in 1992 while the level of compulsory employer contributions was quite low. However, the Committee notes that there is now more casual and part-time employment than when the SG was introduced. This means that those employees who have ‘portfolio’ employment may not be getting employer supported superannuation as the level of earnings with any one employer may not exceed the threshold.

6.45 The Committee is also aware that the shortfall in the adequacy targets identified in this report is higher for those on low incomes. It follows that any initiatives that assist low income earners to boost superannuation savings would be a welcome development.

Recommendation

6.46 **The Committee recommends:**

- **examining the option of extending to the self-employed a framework for making superannuation contributions, with tax treatment similar to that which applies to employees making contributions; and**
- **examining the removal of the $450 earnings threshold for SG contributions.**

People with broken work patterns

6.47 The Committee was also concerned that people with broken work patterns, often women, might also find themselves with an inadequate income in retirement. This is because, in order to meet family and other responsibilities, they will not necessarily have the benefit of a full working life under the compulsory superannuation system. Their contributions levels are also likely to be smaller because many women’s careers are not usually as long as their male counterparts and their incomes tend to be lower.

6.48 The ICAA advised the Committee that the age-based deductible limits discriminate against two groups:

- occupations where income is weighted toward early years in the work force, such as sports people and entertainers; and
- women planning a broken work pattern to have a family.

6.49 The ICAA elaborated that:

> In both these cases the individual has a higher disposable income early in their working life and may not have an opportunity to contribute to superannuation later in life.[28]

Committee view – people with broken work patterns

6.50 The former Select Committee on Superannuation reported on this issue in 1995.[29] In that report, among other matters, the recommendations aimed at addressing shortfalls in superannuation for those with broken work patterns, included permitting contributions for people over age 65, the adoption of appropriate fund transfer protocols, and the development of awareness and educational material for women.

6.51 The Committee considers that a number of the measures it has recommended in this report may assist women, and others with broken work patterns, to achieve an adequate income in retirement. These measures include:

- examining the removal of the $450 earnings threshold;
- removing the work test for making voluntary contributions; and
- extending the government co-contribution concept.

6.52 In addition, as considered in other parts of this report, measures relating to the phased removal of front-end taxes in the long term, including the contributions tax and the surcharge, and incentives to extend working lives may also assist women and others with broken work patterns.

Overall conclusions – adequacy

Identifying and quantifying adequacy

6.53 The Committee found that there is a need to define the meaning of the term ‘adequacy’ of superannuation. In particular, there is a need to establish clearly articulated objectives for Australia’s retirement incomes system, which include targets for representative groups of Australians.

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28 *Submission* 31, ICAA, p. 3.

29 Senate Select Committee on Superannuation, Seventeenth Report, *Super and Broken Work Patterns*, November 1995.

6.54 In order to provide an adequate standard of living in retirement, the Committee notes the high degree of consensus expressed by witnesses at the roundtable that the desirable target for a person on average earnings is a replacement rate of 70-80 per cent of pre-retirement expenditure (which equates to approximately 60-65 per cent of gross pre-retirement income), a target which would need to be higher for those on less than average weekly earnings, and lower for those on high incomes.

6.55 The Committee found that, should this replacement rate be accepted, the available modelling shows that the current arrangements are unlikely to deliver these outcomes, and that other strategies are required to address the anticipated shortfall.

Closing the adequacy gap

6.56 The Committee considers that strategies to close the adequacy gap include more incentives for voluntary contributions, including expanding the government co-contribution concept by raising the threshold and improving coverage to lower to middle income earners, and widening access to superannuation as a savings vehicle by removing the work test for making voluntary contributions, lowering front-end taxes in the long term, providing a cost-effective savings vehicle, and permitting contribution of non superannuation assets to superannuation.

6.57 The Committee considered the evidence in favour of additional compulsory contributions by either employers or employees, but concluded that these could not be supported in the current economic climate.

Factors inhibiting adequacy

6.58 The Committee noted that a number of factors inhibit the effectiveness of the current contributions in delivering adequate retirement incomes, including the impact of front-end taxes, the impact of fees and charges and the impact of rising household debt.

6.59 Although the Committee received no compelling suggestions on how the revenue shortfall could be addressed if front-end taxes were removed or reduced, the Committee favours a gradual move away from front-end taxes. The Committee also re-emphasises the importance of transparent disclosure up front of fees and charges, and notes that there is a need to monitor the relationship between the effect of household debt and the ability of people to save for retirement.

Baby boomers

6.60 Given that the compulsory superannuation scheme has only been in operation since 1992, the Committee notes that most baby boomers will not have the benefit of a full working life under the compulsory superannuation system and, other savings aside, that their incomes in retirement are likely to fall well short of the consensus target level of 70-80 per cent of pre-retirement expenditure (approximately 60-65 per cent of gross pre-retirement income). The Committee considers that a number of its recommendations for change which apply to the wider community will also assist baby boomers to achieve an adequate income in retirement.

Other adequacy issues

6.61 The Committee notes that there are a number of arrangements which could impact on the adequacy of individuals' or groups' retirement incomes. These include:

- arrangements for the self-employed;
- member protection arrangements; and
- the $450 SG earnings threshold.

6.62 The Committee has identified in this report a number of strategies to assist people affected by these measures to improve the adequacy of their income in retirement, including examining the extension to the self-employed of the same contribution arrangements that apply to employees, and examining the removal of the $450 earnings threshold.

6.63 The Committee has also identified strategies to assist women and others with broken work patterns, to achieve an adequate income in retirement.

PART III - EQUITY

Part III of this report is about how the equity arrangements in the superannuation system work and how they could be improved. The equity arrangements applicable to superannuation are based largely on the ability of people to access taxation concessions through superannuation contributions, earnings and end benefits.

This Part of the report begins with a review of how tax concessions are measured and their aggregate impact on the Budget. The Committee also considers the question of whether annual or whole of life equity provisions should be the focus. The suitability of each of the three contributions, earnings, and end benefit taxation points are also discussed.

Chapter 7

Equity and Tax Concessions

Introduction

7.1 The key determinant of equity in the superannuation system is the level of tax concessions provided. A number of key submissions received during the inquiry from peak industry and professional bodies questioned the way that aggregate tax concessions applicable to superannuation are measured and reported. Suggestions were made to change the current approach. This chapter examines the suitability of two different concepts for measuring the level of tax concessions by considering the:

- income or expenditure approach; and
- aggregate level of tax concessions.

7.2 In addition, much of the evidence to the inquiry raised the central issue of whether superannuation taxation should be considered on an annual or whole of life basis, in the context of providing equity within the superannuation system.

7.3 These issues are discussed in the following material.

7.4 A description of the taxation treatment of superannuation is at **Appendix 8**. This material provides an update on a previous Committee publication, *Super Taxing – an information paper on the taxation of superannuation and related matters*.[1]

7.5 In 1995-96, tax receipts from superannuation were $1.6 billion. In 2001-02, tax receipts from superannuation were $4.4 billion. It is projected that in 2005-06, tax revenue from superannuation funds will be $5.8 billion. Superannuation taxes as a proportion of gross domestic product are projected to double from 0.3 per cent in 1995-96 to 0.6 per cent in 2002-03.[2]

Income or expenditure approach

7.6 Since front-end taxes were first implemented in 1988 there has been occasional debate about whether it is best to measure the quantum of tax concessions available to superannuation on the basis of income or expenditure (consumption). In other words is the benchmark for measuring superannuation tax concessions other income in the year that contributions and earnings are allocated to a persons superannuation account, or the payment stage when the superannuation is actually available for consumption?

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1 Senate Select Committee on Superannuation, *Super – an information paper on the taxation of superannuation and related matters – Taxing,* February 1998.

2 2002-03 Budget Paper No 1, *Budget Strategy and Outlook* , pp. 5.33, 5.25, 5.35. See also ATO, *Annual Report 2002*.

7.7 The Australian Council of Social Service (ACOSS) noted in its written submission that there are two methods of measuring superannuation tax concessions – either on an income tax basis or an expenditure tax basis. The Council submitted that it preferred concessional income tax treatment rather than expenditure tax treatment since in its view, it is the fairest way to compensate people for the compulsion to save, to encourage voluntary saving, and to boost the savings of those on the lowest incomes.[3]

7.8 ACOSS also presented in its written submission a table comparing the effective tax subsidy to individual employees per dollar of employer contributions. This is reproduced in **Table 7.1** below.

Table 7.1: Effective tax subsidy per dollar of employer contributions

Income	**$6,001-$20,000**	**$20,001-$50,000**	**$50,001-$60,000**	**$60,001-$85,242**	**$103,507+**
Marginal tax rate[4]	17-18.5%	31.5%	43.5%	48.5%	48.5%
Tax subsidy per dollar contributed	2-3.5 cents	16.5 cents	28.5 cents	33.5 cents	18.5 cents

Source: Submission 65, ACOSS, p. 20.

7.9 At the Canberra roundtable discussion on 8 October 2002, Mr Brake from Treasury provided the following comments in support of the current expenditure tax arrangements applicable to the measurement of superannuation tax concessions:

> I have a couple of comments, firstly one on an issue that is related to equity: tax expenditures and how they should be measured. At present, we measure tax expenditure on the counterfactual basis that superannuation is part of someone's remuneration—that is, if you were to receive that superannuation from your employer, as an employee you would be taxed at your marginal tax rate, and therefore the different tax treatment of contributions from those marginal tax rates gives rise to the tax expenditure.[5]

7.10 In response to questions from the Committee about expenditure tax treatment, Treasury submitted that 'RIM is not in a position to model this new tax expenditure benchmark proposal for the Committee.'[6]

7.11 Treasury further advised that it was of the view that an income tax benchmark is appropriate as the benchmark against which to measure superannuation tax concessions. Its arguments for this position included:

- the fact that historically income tax has been the relevant base;

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3 *Submission* 65, ACOSS, pp. 12-14.

4 Includes Medicare levy. Many tax-payers on the lowest marginal tax rate are exempted from the levy.

5 *Committee Hansard*, 8 October 2002, pp. 694-695.

6 *Submission* 142, Treasury, p.7.

- no major country has a wholly expenditure-based tax system; and
- where government uses tax incentives deliberately, the comprehensive income tax base provides guidance on structuring measures to achieve the desired outcomes in the most efficient and cost-effective manner possible.[7]

The level of tax concessions

7.12 The following material provided by ACOSS demonstrates the aggregate level of superannuation tax concessions available for superannuation in 2001-02 on the basis of the Treasury income test for determining the level of those tax concessions.

Table 7.2: Tax concessions for superannuation in 2001-02[8]

Contributions:	
flat 15% tax on employer contributions *	$4,530m
Deduction for self-employed/un-supported	$190m
10% rebate for low income earners	$15m
18% rebate for contributions on behalf of low income spouse	$10m
Sub-total:	$4,745m
Fund earnings:	
flat 15% tax on fund earnings *	$4,340m
Capital Gains Tax concessions	$370m
Sub-total:	$4,710m
Benefits:	
Under-taxation of un-funded lump sums (minus tax on funded benefits)	$30m
Total:	**$9,485m**

Source: Treasury, Tax Expenditure Statement (2001), cited in Submission 65, ACOSS, p. 15.

*Compared with a benchmark income tax at the marginal rate of each fund member, plus Medicare Levy.

7.13 In its submission ACOSS advised the Committee that the annual cost of superannuation tax concessions, based on an income tax benchmark, was estimated by the Treasury to be $9.5 billion in 2001-02.[9] According to ACOSS, this is equivalent to around 60 per cent of expenditure on age pensions, or all federal government expenditure on hospitals and ancillary health care services.

7.14 ACOSS submitted that **Table 7.2** above shows that the flat 15 per cent taxes on employer *contributions* and fund *earnings* are the largest of these tax concessions.

7 *Submission* 142, Treasury, p.7.

8 *Submission* 65, ACOSS, p. 15.

9 See footnote in ACOSS submission: ‘Treasury, *Tax Expenditure Statement* (2001). Note that this is the estimated cost in a single year only. The cost over time is somewhat less than this, since tax concessions increase the value of superannuation assets, thereby boosting the future stream of fund earnings and benefits subject to taxation. For the purpose of tax expenditure analysis, it is not appropriate to take into account future Age Pension savings brought about by superannuation tax concessions, as some commentators have. This should be calculated separately as a future saving in Government expenses. See *Submission* 65, ACOSS, p. 15.

According to ACOSS, these flat taxes mean a large tax saving to individuals on the highest marginal income tax rates, but offer little relief from taxation for those on lower marginal tax rates. In ACOSS' view, they are therefore highly regressive.[10]

7.15 In response to ACOSS' estimates, ASFA argued in its written submission that ACOSS' estimates suffered from a number of conceptual problems, including the fact that income tax is imposed on assets which cannot be accessed by the individual at the point of taxation.[11] ASFA identified that the principal finding coming from the research was that, on the basis of the preferred expenditure tax approach, superannuation contributions and fund earnings are overtaxed.[12]

7.16 ASFA submitted that Access Economics' preferred benchmark is an expenditure tax approach where the appropriate point of taxation is on receipt of benefits, an approach which has been adopted in many Organisation for Economic Co-operation and Development (OECD) countries including Belgium, France, Germany, Netherlands, and Portugal.[13]

7.17 **Appendix 9** contains a summary of the taxation arrangements in different countries.

7.18 The Committee asked the Treasury to provide information about the level of tax concessions, if any, and what those concessions would be if measured against an expenditure benchmark rather than the income tax benchmark. In requesting this information, the Committee sought to assess the extent of concessions, taking account of the timing delay between making contributions and receiving benefits.

7.19 In response, Treasury provided the following general comments on the level of taxation under an expenditure approach:

> Because superannuation in Australia is (concessionally) taxed at up to three points, rather than fully taxed at a single point as in the expenditure tax model, the conclusion has often been drawn that the overall level of taxation is higher than it would be under an expenditure tax. There is some analysis that indicates that this conclusion may be wrong.[14]

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10 *Submission* 65, ACOSS, p.15

11 *Submission* 108, ASFA, pp. 9-10.

12 ASFA referred to the following research papers: Access Economics 1998, *The cost of superannuation tax concessions,* Report commissioned by ASFA, FPA, ASX, and IFSA, Sydney, September, 1998 and ASFA, 1999, Association of Superannuation Funds of Australia, *Superannuation tax concessions – recent trends and levels*, Sydney, April 1999. See *Submission* 108, ASFA, p. 25.

13 *Submission* 108, ASFA, p. 9.

14 *Submission* 142, Treasury, p. 7.

Annual and whole of life equity issues

7.20 There are three taxation equity measures currently in place, which, taken together provide a mix of annual and whole of life approaches:

- the global whole of life assessment of access to concessional tax under the Reasonable Benefit Limit arrangements;
- the annual age-based limits of deductible employer contributions; and
- the surcharge.

7.21 A number of submissions considered that the equity arrangements are important, but indicated that they could be rationalised. For example, CPA submitted:

> CPA Australia recognises the need for a degree of control in our superannuation system in mitigating the abuse of taxation concessions and ensuring superannuation is directed towards retirement income purposes. The existing controls of both the age based deduction limits and the RBLs are arduous and at conflict with the principle of providing incentives for savings and ensuring a simple and easily understood system. We consider that both the age based deduction limits and the RBLs should be reviewed in order to reconcile with the retirement needs of the community. This may require significant alteration or complete removal of either limit.[15]

7.22 Dr David Knox perhaps best summed up the relative merits of annual and whole of life equity measures at the Canberra roundtable discussion on 8 October 2002. He noted that policy tends to consider equity on a series of micro issues; the surcharge; deductible contributions; and the tax area. He indicated that Australia actually gets equity wrong by looking at the annual considerations and not the whole of life consideration that recognises that people are in the system for a lifetime. He concluded in the following terms:

> In that sense, I believe the best way of looking at equity is to look at the total system and recognise, as best we can, revenue constraints, look at the total benefit accrued within the system and tax the total benefit in a fair and equitable manner.[16]

7.23 Ms Smith from ASFA also made a strong claim that equity is best achieved over the longer term:

> The strategies that we see include both individual effort and effort by government, whether by extra incentives, co-contributions or reducing tax rates. In terms of equity we see the current tax arrangements—the tax on contributions, the tax on earnings and the tax on end—as bringing in a particular set of anomalies and inequities for people with fluctuating incomes or interrupted work patterns. If I had to name one area … it would be the tax arrangements taking income on a year by year basis rather than on

15 *Submission* 43, CPA, p. 7.

16 *Committee Hansard*, 8 October 2002, p. 684.

> the lifetime savings of that person. We think it would be much fairer to look at the lifetime savings of the person and then look at the equity implications of that in terms of the tax arrangements and benefits.[17]

Committee view – equity of tax concessions

7.24 The Committee notes that the majority of the evidence received during the inquiry indicated that the equity of superannuation tax arrangements should be considered on a whole of life basis rather than on an annual basis.

7.25 The majority of the evidence to the Committee also supported the view that it is only at the end benefit stage that the access to superannuation tax concessions can be judged accurately.

7.26 The Committee notes that there are strong differences of opinion between Treasury and key industry groups about the way in which superannuation tax concessions are quantified, with a number of industry bodies supporting an expenditure tax approach rather than the Treasury income tax approach. The Committee considers that resolution of this debate is central to the equity of the superannuation tax concessions issue.

7.27 The Committee notes that the Treasury was not in a position to provide any information about the level of tax concessions if they were measured on an expenditure basis.

7.28 The Committee also notes that there appears to be a wide difference in the level of tax concessions under the two approaches. On the one hand, the income tax approach suggests that tax concessions are of the order of some $9.5 billion; while on the other hand, the expenditure tax approach suggests that superannuation is overtaxed. The Committee therefore considers that there is a case for the Government to review the basis of assessing the tax concessions available to superannuation, in order to find some agreement on the methodology.

7.29 The Committee found it difficult to have a meaningful debate about the distribution of aggregate concessions to individuals or groups where there is no consensus on the level of concessions or how those concessions are assessed. The Committee considers that the proposed review should be undertaken in the context of any changes implemented from the recommendations of this report and that appropriate Government models should be made available to industry to facilitate this process.

7.30 The Committee considers that resolution of the debate about the preferred method of measuring the impact of taxation concessions is essential to the equity of the superannuation tax concessions issue. For this reason the Committee sees merit in the Government working with industry to resolve the matter of determining the appropriate benchmark for measuring the impact of superannuation tax concessions.

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17 *Committee Hansard*, 8 October 2002, p. 686.

Recommendation

7.31 **The Committee recommends that, together with industry, the Government conduct a review of the appropriate benchmark for measuring the impact of superannuation tax concessions.**

Chapter 8

Annual Taxation Measures

Introduction

8.1 Much of the evidence on equity measures focused on the suitability of annual fund level accumulation phase tax arrangements as opposed to end benefit taxation arrangements.

8.2 This chapter examines the evidence that was provided to the inquiry about those annual fund level accumulation phase tax arrangements that apply (or could apply) uniformly to all members. These are:

- generic fund level taxes:
  - contributions tax;
  - earnings tax;
- rebates for individuals rather than generic fund level taxes; and
- maximum deductible contributions.

8.3 The surcharge tax applying to contributions in respect of high income earners will be considered in the next chapter.

Generic fund level taxes

Background

8.4 In the Australian system since 1988 superannuation is taxed at three points – when the contribution is made, on the earnings, and at the time of payment. Before 1988 there were no contributions or earnings taxes and only five per cent of any lump sum was included in the assessable income of the individual.

8.5 Where a person has employer support, superannuation contributions and earnings are taxed at a notional 15 per cent in the hands of the receiving fund. The 15 per cent rate is reduced for any tax offsets such as dividend franking credits on Australian shares and other fund tax deductions. Provided that these contributions are within the employees' annual age-based contribution limits, the contributions are fully deductible to the contributing employer.

8.6 The contributions made by the self-employed are taxed differently. The first $5,000 of annual contributions are deductible as are 75 per cent of any additional contributions that are within the individual's reasonable benefit limits (RBLs). Fund earnings are taxed in the same way as for employees.

8.7 The Committee notes that, according to commentators such as Mr Ross Clare from ASFA, that there appears to have been an increasing amount of science and less ‘black arts’ in forecasting tax revenues collected from superannuation funds.[1]

Summary of views

8.8 During the inquiry, many commentators argued that there should be a move away from front-end contributions and fund earnings taxes towards benefit end taxes. For example, the Australian Bankers’ Association (ABA) submitted such a move should be made on simplicity and efficiency grounds. The ABA noted in this context:

- The pre-1988 system was simple and efficient (namely, the ‘expenditure’ or benefit–stage taxation system) and is the global standard for taxing retirement (pension or superannuation fund) saving;[2]
- Had Australia retained it, many of the complications now in our system would have been avoided. For example, there would be no need for the entire apparatus of benefit and contribution limits if people were taxed only on benefits, and at ordinary progressive income tax rates — perhaps with some allowance for taking a lump sum without going into a higher tax bracket;
- The system would then be both fairer and more efficient. The asset pool would be many billions of dollars greater and on–going national saving flows would be significantly higher. Future Budgets would have greater capacity to meet the needs of our ageing population.[3]

8.9 The Investment and Financial Services Association (IFSA) has also long supported the wind-back of front-end taxes, and made the following important points about intergenerational equity in its written submission:

> We also note that the 1988 changes to the taxation of superannuation represented a bring-forward of future taxation revenues from retirement savings. As the IGR shows, there is a greater need for taxation revenues out into 2030 and beyond than there is in 2002 and the current forward estimates period. Unwinding some of the tax bring-forward achieved by the current rules, and returning that revenue to future years, would ameliorate some of the future fiscal drain outlined in the intergenerational report.

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1 Ross Clare, Principal Researcher, ASFA, *Estimating the revenue impact of superannuation tax changes – weird science or black art?*, paper presented to the Tenth Annual Colloquium of Superannuation Researchers, University of New South Wales, June 2002.

2 See footnote in ABA submission: ‘The question of how best to tax retirement saving — and saving in general, particularly long–term saving — was canvassed in *National Saving: A Report to the Treasurer*, *op.cit*., Section 4.3, p 65ff. The contributions and earnings tax can have a significant impact on final super benefits. ASFA estimated someone on $40,000 a year will get $50,000 less payout in today’s dollars (assuming 9 per cent SG and a 30 year savings period). The impact is almost double if the savings period is 40 years, not 30 (see 19/11/01 Money Manager, The Age).’ See *Submission* 51, ABA, p. 21.

3 *Submission* 51, ABA, p. 21.

> Gradual removal of front–end taxes could increase adequacy for future generations of retirees without sudden and significant fiscal impact on Commonwealth revenue.[4]

8.10 The Institute of Actuaries of Australia (IAA) also called for a move away from front-end taxes and suggested that these taxes could be capped, although the IAA did acknowledge that such a cap is likely to be difficult to implement in practice. Nonetheless, the IAA submitted that this capping proposal could maintain current revenue:

> - The Government could consider capping superannuation taxes as a percentage of Gross Domestic Product. This would allow the Government to maintain existing revenue in real terms but limit the increase in superannuation taxes;
> - Removal of contribution taxes would have a similar impact to raising the superannuation guarantee (SG) contribution rate, however it would not create any additional cost impost for employers. Changing the structure of superannuation taxes away from contributions towards end benefits could also be used to provide further incentives for voluntary superannuation savings to supplement compulsory SG benefits.[5]

8.11 The Association of Superannuation Funds of Australia (ASFA) made the link between the impact of the contributions tax and end benefits by suggesting that removing the contributions tax would reduce the extra amount of contributions needed to achieve 60 per cent of pre-retirement income by two to three percentage points. According to ASFA, this is more or less equivalent to the impact of an additional three per cent employer contribution or a slightly smaller percentage member contribution out of after-tax income.[6]

8.12 ASFA noted that it would be very difficult to implement a full removal of the contributions tax in any one year because of the effect on revenue. To address this issue, ASFA made the suggestion to gradually reduce the contributions tax over a ten year period starting, for example, in 2003-04, and that

> … (t)he continuing reductions in the rate of the tax could be built into the forward estimates on an ongoing basis.[7]

8.13 ASFA noted that both the Government and the Labor Party have put forward proposals to cut tax on contributions to some degree. The Government is proposing to progressively cut the rate of the surcharge from 15 per cent to 10.5 per cent over the next three years. The Labor Party, in its response to the 2002-03 Budget, has put forward proposals to either cut the superannuation contributions tax for all fund

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4 *Submission* 70, IFSA, p. 12.

5 *Submission* 74, IAA, p.12.

6 *Submission* 73, ASFA, p.55.

7 *Submission* 73, ASFA, p. 59.

members from 15 per cent to 13 per cent, or, as an alternative to cut the tax to 11.5 per cent for people aged over 40.[8]

8.14 ASFA also advised that it would welcome any measures that would cut the taxation imposed on contributions as, in the view of ASFA, both the standard contributions tax and the surcharge are inefficient and inequitable taxes. However, the Association suggested that these proposals be extended by moving to complete abolition over a period of time, say, ten years. Depending on the budget surplus in years ahead, and the availability of additional tax revenue from measures such as crystallising the tax on pre-1983 entitlements, it may be possible to remove the contributions tax over a shorter period than ten years.[9]

8.15 ASFA also submitted that:

- It also should be noted that removing contributions tax would lead to additional taxation receipts at the benefit stage as a consequence of the increase that would occur in the net contributions being credited to individual accounts;
- It also would facilitate greater equity in the taxation of superannuation, in that benefits could be taxed at the time of payment in line with the total amount accumulated and the circumstances of the individual when they receive the benefit. Taxing contributions is at best only a very rough if not rugged approach to achieving equity between individuals;
- In regard to options for partial removal, ASFA prefers a uniform cut for all fund members. ASFA acknowledges that applying different rates of tax to contributions according to the age of the member on whose behalf contributions were made would have the potential to boost the retirement savings of the age groups targeted. However, such a measure would involve considerable complexity in administration on the part of funds.[10]

8.16 CPA Australia (CPA) called for a review of superannuation taxation in the context of the recent changes that have been made to personal and business taxes:

> The 1987 bring forward of the 15% contributions tax and the 1996 superannuation surcharge when combined with the most recent round of income tax cuts for individuals and companies have seriously undermined the relative tax effectiveness of superannuation.[11]

8.17 The Institute of Chartered Accountants in Australia (ICAA),[12] the Australian Medical Association (AMA),[13] the Financial Services Consumer Policy Centre

8 *Submission* 73, ASFA, p. 60.

9 *Submission* 73, ASFA, p. 60.

10 *Submission* 73, ASFA, p. 60.

11 *Submission* 43, CPA, p. 6.

12 *Submission* 31, ICAA, p. 2.

13 *Submission* 32, AMA, p.3.

(FSCPC),[14] the Taxation Institute of Australia (TIA),[15] Catholic Health Australia (CHA),[16] the National Seniors' Association (NSA),[17] the Association of Independent Retirees (AIR)[18] and AMP Financial Services (AMP) also supported a move to end benefit taxation of superannuation. The AMP indicated that such an expenditure tax policy is adopted in many developed countries. AMP suggested that a move to end benefit taxes would promote additional voluntary superannuation savings, assist compound interest to work to increase final benefits, increase acceptance of compulsory superannuation, and encourage income stream benefits relative to lump sums.

8.18 In addition the AMP submitted that the removal of the fund earnings tax might dampen the incentive to retire early. The AMP noted that it is when retirement is a viable option that the earnings tax bites most severely, reducing the lifetime reward for working another year.[19]

8.19 The AMP also submitted that a benefits tax reduces the distortion that exists between the two largest investments that Australians are likely to make in their lifetime – housing and superannuation. According to the AMP, a policy of taxing superannuation and housing in a similar manner would potentially reduce over-investment in housing.[20]

8.20 In its supplementary submission, the AMP proposed the introduction of a withholding tax to make up the revenue shortfall associated with any move to an end benefit tax system:

- Adopting a withholding tax on contributions harnessed with a tax on withdrawals (a benefit tax) could partly address this shortfall. The combined impact of the two taxes leaves the retiree in the same net position as if they were only taxed on benefits at marginal rates;
- In its pure form, the equivalence with current tax revenue can be achieved by applying the benefits tax at a progressive rate, less the withholding tax rate, say set at 10 per cent, on a 'grossed up' base. The gross up is required to neutralise the impact on tax revenue of the reduction in payout caused by the withholding tax;
- Focusing on SG contributions made over the next 10 years by a man on average earnings, these should reach $42,361 (in addition to what is already in their

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14 *Submission* 50, FSCPC p.5.

15 *Submission* 54, TIA, p. 2.

16 *Submission* 45, CHA, p. 13.

17 *Submission* 60, NSA, p. 2.

18 *Submission* 16, AIR, p. 5.

19 *Submission* 64, AMP, p.10.

20 *Submission* 64, AMP, p.10.

account) with no change to tax policy. If a benefit tax (with a withholding tax rate of 10 per cent) is adopted, the super balance would grow to $45,976 in today's dollars, an improvement of nine per cent. The advantage of tax free compound interest can be seen for someone with an additional 20 years of saving. The superannuation benefit increases by 12 per cent;

- The individual is always better off under the withholding tax arrangement relative to the current superannuation tax arrangements.[21]

8.21 Dr FitzGerald made the important claim that the budget position if the front-end taxes were removed, would not be as bad as often advanced. In support of the proposal to move away from front-end taxes to end benefit taxes, Dr FitzGerald identified mechanisms that would have the potential to cushion the Budget in the following terms:

> … Partly the way to look at this is in accrual terms, although the accounting standards do not stretch this far. When the dependence of the budget on revenues raised now from superannuation, through the contributions tax and the tax on earnings, is compared with the situation of those revenues being collected later, the comparison typically gives no weight to revenues which will be collected beyond the next few years for budget purposes, for savings on the age pension in the future or any other effect like that. So the hole in the budget is not as big as it seems if it is properly viewed, because each year that you went forward there would be some taxes accruing to the budget to be collected in the future, admittedly beyond the forward estimates horizon. So if a long-term view of those accruals were considered, the hole in the budget is not as deep as it would appear. However, I concede that it is there.
>
> Therefore, any move to put the tax back to the benefit stage—which you really have to do; it makes no sense in public policy terms to just take the contributions tax off and not compensate at the other end—means that to cover the budget hole in the meantime takes some design of the policy. The best proposal that I am aware of is one of the so-called roll-up proposals, where you would choose a transition date and at that date calculate, in every fund, the tax liability that each fund member would have if their benefits were drawn under retirement conditions at that date.
>
> You would calculate all their tax liabilities and benefits at that date and then you would make those, or a selected proportion of them, payable in instalments to the budget over the following, say, five to seven years or some period like that, after which the budget would only be receiving taxes on the new basis. In other words, you would be bringing forward some of the tax that would otherwise be left to collect under the new basis and collecting it over the first five to seven years. The numbers, as I understand them having looked at this for a while, are such that you could actually largely fill the hole for long enough that the growth in superannuation would

21 *Submission* 127, AMP, p.5.

> make the adjustment to the new tax arrangements quite manageable for the budget.[22]

8.22 The ABA submitted that in addition to achieving considerable simplification, any move away from front-end taxes to end benefit taxes would:

- significantly increase the material incentive to contribute — an incentive improvement concentrated at the point where the decision to contribute or not is made;
- facilitate a move to payment of benefits largely as income streams, either by
  - simply applying ordinary income taxation to all benefits, with at most a limited provision for taking part of a benefit as a lump sum. This would strongly encourage taking income streams (since significant lump sums would be taxed in the top tax bracket); or by
  - explicitly requiring payment of benefits (above some lump sum limit) in income stream form; and
- considerably improve the mesh between the superannuation and age pension systems. There would be less encouragement to retire early, draw a substantial part of the available benefit as a lump sum, use this to live on in early retirement then qualify for an age pension.[23]

8.23 The ABA acknowledged that a move away from front-end taxes to end benefit taxes would have significant revenue implications in the short term but, like Dr FitzGerald, noted the position is better in the longer term. The ABA advised the Committee that:

> Overall, as has been concluded in a number of analyses of this issue, the net present value of future tax collections is quite likely to increase. However the current model of accrual budgeting, as adopted by all Australian governments, does not bring to account the present value of the long–term effects of such policy changes, and indeed there is still excessive focus on *cash* Budget measures and *short–term* Budget impacts. In these terms, removing the contributions tax would reduce Budget inflows by around $2.5 billion p.a.[24]

8.24 While ABA believes that the long–term positive impacts on the Budget, for saving and for inter–generational equity should be given the fullest weight, it is nevertheless accepted by the ABA that the short–term Budget impact would need to be managed, by, for example, phasing in the proposed change or timing the change judiciously, that is, when there is capacity for tax cuts in some form.[25]

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22 *Committee Hansard*, 10 July 2002, pp. 292-293.

23 *Submission* 51, ABA, p. 23.

24 *Submission* 51, ABA, p. 24.

25 *Submission* 51, ABA, p. 24.

8.25 The Australian Institute of Superannuation Trustees (AIST) also supported a reduction of the front-end taxes. The Institute submitted that:

- The 15 per cent tax on contributions be phased out. The annual 'cost' to revenue, approximately $2.1 billion (if implemented in 2001-02), would have been about the same as a $6 per week tax cut but the rewards for individuals and the economy are far higher.[26]
- For an individual on average weekly earnings, about $40,000, abolishing the 15 per cent contributions tax, assuming 8 per cent earnings, would boost retirement savings by about $30,000 after 30 years of employment and $52,000 after 40 years of employment.[27]
- The removal of the contributions tax would improve tax equity, since the 15 per cent concessional rate is only slightly favourable for those on the lowest marginal rate of income tax, but more favourable to those on higher rates.[28]

8.26 The Financial Planning Association (FPA) also supported a move away from front-end taxes:

> The FPA further believes that the outcome for taxing super should be at the end point. This method ensures a greater accumulation of super, and more money for people to draw upon in retirement. It also ensures less complication in understanding the taxation of super, as it occurs only once, which in turn makes it attractive to consumers and reduces the administrative burden on the industry, (hopefully resulting in lower MERs). In other words, reducing barriers to effectively enter into the super system would encourage more people, especially younger Australians, to contribute to their retirement.[29]

8.27 The Australian Council of Trade Unions (ACTU) supported superannuation tax arrangements that assist the low and middle income group. Ms Rubinstein from the ACTU expanded on this position as follows at the Canberra roundtable discussion on 8 October 2002:

> … our position on equity issues is pretty well known. We believe that, to the extent that there is government support for superannuation, whether through tax concessions, rebates, co-contributions or whatever it might be, it ought to target the section of the community that is going to have the most difficulty in saving for retirement. By and large that is going to be low and middle income earners, not high-income earners.

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26 See footnote in AIST submission: 'Revenue implications of removing the contributions tax and recent developments in the tax attractiveness of superannuation', ASFA, September 2001. See *Submission* 10, AIST, p. 10.

27 See footnote in AIST submission: 'Retirement Futures Forum', March 2001. See *Submission* 10, AIST, p. 10.

28 *Submission* 10, AIST, p. 10

29 *Submission* 44, FPA, p. 7.

> … the taxation of superannuation could target low income people or people with small accumulations. There is something in that as well. You can put together a range of different factors, including age, income and accumulation. I do not know that that is simple, but certainly some tax changes of that nature could be looked at.
>
> One idea which the Labor Party has floated is to reduce the contributions tax for people aged 40 and over. Those people, because of the relatively short time that most of them have been in superannuation—at best, 15 or 20 years—will not be able to accumulate anything like the targets that we have been talking about here. Contribution levels for most of that time will have been at considerably less than nine per cent. That would be one way of doing it. Other ways of doing it would be to increase mandatory contributions, whether from employers, from employees or some combination, but with tax rebates for or assistance with that, again to target low-income earners. [30]

8.28 The Australian Consumers' Association (ACA) broadly supported a move away from front-end taxes. However, the Association indicated that it would prefer a reduction in the contributions tax ahead of a reduction in the surcharge:

> However, while ACA broadly supports the reduction of front-end taxes on superannuation, to encourage fund growth and adequacy, we have expressed our concern at the reduction of the surcharge ahead of a reduction of the contributions tax.[31]

Committee view – generic fund level taxes

8.29 The Committee notes that the overwhelming majority of the evidence received during the inquiry supports the reduction or removal of the contributions tax in favour of taxing the end benefit.

8.30 The Committee would prefer a gradual move away from all up-front superannuation taxes so that, in the long term, tax would only be applied to superannuation benefits. The Committee considers that the growth in tax revenue on superannuation end benefits could be used to offset the reduction in revenue from the gradual removal of the contributions tax. In an ideal system the Committee considers that taxation equity is best achieved through the application of a progressive tax system on end benefits.

8.31 Accordingly the majority of the Committee considers that the time has arrived to take the first steps in this direction. The Committee notes that any reduction of the contributions tax will increase revenue from earnings taxes as accounts grow more quickly, and that any reduction in front-end tax has the potential to assist people to achieve an adequate replacement rate target. As noted above, the Committee

30 *Committee Hansard*, 8 October 2002, pp. 687.

31 *Submission* 76, ACA, p. 7.

considers that end benefit taxes could be increased to compensate for any reduction in the contributions tax.

8.32 The Committee has been informed by peak industry bodies and commentators that a phased reduction in the contributions tax is the best approach to minimise the impact on the Budget.

Recommendation

8.33 **The majority of the Committee recommends that, in the long term, the superannuation contributions tax be gradually removed and replaced with a new approach to taxing end benefits.**

Rebates for individuals rather than generic fund level taxes

8.34 During the inquiry, some individuals and organisations took the view that equity considerations would be best served by removing the flat front-end taxes and replacing them with taxes and/or rebates at the individual member level. For example, Mr Christie, a financial planner from the Northern Territory, submitted that individual rebates should apply instead of the contributions tax. Mr Christie advised the Committee:

> I have suggested a tax collection system run through the income tax mechanism where SG and additional contributions are taxed at the member's marginal rate minus a rebate, and my first suggestion there was of 17 per cent. A member with income less than \$20,000 but above \$6,000 would not pay any tax on contributions under that model. So it is a fundamental rebate on one's normal taxable income. If the government feels it can reduce the surcharge for those on higher incomes, then such reduction should similarly apply to all others by increasing the rebate beyond 17 per cent, taking it to, for example, 21½ per cent, which would be the shift that the government has proposed with the rebate. This proposal removes the surcharge collection mechanism but preserves equity. I think that is the thing that would find great attraction in the superannuation industry. It also enables the self-employed, those who cannot salary sacrifice because their employer will not do it for them, and those who can salary sacrifice to be treated on the same basis.[32]

8.35 The ICAA supported a superannuation contributions system that is based on the earnings of the individual member. The Institute submitted that:

> A fairer and more equitable system would be to remove the contribution tax and apply the contributions tax in a similar manner to the surcharge on a sliding scale. This should be at a rate below the effective tax rate applicable to the contributor had the money been taken as income. Contributors could

32 *Committee Hansard*, 9 July 2002, pp. 88-89.

be given the option of paying the taxes personally or from their superannuation fund.[33]

8.36 Cbus sought a reduction of superannuation taxes for low income earners through the provision of tax rebates which would be paid into their nominated superannuation fund.[34]

8.37 The Australian Council of Social Service (ACOSS) argued very strongly that the flat rate taxes are inefficient and inequitable as the progressive tax scale applied to income provides higher superannuation incentives to those on higher incomes. Accordingly ACOSS proposed a restructure involving the introduction of a Long-term Savings Rebate, which would be paid into the fund annually, to replace all existing tax concessions for contributions. Under this approach:

- Employer contributions would attract personal income tax in the hands of employers (through the Pay As You Go system) before they are transferred to the fund. Existing taxes on these contributions in the hands of the fund (the 15 per cent contributions tax and the superannuation surcharge) would be abolished;
- Contributions would attract the same annual rebate of tax regardless of their source, the income level of the individual concerned, and whether they are compulsory or voluntary.[35] The existing low-income employee contributions rebate, deductions for self-employed people, and spouse contributions rebate, would be abolished;
- The new rebate would be a percentage of contributions rather than a flat rate. The percentage would be high enough to support compulsory superannuation saving and encourage voluntary contributions, without raising the overall cost of tax concessions;
- The rebate would be capped on a flat dollar basis (not in proportion to individual earnings), to limit tax subsidies for high income-earners. The cap should be high enough to encourage low and middle income-earners to make voluntary contributions (beyond SG levels). It should be low enough to sharply reduce the generous tax subsidies for high income-earners, in order to ensure that the changes are revenue neutral in overall terms;
- The proposed rebate would have two tiers. At low contribution levels it would be a co-contribution. Above that, a rebate would apply up to the cap described above. For example, the rebate could be 100 per cent of contributions up to 0.5

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33 *Submission* 31, ICAA, p. 2.

34 *Submission* 42, Cbus, p. 12.

35 See footnote in ACOSS submission: ‘In the case of defined benefit funds, a similar actuarial methodology to that which is currently used to calculate superannuation surcharge amounts could apply. See *Submission* 65, ACOSS, p. 26.

per cent of AWOTE, plus 20 per cent of additional contributions up to 11 per cent of average earnings;[36]

- The present tax treatment of fund earnings and benefits could remain in place. This means that the tax treatment of superannuation would still be highly concessional for high income-earners, due mainly to the flat 15 per cent tax on fund earnings;[37]
- The current tax treatment of benefits would also remain in place, except that lump sum retirement benefits above the level of the tax-free threshold for such benefits (currently $106,000) would either be prohibited or taxed at a penal rate. This would reduce 'leakage' of retirement savings and encourage greater use of complying pensions;
- Significantly, the new arrangements would only apply to contributions made after the date of their implementation. There would be no need for any grand-fathering arrangements.[38]

8.38 At the Canberra roundtable discussion on 8 October 2002, Dr David Knox cautioned against the ACOSS approach to the adoption of a long-term saving rebate solution because, in his view, it would introduce inequities in the same way that the surcharge does:

> … one of the equity issues we have not picked up here is the whole issue of inequity within the surcharge. The surcharge is a dog of a tax and we all know that. There are lots of inequities within in it, both for individuals who are subject to the surcharge and for individuals who are not subject to the surcharge.
>
> Some of those inequities would, in fact, flow through and be similar to some of Peter Davidson's suggestions on fully taxing contributions. Whether you are in a defined benefits scheme or an unfunded scheme, there are inequities and assumptions that you are going to have to make. So I just put that on the table. If you were going to go down that route, you are actually adding complexity in inequities of a different sort, part of which we see in this surcharge.[39]

8.39 Instead of basing rebates on earnings, Dr Knox suggested in the written submission of PricewaterhouseCoopers (PwC) that member contributions could be

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36 See footnote in ACOSS submission: Since AWOTE was approximately $43,000 in February 2002, these contribution levels are currently $215 and $4,730 respectively. The 11 per cent of average earnings is based on the 8 per cent SG plus 3 per cent to encourage voluntary saving. On (t)his basis, the cap would rise to 12 per cent of AWOTE once the SG requirement reaches 9 per cent of earnings. See *Submission* 65, ACOSS, p. 27.

37 See footnote in ACOSS submission: 'Its cost to revenue is equivalent to that of the concessional 15 per cent tax rate on employer contributions. See *Submission* 65, ACOSS, p. 27.

38 *Submission* 65, ACOSS, p. 26.

39 *Committee Hansard*, 8 October 2002, p. 699.

refundable in certain circumstances. This approach would enable individual people with more scope to tailor retirement incomes in their own circumstances. He said in his submission:

- Initially, it is suggested that members' contributions from taxed income should receive a tax refund, up to a maximum contribution of $4,000 per annum, which represents about 10 per cent of the average wage;
- However such an all encompassing refund for member contributions is likely to provide a financial benefit to some members who are already contributing. In other words, it may be considered a 'free kick' without encouraging any behaviour change. It is therefore suggested that the rate used for the refund should decline with age;
- For example, the rate could be 30 per cent for those under 30 who contribute, 20 per cent for those aged 30-39 and 10 per cent for those aged 40-49. Such a scaling approach has several advantages:
  - It encourages saving amongst younger members thereby building a savings culture and pattern early in one's working career;
  - It encourages savings at ages where it generally does not occur in the current system. That is, it will encourage a change in behaviour and does not reward those who are over 50, many of whom are saving today;
  - It provides greater compensation for longer periods of preservation;
  - It limits the revenue cost to the Government; and
  - It provides some offset to the negative effects of the existing limits of Maximum Deductible Contributions for some younger members.
- The flexibility within this rebate approach could be expanded even further. Recently, the Assistant Treasurer, Senator Coonan has noted that 'interrupted careers and fragmented work patterns inhibit women's capacity to save for retirement;'
- It is therefore suggested that 50 per cent of any unused rebate be rolled forward to future years. Such a process expands the opportunity for those with fragmented careers but the reducing refund rate will also limit its ultimate cost and encourage contributions to be paid earlier and not later.[40]

Committee view – rebates for individuals

8.40 The Committee notes that, while some evidence suggested that individual member rebates were a fairer means of distributing superannuation tax concessions than the current contributions tax arrangements, most of the other evidence received on the issue suggested the removal of front-end taxes such as the contributions tax.

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40 *Submission* 27, PwC, p. 9.

8.41 The Committee notes that the taxation concessions from superannuation contributions increase as income increases. In other words low income earners receive a lower level of concession per dollar of contribution than higher income earners, even when the surcharge is factored in. The Committee also notes that those on higher incomes are more likely than other groups to have access to other non superannuation savings to provide for their retirement needs.

8.42 The Committee considers that the adoption of an approach that provides roughly the same level of concession for taxpayers with different personal marginal rates has some appeal. Nonetheless the Committee notes that superannuation funds do not have access to member salary and tax return information. This would make the implementation of superannuation contributions tax at individual rates, or individual rebates or deductions very difficult to achieve. The application of these suggestions to defined benefits, especially unfunded ones, and to end benefit taxes would also be very complex.

8.43 For these reasons, not all members of the Committee are attracted to the concept of rebates at the individual member level during the accumulation phase.

Age-based deductible contribution limits

8.44 Access to tax concessions available from superannuation is restricted through the operation of annual age-based maximum deductible contribution (MDC) limits. Under these arrangements an employer is not entitled to tax deductions in respect of employer contributions made to an individual that exceed the annual limits. In the 2002-03 year the limits are $12,651 for a member under age 35; $35,138 for a member between ages 35 and 49; and $87,141 for a member over age 50.

8.45 During the inquiry many submitters questioned the equity implications of the limitations on tax deductible contributions each year, given that there are whole of life arrangements in place through the operation of the RBLs.

8.46 ASFA did not support the MDC limits, as indicated by their Chief Executive Officer, Ms Smith, during the hearing on 8 August 2002:

> I have always thought the age-based contributions are rather odd, because people have different opportunities during their work life to save, and we are assuming a constant pattern. A lifetime RBL seems to better capture it. It is dangerous to freeze things in time, because again you have the relative living standards.[41]

8.47 The CPA also argued for reform of the MDC limits in conjunction with a review of the RBLs. In this regard, the CPA submitted that the age-based deduction limits could either be:

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41 *Committee Hansard*, 8 August 2002, p. 599.

- removed as the current RBLs cap the amount of superannuation benefits that are taxed on a concessional basis; or
- increased so that individuals under the age of 35 without commitments are able to contribute more via salary sacrifice and other arrangements while they do not have any commitments such as young children and mortgages. This would recognise the changing demographics of the population.[42]

8.48 As an alternative to removing or increasing the MDC, the CPA suggested providing age-based contribution levels for each employee on a cumulative basis.[43]

8.49 The Small Independent Superannuation Funds Association (SISFA) put forward two options for MDC limits. The first option was to retain them with some modification 'which would allow for a person to make 'catch-up' contributions above their applicable age-based limit if it appears that they will be under-funded for superannuation purposes, or they have claimed less than the maximum limit in previous years (similar to the cumulative effect of the post age-55 threshold for lump sums).' In SISFA's view, this situation may apply to women who have spent many years out of the work force, or individuals whose businesses have only become profitable later in life.[44]

8.50 The second option proposed by SISFA was to remove the age-based limits, with modifications then made to the RBL system. Mr Lorimer from SISFA explained the reasons for this proposal during the public hearing on 10 July 2002:

> We also believe that the reasonable benefit limit system needs to be comprehensively reviewed in conjunction with how it fits in, or does not fit in, with the workings of the age-based deduction limits for superannuation contributions. We cannot really see why you need to have limits on the deductions for super contributions as well as reasonable benefit limits.[45]

8.51 The ABA argued for the abolition of the MDC limits, submitting that 'there is no logic for applying limits to (deductible) contributions as well (as RBLs) – for example, it penalises those who have broken participation in paid employment and seek to 'catch up.'

8.52 In addition the ABA supported the removal of RBLs, in the context of a major overhaul of the taxation arrangements for superannuation, focussing on taxation at the benefit stage.[46]

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42 *Submission* 43, CPA, p. 7.

43 *Submission* 43, CPA, p. 7.

44 *Submission* 47, SISFA, p. 5.

45 *Committee Hansard*, 10 July 2002, p 268.

46 *Submission* 51, ABA, p. 24.

8.53 Rather than abolishing the MDC limits, the FPA argued for the removal of RBLs, to encourage additional superannuation savings. The FPA advised the Committee that:

> Reasonable Benefit Limits, RBLs, need to be removed as they inhibit greater savings by discouraging people from contributing more to super, because of fear of exceeding the RBL. Current Age-Based Contributions are a sufficient equity mechanism to limit possible excesses under concessional superannuation tax laws.[47]

8.54 Mr Hopley from the Australian Institute of Company Directors advocated the abolition of the age-based limits, but retention of the RBLs, in his evidence to the Committee on 9 July 2002:

> We believe there is no need for two controls on the maximum benefits available within superannuation. In other words, why do we have a maximum control on contributions and a maximum control on benefits received? We would recommend a removal of the maximum deductibility levels on the contributions of all ages, but controlling that at the other end by the RBL system-in other words, there are penalties at the other end.[48]

8.55 IFSA argued in its written submission that the current age-based contribution limits constrain flexibility in the current superannuation system and should be removed:

> … The most obvious limit to flexibility are the annual contribution limits, which seem unnecessary given the lifetime limits effected by the RBL regime. IFSA supports the concept of a lifetime limit on concessional treatment of retirement savings, and while there are technical issues with the RBL system, a lifetime limit on concessional treatment is an appropriate concept to the current superannuation regulation regime.
>
> Older workers seeking to make up for periods out of the labour market, but who are not yet over 50, may wish to put more of their salary into superannuation than the current limit. The rigid annual deduction limits on employers operate to restrict this opportunity.[49]

8.56 The AMP also expressed concern about the impact of age-based limits, in particular their effect on certain groups such as the baby boomers who need to make additional contributions over the next 20 years. In the view of the AMP, the MDCs limit the possible gains to individuals from using salary sacrifice arrangements to boost their superannuation savings. AMP recommended that:

> The MDC for those under 50 should be set at a much higher rate. This would enable younger people to make a significant contribution to their

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47 *Submission* 44, FPA, p. 2.

48 *Committee Hansard*, 9 July 2002, p. 185.

49 *Submission* 70, IFSA, p.13

> super and take advantage of long-term compound interest. It also enables women who expect to take leave from the workforce to make a significant contribution to their super while working.[50]

8.57 As previously noted, the ICAA advised the Committee that the age-based deductible limits discriminate against people whose occupations have income weighted toward early years in the work force, such as sports people and entertainers; and women planning a broken work pattern to have a family.

8.58 The ICAA elaborated that:

> In both these cases the individual has a higher disposable income early in their working life and may not have an opportunity to contribute to superannuation later in life.[51]

8.59 Similarly, Dr David Knox, from PwC, in response to a question from the Committee, advised that age-based limits impact on people with disposable savings who want to sacrifice a high proportion of salary at a young age. Dr Knox elaborated as follows:

> We need to be careful. At the moment, we seem to have restrictions at the front-end and the back-end. If we are looking at superannuation as a lifelong saving over your working career and we have caps at the back end, should we have caps at the front-end? If they put too much in and earn investment income, they will be caught at the back-end.[52]

Committee view – age-based deductible contribution limits

8.60 The Committee notes that most of the evidence on this issue suggested that having two limitations on superannuation tax concessions – MDCs and RBLs – were unnecessary, because the limitations were best considered on a whole of life basis either through the RBL approach or progressive tax on benefits. The Committee also notes that most parties suggested that the MDCs should be removed.

8.61 The Committee believes that equity is best considered on a whole of life basis and not on an annual basis. There are many reasons why a person might want to make superannuation contributions in any year that exceed the annual MDC limit; for example, to make catch up contributions following breaks in employment, or where people have excess earnings after child rearing and paying off the mortgage, and have the capacity to pay more at the end than at the beginning of their working lives.

8.62 The Committee is not persuaded to remove MDCs at this time. However, given preservation, and the limitations on early withdrawal, there is not the same case for MDCs as there has been in the past. For this reason the Committee considers that there

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50 *Submission* 64, AMP, p. 16.

51 *Submission* 31, ICAA, p. 3.

52 *Committee Hansard*, 17 July 2002, p. 346.

would be merit in the Government reviewing the scale of the MDCs to ensure their continued relevance.

8.63 The Committee notes that, if the MDCs were ultimately to be removed, any additional contributions would have the advantage of adding to long-term national savings as money is preserved in the superannuation system until at least age 55. Additional contributions would also have the potential to reduce future age pension payments. Women who have broken working patterns would also be able to make catch-up contributions without tax penalty.

8.64 The Committee is not attracted to the concept of cumulative MDCs because of the additional complexity that would result.

8.65 The Committee considers that two limitations on tax concessions are not necessary because the limitations are best considered on a whole of life basis either through the RBL approach or progressive tax on benefits. For this reason the Committee considers that the MDC limits might ultimately be able to be removed when the taxation regime has moved to back-end taxes.

Recommendation

8.66 **The Committee recommends that, until such time as the taxation regime has moved to back-end taxes, which would ultimately enable Maximum Deductible Contribution limits (MDCs) to be removed, the Government review the scale of the annual MDC limits.**

8.67 While not specifically referring to age-based contribution limits, the Committee considers that contribution limits are required in order to ensure that the superannuation system is not being abused by high income earners.

Chapter 9

The Surcharge

Introduction

9.1 Of the annual taxation measures discussed during the inquiry, the surcharge attracted considerable comment, with many submissions criticising the surcharge on one or more of equity, complexity or administrative grounds.

9.2 Following a brief background section, the following issues are then discussed:

- equity considerations;
- application to defined benefit funds; and
- administration issues.

Background information

9.3 The surcharge was announced by the Treasurer in his 1996-97 Budget speech on 20 August 1996. The objective was to reduce the superannuation tax concessions available to high income earners as an equity measure.

9.4 From 20 August 1996 the surcharge has been imposed on relevant superannuation contributions where the members' income is above a minimum threshold. For the 2002-03 financial year that threshold is $90,527. At that point the surcharge is one per cent of contributions and it peaks at the maximum rate of 15 per cent at incomes of $109,924.

9.5 Each superannuation fund is required to provide the Australian Taxation Office (ATO) with details of all contributions received for all members. The ATO then matches that information with each members' annual tax return to determine the amount, if any, of any surcharge that is due. Where the surcharge is payable, the ATO advises the member and the fund. The fund then passes the surcharge payment to the ATO from the member's account.

9.6 During the 2001 election campaign, the Coalition announced its intention to reduce the surcharge from a maximum of 15 per cent to 10.5 per cent over a three year period. Legislation was subsequently introduced which would have seen the first reduction commence from 1 July 2002.[1] At the time of this report, the legislation has not been passed by the Senate.

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1 Taxation Laws Amendment (Superannuation) Bill (No 2) 2002; and Superannuation Legislation Amendment Bill 2002. On 20 June 2002, the Government advised the Committee that it had decided to re-locate the proposed amendments reducing the surcharge into a package of bills implementing the co-contribution concept for low income earners. The package of bills

9.7 The 2002-03 Budget papers indicate that the surcharge is estimated to raise $820 million in revenue in the year.

Equity considerations

9.8 Even though the surcharge was introduced as a measure to improve the equity of the superannuation system, a number of submissions were critical of the surcharge on equity grounds. These included the Corporate Super Association,[2] the Australian Medical Association,[3] the Australian Licensed Aircraft Engineers Association,[4] the Taxation Institute of Australia,[5] and CPA Australia (CPA). For example the CPA submitted that in addition to it being an inefficient tax that has significant compliance costs, the surcharge disadvantages those Australians in a catch-up phase and those taking a redundancy payout:

> The surcharge imposes very significant compliance costs on funds and their advisers and has been consistently regarded by all parties in the superannuation industry as a highly inefficient tax. As well, the surcharge disadvantages those Australians in a 'catch-up' phase and those taking a redundancy payout. At the very least, consideration should be given to raising the income level at which the surcharge cuts in and removing the surcharge where a redundancy payout is rolled into superannuation.[6]

9.9 Women in Super criticised the surcharge in its application to women returning to the workforce after raising children in the following terms:

> If, down the track, a woman finds she is earning a high wage, and can save more for retirement via salary sacrificing part of her income into superannuation, the superannuation contributions surcharge results in a loss of 30% of pre-tax contributions made.
>
> Retirement and Income Modelling (RIM) Unit of the Department of the Treasury found that 'most financial planners (eg AMP, 1999) and the RIM Unit find that superannuation remains a tax preferred investment, even when the full surcharge rate is being paid'.
>
> What it ignores is that this surcharge is an insidious erosion of retirement savings, especially in respect of women with only a few years to retirement,

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were the Superannuation (Government Co-contribution for Low Income Earners) Bill 2002 and the Superannuation Legislation Amendment Bill 2002. Debate on the package of bills was adjourned in the Senate on 18 November 2002.

2 *Submission* 41, Corporate Super Association, p. 5.

3 *Submission* 32, Australian Medical Association, pp. 2,3.

4 *Submission* 149, Australian Licensed Aircraft Engineers Association, p. 2.

5 *Submission* 54, Taxation Institute of Australia, p. 2.

6 *Submission* 43, CPA, p. 6.

> because it takes no account of the inadequacy of accumulated superannuation savings or fluctuating income.[7]

9.10 Commodore Adams from the Australian Council of Public Sector Retiree Organisations (ACPSRO) also commented on the inequitable impact of the surcharge on military personnel during the hearing on 1 July 2002:

> We believe that it is iniquitous that Australians who volunteer to go in harm's way as members of Australia's armed services should be assessed at a higher rate than those in civilian occupations, simply because military superannuation schemes are deemed to be more beneficial. We believe that this is reverse discrimination of the worst sort.[8]

9.11 Mercer Human Resources outlined the following scenario in which an extra dollar could result in liability for the surcharge:

- Consider the case of Eileen who is retrenched from her job after 11 years. Eileen earned $100,000 a year and receives a redundancy payment of $103,507 – which is more than the tax free amount on 20 February 2002.
- Eileen would be liable for a surcharge payment of $8,512.
- However, if her termination payment is just one dollar less, Eileen would not be liable for a surcharge payment.
- Essentially this result is the product of changes made in the 2001 budget. Those changes require that the whole of any termination payment above the surcharge threshold is included in the adjusted taxable income (ATI). Conversely where the termination payment is less than the surcharge threshold only the total payment divided by the relevant years of service is included in the ATI.[9]

Application to defined benefit funds

9.12 The application of the surcharge to members of defined benefit funds can produce outcomes that are not consistent with the objectives of equity. For example, the surcharge can be considerably more than 15 per cent of the employer financed benefit. This is best illustrated in the following material prepared by Dr David Knox for the Society of Superannuants (SOS):

- The member's defined retirement benefit is generally determined by the product of the relevant multiple, the length of service and the member's final (average) salary. Most defined benefit funds have also set up a negative account to offset the surcharge which must be paid during the member's actual membership

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7 *Submission* 109, Women in Super, Appendix B, p. 5

8 *Committee Hansard* , 1 July 2002, p. 62.

9 Mercer Human Resources, Case Study One: Do not pay me that extra dollar, tabled at a public hearing on 2 September 2002, during the Committee's inquiry into three bills relating to the co-contribution, surcharge and choice.

period. The simplest and most common approach has been to set up a negative accumulation account increased by the fund's investment earning rate and reduce the gross defined benefit by this accumulation amount at retirement.

- However, as the defined benefit and surcharge account increase at different rates, due to the different factors that are used to calculate the amount in each case, it is feasible that the 'net' employer-financed retirement benefit will be less than 85 per cent of the 'gross' employer-financed retirement benefit. In effect, a hybrid super scheme has been established where part of the benefit is determined by years of service and the defined benefit scale and part is determined by contributions and the fund earning rate. It is this hybrid nature of the arrangement that causes the problem.[10]

9.13 The SOS also submitted the following basic issues about the surcharge for members of defined benefit fund:

- The surcharge is based on an individual member's entitlement from superannuation in respect of the employer's contribution in a particular year.
- The level of the employer's contribution is easily defined for an accumulation fund but is problematical for defined benefit funds. This problem was always acknowledged and the Government set up an Actuarial Advisory Committee at the time the surcharge was introduced to consider the issue. It is not a new problem.
- As with all actuarial calculations for contribution rates to defined benefit funds, certain assumptions are required. To resolve this issue, regulations have been issued by the ATO prescribing a discount rate of 8 per cent per annum and a salary growth rate of 4.5 per cent per annum. That is, a gap of 3.5 per cent between these two rates is used. No promotional salary scale is assumed.
- In broad terms, the major long-term issue in these assumptions is the 'gap' between the long-term investment earning and the long-term salary increase rate. It is noted that the notional surchargeable contributions factor (NSCF) assumptions use a gap of 3.5 per cent whereas it is not uncommon for actuaries to use a gap for funding purposes, after allowing for salary promotion, of 2 per cent or less over the long-term. Hence the 3.5 per cent gap could initially be considered reasonable from the member's perspective.
- It is recognised that in most circumstances, if the actual 'gap' experienced by the fund is **greater** than the assumed gap, the level of contributions has been too high and the fund moves into surplus. Similarly, in respect of the NSCF, if the gap experienced is greater than 3.5 per cent, the negative accumulation account is likely to be greater than 15 per cent of the employer-financed defined benefit that it relates to.
- Hence, it is feasible that if a superannuation fund's investments earn a rate that is say 5 per cent above the long-term salary experience, then the negative

10 *Submission* 49, SOS, Annex B, p. 1.

accumulation account at retirement could be 20-30 per cent or higher of the employer-financed defined retirement benefit. The actual result will also depend on the individual member's salary movements.[11]

9.14 The SOS provided some examples of how the surcharge could be more than 15 per cent of the employer financed benefit using the situation of QANTAS Pilots in the QANTAS Super Plan. For example, the SOS provided information that showed that for a member receiving annual real salary growth of 1.8 per cent from age 30 to 40 and 0.5 per cent after that until age 60, the member will pay a surcharge of 46.1 per cent of the employer-financed benefit.[12]

Administration issues

9.15 A number of submissions commented on the complexity and the cost of administering the surcharge, because of the way that superannuation funds need to report every contribution for every member to the ATO, irrespective of their income levels. Much of the evidence on this issue recommended streamlining the process by relocating the administration of the surcharge from the funds themselves to the ATO. For example the Australian Institute of Superannuation Trustees (AIST) submitted that:

> AIST would also like to take this opportunity to recommend that the administration of the superannuation surcharge move entirely across to the ATO. The administration of the superannuation surcharge is widely recognized as burdensome and it imposes compliance costs on superannuation funds that are higher than the total cost of revenue gained from the surcharge. AIST accepts that the surcharge is designed to promote equity but would note that the equity gained is eroded by the costs of compliance, which is placed on all superannuation fund members.[13]

9.16 CPA Australia and Supermaster Investments also supported moving the administration of the surcharge from funds to the ATO.[14]

9.17 The Australian Consumers' Association (ACA) also commented on the costs associated with the administration of the surcharge:

> Superannuation funds have reported significant administrative costs associated with the imposition of the surcharge, and it is unpopular with higher-income earners.[15]

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11 *Submission* 49, SOS, Annex B, pp. 1-2.

12 *Submission* 49, SOS, Annex B, p. 2. Assumes a 9 per cent annual fund return.

13 *Submission* 10, AIST, p.10

14 *Submission* 121, CPA, p.1 and *Submission* 92, Supermaster Investments, p. 1.

15 *Submission* 76, ACA, p. 7.

9.18 The Committee requested the ATO to comment on the proposal to move the surcharge administration from funds to the ATO. The Committee was informed by the ATO that the question raised policy issues and was therefore a matter for Treasury. In its supplementary written submission, Treasury advised the Committee

> The transfer of administration of the surcharge would require a change in current government policy. As such we are not in a position to comment on this matter.[16]

Committee view - surcharge

Surcharge

9.19 The Committee notes that, although designed as an equity measure, much of the evidence received on the issue of the surcharge was critical of the tax as an equity measure because it disadvantages some Australians particularly those seeking to catch up following broken working patterns, and those receiving redundancy payments. However, the Committee is fully aware that a vast majority of Australians, particularly women with broken work patterns, are unlikely to ever receive the level of remuneration sufficient to pay the surcharge and are consequently not directly affected.

9.20 The Committee also notes the evidence which demonstrates that that the application of the surcharge can have unintended consequences for members of defined benefit funds where the salary experience of the member or the earnings history of the fund vary from the assumptions on which the measure is based.

9.21 The Committee also notes that some consider that the administration of the surcharge would be streamlined if it were to be transferred from the funds to the ATO.

9.22 The Committee considers that the surcharge is a complex and inefficient tax, which is administratively costly, with the cost borne by all members. The surcharge is meant to provide an annual limit on the access to individual superannuation tax concessions. However, the Committee notes that the surcharge can apply to individuals in some years when they are attempting to make catch-up contributions because of the proximity of retirement or because of broken working patterns, or because of fluctuating incomes. Often these people will be well within their relevant RBL and consequently have not reached the extent of the tax concessions available on a whole of life basis.

9.23 The Committee has a strong preference for measuring access to superannuation tax concessions only at the time of access to benefits, and not on an annual or other short-term basis. Accordingly, the majority of the Committee supports the gradual phasing out in the long term of both the surcharge and the contributions tax as part of an overall policy to move towards a more equitable system of end-benefit taxation,

16 *Submission* 142, Treasury, p.10.

with a reduction in the contributions tax a priority as it applies to all, rather than a small minority of superannuation fund members.

Impact on defined benefit schemes

9.24 The Committee has received very detailed evidence about how the surcharge produces very anomalous and inequitable results for members of defined benefit funds and for people receiving retrenchment payments.

9.25 The Committee considers that the equitable application of a surcharge to annual employer contributions is not possible in defined benefit funds. This is because there is no relationship between employer contributions and the level of benefit available to any specific individual member. The Committee understands that the employer contributions in any given year for specific fund members cannot be determined with any precision before the member claims a benefit. This is because the member benefit is usually very different depending on salary experience and whether the member qualifies for a retirement, retrenchment, or invalidity benefit. In the view of the Committee, the result is that the surcharge can and does represent more than 15 per cent of the benefit in some private sector defined benefit funds.

9.26 The Committee is aware that there is a 15 per cent cap on unfunded public sector defined benefit schemes. However, the Committee is persuaded that the same cap is now necessary in private sector defined benefit schemes, in order to ensure that members are not taxed at a rate that exceeds the maximum for the surcharge.

Administration of the surcharge

9.27 The Committee is very concerned about the impact of the administration of the surcharge on all members of superannuation funds, even where those members are not liable to pay the surcharge themselves because they do not reach the lower income threshold from which the surcharge commences. The Committee considers that the costs of surcharge administration could be reduced if the ATO assumed responsibility for its administration, because the ATO is better placed to review income tax information for the surcharge target group.

Recommendation

9.28 **The majority of the Committee recommends that, as part of a policy to move towards a more equitable system of end-benefit taxation, the surcharge be gradually removed in the long term (given the revenue implications this may be achieved through a staged reduction).**

Recommendation

9.29 **The Committee recommends:**

- **a surcharge cap of the maximum rate of surcharge (currently 15 per cent) be implemented for members of private sector defined benefit funds; and**

- **the burden of administering the surcharge be transferred from superannuation funds to the Australian Taxation Office.**

Chapter 10

Whole of Life Taxation Arrangements

Introduction

10.1 The previous two chapters dealt with annual fund level taxes and the surcharge. In those chapters, the Committee recommended significant changes in those 'front-end' taxation arrangements. This chapter considers the impact of those recommendations, in the context of the evidence received during the inquiry, for the whole of life equity arrangements. The following issues are considered:

- reasonable benefit limits (RBLs); and
- taxation of end benefits.

10.2 The issue of income streams and taxation of lump sum benefits is discussed in more detail in Part IV- Integration.

Reasonable benefit limits

10.3 The RBLs are a whole of life equity arrangement. They are intended to limit the individual access to superannuation tax concessions.

10.4 The RBLs have been in place in one form or another for many years as a means of limiting the access to the taxation concessions available to superannuation. The RBLs are measured on a whole of life and whole of superannuation holdings basis rather than an annual basis like the annual deductible contribution limits and surcharge.

10.5 There are two RBL tests. One applies where the majority of the superannuation benefit is accessed as a lump sum (or allocated pension) and the other apples where the majority of the superannuation is accessed as an income stream. The RBLs for 2002-03 are $1,124,384 where at least 50 per cent of the benefit is taken as an income stream and $562,195 where the main benefit is a lump sum. The income stream RBL is higher than the lump sum RBL to encourage people to take their benefit as income. Any benefits that exceed the relevant RBL are taxed at the top personal marginal rate.

10.6 Treasury indicated in its written submission that very few people exceed the RBL over a lifetime.[1] The Treasury also informed the Committee that the average superannuation holding per person is about $62,000 and that average superannuation payouts are currently around $72,000 per person.[2]

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1 *Submission* 78, Treasury, p. 29.

2 *Submission* 78, Treasury, p. 16.

10.7 ASFA indicated that the real life impact of the RBLs is limited. ASFA stated that:

> Around about 650 people a year pay tax on excess benefits, but others are likely to have put in place strategies to deal with their potential excess benefits. This compares to the one million or so taxpayers in the age group where superannuation benefits are customarily or required to be taken.[3]

10.8 As indicated above, the RBLs are flat dollar based limits, irrespective of the income of the individual. In the past the RBLs have been based, at least in part, on income. There are layers of transitional arrangements currently in place that apply to people who have superannuation that was accrued under different RBL provisions. As will be seen later in this report the transitional, or grandfathering arrangements, add considerable complexity to the superannuation system.

Committee view – reasonable benefit limits

10.9 The Committee notes that the average superannuation holdings and benefit payments are a very small proportion of the lump sum RBL. The Committee considers that this large gap, which, taken together with the high lump sum tax free threshold, provides little encouragement for people to take income streams.

10.10 The Committee feels that, although the RBLs are having a minor role to play in the management of equity within the superannuation system, they are important as are the other measures such as annual contribution limits and the annual surcharge. The Committee also notes that RBLs would have less relevance if all superannuation benefits were taxed progressively.

10.11 The Committee considers that the RBLs become redundant in an environment where progressive taxation applies to all superannuation end benefits. Nonetheless if the Committee's recommendations relating to the taxation of end benefits are not adopted, the Committee considers that there would be merit in the Government examining measures that would make the RBL more effective. For example through freezing or reducing the annual indexation of both RBL thresholds, or just the lump sum threshold. Another option would be the introduction of single and couple RBLs that would more closely align with the age pension arrangements (which apply differently to singles and couples).

Recommendation

10.12 **The Committee recommends that the current Reasonable Benefit Limits (RBLs) be retained, but that the annual indexation applicable to RBL thresholds be limited.**

3 *Submission* 73, ASFA, p. 29.

Taxation of end benefits

10.13 The taxation of end benefits also form part of the whole of life superannuation arrangements. Lump sums are taxed only once while income streams are taxed at regular intervals over the payment period. Accordingly the lump sum/income stream dichotomy has important implications in the level of access to the age pension.

10.14 The taxation of superannuation lump sum and income stream benefits have become very complex over the last 20 years. Largely this complexity is a product of the 1983 eligible termination payment (ETP) arrangements and the introduction of fund contributions and earnings taxes in 1988.

10.15 Prior to 1983 only 5 per cent of the lump sum benefit was taxable at the individual's marginal rate of tax. Any income stream was fully taxed as normal income.

10.16 The Committee requested the Australian Taxation Office (ATO) to provide some representative examples of the operation of superannuation taxes on end benefits. The examples provided by the ATO are at **Appendix 10.** The examples demonstrate the complexity of the arrangements.

10.17 Much of the evidence quoted in the chapters on the annual taxation measures, indicated that Australia should move taxation away from front-end measures that apply during the accumulation phase to the end benefits. In the chapters dealing with annual taxation measures and the surcharge, the Committee made a number of recommendations to gradually phase out the front-end taxes in the long term.

10.18 As discussed, in its written submission to the inquiry, Treasury indicated that most superannuation benefits are taken in lump sum form, with the average superannuation payment around $72,000 per person, which is well below the lump sum tax free threshold of $112,405.[4]

10.19 The Committee is aware that in the year ending 30 June 2001 some $30.2 billion was paid as superannuation benefits. Of this, about 79 per cent, or $23.8 billion, was taken in lump sum form.[5]

10.20 The Committee is also aware that ASFA has calculated that the post 30 June 1983 lump sum tax for the year ending 30 June 2001 was $510 million.[6] This implies an average lump sum tax of just over two per cent on the $23.8 billion in lump sum payments. With such a small amount of lump sum tax, there does not appear to be any incentive to take an income stream and no real progressive base for an equity measure.

4 *Submission* 78, Treasury, p. 16.

5 APRA, *Superannuation Trends*, June quarter 2001.

6 ASFA, 'Revenue implications of removing the contributions tax and recent developments in the tax attractiveness of superannuation', September 2000.

Committee view – taxation of end benefits

10.21 The Committee is concerned that the RBL and end benefit arrangements are implicated in the current situation whereby most superannuation benefits are paid as tax free lump sums. The Committee considers that there would be merit in the Government looking at ways of reversing this situation so that lump sums are not limited or banned but are discouraged by the application of a progressive tax.

10.22 The Committee is aware that a person can access a lump sum of $112,405 from age 55 and pay no additional tax. The lump sum tax threshold is indexed to AWOTE annually. The Committee considers that the threshold encourages people to access superannuation in lump sum form rather than as an income stream. Often no additional end benefit tax is paid on the lump sum. By contrast any income stream purchased with the same lump sum would attract income tax at the members' marginal rate less any rebate.

10.23 The Committee considers that all possible measures to encourage income streams relative to lump sums need to be implemented. There are several reasons for this view. Income streams provide people with regular and certain income. The income is more likely to be captured by the age pension asset test than a lump sum. In addition the progressive nature of the income tax provisions provides a high degree of equity at the benefit payment end of the system than the high lump sum tax free threshold.

Recommendation

10.24 **The Committee recommends that:**

- **the lump sum tax free threshold be gradually reduced to the annual equivalent of average weekly ordinary time earnings (AWOTE) and maintained at that level; and**
- **lump sum taxes on amounts in excess of the thresholds be gradually adjusted in line with the tax rate applicable to income streams.**

Overall conclusions - equity

10.25 The Committee found that the current taxation arrangements applying to superannuation are not delivering equity to all Australians because of flat rate contributions and earnings taxes and end benefit taxes that encourage lump sums.

10.26 The Committee considers that equity in the superannuation system is best achieved through a whole of life approach to taxation concessions. The Committee suggests that, together with industry, the Government undertake a review of the appropriate benchmark for determining and measuring the impact of superannuation taxation concessions.

10.27 The Committee prefers to gradually move the taxation of superannuation away from the accumulation phase, that is at the front-end, in favour of end benefit taxation.

However, not all members of the Committee are attracted to the suggestion of providing front-end rebates on individual contributions. Instead, the majority of the Committee prefers phasing out the contributions tax in the long term.

10.28 The Committee considers that by implementing the measures outlined in this report, there is scope to improve the ability of individuals, such as women and others with broken working patterns and baby boomers, to increase their retirement incomes.

10.29 The Committee considers that the surcharge is an inefficient tax which is costly to administer. It causes serious inequities for members of defined benefit funds. It also imposes costs on all members, irrespective of whether they are liable to pay the surcharge or not. For this reason, the Committee would prefer to transfer the administration of the surcharge to the ATO and to introduce a maximum 15 per cent cap on employer financed benefits in all defined benefit fund schemes.

10.30 In the context of the Committee's preference to remove or reduce superannuation taxes during the accumulation phase, the Committee considers that lump sum benefit taxes should be adjusted in order to provide for equity through the progressive tax system and to replace revenue lost through any reduction in front-end taxes.

10.31 In addition, the Committee considers that, while the current RBLs should be retained, the annual indexation applicable to the RBL thresholds should be limited.

PART IV - INTEGRATION

Part IV of this report is about integrating the compulsory superannuation system with the health and aged care systems and the age pension system. Issues raised in this Part include the possibility of meeting the health costs of the ageing by the introduction of health accounts in superannuation funds, the sustainability of the age pension at current levels given the current means test settings, and means of providing support to asset rich but income poor retirees.

Chapter 11

Health and Aged Care

Introduction

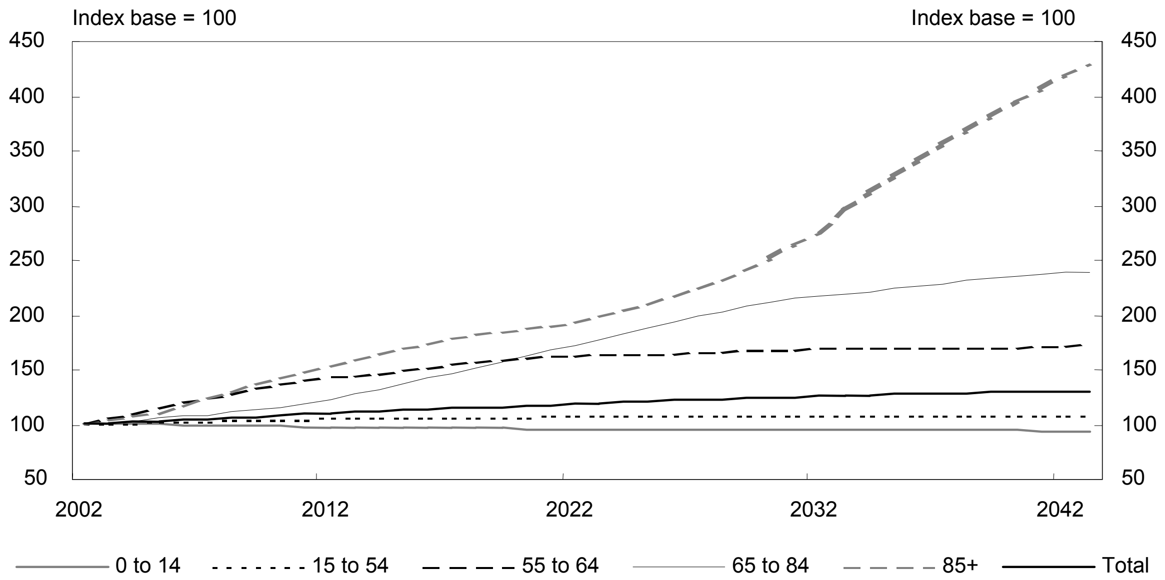
11.1 This chapter examines the potential for further integration of Australia's superannuation, health and aged care systems. Initially, it summarises information about the ageing of Australia's population, together with current and projected health care and residential aged care expenditure in Australia. Subsequently, it examines two alternatives for reform of funding of health and aged care in Australia:

- the introduction of health accounts through superannuation; and
- the introduction of compulsory health insurance through superannuation.

Australia's ageing population

11.2 Australia's population is ageing. Increasing life expectancy and decreasing birth rates together mean that the proportion of the total population that is over 65 years is increasing. **Chart 11.1** below shows projected growth by age group over the next 40 years in Australia.

Chart 11.1: Projected growth by age group over the next 40 years



Source: Commonwealth Treasury, *Intergenerational Report 2002-03*, p. 23.

11.3 Population growth in Australia is expected to continue slowing, from 1.2 per cent in 2000 to around 0.2 per cent by 2042. However, **Chart 11.1** shows that the growth rate of the population aged 85 or over is projected to accelerate sharply, while the youth population is anticipated to decline slightly. While the size of the labour force is projected to grow by just 14 per cent over the next two decades, the number of people aged 55 to 64 is projected to increase by more than 50 per cent. This is expected to be the fastest growing group of labour force age.[1]

11.4 **Chart 11.1** also highlights the expected growth in the proportion of the population in the 'very old' cohort, that is over 85. Currently, around 1.5 per cent of the population is in this age range, but by 2042 that is expected to rise to over four per cent.[2]

11.5 The ageing of Australia's population brings with it an anticipated increase in health expenditure. Persons aged over 65 years have per capita health expenditure around four times higher than the rest of the population, are admitted to hospitals more often and stay longer, and have expenditure on pharmaceuticals 2.5 times higher than the rest of the population. While the elderly aged over 65 currently comprise 12 per cent of the population, they consume 35 per cent of health expenditure.

11.6 Most importantly, the health costs of the aged tend to be concentrated amongst the over 75 years age group, projected to grow rapidly in the next 50 years. There is considerable evidence that the increasing longevity of the elderly does not produce longer periods of life in ill health. It appears that severe disability tends to be concentrated in the last few years of life. Accordingly, the most expensive time in terms of health costs is the last two to three years of life.

11.7 With growing numbers of elderly expected to live well into their 80s, a strong increase in health costs for the aged over the next 50 years is anticipated.[3]

Health care expenditure in Australia

11.8 Funding and provision of health and aged care in Australia is distributed amongst all levels of government, together with the non-government sector (religious/charitable and private providers). In addition, consumers and carers have roles in funding, administering or providing services. This mix of responsibilities helps to ensure access and choice for consumers and sustainability of the national health and aged care system.[4]

11.9 Of the $53.7 billion spent nationally on health in 1999-2000, 48.0 per cent was provided by the Commonwealth Government, 23.2 per cent by State and local governments and the remaining 28.8 per cent by the non-government/private sector. The sources of the private expenditure were estimated to be 56.4 per cent from

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1 Commonwealth Treasury, *Intergenerational Report 2002-03*, p. 22.

2 Commonwealth Treasury, *Intergenerational Report 2002-03*, p. 22.

3 Australian Institute of Health and Welfare, cited in P.Downes, 'Sustainable Retirement – An Old Concept, New Thoughts', DOFA paper, April 2002, p. 39.

4 *Submission* 80, Department of Health and Ageing, p. 7.

individuals, 24.7 per cent from health insurance funds, and 19.0 percent from other sources including workers' compensation and third party motor vehicle insurers.[5]

11.10 The health and aged care systems operate in conjunction with social safety net payments and concession cards, the tax system (30 per cent private health insurance rebate, the Medicare levy, the Medicare levy surcharge for high income earners without private health insurance) and the insurance sector (private health insurance, medical indemnity, workers compensation).[6]

11.11 Through Medicare – Australia's universal health insurance scheme – the Commonwealth funds the Medicare benefits schedule (MBS; which provides subsidies for medical practitioner services, optometry, diagnostic imaging and pathology) and the Pharmaceutical Benefits Scheme (PBS; which subsidises a select list of pharmaceuticals). In addition, the Commonwealth provides:

- funding for hospitals services provided by State and Territory governments through the Australian Health Care Agreements;
- the 30 per cent (tax) rebate to subsidise the cost of private health insurance; and
- funding for medical research, health promotion and protection, indigenous health services, health information management and access, health safety and quality, and medical workforce development and infrastructure.[7]

11.12 The substantial private sector provides private hospitals and private health insurance, and private practitioners provide most community based medical, dental care and diagnostic services. Consumers contribute through various co-payments and may choose to provide for their own health care through private health insurance.[8]

11.13 Accordingly, Medicare (publicly insured) services are complemented by additional services privately purchased at the consumer's own cost, including services refundable under private health insurance.[9]

Projected health care expenditure

11.14 The Commonwealth Government's *Intergenerational Report* for 2002-03 notes that Commonwealth spending on health is projected to increase from 3.96 per cent of

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5 AIHW, *Health Expenditure Bulletin No.17*, Canberra, September 2001 – most recent comparable data across all government and non-government sectors. The AIHW includes high-level care residential aged care (nursing homes) as health costs. The number of people with private health insurance has increased significantly since the introduction of Lifetime Health Cover in July 2000, so the contribution of the private sector will have increased since then.

6 *Submission* 80, Department of Health and Ageing, p. 8.

7 *Submission* 80, Department of Health and Ageing, p. 8.

8 *Submission* 80, Department of Health and Ageing, p. 8.

9 *Submission* 80, Department of Health and Ageing, pp.7-9.

Gross Domestic Product (GDP) in 2002-02 to 4.3 per cent of GDP in 2011-12 and to 8.1 per cent of GDP in 2041-42. This is roughly equivalent to a real non-demographic growth rate for all Commonwealth health spending of about 2.6 per cent per year over the next four decades.[10] This is shown in **Table 11.2** below:

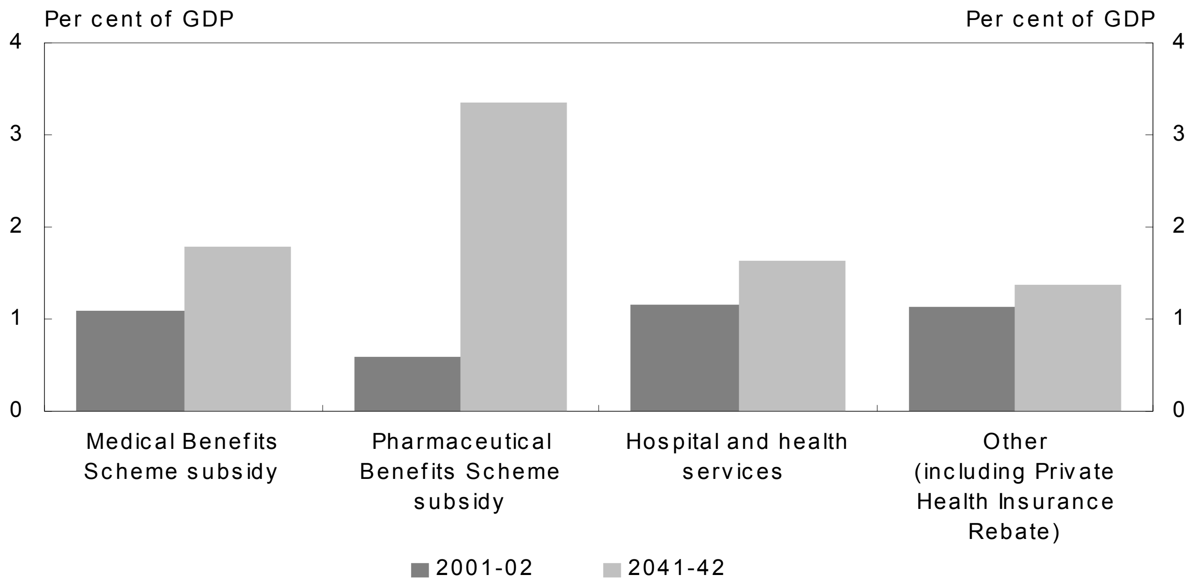
Table 11.2: Projected Commonwealth health spending by component (per cent of GDP)

	2001-02	2006-07	2011-12	2021-22	2031-32	2041-42
MBS subsidy	1.09	1.10	1.15	1.33	1.56	1.78
PBS subsidy	0.60	0.63	0.79	1.31	2.15	3.35
Hospital and other services	1.16	1.16	1.20	1.34	1.51	1.63
Other	1.12	1.14	1.16	1.22	1.29	1.37
All health	**3.96**	**4.02**	**4.30**	**5.20**	**6.51**	**8.13**

Source: Commonwealth Treasury, *Intergenerational Report 2002-03*, p. 39.

11.15 As shown above, of all the components of Commonwealth health expenditure, spending on PBS subsidies is projected to grow the fastest. As a proportion of GDP, the PBS is projected to grow more than five times from 0.6 per cent of GDP currently to 3.4 per cent of GDP in 2041-42. Spending on MBS subsidies as a proportion of GDP is expected to grow by 60 per cent, with hospital and health services spending growing by 40 per cent. This is shown in **Chart 11.3** below.[11]

Chart 11.3: Projected growth in components of Commonwealth health spending



Source: Commonwealth Treasury, *Intergenerational Report 2002-03*, p. 38

10 Commonwealth Treasury, *Intergenerational Report 2002-03*, p. 37.

11 Commonwealth Treasury, *Intergenerational Report 2002-03*, p. 37.

Committee view – health care expenditure

11.16 While mindful that some of the modelling assumptions behind the *Intergenerational Report* have been queried by some commentators, the Committee notes that the increase in health care expenditure from 3.96 per cent of GDP in 2002-02 to 8.13 per cent in 2041-42 is highlighted in the Government's *Intergenerational Report* and other reports published in the last decade as one the main factors contributing to an increase in projected Commonwealth demographic spending[12] from 13.9 per cent of GDP in 2001-02 to 19.2 per cent of GDP in 2041-42. By 2041-42, the gap between Commonwealth spending and revenue is projected to have grown to around 5.0 per cent of GDP.[13]

11.17 Accordingly, the Committee considers that every effort should be made to find savings in the health care system, while meeting community health expectations, or to increase the provision for health care funding in the future. This is discussed later in this chapter.

Residential aged care expenditure in Australia

11.18 The aged care system is structured around two main forms of care delivery: community and residential care. Together these systems offer older people a broad range of services and support depending on their needs and circumstances.[14]

11.19 The Government's residential aged care programs assist people to stay in their homes where they generally want to be. When frail, older people can no longer be assisted to stay in their homes, care is available in residential aged care facilities. Of older Australians aged 70+ years, only about eight per cent are in residential care and 13 per cent make use of community services and support. Even amongst the very old (85+ years), only about 25 per cent are cared for in residential care and around 50 per cent receive some help to live active lives in their own homes (eg, centre day care, home meals, domestic assistance, lawn mowing).[15]

11.20 In 2000-01, the Commonwealth government spent $5.5 billion (0.72 percent of GDP) on residential aged care, which comprised expenditure by both the Department of Health and Ageing and the Department of Veterans' Affairs (DVA), which arranges services for war veterans and their widow(er)s.[16] Of this:

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12 Demographic spending includes spending on health and aged care, age and service pensions, disability support pensions, parenting allowances, unemployment allowances, family tax benefits, education, and unfunded government superannuation.

13 Commonwealth Treasury, *Intergenerational Report 2002-03*, pp. 57-59.

14 *Submission* 80, Department of Health and Ageing, pp. 9-10.

15 *Submission* 80, Department of Health and Ageing, pp. 9-10.

16 Commonwealth Department of Health and Ageing, *Aged Care in Australia: Aged and Community Care*, Canberra, February 2002. This publication provides an overview of the aged

- $4 billion related to residential care subsidies to more than 3,000 aged care homes providing 143,400 places;
- $248 million provided close to 24,700 community aged care packages through some 731 service outlets; and
- $615.5 million was contributed to the health and community care program (approx. 60 per cent of total program funds) with the States and Territories providing an additional $396.7 million (40 per cent). In some states this includes contributions from local government. There are about 4,000 health and community care funded services, providing services to around 300,000 people at any given time, or about 470,000 people per year.[17]

11.21 The Department of Health and Ageing advised that recipients of residential and community care make a financial contribution to the cost of their care, with the Commonwealth regulating the maximum level of charges to ensure that, in its view, care is affordable for all:

- in residential care, residents may pay daily care fees (set at 85 per cent of the age pension), income tested fees, and accommodation bonds or charges. On average, residents contribute 28.5 per cent of the total cost of their care. Contributions vary from 23.2 per cent for high care residents, to 46.2 per cent for low care residents (ie, the greater the need for care, the more support the Commonwealth provides); and
- fees for community services depend on the type of service and the consumer's capacity to pay. For community aged care packages, recipients contribute, on average, 14.1 per cent of the package cost.[18]

11.22 About 2.3 million carers, usually female family members, assist people to continue living in their homes. The Commonwealth funds a range of respite, information and practical support services for carers, and provides a carer allowance for carers looking after people with high level needs in their own homes.[19]

11.23 Many older Australians also choose to buy or lease independent living units in retirement villages at their own cost. This allows them to use their capital to obtain housing more suited to their life stage in a supportive and secure social and physical environment. In 1997, there were an estimated 1,700 retirement villages with 70,000 units of accommodation and 90-95,000 occupants. Many retirement villages offer privately funded services equivalent to low level aged care, particularly where there are 'serviced apartments' in the village. Some offer low income residents furnished, serviced, independent units together with meals and other services, for payment

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care system and provides details of the wide range of program components funded by the Commonwealth. It may be accessed at: http://www.health.gov.au/acc/about/agedaust/agedaust.htm

17 *Submission* 80, Department of Health and Ageing, pp. 9-10.

18 *Submission* 80, Department of Health and Ageing, pp. 9-10.

19 *Submission* 80, Department of Health and Ageing, pp. 9-10.

similar to that in nursing homes (ie, 85 per cent of pension plus 100 per cent of rent assistance).[20]

11.24 In the 2002-03 Budget, the Government committed $14.9 million over four years for a pilot program to provide aged care packages in retirement villages. The program aims to ensure that residents in retirement villages have access to the same range of support services as they would have if they continued to live in their own homes.[21]

11.25 The Committee notes that in its written submission, the Council on the Ageing (COTA) strongly supported the residential aged care system in Australia as both cost effective and offering the aged an opportunity to maintain their independence:

> Services such as Home and Community Care which help older people to remain independent and living in the community must also be retained as they are very cost effective, and highly preferable to early admission into residential care.
>
> Residential aged care will only ever be used by a small proportion of the population. Most people will continue to live independent lives in the community. Community care is a much more economical alternative, and is the preferred option for most older people. Ensuring that individuals remain independent and able to care for themselves is an important policy goal in itself, as well as presenting the most cost effective solution. However, special attention must continue to be paid to those who are in need of residential care as they are most vulnerable.[22]

Projected residential aged care expenditure

11.26 The Committee notes that projected expenditure on residential aged care is estimated by Treasury to grow to 1.77 per cent in 2041-42. This is shown in **Table 11.4** below.

Table 11.4: Projected Commonwealth aged care spending by component (per cent of GDP)

	2001-02	2006-07	2011-12	2021-22	2031-32	2041-42
Residential aged care	0.58	0.59	0.65	0.81	1.10	1.45
Community care	0.14	0.16	0.17	0.21	0.27	0.32
All aged care	**0.72**	**0.75**	**0.82**	**1.01**	**1.37**	**1.77**

Source: Commonwealth Treasury, *Intergenerational Report 2002-03*, p. 39.

11.27 In the *Intergenerational Report* for 2002-03, Treasury noted that most of the projected growth in health spending reflects the increasing cost and availability of new

20 *Submission* 80, Department of Health and Ageing, pp. 9-10.

21 *Submission* 80, Department of Health and Ageing, pp. 9-10.

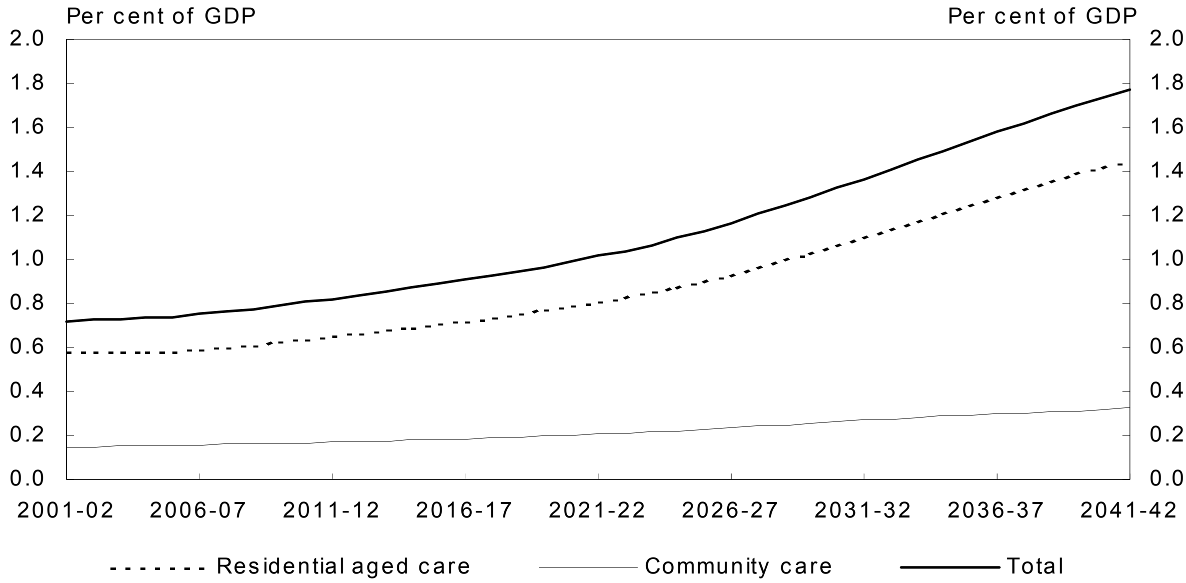
22 *Submission* 63, COTA, p. 32.

high technology procedures and medicines, and an increase in the use and cost of existing services. Consumers have a high demand for more effective treatments, and expect these treatments will be provided to them soon after the technology first becomes available.

11.28 The ageing of the population also is projected to require increased health spending, as older people tend to have a greater need for health services. However, this is projected to have a much smaller effect on spending than the growing cost of new health care technology, increasing use of services and strong consumer demand and expectations.[23]

11.29 **Chart 11.5** below shows the projected growth in Commonwealth aged care expenditure.

Chart 11.5: Projected growth in Commonwealth aged care expenditure



Source: Source: Commonwealth Treasury, *Intergenerational Report 2002-03*, p. 39.

Committee view – residential aged care expenditure

11.30 The Committee recognises that community care programs that help the elderly to remain independent and living in their homes have been judged to be very successful, are very cost efficient, and are preferable to early admission into residential care.

11.31 The Committee notes evidence from witnesses that the current arrangements in relation to community and residential aged care are adequate. However, the Committee considers that, in the light of the projections identified in the *Intergenerational Report* and other reports published in the last decade, community

23 Commonwealth Treasury, *Intergenerational Report 2002-03*, p. 39.

and residential aged care programs should be kept under review to ensure their effectiveness and sustainability.

Alternatives for reform of the health system

11.32 The Committee has noted in this chapter the projected sharp rises in the cost of health and aged care over the coming four decades. This raises the question of the ongoing sustainability of Australia's health and aged care system in the future.

11.33 In its written submission, the Department of Health and Ageing argued that 'the fundamentals of Australia's retirement income and health and aged care systems are sound', and that 'Australia is well placed to respond to the challenges of an ageing society.'[24]

11.34 However, the Committee also notes an article by Dr FitzGerald entitled *Refocussing and Reinvigorating Retirement Policy – A Stocktake and Suggested Agenda for Advance*, dated March 1999, in which Dr FitzGerald argues that Australia's health and aged care systems are not sustainable.

11.35 Dr FitzGerald notes that unlike the age pension, publicly funded health care is not means–tested, and it is utilised by people across the income range, as indeed is private health insurance. Accordingly, looking ahead 40 years, he argues that with the projected substantial growth in public health care costs, principally due to the ageing of the population, there is no effective way to prevent an unbalanced share of the financial burden falling on future young Australian taxpayers unless:

- reliance on the 'free' public health system shrinks and the private sector share increases – which he argues seems unlikely to happen on any scale as long as the public system remains 'free'; or
- some kind of patient contribution is phased in, presumably over an extended period, within the public system. Such a contribution could be met by people from funds built up via some 'add–on' to the superannuation system, or separately. There would appropriately be 'safety net' exemptions and the contribution could be capped at an annual limit. The limit could be broadly income-related (e.g. a basic amount – subject to safety net provisions[25] – plus one or two steps applying to people on higher incomes).

11.36 Given his concerns, Dr FitzGerald suggested in his paper two options for reform of funding of health care in Australia, based on a closer integration of health care and the superannuation systems.

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24 *Submission* 80, Department of Health and Ageing, p. 14

25 Presumably such safety net provisions would not generally exempt retirees with adequate balances in their health care accounts (as discussed in the text following), other than in circumstances of hardship.

11.37 First, Dr FitzGerald proposed that individuals could contribute directly to their own accumulated 'health care accounts' in a similar manner to their contributions to their superannuation nest eggs. One practical argument for this is that the superannuation industry has established systems to collect contributions (related to wage and salary income) from almost every employer in respect of virtually all employees.[26]

11.38 Secondly, and alternatively, Dr FitzGerald proposed that superannuation could be used to fund compulsory health insurance. Under this model, individuals could pay their insurance premiums under a lifetime community rating system through savings built up before retirement. Dr FitzGerald continued:

> As a related element of security in retirement, the balances in the accounts could be used by self–funded retirees to 'buy' the PHB card (now more accurately called the 'health concession card'), for an annual payment equal to its average cost to the government for pensioners. It is believed from attitudinal research that many self–funded retirees would be prepared to pay considerably more than the card would actually cost the Government in order to gain security against the downside financial risk posed by unforeseen substantial health expenses. The card should be able to be provided to non–pensioner retirees for $4 to $5 per week ($200 to $250 per year) on a revenue neutral basis.[27]

11.39 Under this model, health care accounts residing with superannuation could serve to build up the means (especially ahead of retirement) from which to on–pay premiums to specialised private health insurance funds, but also to cater for those who do not wish to pay such premiums. Also, excess balances could simply be added to ordinary superannuation provision.

11.40 Dr FitzGerald proposed the bones of these two approaches could be as follows:

> a) The co–contribution concept could be brought back into the debate, with (say) a two or three per cent co–contribution phased in and earmarked to a health care account within individual's superannuation fund (or as one 'compartment' under a master trust). Such a contribution could be phased in in steps of 1 per cent at two–year intervals following completion of the phasing–in of the Superannuation Guarantee in 2002. There should be no difficulty in incorporating this element into defined benefit funds; almost all such funds have an accumulation component for members' own contributions.

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26 Dr V.W.FitzGerald, *Refocussing and Reinvigorating Retirement Policy – A Stocktake and Suggested Agenda for Advance*, paper presented at the Conference of Major Superannuation Funds, March 1999.

27 See D. Schofield, 'Re–examining the distribution of health benefits in Australia: Who benefits from the Pharmaceutical Benefits Scheme?', NATSEM Discussion Paper No. 36, University of Canberra, October 1998.

b) Subject to consistency with an overall reform of the structure of taxation applying to superannuation, the health care contributions should be

– treated as salary sacrifice contributions; and

– taxed as for other superannuation amounts.

c) The health care account could be used:

– for hospital–related costs, either private hospital costs or, in future, to meet a possible income–related (and capped) patient contribution to the cost of treatment in the public health system (as outlined above); and

– would attract the private health insurance rebate when so used.

d) Alternatively, the health care account could be drawn upon to pay private health insurance premiums (with eligibility only once for the private health insurance rebate). Those so insured would of course also pay the patient contribution when they used the public system—as many privately insured patients do on occasion.

e) Purchase of the health concession card in retirement would be a further eligible use but would presumably not attract any rebate.

f) Any excess balances in the accounts[28] could be transferred to one's ordinary superannuation accumulation account. At retirement the account balance would remain invested under something like the allocated pension regime. Rules would need to be devised to phase down the maximum balance while recognising the higher demands in very old age.

11.41 Dr FitzGerald noted in his paper that the above proposal is not fully fledged, and that introduction of such a scheme would obviously be contemplated only in conjunction with consideration of parallel reforms to Medicare itself. Ideally, the Medicare funding arrangements (at government level) should also be moved towards pre–funding for the future. For example, if the Medicare system were operated through a trust fund, that fund could be managed so that projected income from relevant sources, including patient contributions, would (together with anticipated fund investment income) meet projected future liabilities.

11.42 Similarly, the system of patient contributions outlined would need to be introduced only after a significant lead time and would, as discussed, ideally involve a

28 Research would be required to determine an appropriate maximum balance, amounts in excess of which could be ‘swept’ across into one's ordinary superannuation account. Ideally this would be income–related in some simple way (e.g. a basic amount plus additional amounts for those in upper income bands).

system of income-related caps and appropriate safety net provisions – particularly over the transition period.[29]

11.43 The Committee took evidence from Dr FitzGerald during its hearing in Sydney on 10 July 2002 during which Dr FitzGerald reinforced the case for additional contributions through the superannuation system to help fund health care in the future:

> The idea that I have put forward to help fund health care in the future is essentially a matter of using the superannuation system as a front-end or collection device since it is ubiquitous now—it stretches into every workplace and is administratively efficient in bringing the funds together. I think also that the superannuation funds management industry is very efficient at holding funds in suitable investments for this purpose, which might be rather more orientated to fixed income sorts of investments rather than growth investments. What happens to it after that depends on the policies for health financing. The way I suggested it might work is that, once such a system were phased in and people had a balance in their accounts that meant they could afford it, some sort of contribution could be introduced into the public system with an annual cap to protect people from charges beyond a certain level.[30]

11.44 The Committee considers below the response of parties during the inquiry to Dr FitzGerald's two alternative proposals for funding the health care system in the future.

Health accounts through superannuation

11.45 In its supplementary submission to the inquiry, the Department of Health and Ageing made a number of responses to Dr FitzGerald's proposal for compulsory health savings accounts funded through additional superannuation contributions:

> a) Firstly, the Department argued that health accounts would fit more comfortably within a managed care health system such as that in the United States, than within the Australian mixed public/private health and aged care system. This would depend on the detailed design of any specific model proposed for the Australian context, include assessment of the potential substitution of these savings for discretionary savings and private health insurance membership or premium levels.
>
> b) Secondly, the Department argued that health savings accounts would not cater for variations in health care needs between individuals and from year to year. In addition, health care costs tend to be concentrated in the last few years of life. Accordingly, the Department argued there needs to be some pooling of health care costs. In addition, research shows that high health care

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29 V.W.FitzGerald, '*Refocussing and Reinvigorating Retirement Policy – A stocktake and suggested agenda for advance*', March 1999, pp 23-24.

30 *Committee Hansard*, 10 July 2002, p. 291.

expenditure is more likely to be required by those who are least likely to be able to pay for it.

c) Thirdly, the Department argued that individuals have limited capacity to assess their health risk and quantify what future resources will be needed to deal with that risk, particularly in old age. This is compounded by the fact that people with higher health care needs often have low or interrupted workforce participation and low lifetime income.

d) Fourthly, the Department argued that the higher the proportion of income directed into health care accounts, the greater the amount of money likely to still be in accounts when people die. The money left over would in effect be ‘wasted’, as it was put aside to cover health needs but not spent on health.

e) Finally, the Department also questioned who would own any money remaining in a health account at the time of the account holder’s death. Bearing in mind that the funds have been contributed not only by the account holder but also by employers and the Government (through forgone taxation revenue) would these other contributors receive any of the funds remaining?[31]

11.46 In its written submission to the inquiry, ASFA also did not support the concept of compulsory health savings accounts funded through additional superannuation contributions. It noted that at current rates of contributions, superannuation does not have the capacity to meet the projected increase in aged care and health costs. As previously noted, the *Intergenerational Report* projects health and aged care costs to increase by 5.2 percentage points of GDP over the 40 years to 2042, whereas the flow of income from a fully mature superannuation system is likely to be around three per cent of GDP. In addition, ASFA noted that:

> In any event, self insurance through access to savings type accumulation accounts would not be an effective mechanism at an individual level. Personal savings generally will be either too much or too little to deal with health and aged costs. Most individuals do not have the capacity to deal with the large or catastrophic costs of health care and aged care that are faced by just a minority of the aged population. Money set aside for such costs will either be wasted and form part of the estate of the person, or will be nowhere sufficient to meet the costs that might be involved.
>
> Governments will and should have ongoing roles in providing what is in effect community based insurance against health and aged care costs which would be catastrophic at the individual level.[32]

11.47 Similar concerns were expressed to the Committee during hearings. For example, in evidence on 19 July 2002, Mr Schneider from the Australian Health

31 *Submission* 140, Department of Health and Ageing, pp. 2-4.

32 *Submission* 73, ASFA, pp. 34-35.

Insurance Association indicated his concern that the provision of health savings through the superannuation system or a similar system would be difficult. Mr Schneider argued that it would be unlikely that an individual could generate sufficient savings in their lifetime to be quite sure of covering any health costs they could face in retirement. At the same time, the paradox is that some individuals may indeed have a very large surplus, because not all people need health care before they die. Mr Schneider continued:

> … I think it would be a policy error to transfer the funding that is currently provided to the health insurance rebate to a long-term savings scheme. The outcome of that would be that many people would drop their health insurance totally, which would immediately drive premiums up, and that would have to be met by the people who remain insured, who would tend to be older or sicker. So there would be an immediate negative impact and that would compound over time, which would mean that again the cost of even buying insurance in retirement would become unaffordable. I would prefer the rebate to be retained and emphasis placed on continuing to generate growth within the insurance system from younger people or lower risk people. Younger people are not necessary all lower risk but the majority of them are lower risk than those who are older.[33]

11.48 In evidence to the Committee on 8 October 2002, Dr Knox also opposed any proposal for separate health accounts through the superannuation system:

> My third point concerns health funds and super—whether we should have health funds as an extra account area. My view at the moment is that we should not, for a couple of reasons. Mr Gallagher highlighted the fact that individual health expenditure is incredibly variable. When we retire, most of us expect to live for 10, 20 or 25 years and have a fair idea of what our income needs will be. Some of us will have very significant health costs in retirement, and some of us will have almost nil—we will live a healthy life for 10 years and drop dead on the golf course or something like that. There is incredible individual variety—much more so than in retirement income—and you will therefore need some pooling. So, at the moment, I do not think the super system is the way to go. I would also make the point, which we talked about this morning, that it is important to get the super system for retirement income right before adding health—to get the adequacy and the tax system appropriate before adding another area of complexity. So my view at the moment is that we should not add health to super; we should get the retirement income component right first.[34]

11.49 In response to these concerns regarding a compulsory health savings accounts funded through additional superannuation contributions, the Committee notes the evidence of Dr FitzGerald at the Canberra roundtable on 8 October 2002:

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33 *Committee Hansard*, 19 July 2002, pp. 574-575.

34 *Committee Hansard*, 8 October 2002, pp. 720.

> The issue is not about whether it is a good or a bad thing to provide good health care for that generation. We will do it and we will want to do it. Really the issue is about how it is to be equitably funded. Given that it is a large future foreseeable need of a similar kind to the retirement income we are funding for, one would think that some sort of pre-funding has to be part of the solution. Some of that pre-funding might be what we already see around us—that is, the money that is going into superannuation or into our houses—and the question then becomes: how do you have the baby boomers, in their old age, with enormous assets, pay a fair share as against the future young taxpayers? …
>
> That was the set of thoughts that led me, as the one who threw this into the ring a couple of years ago, to think of having something like health accounts in the superannuation system. This would not be a full-service health insurance type operation—because obviously, as a couple of the speakers have said, everybody over 65 can pay regular premiums, but the actual need for health services is highly variable. So there has to be some pooling aspect; but I do not see that as being done in the superannuation system. It may be done as it is now in the public system, by sharing all the imposts on the budget and having them met either by taxpayers or by individual contributions that we make when we go to the chemist and so on. But my view is that the balance does have to shift, otherwise the situation looks inequitable.[35]

11.50 The Australian Prudential Regulation Authority suggested that an alternative to superannuation health accounts could be the provision of a Retirement Savings Accounts type product, outside the superannuation system, to meet health costs. Any preservation requirements imposed as a trade off for concessional tax treatment or rebate could be tailored specifically for such purposes rather than attempting to fit it on to the superannuation system.[36]

Compulsory health insurance through superannuation

11.51 In response to Dr FitzGerald's second proposal for compulsory health insurance through the superannuation system, the Department of Health and Ageing made the following points in its supplementary submission:

> a) Firstly, the Department noted that this approach is a feature of employer benefits schemes in the United States. There, most health fund members are younger and in good health, with the result that most health insurance products tend to be very limited in scope. Coverage may also be limited to the worker, with the result that family members have no health coverage. Workers may also drop out of health coverage when they retire or leave a particular employer, and believe themselves to be covered when this is no longer the case. In addition, the system tends to exclude those who are

35 *Committee Hansard*, 8 October 2002, pp. 721-722.

36 *Submission* 100, APRA, pp 2-3.

most likely to need care, such as older people, people with chronic illness, people with disabilities and people of lower socio-economic status who work in jobs that do not provide health cover, in casual employment or the “underground” economy.

b) Secondly, on the basis of the US experience, the Department argued that a superannuation-based fund could discourage health fund membership for people outside the workforce, who are more likely than workers to need health services. For example, coverage for women could be adversely affected, due to their broken workforce participation especially during child-raising years. Alternate policies that cover a dependant spouse could create administrative difficulties and duplication where partners are in and out of the workforce.

c) Thirdly, the Department noted that a move to compulsory private health insurance coverage for any sector of the population could be seen to be at odds with the Government’s commitment to choice in private health cover and universal access to Medicare. The introduction of compulsory additional superannuation coverage or funding through abolition of the Government’s highly popular 30 per cent rebate would be a major shift from current Government policies.[37]

11.52 Mr Wells from the Department of Health and Ageing reiterated the Government’s commitment to universal health coverage through Medicare with optional private health insurance at the Canberra roundtable discussion on 8 October 2002:

> The current system of universal coverage through Medicare with optional private health insurance is, as surveys have shown, supported by the Australian people and also has the support of the major political parties. The department sees on the horizon no pressure from those ends to move away from the current system.[38]

11.53 The Committee notes that other parties at the Canberra roundtable discussion on 8 October 2002 also did not support the proposal for compulsory health insurance through the superannuation system. For example, Mr Davidson from the Australian Council of Social Service submitted:

> In relation to health and aged care, the main issue is whether the superannuation system should be used for health insurance or health saving purposes. We are actually in favour of using superannuation, within certain strict limits, for a range of purposes, such as health care, housing or career breaks for further education or child rearing, but probably not specifically for health purposes. The reason for that is that we are not convinced that that is the best and fairest way to shift the incidence of the costs of health care

37 *Submission* 140, Department of Health and Ageing, pp. 4-5.

38 *Committee Hansard*, 8 October 2002, p. 707.

> from government to individuals or whether that is a desirable thing to do. Essentially, that is what you would be doing by using superannuation for health purposes. There would inevitably be a shift in the incidence of the cost of health care from government and general taxation to individuals through their super accounts, whether or not that is the intention of the policy in the first instance.[39]

11.54 The Committee notes, however, that although ASFA did not support the concept of individual health account through the superannuation system in its written submission, it offered conditional support to the concept of superannuation being used to meet health insurance costs:

> … enhanced retirement incomes do have the capacity, amongst other things, to facilitate the maintenance by individuals of membership of private health insurance in the post-retirement period, and to pay for ancillary services and a better quality of lifestyle. The primary goal should be to generate significant retirement incomes, which can then be used for a range of purposes according to the needs and interests of specific individuals.[40]

Dental health

11.55 COTA drew the Committee's attention to the lack of a comprehensive national dental health service, advising the Committee that this is 'perhaps the greatest deficiency in our health services'. COTA explained the importance of dental health:

> Poor oral health affects many older Australians, and failure to act to improve services will ensure that older people far into the future will continue to suffer the same problem. Oral health is fundamental to well being. Numerous other conditions and illnesses arise from it.[41]

Committee view – alternatives for reform of the health system

11.56 The Committee broadly supports the concept of additional funding being set aside through the superannuation system, or other savings vehicles, to meet future health care needs, and believes that a model of voluntary health insurance through superannuation could be examined further by the Government.

11.57 In the Committee's view, there could be administrative economies to be generated by closer cooperation between the private health funds and superannuation funds. They may include savings to be gained from the joint administration of private health funds and superannuation funds, for example through the collection of health insurance and superannuation contributions jointly, and streamlining the payment of benefits.

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39 *Committee Hansard*, 8 October 2002, p. 711.

40 *Submission* 73, ASFA, pp. 34-35.

41 *Submission* 63, COTA, p. 30.

11.58 However, the Committee acknowledges that voluntary health insurance through superannuation would raise significant issues that would need to be addressed before any proposal could proceed. In particular, as highlighted by the Department of Health and Ageing, any proposal for voluntary health insurance through superannuation would need to address the position of those outside the workforce, or those moving between jobs. As reported in this chapter, employer benefits-based health insurance products in the USA have tended to be limited in the coverage they provide, effectively excluding those who are most likely to need care, such as older people, people with chronic illness, people with disabilities and people of lower socio-economic status.

11.59 In addition, the Committee notes that any proposal to set aside additional funding through the superannuation system to meet future health care needs would need to be considered in the context of Australia's successful Medicare system. Surveys have shown that Medicare has broad support in the Australian community. The Committee would not envisage that any move to encourage those in employment to put aside additional savings towards their health care in later life would be at the expense of universal public health care for those without health care savings for whatever reason. The Committee believes in the benefits of the Medicare system.

11.60 The Committee notes that the cost of health care can vary significantly from individual to individual. However, as health care costs are expected to increase significantly in the next four decades, the Committee considers that proposals by which superannuation could be used to help meet these costs warrant further examination. In particular, a model of voluntary health insurance through superannuation could be examined further by the Government. In addition, the Government could examine whether there may be administrative economies to be generated by closer cooperation between superannuation funds and private health funds.

11.61 The Committee also notes the evidence of COTA about the importance of ensuring access to dental health services.

Recommendation

11.62 **The Committee recommends that the Government consider proposals by which the superannuation system could be used to help meet health care costs in Australia, including dental health costs, which are expected to increase significantly in the next four decades.**

Chapter 12

Income Support

Introduction

12.1 Australia has a retirement income system designed to facilitate adequate retirement incomes. As discussed earlier in this report, it consists of three pillars: compulsory employer Superannuation Guarantee (SG) contributions, voluntary superannuation, and social security payments funded from general revenue and targeted at those in need through the income and asset tests.

12.2 This chapter examines the relationship between these three pillars of the retirement income system. It considers a number of issues:

- the age pension;
- the age pension income and asset means tests;
- other income support;
- extended working lives (the so-called fourth pillar);
- double dipping;
- retirement income streams; and
- accessing the wealth in housing.

The age pension

12.3 The age pension was introduced in 1909. It is a means tested safety net payment for older people who are unable to fully provide for themselves in retirement.[1]

12.4 The age pension is funded from general taxation revenue, with no explicit tax or contribution required. It is a flat rate payment. In other words, the same basic rate of pension is the starting point for calculation of an individual's age pension payment, regardless of previous earnings. Neither receipt of, nor rate of payment of the age pension is linked to previous workforce participation. In this way, the age pension is potentially available to the entire Australian community of age pension age (subject to residence qualifications), including those with marginal connections to the workforce, or no previous employment history.[2]

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1 *Submission* 79, FACS, Attachment A.

2 *Submission* 79, FACS, Attachment A.

12.5 The age pension is thus the fundamental building block of Australia's retirement income system, in that it provides the foundation that the compulsory and voluntary superannuation pillars, and voluntary earned income, build upon. The age pension provides a critical safety net, assisting those who have not been able to accumulate sufficient superannuation and other savings.[3]

12.6 The age pension is paid to people of age pension age and over (65 for men, and currently 62[4] for women). Generally a person must be an Australian resident, and residing in Australia, to be granted the age pension. However, in certain circumstances, a pension may be granted to a former Australian resident who lives in a country with which Australia has a social security agreement.[5]

12.7 The Department of Veterans' Affairs (DVA) provides a similar payment (service pension) to veterans. It is available to people five years before age pension age. At March 2002 there were 268,989 service pensioners.[6] **Table 12.1** below shows the population aged 65 and over by the type of assistance at December 2001.

Table 12.1: Proportion of the population aged 65 and over by type of assistance (Dec 2001)

Type of Assistance	Number	% of population
Full-rate age pension	1,204,860	45.2
Part rate age pension,	598,022	22.5
DVA pension	353,540	13.3
Other income support payment	25,787	1.0
Commonwealth Senior Health Card	271,554	10.2
No FACS* or DVA assistance	208,539	7.8
Total	**2,662,302**	**100**

Source: *Submission* 79, FACS, p.9.
* Department of Family and Community Services (FACS)

12.8 Notwithstanding the progress made in expanding superannuation coverage, the age pension is the major provider of retirement income for the majority of Australians. At March 2002, around 82 per cent of people aged 65 or over received an age pension, service pension, or an income support supplement. Of those, 66.5 per cent of age pensioners receive the maximum rate of pension. The other 33.5 per cent of age pensioners receive a part rate pension because of their other income or assets. Of age pensioners granted in the last 12 months, 51.8 per cent received a full rate pension and 48.2 per cent received a part rate pension.[7]

3 *Submission* 79, FACS, Attachment A.

4 The age at which women qualify for age pension is gradually increasing. By 1 July 2013 it will be 65 years, the same as for men.

5 *Submission* 79, FACS, Attachment A.

6 *Submission* 79, FACS, Attachment A.

7 *Submission* 79, FACS, Attachment A.

12.9 The rate of the age pension is adjusted every March and September in line with movements in the Consumer Price Index (CPI). Payment rates are also indexed in line with wages growth; the maximum single rate of pension is maintained at (at least) 25 per cent of Male Total Average Weekly Earnings (MTAWE), with flow-ons to the partnered rate. Pensioners are therefore protected against price increases, and also share in improvements in community living standards, as measured by wages.[8]

12.10 **Table 12.2** below compares the pension benefit in Australia with that in other countries, based on its replacement of earnings of average production workers, net of taxes and contributions. The table is based on the OECD publication *Policy Responses to the Challenges of Ageing Populations - A Synthesis*, released in April 2002. An important caveat is that the pension systems in different countries are very different in their coverage and retirement ages. This is identified in the table.

Table 12.2: Pension scheme benefit levels across OECD countries

Country	Scheme	Earliest retire-ment age	Normal retire-ment age	Replace-ment rate at earliest retire-ment age[a]	Replace-ment rate at normal retire-ment age[a]
Australia	State means-tested pension		62/65[b]	23	55
Canada	State basic pension		65	21	53
	State earnings related pension	60	65		
Finland	State basic pension	60	65	55	64
	Mandatory earnings related pension	60	65		
France	State basic pension for private sector employees	60	60	87	87
	State supplementary pension for private sector employees	60	60		
Germany	State pension for private sector emp	63	65	68	77
Italy	State pension for private sector emp		57-65	55	80
Japan	State basic pension for private sector employees		65	15	62
Korea	State pension	55	60	50	74

8 *Submission* 79, FACS, Attachment A.

Netherlands	State basic pension		65	83	92
Norway	State basic pension State supplementary pension	 62	67 67		63
Spain	State pension	60	65	71	101
Sweden	State pension (including mandatory contributions to individual funds)	62	65	72	72
Switzerland	State basic pension Mandatory occupational pension	63 63	65 65	55	68
UK	State basic pension State earnings related pension		60/65[b]		40
USA	State pension		65	43	58

[a] Replacement rates at earnings of average production workers net of taxes and contributions
[b] Men/Women
Source: OECD, *Policy Responses to the Challenges of Ageing Populations - A Synthesis, April 2002*, Tables 8,14.

12.11 The Committee notes the overwhelming support for Australia's pension system, and a continuation of a separate age pension and occupational superannuation arrangement. For example, ASFA indicated that:

> … the Australian arrangements have had advantages compared to other countries. In some countries the very strong links between occupational retirement income arrangements and social security provisions have led to substantial integration of the two systems, but at the cost of large and growing social security obligations as the population ages. Clearly, the experience of these countries shows that any benefits of improved integration through having earnings related, publicly provided social security provisions are outweighed by the costs. Social security arrangements are effective and affordable when they target poverty alleviation, and private arrangements are best for providing retirement income above that level. Accordingly the sensible and realistic option for Australia is to continue to have social security and occupational superannuation arrangements that are separate.
>
> The challenge is to have them both separate and better integrated. Better integration will have both efficiency and equity benefits. However, it should be acknowledged that poverty alleviation and, to a lesser extent, equity goals are already delivered to a considerable extent by the provision of Age and Veterans Pensions.
>
> The Australian social security provisions are effective in providing poverty alleviation, essentially through providing a means tested minimum benefit. An annuity with similar characteristics that was purchased privately would have a capital value of over $200,000 for persons of Age Pension age. In effect, the existence of the Age Pension means that persons of Age Pension

age who do not have private savings receive a significant wealth transfer from the government, albeit one that can be accessed only in income form.[9]

12.12 However, in its written submission, the Council on the Ageing (COTA) was more critical than ASFA of the adequacy of the current age pension arrangements, arguing that the current age pension is not sufficient to support a modest but adequate lifestyle:

> Discussion of the adequacy of future retirement incomes funded through superannuation should not preclude debate on the adequacy of current Age Pension and social safety net arrangements. COTA believes the Government needs to address the issues raised by the recent studies, which indicate a disturbing increase in poverty amongst older people. There is much evidence to suggest that current Age Pension and safety net do not result in the "modest but adequate" lifestyle which they are intended to provide. The Government must find the resources to assist older people on the lowest incomes and with the least assets. Assistance must be afforded to older people on the lowest incomes and priority must be given to older people without their own homes.[10]

The age pension income and asset means tests

12.13 The age pension is integrated with the superannuation system through the provisions of the income and asset means tests:

a) Income. As at 1 July 2002, once an individual's private income reaches $1,185 per fortnight, he or she is not eligible for the age pension. For the purposes of the means test, income includes earned income such as wages and also income from investments. For some investments, such as most financial investments, the amount of income is deemed by way of set percentages applied to the aggregate amount of the financial investments. For other investments it is usually the actual amount of income derived or received. In the case of some income payments such as pensions or annuities there is an adjustment made to the gross amount received in order to reflect any return of capital.

b) Assets. The pension asset test was introduced in 1985 and operates alongside the income test. The test which produces the lower rate of pension is the one that is applied. Certain assets, principally the recipient's home and certain long-term income streams which meet strict criteria, currently are excluded. The asset test tends to predominate over the income test once a significant level of assets are held. For a single home owner as at 1 July 2002, no age pension is available once assets exceed $288,000. At a 7 per cent annual return,

9 *Submission* 73, ASFA, p. 36.

10 *Submission* 63, COTA, p. 13.

> such a lump sum would generate an income substantially less than the maximum income allowed under the income test.[11]

12.14 The income and asset test arrangements are described more fully in **Appendix 11**.

12.15 The Committee notes that the impact of the income and asset tests on age pension payments is significant. In evidence on 8 October 2002, Mr Dolan from the Department of Family and Community Services (FACS) indicated that the income and assets tests currently save between $6 billion to $7 billion a year on the age pension. As a result, expenditure on the age pension is currently approximately $17 billion a year.[12]

12.16 In its written submission to the inquiry, ASFA argued that the means test system currently works reasonably simply and fairly, but that this is likely to change in the future:

> Currently the means test system works reasonably simply and fairly for the bulk of current retirees. Unfortunately, for the current minority of retirees with significant superannuation derived savings in the order of $140,000 to $280,000 the system is neither simple nor fair. In the future as the proportion of retirees with assets and income in excess of the free areas increases, this problem of lack of appropriate integration will increase. Superannuation and other financial assets of the order of $140,000 to $280,000 is fair and square in the range of outcomes that the Superannuation Guarantee is projected to deliver over 30 to 40 years for a person on average earnings. The means test is already a problem for middle Australia, and will become an even greater problem in the future if it is not reformed.[13]

12.17 Given this concern, ASFA made a number of recommendations for improving integration and fairness in regard to the various parameters of the means test. A number of these suggestions also have the potential to improve the simplicity of the system through adoption of clearer and more uniform rules:

a) The introduction of an income bank for age pensioners for income derived from employment. ASFA argued that the current arrangements discourage intermittent and casual work because the combined effect of withdrawal of the age pension with any income tax liability leads to very high effective marginal tax rates for employment by persons primarily reliant on the age pension. ASFA submitted that this is inconsistent with the thrust of government policies, which aim to increase labour force participation by those

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11 *Submission* 73, ASFA, pp. 41-42.

12 *Committee Hansard*, 8 October 2002, p. 720.

13 *Submission* 73, ASFA, p. 42.

past normal retirement age and to support flexibility of arrangements past age pension age.

b) The replacement of the current asset and income test by an integrated means test in which a deemed earnings rate is applied to all assets which are included in the test. ASFA argued that there are significant differences at present with regard to how various forms of non-wage income are included in the income test for the age pension. For example, ASFA argued that income from financial investments is treated in a simple and consistent way through the operation of the deeming provisions. In contrast, ASFA suggested that other financial investments such as allocated pensions and annuities and complying pensions and annuities include in the amount subject to the income test the gross amount received by the recipient less an adjustment for any return of capital. This adjustment has to make use of factors relating to life expectancy or the term of the pension or annuity, and identification of an initial capital purchase price.

c) A reduction in the taper rates for income and particularly for assets so as to provide both greater integration and increased incentives for self provision. ASFA noted that the taper rates can still provide considerable disincentives for private provision of retirement income, at least over some income ranges. For example, the most recent significant change to the taper rate for the pension income test was in June 2000 when the taper rate for income above the free area was reduced from 50 per cent to 40 per cent. This change formed part of the ANTS changes, and was estimated to involve additional pension expenses of around $400 million a year. However, ASFA argued that even after this change effective marginal tax rates on additional private income are still quite high, particularly over income ranges where a particular benefit is phased out, or income tax is phased in.[14]

Projected age pension expenditure

12.18 Projected age pension expenditure in Australia over the next four decades will be influenced by two factors: the increase in the number of retirees in Australia, and the maturing of the superannuation system.

12.19 On the first point, the Committee notes the earlier evidence in Chapter 11 relating to the ageing of Australia's population, and the increasing proportion of retirees in the population. In 2002, Australia had 2.2 million people aged 65 – 85, and 0.3 million people aged over 85. By 2042, it is anticipated that these cohorts will have grown to 5.1 million and 1.1 million respectively.[15]

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14 *Submission* 73, ASFA, pp. 43-47.

15 Commonwealth Treasury, *Intergenerational Report 2002-03*, p. 22.

12.20 On the second point, the proportion of pensioners not receiving the age pension, or receiving a reduced rate of the age pension, is also expected to increase over the next four decades. This is shown in **Table 12.3** below, which shows projected changes in the receipt of the age pension between 2001 and 2050.

Table 12.3: Projected changing patterns of age pension

<table>
<tr><th></th><th>2001</th><th>% of population</th><th>2050</th><th>% of population</th></tr>
<tr><td>DVA pensioners</td><td>341,000</td><td>13% (of age pension age population)</td><td colspan="2" rowspan="2">4.9 million
75% (of age pension age population)</td></tr>
<tr><td>Age pensioners</td><td>1.79 million</td><td>69% (of age pension age population)</td></tr>
<tr><td>Full rate age pensioners</td><td>1.14 million</td><td>67% (of age pensioners)</td><td>1.7 million</td><td>33% (of age pensioners)</td></tr>
<tr><td>Part rate age pensioners</td><td>650,000</td><td>33% (of age pensioners)</td><td>3.2 million</td><td>67% (of age pensioners)</td></tr>
<tr><td>People over age pension age</td><td>2.6 million</td><td>12.3% (of total population)</td><td>6.6 million</td><td>25% (of total population)</td></tr>
</table>

Information based on:

FACS Annual Report 2000-01, pages 204 and 206 (current age pension numbers, full/part rate age pensioners);

ABS Cat. No 3222.0, pages 6 and 11, Series II (population over 65 years in 2050 is projected at 6.6 million); and

The National Strategy for an Ageing Australia*, Independence and Self Provision Discussion Paper,* November 1999, page 13.

Source: *Submission* 79, FACS, p. 7.

12.21 **Table 12.3** shows that in 2001, around 82 per cent of people aged 65 or over received age pension, service pension, or income support supplements. By 2050, this is anticipated to fall to 75 per cent. Similarly, in 2001, 67 per cent of retirees in receipt of the age pension received the full rate of the pension, and only 33 per cent a part rate. By 2050, this is expected to have reversed, with 67 per cent of retirees in receipt of the age pension receiving a part rate of the pension, and only 33 per cent receiving the full rate.[16]

12.22 The decline in the availability of the age pension reflects the maturing of the superannuation system, which will result in higher average superannuation savings and hence (through the operation of the means test) lower age pension payments. The general effect is that people will receive increased retirement incomes, even if they receive lower pensions. However, it is important to note that notwithstanding substantial and increasing superannuation coverage, the majority of older Australians will still rely on the age pension for a significant part of their income.[17]

16 *Submission* 79, FACS, p. 7.

17 *Submission* 79, FACS, p. 7.

12.23 In this regard, the Committee notes the modelling of retirement incomes provided by Treasury in its written submission. Treasury's modelling, using standard assumptions, indicates that a singe male aged 65, retiring in 2032 following 40 years in the workforce at 1.5 times AWOTE, will still draw 82 per cent of the age pension. For a single male in the same situation receiving exactly AWOTE over 40 years in the workforce, Treasury's modelling indicates that he will draw 90 per cent of the age pension.[18]

12.24 **Table 12.4** below shows projected Commonwealth spending on payments to individuals, including age and service pensions, from 2001-02 to 2041-42. The Table shows a large increase in expenditure on the age and service pension which reflects the ageing of the population. This is despite the expected decline in the eligibility for the age and service pension in the future, reflecting the maturing of the superannuation system.[19]

Table 12.4: Projected Commonwealth spending on payments to individuals (per cent of GDP)

	2001-02	2006-07	2011-12	2021-22	2031-32	2041-42
Age and service pension	2.93	2.83	2.90	3.64	4.28	4.59
Disability support pension	0.91	0.72	0.79	0.84	0.85	0.86
Parenting payment (single)	0.59	0.60	0.61	0.61	0.61	0.60
Unemployment allowances	0.85	0.78	0.71	0.59	0.49	0.41
Family tax benefit	1.57	1.34	1.22	1.08	1.01	0.93
Total	**6.85**	**6.26**	**6.23**	**6.76**	**7.24**	**7.38**

Source: Commonwealth Treasury, *Intergenerational Report 2002-03*, p. 44.

12.25 In response to the large increase in expenditure on the age pension over the next four decades, the Committee notes the evidence of Dr Knox on 8 October 2002 that, in his view, the current income support arrangements in Australia are sustainable in the long term. Dr Knox attributed this to the means testing of the age pension and its relatively low rate compared to other Organisation for Economic Cooperation and Development (OECD) countries.[20]

12.26 However, in its written submission, IFSA canvassed a number of options for the Government to finance the shortfall in the growth of age and service pensions (together with other funding shortfalls). They include:

- imposing higher taxes on the contemporary generation of taxpayers;
- cutting benefits to current and future generations of retirees, for example by holding the ratio of spending on the aged to a GDP constant;

18 *Submission* 78, Treasury, pp. 40-41.

19 Commonwealth Treasury, *Intergenerational Report 2002-03*, p. 44.

20 *Committee Hansard*, 8 October 2002, p. 720.

- targeted policy intervention to reduce future cost, for example by reducing benefits or tightening eligibility and targeting of assistance; and
- transferring the cost to future generations of taxpayers, through increasing government debt.[21]

12.27 Finally, the Committee also notes evidence provided by AMP estimating the increase in expenditure on the age pension under various scenarios, including the provision of a universal age pension without means testing. This is cited in **Table 12.5** below.

Table 12.5: Projected costs of age pension under various scenarios (per cent of GDP)

	Base (25%)	30 %	Universal pension	No SG
1998-99	2.99	2.99	3.68	2.99
1999-2000	2.94	3.45	3.61	2.94
2000-01	2.94	3.45	3.62	2.94
2010-11	3.06	3.61	3.81	3.08
2020-21	3.55	4.22	4.72	3.67
2030-31	4.07	4.86	5.79	4.33
2040-41	4.49	5.33	6.38	4.76
2049-50	4.48	5.32	6.44	4.76

Source: Rothman (1998), cited in *Submission* 64, AMP, p. 27.

12.28 **Table 12.5** shows that increasing the age pension to 30 per cent of male total average weekly earnings (MTAWE), or offering a universal age pension, would significantly increase the cost of the age pension to the Commonwealth under current means test arrangements.

Committee view – the age pension

12.29 The Committee notes that the age and service pension is expected to increase in cost to 4.59 per cent of GDP by 2041-42 from 2.93 per cent in 2001-02. This increase is attributable to the ageing of the population, despite the expected decline in the eligibility for the age and service pension in the future, reflecting the maturing of the superannuation system.

12.30 Treasury's modelling of retirement incomes reinforces the Committee's concern. As noted, Treasury's modelling, using standard assumptions, indicates that a singe male aged 65, retiring in 2032 following 40 years in the workforce at 1.5 times AWOTE, will still draw 82 per cent of the age pension. For a single male in the same situation drawing exactly AWOTE, Treasury's modelling indicates that he will draw 90 per cent of the age pension.[22]

21 *Submission* 70, IFSA, p. 6.

22 *Submission* 78, Treasury, pp. 40-41.

12.31 By 2050, with a mature superannuation system, it is expected that the proportion of people aged 65 and over not receiving the pension will rise to around 25 per cent, and of those that do receive the pension, only about one third will receive the full rate. However, in the Committee's view, to reduce pressure on the age pension, through a heightened emphasis on individual self-reliance, the Government should continue to strive for universal and adequate superannuation coverage for all Australians including employees, the self-employed and non-working people, with a focus on assisting low and middle income earners.

Recommendation

12.32 **The Committee recommends that the Government continue to strive for universal and adequate superannuation coverage, with a focus on low and middle income earners.**

12.33 Given the rising cost of the age pension, the Committee also notes the options canvassed by IFSA for financing of the age and service pension in the future, including the possibility of tightening the age pension means tests. The Committee does not support these options at this time, favouring instead an ongoing commitment to broadening superannuation coverage.

12.34 The Committee also understands that there have been some suggestions that the age pension should be made universal, on the basis that such a move would involve significant savings in administration of the means tests.[23] Although the Committee believes that this option is worth investigating, evidence to the Committee indicates that the cost of doing so would be very high (close to 2.0 percentage points of GDP by 2049-50).

12.35 The Committee also notes the findings of a research paper presented at the annual colloquium of superannuation researchers that there appear to be differences in the way younger pensioners (those aged under 70) and older pensioners (those aged 70 and over) hold their assets, which can influence the amount of pension paid. The researchers indicated that this points to the importance of undertaking further analysis of data in this area.[24]

Other income support

12.36 People who receive age or service pensions may, depending on their circumstances, also be eligible for supplementary assistance from a range of additional concessions and allowances:

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23 *Submission* 79, FACS, p. 16. See also *Submission* 73, ASFA, pp. 27-28.

24 Justin Marshall and Kaye Brown, Senior Research Officers, Research and Analysis Section, Seniors and Means Test Branch, Department of Family and Community Services, *Preliminary Report on the assessable assets of age pensioners,* paper presented to the Tenth Annual Colloquium of Superannuation Researchers, University of New South Wales, July 2002.

- pensioner concession card which provides concessional access to listed Pharmaceutical Benefit Scheme (PBS) items and to concessions provided by State and Territory Governments;
- rent assistance (for those who rent privately);
- subsidised rent (through state and territory governments) for those in public housing;
- a telephone allowance;
- the Commonwealth Seniors Health Card; and
- a remote area allowance.

12.37 These additional concessions and allowances are discussed in more detail in **Appendix 12.**

12.38 Pensioners and self-funded retirees of age pension age also benefit from generous taxation concessions that help to increase their disposable retirement incomes. Under changes announced in the 2001-02 Federal Budget, the Senior Australians Tax Offset (SATO) means that single people in this age group can have income up to $20,000 a year without paying income tax or the Medicare levy. The SATO phases-out over the income range $20,000 to $37,840 (for singles). Similarly, couples can have combined incomes up to $32,612 without paying tax (depending on the income split between the partners). For couples, the SATO phases out between $32,612 and $58,244, if incomes are evenly divided.[25]

The pharmaceutical benefits scheme

12.39 As noted in **Appendix 12**, concession cardholders currently pay only $3.60 for medicines listed on the PBS, excluding any premium for higher cost alternatives. After spending $187.20 (52 scripts) on prescription medicines in a calendar year, cardholders are entitled to free PBS prescription medicines for the rest of that year.

12.40 In its written submission, the Department of Finance and Administration (DOFA) noted that expenditure on the PBS is expected to grow more than five fold as a share of GDP over the next four decades, up from 0.6 per cent of GDP in 2001-02 to 3.4 per cent of GDP in 2041-42.[26]

12.41 The Committee notes that the increase in the cost of the PBS did not receive significant comment during the conduct of the inquiry. However, in its written submission, Catholic Health Australia (CHA) recommended a review of the PBS scheme to address perceived over-utilisation of the scheme.[27]

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25 *Submission* 79, FACS, pp. 6-9.

26 *Submission* 89, DOFA, p. 9. See also Commonwealth Treasury, *Intergenerational Report 2002-03*, p. 69.

27 *Submission* 45, Catholic Health Australia, p. 14.

The Commonwealth seniors health card (CSHC)

12.42 The Committee notes that the Government substantially increased in the 2001-02 Federal Budget eligibility for the CSHC. Singles with incomes below $50,000 and couples with incomes below $80,000 are now eligible for the card, even where they are not entitled to the age pension. In its written submission, FACS indicated that this change was made for the following reason:

> As well as supporting and rewarding self-provision, availability of the CSHC to self-funded retirees is an important way of smoothing the transition between the reduced rate pensioner group, and the fully self-funded retiree group. Previously, someone who moved from a reduced rate pension to being fully self-funded experienced the complete loss of concessions, (and a corresponding reduction in living standards in retirement).[28]

12.43 The Committee also notes the evidence of DOFA that around 88 per cent of people over the age pension age including veterans, or 2.3 million people, held a health concession card at 30 June 2001. This estimate includes 226,140 self-funded retirees holding a CSHC.[29]

12.44 In its written submission to the inquiry, COTA argued that the CSHC scheme is not sufficiently targeted at those in genuine need of health care financial support:

> There is no justification for additional support for higher income groups amongst the older population. Non-pensioner retiree groups have been the targets of significant public expenditures in recent years through initiatives such as the extension of the Commonwealth Seniors Health Card to people on incomes of $50,000 (singles) and $80,000 (couples) which will eventually afford this group with the full suite of both Commonwealth and State Government concessions. With an ageing population, this measure will prove very expensive over the long term and is not justifiable on either efficiency or equity grounds.[30]

12.45 Catholic Health Australia also argued in its written submission that the Government needs to address the proliferation of health care cards, suggesting that an asset test for qualification for a card may be indicated.[31]

Committee view – other income support

12.46 During the conduct of the inquiry, the Committee did not receive significant comment on other income support arrangements provided by the Commonwealth and the States. However, the Committee does wish to comment on the CSHC scheme.

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28 *Submission* 79, FACS, p. 8.

29 *Submission* 89, DOFA, p. 9.

30 *Submission* 63, COTA, p. 14.

31 *Submission* 45, Catholic Health Australia, p. 14.

12.47 The Committee notes that the extension in the availability of the CSHC in the 2002-02 Budget is not targeted at those in society in greatest need of Government support. This is evidenced by the fact that around 88 per cent of people over the age pension age held a health concession card at 30 June 2001. In addition, 226,140 self-funded retirees held a CSHC at that time. In the Committee's opinion, the Government should consider reviewing access to the Commonwealth Seniors Health Card scheme to ensure that it is focused on those in greatest need.

Recommendation

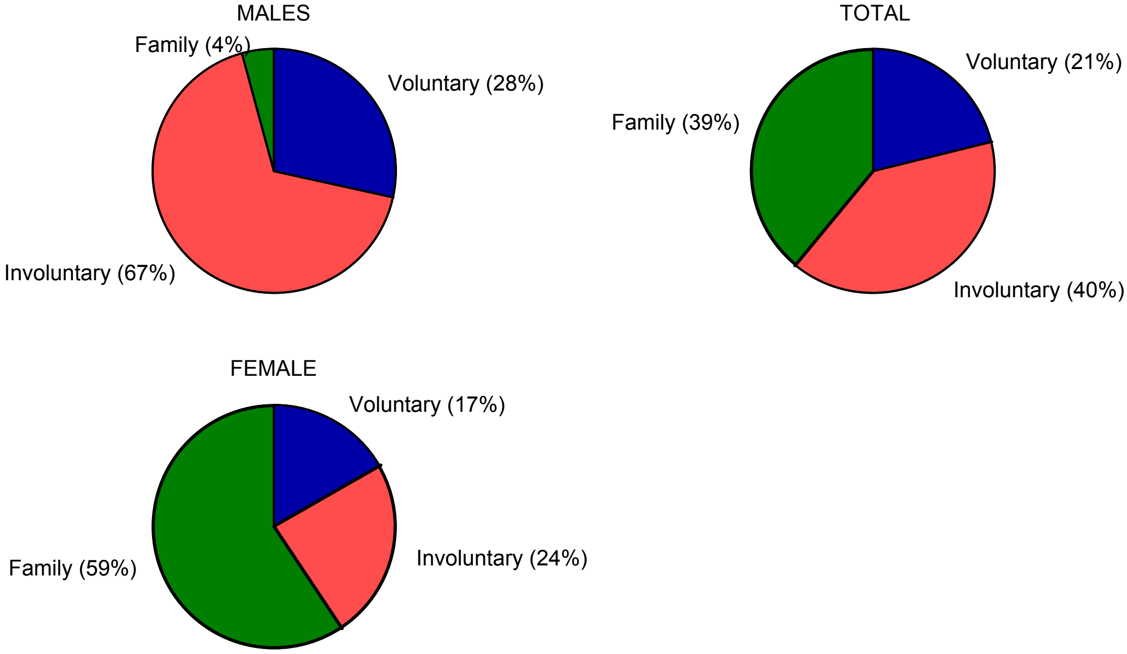
12.48 **The Committee recommends that the Government review the current arrangements for access to the Commonwealth Seniors Health Card scheme to ensure that it focuses on those in greatest need.**

Extended working lives

12.49 During the conduct of the inquiry, various parties raised the fact that many individuals in Australia retire early, before the official age pension age. In this regard, the Committee notes the research of Dr FitzGerald, based on the ABS Retirement and Retirement Intentions[32] that the majority of males in Australia retire involuntarily. This is shown in Chart **12.6** below:

32 ABS Cat No. 6238.0.

Chart 12.6: Reasons for Retirement



Source: Dr FitzGerald, 'Economic Implications of the Greying of the Baby Boomers', Presentation to the Business Symposium on the Economic and Business Implications of the Ageing Baby Boomers', Adelaide, 4 October 2002.

12.50 The early retirement of Australians, be it voluntary, involuntary or for family reasons, results in an early loss of income and contributions to superannuation, coupled with an early drawing down of superannuation savings. Together, they have a significant impact on retirement incomes, especially when coupled with the increasing life expectancy of retirees.

12.51 In this regard, the Committee notes the evidence of Mr Kelly from the National Centre for Social and Economic Modelling at the Canberra roundtable discussion on 8 October 2002 that even an SG rate of 15 per cent would be unable to compensate for the income lost from early retirement:

> I have also looked at increasing the superannuation guarantee to 15 per cent and I have found that it does not make a substantial difference because people are still taking early retirement, which almost negates it. So the priority is to encourage people to stay in employment and to look at ways for them to do so. The superannuation accumulation phase is more important than whether it should be nine or 15 per cent.[33]

12.52 Given the impact of early retirement on retirement incomes, the Committee notes that during the hearing on 19 July 2002, Ms Flanagan from FACS labelled

33 *Committee Hansard*, 8 October 2002, p. 690.

returning to work after formal retirement as a fourth pillar of Australia's retirement income system:

> Something we are very interested in focusing on is the fact that the three pillars can be supplemented by earnings for people who can and wish to work—and we have evidence showing that people after retirement age are interested in continuing to work, perhaps on a part-time or casual basis. We now refer to this as the fourth pillar of retirement income. We believe that it is very important, in a policy design sense, to break away from the concept that people have a full working life and then they retire. The reality today is very different, and we need to have public policy responses to recognise this. For example, the government has already introduced measures to allow superannuation contributions to be made after the age pension age—I think up to 70 years old. We think there are other measures that need to span across the de facto retirement age of 65, perhaps in terms of labour market assistance, encouraging people to continue in education et cetera.[34]

12.53 During the inquiry, various parties suggested means of encouraging more gradual transition arrangements from work to retirement, to encourage a delay in full dependency upon superannuation and the age pension. As stated by the Institute of Actuaries of Australia (IAA) in its written submission:

> One problem of an inflexible retirement age is that it discourages people to wind down and work part-time. In reality, we should encourage people to work part-time until age 70 or later, if they chose to do so. However it is not practical for people to work part-time under the current system as they do not qualify for the Pension Bonus Scheme.[35]

12.54 In its written submission, IFSA noted that many rules in tax and superannuation legislation appear to assume that a person retires once, and once only, on a day they have selected in advance. For example:

a) an income stream (an allocated pension taken out on retirement), once commenced, cannot be suspended if the purchaser returns to work – it must be commuted and re-started;

b) an income stream, once commenced, cannot be topped up by new monies, even by later release from other superannuation accounts – it must be commuted, added to, and a new income stream commenced.

c) The release of benefits rules do not allow someone to continue in the same employment – say on a part-time or project basis – and draw the benefits that they had accumulated up to the change in the nature of their employment.[36]

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34 *Committee Hansard*, 19 July 2002, p. 527.

35 *Submission* 74, IAA, p. 19.

36 *Submission* 70, IFSA, p. 14.

12.55 Dr FitzGerald also pointed out that:

> There are many rigidities in legislation including superannuation that define retirement as a one-way trapdoor – you are either in work or you are retired – and if you are in one category you cannot touch it, and if you are in the other category, some equally rigid things apply to you.[37]

12.56 Similarly, in its written submission, COTA noted that current superannuation processes do not encourage phased retirement:

> Despite benefits to both employees and employers, current superannuation arrangements do not enable this process [phased retirement]. The requirement that superannuation funds do not accept contributions unless the contributor is working at least 10 hours a week is unwieldy and unhelpful to people who wish to continue limited workforce participation. These barriers should be removed to encourage phased retirement.[38]

12.57 This concern was also raised in hearings. For example, Dr Knox noted at the Canberra roundtable discussion on 8 October 2002 that the superannuation and social security systems need to be flexible enough to enable people to move in and out of part-time or casual employment while they are in their sixties and even their seventies. Dr Knox emphasised that there was a need to 'encourage behaviour to maximise … the human capital.'[39]

12.58 In response to this perceived lack of flexibility in retirement, the Committee notes that COTA recommended in its written submission a number of strategies to assist and help promote mature age employees:

a) Maintaining strong and sustainable economic growth which will generate sufficient jobs for all who want them combined with effective labour force management.

b) Tackling age discrimination so that mature age people are neither targeted for retrenchment nor prevented from gaining jobs for which they are qualified and that there is fair distribution of jobs between groups in the labour market.

c) Promoting opportunities for education, training and life long learning so that all members of the workforce are able to maximise their capacity for maintaining and increasing their skills and mature age people in particular are able to maintain and attain skills.

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37 *Committee Hansard* , 8 October 2002, p. 668.

38 *Submission* 63, COTA, p. 20.

39 *Committee Hansard*, 8 October 2002, p. 719.

d) Greater flexibility in the workplace and in social security provisions to enable people to change the pattern and intensity of their workforce participation as they age.

e) Ensuring that there are adequate safety net provisions for people who are unable to participate in the labour market.[40]

12.59 The Committee also notes evidence raising a possible increase in the preservation age of superannuation to encourage individuals to stay in employment. For example, Mr Kelly from the Department of Health and Ageing argued that the Government could consider increasing the preservation age of superannuation (currently 55 but gradually being moved to 60) closer to the minimum age for eligibility of the age pension.[41]

12.60 At the same time, however, the Committee also notes the caution of Mr Stanhope from IFSA on 8 October 2002 in relation to changing the preservation age of superannuation funds:

> I will make a comment, in terms of this integration debate, about preservation ages. We need to be very careful. If we move the preservation ages upwards, we will expose even more people to preservation ages after they get to a point where they cannot work or do not want to work, either because of their health status or because they do not have a job. We will need a whole raft of new release of benefit rules if we start to play around too much with the preservation age. Senator Sherry has made much of the fact that we currently have about $350 million a year coming out in early release, and so those rules would have to be changed.[42]

The pension bonus scheme

12.61 On 1 July 1998, the Government introduced the pension bonus scheme to encourage people to work beyond normal retirement age and defer receipt of the age pension. The scheme is targeted at people eligible for the age pension who are in employment. By remaining in the workforce, they attract a bonus payment accumulating at 9.4 per cent of the age pension per year, so that at the end of five years they attract a bonus of 47 per cent of the maximum payable pension. The scheme is thus designed to maintain workforce participation for the full five years.[43]

12.62 In its written submission to the inquiry, ASFA recommended refinement of the pension bonus scheme, so as to make it more attractive to potential users and more fair:

40 *Submission* 63, COTA, pp. 21-22.

41 *Committee Hansard*, 8 October 2002, p. 709-710.

42 *Committee Hansard*, 8 October 2002, p. 713.

43 *Submission* 63, COTA, p. 18.

> Currently the labour force participation rate for persons of Age Pension age is very low, and is mostly made up of professionals and the self-employed who are less likely to be eligible for the Age Pension. The bonus payable is also a relatively small proportion of the value of the pension foregone. If this is a tool to encourage higher labour force participation post normal retirement age then it needs to be sharpened somewhat.[44]

12.63 Similarly, COTA argued in its written submission that the pension bonus scheme fails to provide sufficient incentive for people to stay in the workforce:

> COTA believes that there should be greater incentives for people to stay in the workforce for one to four years. Many more people could benefit from the program if there were higher incentives for continuing for these shorter periods. We believe that there would be commensurate savings and tax revenue for the Government as well.
>
> Older people who are part of our organisation say that the pension bonus scheme should offer more to people staying on in employment for shorter periods. Under present arrangements, a single person working for an additional three years gets roughly one third the bonus of the person working five years although the person is saving the Government around $20,000 on the Age Pension and is paying tax.
>
> The program in its present form does not meet the needs of older people or sufficiently take account of their labour market circumstances. We think that some of the underlying formulas for the program are unfair and cause confusion amongst older people.[45]

12.64 Accordingly, COTA recommended in its written submission that the pension bonus scheme be reviewed to provide stronger incentives for people to remain in employment for between one and four years. COTA also recommended that the scheme should allow older people who have already received an age pension to take advantage of the scheme if they have opportunities to return to work.[46]

Committee view – extended working lives

12.65 The Committee accepts the evidence provided during the inquiry that the superannuation system at present is premised on the understanding that individuals retire once on a given day, and do not undertake remunerated work again.

12.66 In the Committee's view, there are a number of areas in the superannuation and social security systems in which the Government could act to encourage individuals to extend their working lives, in line with overseas developments, and make a more gradual transition from work to retirement. These include:

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44 *Submission* 73, ASFA, pp. 43-47.

45 *Submission* 63, COTA, p. 19.

46 *Submission* 63, COTA, p. 19.

- altering the release of benefits rules for individuals who return to part-time work;
- removing the requirement that superannuation funds do not accept contributions unless the contributor is working at least 10 hours a week;
- changing the provisions of the Pension Bonus Scheme to provide additional incentive for older persons to remain in or return to work.

12.67 Changes to the treatment of lump sum payments and income stream products would also encourage individuals into more gradual transition arrangements from work to retirement. This is discussed in more detail below in the section on double dipping and the sections on income streams.

Recommendation

12.68 **The Committee recommends that the Government examine options to encourage older workers to remain in the workforce beyond the superannuation preservation age, particularly on a part-time basis.**

Double dipping

12.69 During the conduct of the inquiry, various parties raised the issue of double dipping, whereby individuals may retire early from the workforce, and spend their lump sum superannuation payment before they get to pensionable age. Having done so, they may subsequently draw the full age pension.

12.70 In its written submission, Treasury indicated that lump sums account for 79.6 per cent of superannuation benefits paid in 2001, a share that has been relatively stable over the past five years. Treasury noted that from the Commonwealth Budget perspective, double dipping means:

- Commonwealth expenses on age pensions are higher than they otherwise would be if individuals had taken their superannuation benefit as a pension; and
- the Commonwealth's superannuation tax concessions are not necessarily used for the intended purpose, that is, to provide superannuation retirement income.[47]

12.71 However, Treasury continued in its written submission that double dipping is not currently a significant problem:

> Given the high propensity to take superannuation in the form of a lump sum there is the possibility that some superannuation dissipation is being practiced. However, current indications are that such a practice is not wide spread, and that evidence is anecdotal only.
>
> Maximum limits are placed on the amounts of retirement benefits that individuals can receive over their lifetime at concessional tax rates. Reasonable Benefit Limits are set for both lump sums and pensions and

47 *Submission* 89, DOFA, p. 13.

> these are indexed annually to movement in average weekly ordinary time earnings. For the financial year 2002-03, the lump sum RBL is $562,195, while the pension RBL is $1,124,384. If an individual's lump sum benefit is above the RBL, tax is payable at the highest personal income tax rate (currently 47% plus the Medicare levy).
>
> Currently, a lump sum of at least $80,000 is required to purchase an income stream product from a superannuation fund or life office. A couple in receipt of an income stream from a lump sum of up to $100,000 would pass the income test for a full age pension (up to $204 per fortnight is allowed). Research by Treasury's Retirement Income Modelling Unit for this Inquiry suggests that the average superannuation balance per person is currently about $62,000, with a wide variation about this average depending on years of membership and level of contributions. A survey by the ABS in 2000 found that for those aged 55 to 69 years with superannuation, one half held superannuation balances of less than $30,000 (ABS 2001).
>
> When the vast majority of lump sums are below the threshold for an income stream product and still within the means tests for the age pension, dissipation of lump sums is not a significant issue.
>
> However, as superannuation saving increases further, a growing number of retirees will have sufficient savings for a superannuation pension. To the extent that retirees base their investment decisions on the age pension means tests rather than the aim of maximising their private retirement income, they are likely to experience a lower standard of living in retirement.[48]

12.72 The Committee notes, however, that other parties raised greater concern about the potential for double dipping. For example, in its written submission, ASFA recommended that in the future, retirement benefits should be taken in the form of an income stream along the lines of a complying pension or a growth pension. To help implement this, ASFA recommended a cap of, say, $50,000 be placed on the lump sum reasonable benefit limits (RBLs).[49]

12.73 Similarly, the Australian Council of Social Service (ACOSS) argued in its written submission:

> The lump sum RBL should be sharply reduced in order to encourage the purchase of complying pensions. One option would be to reduce the lump sum RBL to the current tax-free threshold for lump sums - $106,000. This is sufficient for the vast majority of retirees to meet immediate expenses on retirement and undertake investments that will improve their retirement living standards (especially paying off their home mortgage). Beyond this, retirees should be either compelled or encouraged (via a penal tax rate) to invest in complying pensions. This is necessary to prevent double dipping:

48 *Submission* 89, DOFA, p. 14.

49 *Submission* 73, ASFA, pp. 47-48.

> the dissipation of retirement savings in order to maximise Age Pension entitlements.[50]

12.74 In addition, the Australian Bankers' Association (ABA) argued in its written submission that a move away from front-end taxes to end benefit taxes would encourage a move towards taking superannuation benefits as income streams, either by

- simply applying ordinary income taxation to all benefits, with at most a limited provision for taking part of a benefit as a lump sum. This would strongly encourage taking income streams (since significant lump sums would be taxed in the top tax bracket); or by
- explicitly requiring payment of benefits (above some lump sum limit) in income stream form.

12.75 The ABA argued that this would considerably improve the mesh between the superannuation and age pension systems. There would be less encouragement to retire early, draw a substantial part of the available benefit as a lump sum, use this to live on in early retirement then qualify for an age pension.[51]

12.76 These arguments were reiterated during hearings. In his evidence to the Committee at the Canberra roundtable discussion on 8 October 2002, Mr Gallagher from Treasury played down the incidence of double dipping:

> One major issue here has been whether there is a major problem with double dipping—people getting their superannuation money and spending it, before accessing the age pension. In looking at the overall equity of the scheme, certainly double dipping presents a theoretical problem. However, we did some research in RIM that looked at ABS data on what people did with their lump sums. We found that people with enough money to affect their pensions—that is, they had a reasonable amount of money, given the three tests: the age pension, income test and asset test—predominantly invested any superannuation amount received. Even if they took it as a lump sum, they still invested it and tried to make use of it rather than spend it on an overseas holiday. So it is not clear that there are major issues with double dipping at the moment. But there certainly is potential there, and it is an issue that probably will be kept under review.[52]

12.77 However, Ms Smith from ASFA suggested at the Canberra roundtable discussion on 8 October 2002 that double dipping might become a greater problem in the future:

> Looking to a mature system, I think there are a couple of things that need to be touched on in terms of the integration. … at the moment I do not think

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50 *Submission* 65, ACOSS, p. 16.

51 *Submission* 51, ABA, p. 20.

52 *Committee Hansard*, 8 October 2002, p. 718.

> there is any evidence of double dipping occurring in terms of the lump sum—for the most part, people use that money sensibly. On the mature system though, for when those amounts of money become larger, I think it is sensible to put in place now some cap on what that lump sum might be—whether it is $50,000 or something like that for use and then the rest required as an income stream. We think that going with an income stream model makes sense in terms of retirement strategy, although if we do go down that path we need to think of a broader range of products than are there now. Clearly, the set of allocated pensions versus complying pensions does not give much flexibility for people to meet their needs.[53]

12.78 The Committee also notes the evidence of Mr Davidson from ACOSS at the Canberra roundtable discussion on 8 October 2002:

> In relation to the age pension, there is a disconnect between the superannuation system and the age pension system, and in a sense there always will be, because they perform different roles. One is about income replacement and is based on the individual to a large extent; the purpose of the other is poverty alleviation and it is based on the income of the family unit.
>
> I would like to put to rest the notion that ACOSS would like to use the superannuation system to equalise wealth distribution in Australia. We are not that ambitious, to be honest. I would be very happy if the present superannuation system did not contribute to making the distribution of income and wealth worse. If the tax treatment overall, for example, were proportional rather than regressive, that would leave the age pension to do what it does best, alleviate poverty, rather than its having to focus on compensating for a regressive superannuation system. Having said all that, the superannuation and age pension systems would be better connected if lump sums were more restricted. There is a serious disconnect between the two systems that threatens to undermine both. In our view, the best way to achieve that is to place restrictions on the level of lump sum benefits—a simple cap which is either reinforced through the tax system or reinforced by banning lump sums above a certain level. Other countries do that; why can't we? We do not believe the solution lies in making income streams more attractive through further concessional tax or income and asset test treatment, because we do not believe it is necessary or desirable to forgo further public revenue to that end when a simple cap would, to a large extent, do the job.[54]

Committee view – double dipping

12.79 The Committee shares the concerns expressed by some parties during the inquiry that the incidence of double dipping, while not currently a significant problem,

53 *Committee Hansard*, 8 October 2002, p. 722-723.

54 *Committee Hansard*, 8 October 2002, p. 711.

may increase dramatically as the superannuation system matures and lump sum payments become larger.

12.80 To address this issue, the Committee notes a range of possibilities. As discussed earlier in this chapter, this includes the option of moving the superannuation preservation age closer to the age pension eligibility age, and the option of capping lump sum RBLs.

12.81 The Committee considers that its earlier recommendations to limit the indexation applicable to RBLs, together with its proposed changes to the taxation treatment of lump sum benefits, may assist in reducing the incidence of double dipping, in favour of encouraging income streams.

12.82 The following section examines means to encourage retirees to take their superannuation benefits as an income stream rather than as a lump sum.

Retirement income streams

12.83 Income streams are purchased investment products designed to provide payments to a person on a regular basis over either their remaining life or a set term. The payments may comprise both income and a return of the capital used to purchase the product.

12.84 In its written submission to the inquiry, IAA indicated its belief that individuals should be encouraged to take superannuation benefits as income streams rather than lump sum benefits:

> Income streams can be designed to match needs in retirement, and to address issues such as longevity risk (or the risk of outliving your superannuation benefit). Further, one of the reasons for poor integration between the superannuation and social security systems is that superannuation benefits are generally taken as lump sums, while social security benefits are paid as pensions.
>
> There are a range of ways in which the Government could encourage (or require) superannuation benefits to be primarily taken in pension form and hence improve the integration of superannuation and social security. These include:
>
> - enhancing the range of pensions that are regarded as “complying pensions”, to include for example, annuities and pensions invested in equity or growth assets; and
> - requiring superannuation benefits to first be used to purchase a pension that is equivalent to the Age Pension, or only allowing lump sum superannuation benefits to be taken (perhaps above some initial

> threshold such as $100,000) once a retirement income that exceeds Age Pension income test eligibility levels has been taken.[55]

12.85 The Committee also notes with interest IFSA's reporting in its written submission of the results of its *Retirement Savings – Desires and Drivers* research project. This project asked retirees and pre-retirees (aged from 45 to five years post retirement) to rank a range of income streams features, both independently and as paired trade-offs, on a zero to ten points scale of importance. The results were as follows:

- Pooling risk: Above all other features, respondents singled out pooled lifetime (longevity) risk as their most disliked feature.

– The most important single attribute of retirement income stream products, was that 'the balance of the fund goes to the estate or to your partner if you die early' (mean importance score 9.2).

– The least important feature among the paired attributes was 'Income is a guaranteed amount, paid for life, but if you die early no further money may be paid to your estate' (mean importance score 2.8)

- Guarantees: Guaranteed income aspects were given very high importance in the single attributes, but fared less well when balanced against trade-offs. Single attribute importance scores were:

– Guaranteed income for life (mean importance score 8.7)

– Income indexed against inflation (mean importance score 8.2)

– Guaranteed level of payment each month (mean importance score 8.1)

- Transparency: 'Transparency' aspects of income streams were rated as having high importance:

– Receive regular account statements, showing balance (mean importance score 7.9); compared to

– No account statements, but you are paid a set amount of income each week or month (mean importance score 5.0)

- Control: 'Control' aspects of income streams were given similar importance:

– Can choose initial investment mix (mean importance score 7.7)

– Can change investment mix (mean importance score 7.7)

– Can switch to another fund manager easily (mean importance score 7.6)

12.86 Taken together, Mr Stanhope from IFSA suggested that two things cropped up as the most liked and disliked components of retirement income streams. The most disliked was losing your money into a risk pool, and the most liked was that, if you

55 *Submission* 74, IAA, p. 22.

died early, any remaining benefit that you had not been able to use in life would pass to an estate.[56]

12.87 The Committee notes, however, that take up of retirement income streams at the current time is low. In her evidence to the Committee at the Canberra roundtable discussion on 8 October 2002, Ms Doyle from AMP indicated that only 30 per cent of retirees are investing their superannuation in income streams. Of that 30 per cent, 90 per cent is being invested in allocated annuities and pensions, and only 10 per cent in complying annuities.[57]

12.88 In response, Mr Maroney from IAA indicated at the Canberra roundtable discussion on 8 October 2002 his opinion that the fact that 30 per cent of retirees invest in income streams is in fact 'quite good' and that ten years ago it would have been close to zero:

> Despite the lack of enforcement, we have moved from an almost zero pension system to a 30 per cent pension system by the way that the rules have evolved. Maybe the problem is solving itself, because there is a big attraction under the tax and social security rules for people to take a pension. As education continues and people's benefits grow et cetera, I am not nearly as pessimistic as I would have been a few years ago.[58]

12.89 Mr Maroney further indicated that within the next five to ten years, depending on the investment in superannuation education by the Government, uptake of income streams may reach 50 per cent. He further argued that individuals' attitudes to guaranteed income streams will probably be far more positive over the next couple of years, based on recent investment returns.[59]

12.90 The Committee explores below the features and take-up of allocated annuities and pensions, and complying annuities.

Allocated annuities and pensions

12.91 Allocated annuities and pensions are a particular type of income stream, based on an individual account which changes in value with investment returns and income draw downs (calculated according to life expectancy). Upon death, the balance of the account can be used to pay an income to a spouse or can be paid as a lump sum to the beneficiaries of the estate. In its written submission, AMP indicated:

> Allocated annuities and pensions are the most popular type of income stream with retirees, accounting for 90% of sales in 2001. These products give the retiree investment choice and allow them to choose the amount of income they can draw out (within limits). On death, the remaining balance

56 *Committee Hansard*, 8 October 2002, pp. 712-713.

57 *Committee Hansard*, 8 October 2002, p. 676.

58 *Committee Hansard*, 8 October 2002, pp 724-725.

59 *Committee Hansard*, 8 October 2002, p. 725.

> of the fund is returned to the family. However, the allocated annuity can also leave the retiree with no income if they live past their life expectancy. They also allow leakage of funds into a lump sum, as the pension/annuity can be cashed in at any time.[60]

12.92 Despite the popularity of allocated annuities and pensions, the Committee notes that in its written submission, IFSA expressed concern in relation to the current drawdown factors for allocated income products. IFSA noted that tax and social security regulation of allocated products is based on a single mean life expectancy. While this life expectancy is true on average, it does not address the simple statistical principle that half of retirees will outlive average life expectancy. IFSA continued:

> One simple consequence is that the current drawdown factors for allocated products drop to low numbers after mean life expectancy. This eventually forces retirees to draw a significant proportion of the account, however long the account holder may expect to live. It may not be desirable to reduce the minimum drawdown factors significantly early in retirement – say up to age 75 – to limit tax deferral. However, once a retiree is approaching the mean life expectancy of her or his age 65 cohort, say around age 80, remaining life expectancy can be quite long indeed relative to that mean. It seems a little counter-productive to then require annual drawdowns that will rapidly exhaust the remaining capital.
>
> It would make considerable sense to model the consequences of applying longer life expectancies to the drawdown factors of allocated products. This would allow a sensible trade-off between prolonged income drawdown and the risk of creating inappropriately large estates.[61]

12.93 Given this concern, Treasury noted in its written submission its support for lifetime pensions and annuities which manage longevity risk:

> From the Commonwealth's perspective, if individuals have insufficient retirement savings to partly or fully cover their living expenses over long retirement periods, their dependency on Commonwealth income support will increase in their final years of life when health and aged care needs are greatest. These fiscal implications highlight the importance of encouraging *lifetime* pensions and annuities, which manage longevity risk. The current pension RBL does not apply to *allocated* pensions which carry longevity risk, and provides a substantial incentive for lifetime pensions and annuities for those retirees with substantial superannuation balances.[62]

Complying annuities

12.94 In its 1997-98 Budget, the Federal Government announced a proposal to introduce a new class of 'complying' superannuation pensions and annuities, which

60 *Submission* 64, AMP, p. 20.

61 *Submission* 70, IFSA, pp. 17-18.

62 *Submission* 89, DOFA, p. 16.

would receive favourable social security and tax treatment. This was subsequently enacted through the *Social Security and Veterans' Affairs Legislation Amendment (Budget and Other Measures) Act 1998*, which came into effect from 20 September 1998.[63]

12.95 Under this Act, complying income streams qualify for a higher RBL, and may also be exempt from the social security assets test. However, as discussed by the AMP in its written submission, complying annuities are unpopular in Australia:

> Australians have shown little preference for complying annuities, despite their favourable RBL and social security rules. Only 4% of income stream sales in 2001 went into complying annuities.
>
> There are several factors which give rise to their unpopularity. Complying annuities must provide a guaranteed rate of return to investors. The capital backing the annuities are therefore generally invested long-term in conservative assets (bonds and cash). The result is a very low income for the retiree. Times of low interest rates make it unattractive to "lock into" a guaranteed long-term investment.
>
> A further disadvantage of lifetime complying annuities is the loss of capital to the estate on death. The longest that the capital can be guaranteed for is 10 years, which is less than most retirees life expectancy. On the other hand, a complying life expectancy annuity allows the capital to be returned to the estate on death.
>
> Regardless, complying annuities have some attractive features: - they are not commutable, they last for at least life expectancy, and they are designed to drawdown capital.[64]

12.96 This unpopularity of complying annuities was also raised by IFSA in its written submission. IFSA reiterated that the capital backing complying annuities is generally invested long-term in conservative assets (bonds and cash), due to the requirement that complying annuities guarantee returns. However, IFSA suggested that removing this requirement of guaranteed returns would promote the development of 'growth pensions' – complying annuities which included growth assets such as share in their portfolio:

> The current tax and social security treatment of retirement income streams also contributes to inadequate retirement incomes. The current rules for complying income streams – broadly, those that qualify for the higher pension RBL and that are exempt from the social security assets test – heavily favour interest-based investments. This distortion has been canvassed in IFSA's submission to Government supporting the recognition of Growth Pensions – copies were provided to the Senate Committee on

63 *Submission* 70, IFSA, p. 70.

64 *Submission* 64, AMP, p. 20.

> 4 May 2001. It arises from the restrictions placed on complying products – chiefly that income paid cannot vary, except for indexation.
>
> If this distortion were removed, and retirement income streams which include growth assets were recognised, IFSA has calculated that a retiree with $100,000 to invest in a 15 year income stream would receive around $30,000 more in real terms than $100,00 invested in a 15-year CPI-indexed guaranteed pension or annuity.
>
> The distortion towards interest-bearing investments affects capital markets, reducing the allocation of retirement savings to economically productive equity (and other) investments. This impact reduces the efficiency of the economy overall, and the impact will become larger as higher future levels of retiree savings are forced into interest-based investments.[65]

12.97 Similar to IFSA, AMP proposed in its written submission that complying annuities would be more attractive if they were able to include a broader range of assets other than interest bearing investments such as cash or bonds:

- First, this would allow the providers to remove the rate of return guarantee from the product and pass the investment risk and rewards through to the retiree, making the annuity cheaper as a result.
- Second, retirees would have investment choice, allowing them to select assets according to their risk preference.
- Third, this would allow retirees to benefit from a long-term investment in growth assets, with the potential for capital growth and therefore improved retirement income. It also avoids retirees having to lock in at low rates of return.[66]

12.98 Ms Doyle from AMP Financial Services also argued at the Canberra roundtable discussion on 8 October 2002 that the incentives for taking out complying annuities need to be increased:

> At the moment, we have the most preferential arrangements given to those income streams which last for a lifetime or a life expectancy. But in the market, we are finding that they are not very popular with consumers. Some of the characteristics of those income streams are that they lock the retiree into a fixed rate of return and, therefore, a fixed income—be that nominal or indexed at a certain rate. Coming out of an environment where you have had asset and portfolio choices and then locking yourself for a long time into those sorts of flows has not been very popular. Likewise, it is only when you hit the really high RBLs that those sorts of income streams make a bit more difference to you as well. So those are features of the products that you might say we really need to address by asking, 'What do today's retirees want?' Those types of products were derived a long time ago, and one

65 *Submission* 70, IFSA, p. 16.

66 *Submission* 64, AMP, p. 20.

would say that they need to be brought into the 21st century for the needs of today.[67]

Committee view – retirement income streams

12.99 The Committee favours effective and equitable steps which will provide incentives to take benefits as an income stream, rather than as a lump sum.

12.100The Committee notes that, by comparison with allocated annuities and pensions, complying annuities are less popular because of the requirement that they must provide a guaranteed rate of return. As a result they tend to provide a low rate of return.

12.101 The Committee notes the arguments made by IFSA and AMP for a revisiting of the *Social Security and Veterans' Affairs Legislation Amendment (Budget and Other Measures) Act 1998* as it relates to the regulation of complying annuities (growth pensions), on the grounds that it may be that the current favouring of interest bearing investments in complying annuities in order to meet guaranteed rates of return is an unintended consequence of the Act that the Government can redress.

12.102 Accordingly the Committee believes that the Government should monitor the uptake of complying annuities, to ensure that the restrictions imposed do not inhibit the attractiveness of complying annuities.

12.103 It may also be possible to simplify the legislation applying to allocated annuities and complying annuities so that there can be a standard set of rules applying to income streams. Importantly, the Committee believes consideration of any legislative reform should accompany any moves to encourage individuals to take income streams in preference to lump sums when accessing their superannuation.

Recommendation

12.104 **The Committee recommends that the Government:**

- **monitor the uptake of complying annuities, to ensure that the restrictions imposed do not inhibit the attractiveness of complying annuities;**
- **consider the appropriateness of the current minimum draw-down limits for allocated annuities; and**
- **develop a standard set of rules applying to income streams.**

Accessing the wealth in housing assets

12.105 During the conduct of the inquiry, various parties raised the issue that retirees in Australia tend to be asset rich, but income poor. That is to say that many older Australians have considerable wealth invested in their family homes, but do not have

67 *Committee Hansard*, 8 October 2002, pp. 714-715.

access to that wealth in terms of day-to-day income. Accordingly, they continue to draw the age pension.[68] In its written submission, IAA made the following observation:

> As the family home is exempt from the Assets Test and usually generates no income, there is an incentive for pensioners with valuable homes to remain in them and still receive social security benefits. Many older people are also reluctant to move away from familiar territory. However, the absence of death duties means that the Government pays social security while an asset (such as the family home) is appreciating, for the children to then inherit a valuable tax-free estate.
>
> Australia's high rate of home ownership ensures that most retirees live above poverty levels. Encouraging more people to own a home in retirement continues to be a worthwhile objective. However, for the foreseeable future, it is unrealistic to expect the average Australian to be able to afford to buy their own home and to also fund sufficient income to be self-sufficient in retirement.
>
> Ways should be considered for unlocking the value of the family home in retirement, for example through reverse mortgages or loans from government that are repayable on death.[69]

12.106 COTA supported in its written submission consideration being given to the provision of home equity loans, provided they were developed in conjuncture with strong consumer protection codes:

> … there are dangers and limitations in home equity conversion for some. At worst, there is the prospect of reaching nil equity, and lenders calling for possession of the asset – the family home. There are concerns regarding decision making impairment experienced by some older people and the need to protect these individuals. There is also the fact that these schemes are likely to be available only in metropolitan areas, and to owners of more expensive homes. We believe that safeguards need to be put in place to ensure that Home Equity Conversion schemes are fully understood by older people before they enter into such agreements.[70]

12.107 Home equity or reverse mortgage loans were also raised in hearings. For example, in the hearing on 17 July 2002, Dr Knox noted:

> I think, in concept, it is a great idea to use the family home, or the residence, to borrow money against. There are clearly some issues related to that. For instance, the person lending you the money and, in effect, taking an increasing ownership of the home, would want the home to be maintained and to maintain its value. If you have an elderly couple in the home and they

68 *Committee Hansard*, 8 October 2002, p. 709.

69 *Submission* 74, IAA, p. 18.

70 *Submission* 63, COTA, p. 33.

> have no financial interest in doing that then you have some conflicts. But you can constrain that with certain limits and so forth by not borrowing the full value of the home but half the value of the home.[71]

12.108 Similarly, Ms Wolthuizen from the Australian Consumers' Association (ACA) raised reverse equity mortgages at the Canberra roundtable discussion on 8 October 2002. She indicated the ACA's broad support for a re-examination of such schemes:

> We think they are worth considering, particularly as long as eligibility for the age pension is measured with respect to a means test but the family home is not subject to that same test. It is worth looking at ways of unlocking equity in the family home, particularly in the kinds of situations we have reported to us by people who have elderly parents or relatives who cannot pay their rates because they are living in a house in an area which has experienced rapid property value rises. In those scenarios they do not necessarily want to see the individual having to move and sell up in order to afford to live. By the same token, there is a sense of a growing demand for that sort of product and it is worth looking into, to see if it can be made viable. I also think some of the demand issues which may have prevented it from being popular when last examined in the Australian context possibly do not exist any more, largely because of the focus on rising property values in certain Australian property markets.[72]

12.109 However, Mr Kelly from the Department of Health and Ageing raised at the Canberra roundtable discussion on 8 October 2002 the failure of reverse equity loans to gain widespread support in Australia. According to Mr Kelly, a similar scheme met with limited success in the USA, although the scheme in the UK has been more successful.[73]

12.110 Similarly, Mr Stanhope from IFSA commented:

> I will make a comment about reverse equity mortgages, because they are always put on the table in this debate. The question is often asked: 'Why aren't they available?' One of the first points to make is that, in the US experience, they were expected to be so popular that the first run was balloted to 50 institutions. There have been a number of supplier exits from the reverse equity mortgage market in the US, because it simply has not worked the way anyone expected it to. The demand that people keep hypothesising just does not eventuate. Perhaps the most compelling fact is that the US government started the securitisation of those mortgages. They intended they would all be securitised into the secondary market through the Fannie Mae Corporation—their federal national mortgage loans association—which is a US government instrumentality. They have not been able to exit that market—they are still the only securitiser of those mortgages—and so, in effect, the risk in that portfolio is still underwritten

71 *Committee Hansard*, 17 July 2002, p. 348.

72 *Committee Hansard*, 8 October 2002, p. 719.

73 *Committee Hansard*, 8 October 2002, pp. 683, 709-710.

> by the US government. So these things have a lot in promise but not a lot in actuality. They are very complex beasts to get into place.
>
> The risks and the costs associated with them mean that they probably could not be provided as a pure market product for the same rate as an ordinary housing mortgage, and I think that that would meet with very great resistance on the demand side. The pilot scheme that was started under the Keating Labor government and not continued by the current government had an interest rate subsidy in it of one per cent. Those kinds of issues are quite critical to acceptance of reverse mortgage schemes. People in Australia keep forgetting that not only are there a whole lot of supply issues in getting the thing to market but also there is a real demand issue—whether people are prepared to pay for the risk in the product and whether a subsidy would be needed to get over that demand hurdle, much less all the other hurdles.[74]

12.111 As noted, however, reverse mortgages have had some success in the UK. In evidence to the Committee on 8 October 2002, Ms Doyle from AMP Financial Services expanded on this:

> In the UK we have what we call an 'equity release' product which is offered through one of the UK subsidiaries. It is usually bought by people who are 70 to 75 who are maybe looking for funding from a proportion of their house equity. It is not very often that you find that they would actually release 100 per cent of the capital in the house—it might only be 20 per cent. It can be as a lump sum or as an income stream for the retiree, but usually it is not a great deal that is coming out. Lump sums are very popular, and if they want to they can pay it back; so they can release the mortgage over the house. Usually you will find that we have done it with a mortgage provider underneath, and so it is not the life company that takes the sole risk of that; it is with a partner as well. That way has been seen to be quite popular in the UK.[75]

12.112 Finally, the Committee notes that as an alternative to home equity loans or reverse mortgages, Third Son Financial Services submitted the following HOMEX model for accessing housing wealth:

> An estimated 31.5% of older Australians are homeowners but are dependent on Government payments and allowances for 90% or more or their income. The ability of these older Australians to purchase aged care services, beyond those provided free by Government and Charitable Organisations, is directly related to their income position, and hence limited by their dependence of Government payments.
>
> The Home Exchange Program (HOMEX) has been specifically designed to address these problems, by providing a new mechanism to generate significant additional income for homeowner older Australians who are

74 *Committee Hansard*, 8 October 2002, pp. 713-714.

75 *Committee Hansard*, 8 October 2002, pp. 715.

currently dependent on Government pensions and allowances for their income, without losing the key benefits commonly associated with owning their home.

HOMEX involves:

. The sale of an older Australian's home to the State Government,

. The older Australian gaining rent-free lifetime tenancy of their own home,

. The older Australian retaining 100% of their existent Age pension and associated entitlements,

. The older Australian receiving an additional monthly "pension payment" for the rest of their life with payments annually incremented by a fixed percentage or CPI (these payments being guaranteed for 10 years even if they pass away within that time period),

. The older Australian having an entitlement to a once-off Health Care Grant from the Government, the value of which will be up to 25%[76] of the prevailing market value of their home, to be used to meet their health care needs should they need to enter a hospice or nursing home accommodation.

HOMEX is an entirely voluntary program providing benefits to older Australians who chose to enter into the program.

The decision to enter the program is entirely the decision of those older Australians, made in consultation with their family and loved ones should they so chose to do so, and supported by the Government.[77]

Committee view – accessing the wealth in housing assets

12.113 The Committee notes that in general terms, many retirees continue to live in their family home, and are not in a position to access the wealth stored in the home to fund their retirement. As a result, they are forced to rely on the social security and health systems for income and other support in retirement.

12.114 The reliance on Government support through the social security system rather than drawing down assets in retirement clearly has equity implications. In general terms, asset rich but income poor retirees often continue to rely on the taxpayer funded age pension, but leave to their children or other beneficiaries assets such as the family home of significant value. This raises the question whether additional avenues

76 A Health Care Grant of up to 25% of the prevailing market value of the home is available under a Private Funding scenario for HOMEX, under a Public Funding scenario this percentage is about 12.5%.

77 *Submission* 13, Third Son Financial Services, Attachment 1.

could be explored by which asset rich retirees could contribute to some of the costs of their access to the age pension and health care.

12.115 The Committee considers that the Government could offer loans to retirees, repayable on death. The Committee also believes that there may be some merit in the Government re-examining reverse equity or home equity loans. The Committee notes that similar schemes have met with limited success in the USA, but that the UK has had greater success through introducing a range of flexibilities into their schemes.

Recommendation

12.116 **The Committee recommends that the Government examine options by which those who wish to could draw an income stream from their owner-occupied housing assets for retirement income purposes, including health and aged care expenses.**

Overall conclusions - integration

12.117 The Committee found that Australia's public and private health and aged care system is well regarded, but, in the light of projected expenditure identified in the *Intergenerational Report* and other reports published in the last decade, the system faces significant challenges in the future as Australia's population ages.

12.118 The Committee believes that the Government could consider a number of strategies to address these challenges, including:

- identifying ways to make savings in health care costs, through further examination of options such as voluntary heath insurance through superannuation protocols; and
- monitoring community and residential aged care programs to ensure their effectiveness and sustainability.

12.119 The Committee notes that Australia has a modest universal age pension system which includes targeting through the assets and incomes tests. The Committee also notes that the costs associated with the system are expected to increase in the future, and that strategies need to be identified to deal with this anticipated development.

12.120 To address this, the Committee believes that there are a number of initiatives that the Government could undertake to enhance integration of the three pillars of the retirement income support system in Australia: compulsory employer SG contributions, voluntary superannuation, and social security measures. Specifically, as discussed in this chapter, the Committee believes the Government should:

- continue to strive for universal and adequate superannuation coverage, with a focus on assisting those who face the greatest challenges in achieving an adequate retirement income – the low and middle income earners;
- review current arrangements for access to the Commonwealth Seniors Health Card scheme to ensure that it focuses on those in greatest need of Government support;

- explore options to encourage workers to remain in the workforce beyond the current superannuation preservation age;
- monitor the uptake of complying annuities, to ensure that they offer an attractive investment option for retirees;
- consider the appropriateness of the current minimum draw-down limits for allocated annuities;
- develop a standard set of rules applying to income streams; and
- develop means by which those who wish to could draw an income stream from their owner-occupied housing assets for retirement income purposes, including health and aged care expenses.

PART V - SIMPLICITY

Part V of this report is about simplifying the superannuation system. The Committee is conscious the superannuation guarantee system is a compulsory one, however, a large number of people are not in a position to fully understand superannuation, and how it applies to them. Accordingly, the Committee gives consideration to means of streamlining the operation of the superannuation system to reduce cost and improve the understanding of superannuation amongst fund members.

Chapter 13

Simplicity

Introduction

13.1 This chapter examines issues raised during the inquiry in relation to the real and perceived complexity of superannuation in Australia, and avenues for making it simpler and easier to understand. The following issues are considered:

- the legislative and regulatory framework;
- 'grandfathering' arrangements;
- the work test for making voluntary contributions;
- account consolidation; and
- education.

The legislative and regulatory framework

13.2 In its written submission, ASFA argued that it is widely accepted that superannuation and retirement income arrangements need simplification. In particular, ASFA suggested that simplification of tax arrangements relating to superannuation has widespread support in the community, the industry and even amongst elements within the government. In addition, ASFA suggested that there is community unease when most individuals with even modest assets or private retirement income need to consult professional financial advisers. ASFA continued:

> Over the last decade arrangements at the fund level have tended to become more complex rather than less. Each year there have been scores if not hundreds of changes in tax and prudential provisions relating to superannuation. Some of these changes have been relatively minor or technical, but many have been substantive and have been perceived as such by superannuation funds and, when they have been aware of the changes, by the members of funds. …[1]

13.3 ASFA subsequently nominated a number of areas of complexity within the superannuation system. They include:

- the processing of transitional arrangements for older workers;
- changes to the preservation arrangements governing the age at which benefits can be accessed;
- changes to the type of investments a self managed fund can make;

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1 *Submission* 73, ASFA, p. 49.

- the tax and social security consequences of either cashing out, rolling over or purchasing a retirement income product with the benefit; and
- The layering of superannuation taxes, with two levels of taxation at the contributions level, taxes on fund earnings, and multiple rates applying to benefits depending on the age and other circumstances of the member. [2]

13.4 Dr Anderson from ASFA reiterated these concerns in relation to the continuing changing of superannuation legislation at the Canberra roundtable discussion on 8 October 2002:

> One of the things we suffer from all of the time is having a policy land on us, one that is usually rather piecemeal, and then having to look at how we can implement it. We can all think of several examples where the implementation has not been what the industry would have suggested and where, with more and earlier consultation about what the objective was, we probably could have got to a better outcome. I am worried that, with all the talk about simplifying, we will just continue to put little patches over the system—and that means patches over our systems—which are very costly. Putting it mildly, I am dismayed at the kinds of figures that funds give for implementation costs. So, yes, we need to get to simplicity, but government have to actually come to the party and tell us about the initiatives that they want to put in so we can suggest lower cost applications.[3]

13.5 The Committee notes that these views in relation to the real and perceived complexity of the legislative and regulatory superannuation arrangements were reiterated by IFSA in its written submission. IFSA noted:

> The overwhelming complexity, and persistent uncertainty, of the tax treatment of superannuation has significant impacts on confidence and behaviour. IFSA research, released at our 2001 Conference, found that legislative change was a major turn-off to discretionary superannuation. "The government keeps changing the superannuation rules, and will therefore probably continue to do so".[4]

13.6 The Committee also notes the evidence of the Australian Institute of Company Directors (AICD) that the complexity of the system engenders high compliance costs and reduced contributions:

> This complexity has reached the stage that relatively few practitioners are fully cognisant of the whole system's rules and regulations. This complexity acts as a disincentive for people to contribute beyond the required minimum levels.

2 *Submission* 73, ASFA, pp. 49-50.

3 *Committee Hansard*, 8 October 2002, pp. 727-728.

4 *Submission* 70, IFSA, p. 13.

> A complex system leads to high compliance costs. The compliance costs - other than those relating to prudential regulation and the protection of members' funds - should be minimal.[5]

Committee view – the legislative and regulatory framework

13.7 The Committee discusses elsewhere in this report the complexity of the three-tier superannuation tax regime, and the desirability of rationalising and simplifying the taxation arrangements. Clearly, as highlighted by the parties above, ongoing legislative amendments over the years, especially the increasing tax take out of superannuation, have contributed to reduce public confidence in the current superannuation arrangements.

13.8 The Committee accepts that this lack of confidence in the superannuation taxation arrangements, and expectations of further changes in the future, actively work to discourage individuals from contributing to superannuation beyond the required minimum levels.

13.9 The Committee made significant recommendations for change in the tax treatment of superannuation contributions and benefits in Part III – Equity. If implemented, these recommendations will produce a considerable simplification of the superannuation system.

'Grandfathering' arrangements

13.10 One of the principle causes of complexity in the current superannuation system is the grandfathering of the taxation provisions for superannuation when calculating superannuation entitlements.

13.11 Grandfathering refers to the continued application of superannuation taxation provisions from an earlier time period when calculating current superannuation entitlements, even though those provisions have since been superseded by changes to the legislative or regulatory superannuation framework. The objective is to ensure that no-one is disadvantaged retrospectively by a change to the legislative or regulatory superannuation framework.

13.12 In response to a request from the Committee for information on the 'grandfathering' arrangements for superannuation, the Committee received a supplementary written submission from the ATO in which it described in detail the grandfathered/sunset provisions relating to the taxation of eligible termination payment (ETPs). The ATO noted three important periods in the treatment of ETPs:

a) Pre-1 July 1983: only five per cent of certain lump sum benefits, including superannuation, were included in the recipient's assessable income and taxed at marginal rates.

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5 *Submission* 67, AICD, p. 5.

b) Post-30 June 1983: five per cent of the pre-July 1983 ETPs continued to be assessable at the taxpayer's marginal rate, and the post June 1983 component became fully assessable. The rate of tax payable on the fully assessable amount ranged from 30 per cent, depending on the source of the payment, the eligible service period, and the age of the recipient.

c) Post-30 June 1988: a tax on the earnings of superannuation funds was introduced. This tax meant that superannuation funds, Approved Deposit Funds and life organisations which had previously been virtually free from tax, would be taxed on their earnings. The rate was 15 per cent for funds which complied with the relevant legislation.[6]

13.13 Successive reasonable benefit limit (RBL) and preservation arrangements, which have also been 'grandfathered', add significantly to the complexity of superannuation.

13.14 The ATO's supplementary submission which contains additional details of the grandfathered/sunset provisions relating to the taxation of ETPs and provisions relating to the taxation treatment of RBLs, annuities and pensions is reproduced in **Appendix 13.**

13.15 In its written submission, ASFA noted that a significant source of complexity in the superannuation system is the different tax treatment of superannuation entitlements according to the time period for which the entitlement is attributable. ASFA cited the following examples:

> … under current arrangements benefits attributable to pre-1983 service will need to be separately identified by superannuation funds and employers until the last person with pre-1983 employment has retired or otherwise taken all their superannuation benefit. This may not occur until the year 2030 or even later. Similarly, superannuation funds need to identify for preservation purposes entitlements prior to certain dates so as to draw a distinction between preserved and non-preserved benefits. Again, while Treasury has estimated that the proportion of non-preserved benefits will fall to around 10 per cent of total superannuation assets by 2007 compared to around 65 per cent in 1995 (Rothman, 1997) it will be some decades before funds will be able to do away with this distinction.[7]

13.16 Given the complexity arising from grandfathering of different tax treatments of superannuation, ASFA suggested in its written submission a number of alternatives which would make a break with the past and be conducive to greater simplicity:

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6 *Submission* 148, ATO, Attachment C.

7 *Submission* 73, ASFA, p. 51.

a) A **sunset clause** provides a time limit for the further operation of a concession. This can allow orderly planning and fair treatment of persons close to retirement. The downside for individuals is that if they retire outside the time limit allowed then no concession at all is available. For instance, if a period of five or ten years starting in 2003 were set for access to superannuation benefits under the five per cent assessable arrangements, then those near retirement would not have their retirement arrangements unduly disturbed. Those losing the benefit of the concession would have little objective cause for concern given that it related to employment some 25 or more years earlier. Arguably, the current treatment of superannuation and other benefits even vaguely linked to pre-1983 employment goes beyond what equity strictly requires. Similarly, a sunset clause could apply to non-preserved superannuation benefits, with all benefits becoming preserved in, say, five year's time.

b) **Transition based on age or years until retirement** could work in a similar way. For those aged under 45 or 50, retirement is sufficiently far off that loss of the ability to access previously unpreserved benefits could not be seen as being an undue imposition. Similarly, for such individuals the loss of any pre-1983 employment related concessions in most cases will not involve any substantial amount. If the amount is more substantial then the overall superannuation benefit being received almost certainly will be substantial, with the individual having the capacity to pay a larger amount in benefit tax.

c) Another approach is to **calculate a value of tax benefits at the transition date** and for this to be carried forward in the personal records of the taxpayer, or perhaps recorded in the database used for assessing compliance with the RBLs. While maintaining the value of the concession in nominal terms (or indexed to inflation or average earnings if preferred), this would negate the need for funds to maintain separate records of pre-1983 service and would provide a more transparent valuation of the concession for the individuals concerned. It also would stop the concession flowing to benefits attributable to employment after the transition date, as is often the case to some extent at the moment.

d) **Payment of the accrued tax liability associated with any previously grandfathered concession** as at the transition date also would simplify future record keeping while capping the value of the concession provided. It also would have the advantage, at least from the point of the view of the government, of bringing forward the collection of tax revenues. This might be particularly important if other changes made by the government led to lower tax collections in the immediate future.

e) **Paying a bonus or providing a tax benefit** is an option that may need to be considered if there were a shift from the current system where there is tax on contributions and fund earnings to one where tax was paid only when benefits were received. If grandfathering were to be avoided, allowance would need to be made when benefits were paid under the new arrangements for tax paid on contributions and fund earnings in the period 1988 to the date of implementation of the new arrangements.[8]

13.17 Similar to ASFA, the Australian Bankers' Association (ABA) also proposed in its written submission a number of measures to end grandfathering in conjunction with a shift in taxation of superannuation to the benefit stage. These included:

a) **Sunsetting** — setting a date after which the concessions involved can no longer be claimed. If this were set liberally e.g. five to seven years from announcement, any 'rough justice' would generally be minor and could be ignored or dealt with by exception; and

b) **An age–related cutoff** — removing these concessions for those below a certain age (e.g. 50 years), chosen to be a reasonable number of years of age ahead of the typical retirement age (now around 58 for males).[9]

13.18 However, the ABA argued that these two options do not appear to be suitable for avoiding new grandfathering if taxation of super were to be moved to the 'back end' of the system, as advocated by the ABA. The ABA argued that it would be punitive to apply normal income tax to benefits derived from contributions on which tax had already been paid at the 'front-end' (as well as on earnings along the way), so some transitional provisions would be necessary. Accordingly, the ABA favoured 'crystallising' benefits and crediting them to those concerned, so that grandfathering does not otherwise have to be carried forward in the system. The ABA proposed the following methods to do this:

a) determining for every fund member the value of **tax concession/adjustment entitlements as at a certain date**, and carrying these amounts forward to be applied to their assessment when benefits are ultimately drawn; or

b) determining the member's **tax liability at a certain date**, taking account of grandfathered concessions (i.e. as if their accumulated benefit were drawn at that date) *and paying that liability to government* — possibly in instalments over a (somewhat) extended

8 *Submission* 73, ASFA, pp. 51-52.

9 *Submission* 51, ABA, p. 25.

> period. The new tax system would then apply cleanly to benefits accumulating from contributions after the set date.[10]

13.19 Subsequently, the ABA argued in its written submission that these options to 'crystalise' benefits and credit them to those concerned would lead to tax liabilities for those affected of at least several billion dollars. The ABA suggested that these crystallised amounts could be paid to the Government by superannuation funds over (say) 3–5 years, considerably easing the short–term Budget impacts. The ABA continued:

> ABA is not in a position to provide detailed modelling of the short– and long–term Budget (and other) impacts of such proposals, but estimates of the impacts of specific alternatives could readily be undertaken by the Retirement Income Modelling Unit. Sufficient work has already been done by other experts, however, to demonstrate that substantial simplification by crystallising and ending grandfathering is not 'too hard'; and the short–term Budget impacts can be effectively managed.[11]

13.20 In addition to this evidence from the ABA and ASFA on grandfathering, the Committee notes that IFSA also argued in its written submission for reform of the current grandfathering provisions within the superannuation system:

> There is considerable merit in the idea to remove the daunting complexity, which persists in superannuation because of the grandfathering provisions on earlier concessional treatments. This is an idea that would require much further work, but one worth exploring. For instance, the previous concessional treatment available to an individual could be calculated at a point in time, appropriately indexed to retirement, and retained via a central system such as the RBL system maintained by the ATO. As superannuation funds have at best partial information, it is not sensible or cost-effective to manage this information via funds' member records.[12]

13.21 Mr Stanhope from IFSA reiterated this position at the Canberra roundtable discussion on 8 October 2002:

> I do not know whether you want to take it further but I think there is considerable merit in talking about the possibility of rolling up some of the taxation arrangements and some of the grandfathering. Even if we were not talking about a change in where the tax occurs, if we were to roll up the concessional amounts, fix them and carry them forward in some way, we would simplify the system quite dramatically.[13]

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10 *Submission* 51, ABA, p. 25.

11 *Submission* 51, ABA, pp. 25-26.

12 *Submission* 70, IFSA, p. 13.

13 *Committee Hansard*, 8 October 2002, pp. 725-726.

13.22 The Committee also notes the evidence of Dr FitzGerald during the Canberra roundtable discussion on 8 October 2002 in relation to a transition date for determining the member's tax liability at a certain date, taking account of grandfathered concessions (i.e. as if their accumulated benefit were drawn at that date):

> The proposal that I think holds most promise is … having the assessed tax or part of the assessed tax that would be payable to consolidated revenue as of a certain date, if you were notionally to take all of your benefits out under the old rules at that date, paid in instalments to the budget over the transition period or over a reasonable period of time. This would if not entirely then at least substantially ameliorate the effect on the budget deficit as currently viewed—this is rather a narrow view anyway, since it does not really take a long enough view of the consequences of tax changes of this sort.[14]

13.23 The Committee subsequently raised the difficulty of drawing a so-called 'line in the sand', especially as relates to retrenchment benefits, retirement benefits and so on. In response, Mr Stanhope from IFSA noted that for accumulation funds, it would not be a particularly difficult thing, and that difficulties would only arise in relation to non-accumulation funds. Similarly, Dr FitzGerald commented:

> … doing the calculations is tricky, but that is essentially only for defined benefit funds. Since they are a threatened species outside the public sector, if not already extinct in many parts of the economy, you would think that with cooperation among the governments—who mainly have the schemes where these sorts of complexities arise—you could find solutions in that area and marginalise the remaining areas of problems to a fairly small margin.[15]

Committee view – grandfathering arrangements

13.24 The Committee notes that there are many different 'grandfathered' and sunset provisions applying to ETPs, RBLs, and preservation and that a variety of taxation arrangements apply to annuities and pensions. The Committee accepts that the current 'grandfathering' of different tax treatments of superannuation when calculating benefit entitlements has made the superannuation system significantly more complex for older workers. At present, as an example, the benefits available to fund members with superannuation funds predating the legislative changes of 1983 need to be recalculated on a daily basis to take into account the changing proportion of their superannuation predating 1983.

13.25 The Committee considers that the desire to ensure that changes have no detrimental impact on individuals through the introduction of open-ended 'grandfathering' arrangements has been extensive in Australia in the past, and that this has added to the complexity of superannuation. However, all tax systems must

14 *Committee Hansard*, 8 October 2002, pp. 695.

15 *Committee Hansard*, 8 October 2002, p. 726.

balance the competing goals of simplicity and equity, and it would undermine the confidence that Australians have in the superannuation system if retrospective changes were made to the detriment of fund members.

13.26 The Committee notes the suggestion made by Dr FizGerald, together with ASFA and the ABA, to determine a superannuation fund member's tax liability at a certain date, taking account of grandfathering concessions (i.e. as if their accumulated benefits were drawn at that date) and paying that liability to the Government – possibly in instalment over a (somewhat) extended period. Under this suggestion, the new tax system would then apply cleanly to benefits accumulating from contributions after the set date - this 'crystallising' of benefits and crediting them to those concerned at a particular date could address the problems created by the large number of 'grandfathered' provisions.

13.27 The Committee notes that under this suggestion, the Government could, as an example, select 30 June 2005 as the transition date for accumulation funds. At that date, the balance of superannuation funds by an individual could be calculated similar to the calculation of the benefit available to a retiree, with subsequent taxation arrangements going forward simply applied to the balance of the fund at 30 June 2005. The Committee notes the evidence of Dr FitzGerald that different arrangements would need to be considered for those in defined benefit schemes.

The work test for making voluntary contributions

13.28 An additional complexity in the superannuation system drawn to the attention of the Committee during the inquiry is the complex arrangements governing who can make a contribution to a superannuation fund. In its written submission, ASFA noted that currently, superannuation contributions are restricted to:

- those who are in the paid labour force;
- those who were in the paid labour force in the last two years;
- those who have been on maternity leave but were employed in the last seven years;
- those with a spouse of the opposite sex who can make contributions on their behalf or whose superannuation entitlement is transferred in part at the time of divorce or separation; and
- some individuals who have reached aged 65 but are still in employment and wish to have contributions made, with amendments to the SIS Regulations and consequential changes to tax legislation to extend this to individuals aged over 70.[16]

13.29 In addition, ASFA noted that the government is also proposing to extend the ability to establish a superannuation account and make contributions to:

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16 *Submission* 73, ASFA, pp. 52-53.

- relatives and friends of children making contributions into accounts established by a parent of guardian for a child; and
- single mothers and those in same sex relationships (presumably recipients of artificial insemination) who do not have a link to the paid labour force but have received the Baby Bonus in the previous twelve months (spouse contributions would be available if there were an opposite sex spouse present).[17]

13.30 However, ASFA argued in its written submission that the work test for making voluntary contributions should be removed in the interests of simplicity:

> While a link with employment has traditionally been part of superannuation, the introduction of spouse contributions and the more recent provisions relating to children and recipients of the Baby Bonus have placed greater emphasis on retirement income provision rather than employment. As well, the introduction of compulsory splitting in certain circumstances of superannuation account balances or benefits as proposed by recently introduced amendments to the Family Law Act and the Superannuation Industry Supervision Act further breaks the link between employment and the ability to have contributions made.
>
> It could be argued that the occupational link for superannuation is in such disarray that the pretence of maintaining it should be abandoned. Allowing any individual who is in receipt of taxable income to participate in the accumulation phase of superannuation, subject to the age limits and appropriate reasonable benefit limits that apply to other contributors, would both reduce the complexity of current arrangements and improve adequacy. The revenue costs would be very minor because only a relative few with the capacity to contribute now fall outside the current convoluted criteria. Requirements related to involvement in the labour force are confusing and difficult for both members and funds, and increasingly are becoming less relevant in a public policy context.[18]

13.31 The Committee notes that this issue was raised by a number of other parties in their written submissions, including the ABA,[19] the CPA Australia and IFSA. For example, CPA observed in its written submission:

> The employment link with superannuation should be reviewed in order to assess its continued relevance and appropriateness in a society that has seen far reaching changes to demographic and working patterns. The employment nexus of superannuation is gradually being removed with the introduction of spouse contributions, the splitting of superannuation benefits under the Family Law Act reforms and the proposals relating to splitting of contributions and child superannuation.

17 *Submission* 73, ASFA, pp. 52-53.

18 *Submission* 73, ASFA, p. 53.

19 *Submission* 51, ABA, p. 26.

> CPA Australia considers that the rules that apply to contributions made to superannuation for under 65s should be removed. In this regard there would be no barriers to making contributions to superannuation. There should no longer be a requirement for an employment nexus for the receipt of superannuation contributions by a superannuation fund where the member is under 65.[20]

13.32 Similarly, in its written submission, IFSA noted:

> It seems very few people are now unable to make personal contributions to superannuation, though among these there may be significant groups excluded more by omission than conscious policy. Further expansion of the categories of people able to make contributions in the 2002 Budget heightens the issue.
>
> Rather than stating who may not contribute, superannuation regulations contain multiple categories of people who can. This seems to result in complicated systems and costly administrative processes, all of which come at cost to fund members saving for their retirement. All can be traced to the original employment nature of superannuation – the employment nexus.
>
> The obvious and simple solution – to remove the employment nexus from personal superannuation contributions – warrants exploration. It would not be difficult to assess who would benefit, who (if anyone) might lose, and to scope the costs and benefits to superannuation fund members, superannuation funds, and retirees. Assessing Commonwealth fiscal cost and benefit might be more involved, but it would allow reasoned consideration of the issue.[21]

13.33 The Committee also notes that this issue was raised at the Canberra roundtable discussion on 8 October 2002. For example, Mr Stanhope from IFSA stated:

> Other suggestions made in our submission were to remove the vast number of categories of people who are not in employment who can contribute. That would leave us with deductible contributions from the employer, deductible contributions from the self-employed and voluntary contributions. A world in which there are only three categories of superannuation contribution would be simpler than the one that we have.[22]

13.34 Similarly, Ms Doyle from AMP stated at the Canberra roundtable discussion on 8 October 2002:

> From the trustee’s perspective, if we could remove the work test for voluntary contributions, that would add to simplicity. We were talking today about adequacy, and we touched on the third pillar as being very important, particularly for baby boomers going forward. So we are looking at personal

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20 *Submission* 43, CPA, pp. 7-8.

21 *Submission* 70, IFSA, p. 14.

22 *Committee Hansard*, 8 October 2002, p. 726.

> contributions there. At the moment we have a work related test in order to make those voluntary contributions. If we could remove that test and make it such that anyone can make a superannuation contribution voluntarily, that would help not only from the individual's point of view but also from the trustee's point of view in being responsible for asking, 'Are you actually eligible to make these contributions?' We are putting more pressure on trustees, and that adds to the whole complexity from their point of view and it costs.[23]

Committee view – the work test for making voluntary contributions

13.35 The Committee accepts that work test for making voluntary contributions has added unnecessarily to the complexity of superannuation. The Committee supports the removal of this test.

13.36 The Committee considers that allowing any individual who is in receipt of taxable income to participate in the accumulation phase of superannuation, subject to the age limits and appropriate RBLs that apply to other contributors, would both reduce the complexity of current arrangements and improve adequacy.

Account consolidation

13.37 The Committee notes that the average employee already has three superannuation accounts. In addition, there is currently around \$6.8 billion, or an average of \$1,600 per person, waiting to be claimed in 'lost' superannuation.

13.38 Given this proliferation of accounts and lost superannuation, DOFA argued in its written submission to the inquiry for reform of choice and portability arrangements:

> Compulsory superannuation, without associated reforms to choice and portability, has increased the number of small superannuation accounts. For example, at end-December 2001, industry superannuation funds held only 8.9 per cent of total superannuation sector assets but had 30.2 per cent of all superannuation accounts (APRA 2002). Superannuation assets per account in industry funds averaged only \$6,580.
>
> Other things being equal, the greater the number of small accounts held by an individual, the greater the likelihood that these savings will be dissipated at the benefits stage. Choice and portability reforms, when implemented, have the potential to address this risk if employees take up opportunities to consolidate their superannuation accounts. However, it would also depend upon the extent to which these reforms are available to individuals.[24]

13.39 Similarly, in his evidence to the Committee on 8 October 2002, Mr Luke, Chief Executive Officer of Sunsuper, commented:

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23 *Committee Hansard*, 8 October 2002, p. 730.

24 *Submission* 89, DoFA, p. 15.

> We really need to do something about account consolidation, which we talked about before. The fact that people have four or 10 accounts when they are 17 is inefficient and it costs a lot of the money for the system overall. Someone pays for those inefficiencies, so we have to do something to encourage people. For people who have been working in the system for a number of years to have member benefit protection does not make any sense at all. There has to be a time when they do not get it any more or there is some form of forced consolidation. Perhaps that is the way it needs to be done.[25]

13.40 The Committee also notes the written submission of Mr Bob Stephens, Chief Executive Officer of Host Super, that the resources used to operate the Superannuation Holding Account Reserve and Lost Members Register with the ATO could be better used to fund an independent account consolidation service. Mr Stephens suggested that Tax File Numbers are an obvious central identification tool.[26]

13.41 ASFA also advocated in its supplementary written submission more effective and efficient mechanisms for dealing with small superannuation payments and their consolidation.[27] Indeed, Mr/s Sasha Vidler, who made a private submission to the inquiry, advocated fines for funds that do not force consolidation of accounts (presumably within the one fund).[28]

Committee view – account consolidation

13.42 The Committee notes that the Government has recently introduced its choice of fund bill, the Superannuation Legislation Amendment (Choice of Superannuation Funds) Bill 2002, and has also released its portability proposals in a discussion paper.[29] The Committee considers that, together, successful implementation of choice and portability may facilitate consolidation of superannuation accounts, however significant barriers to effective consolidation remain, including substantial entry and exit fees in some funds.

13.43 In its report on the Choice of Superannuation Funds Bill,[30] tabled on 12 November 2002, the Committee noted that a considerable proportion of fund members are already able to consolidate their superannuation accounts but don't because of the paperwork involved and/or the exit fees levied on them. The Committee also noted that, as part of the 'Unclaimed Super Recovery Initiative', launched by the Government in October 2002, a number of members have been reunited with their

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25 *Committee Hansard*, 8 October 2002, p. 731.

26 *Submission* 101, Mr Bob Stephens, p. 2.

27 *Submission* 108, ASFA, p. 20.

28 *Submission* 71, Mr/s Sasha Vidler, p. 11.

29 *Portability of Superannuation Benefits, Enhancing the Right of Members to Move Existing Benefits Between Superannuation Entities*, Consultation Paper, September 2002.

30 Senate Select Committee on Superannuation, *Provisions of the Superannuation Legislation Amendment (Choice of Superannuation Funds) Bill 2002*, November 2002.

'lost' or 'inactive' accounts. With over $6.8 billion in 'lost' accounts, and an average of $1,600 per account, this important initiative is an encouraging step towards reuniting some 2.7 million Australians with their accounts. The Committee notes that $4.7 million was recovered in the first week of the initiative.

Education

13.44 The Committee notes concerns that the general Australian population lacks sufficient education to make informed decisions in relation to the management of their superannuation.

13.45 For example, in its written submission, IFSA noted that its research, and a wide range of other research, highlights an evident gap in people's knowledge and awareness about saving, superannuation and investment generally. IFSA continued:

> This gap could be addressed by a well targeted campaign to educate people about retirement saving at points in their lives when they would be most likely to absorb, and possibly respond, to new information and understanding. IFSA has long supported the development of measures to help grow a savings culture in Australia.
>
> A well-constructed and targeted education program on these issues could only assist in improving voluntary savings for retirement.[31]

13.46 In relation to a Government-sponsored superannuation education program, the Committee notes the written submission from Mr Bob Stephens, Chief Executive Officer of Host Super. He noted that:

> The development and implementation of a comprehensive education programme should be a key objective. While such a strategy requires industry participation, the central focus must lie with the Government to ensure that is aimed at providing a genuine increase in understanding, not increasing sales.[32]

13.47 In response to this issue, FACS highlighted in its written submission that it provides free information through a number of means:

- a series of information publications for retirees and pre-retirees. The department works with industry bodies, other agencies and community groups in producing these publications;
- the National Information Centre on Retirement Investments Inc (NICRI). NICRI is an independent body funded by the Commonwealth Government to provide the public with free information on these issues; and

31 *Submission* 70, IFSA, p. 20.

32 *Submission* 101, Mr Bob Stephens, p. 1.

- the Financial Information Service provided by specialist Centrelink officers.[33]

Committee view - education

13.48 In the Committee's opinion, there is clearly a critical need to educate the public on the benefits of superannuation, and the level of incomes they can realistically expect in retirement. In many cases, the Committee notes, individuals may hold unrealistic expectations of the income that will be available to them from superannuation in retirement.

13.49 The Committee notes the evidence of FACS in its written submission that it already provides free information to superannuation fund members through a number of means. In addition, the Committee also notes that as part of the current choice bill before the Parliament, the Government has committed $28.7 million over four years to an education program to inform employers and employees of their rights and obligations under a choice superannuation environment. The Committee notes that $14 million will be spent on education and communication, with the rest allocated to administration and infrastructure within the ATO.

13.50 The Committee welcomes this initiative, together with ASIC's *Consumer Education Strategy 2001-2004*, which includes a commitment to a financial literacy in schools project, to encourage the provision of financial education to children and teenagers through school education.

13.51 However, while the Committee acknowledges that there is a great deal of good work already being done, the Committee considers that there should be more resources allocated by Government agencies to assist people to prepare for retirement. Such resources should be directed towards those still in employment and better means of delivery should be developed.

Recommendation

13.52 **The Committee recommends that more resources be allocated by Government agencies to assist people to prepare for retirement.**

Overall conclusions - simplicity

13.53 The Committee accepts that there are some real and perceived complexities in Australia's superannuation system which need to be addressed in order to streamline the operation of the system and improve individual's understanding of their entitlements.

13.54 Some of these complexities include:

- the ongoing amendments to the legislative framework, specifically relating to transitional arrangements for older workers, the preservation age of benefits, and

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33 *Submission* 79, FACS, p. 17.

the tax and social security consequences of either cashing out, rolling over or purchasing a retirement income product;

- the ‘grandfathering’ of taxation provisions for superannuation when calculating superannuation entitlements;
- the arrangements governing who could make a contribution to a superannuation fund (i.e. the work test for making voluntary contributions);
- the proliferation and loss of monies in superannuation fund accounts; and
- the lack of understanding of superannuation in the Australian population generally.

Recommendation

13.55 **The Committee recommends that the Government consider the matters raised in this report in order to identify ways to make the superannuation system less complex and more comprehensible to the Australian people.**

13.56 The Committee considers that the implementation of its major recommendations in Part III – Equity, together with the suggestions for simplifying the system in Part IV – Simplicity, would significantly reduce the complexity of the superannuation system, enhance member understanding, and assist with the efficient administration of superannuation funds.

PART VI – OTHER ISSUES

This Part addresses a number of other issues which were raised during the inquiry, which could have the potential to affect the adequacy of retirement incomes. These include other savings vehicles, the indexation of Commonwealth superannuation pensions, and the Australian Prudential Regulation Authority's powers to ensure the safety of superannuation.

Chapter 14

Other Issues

Introduction

14.1 During the inquiry a number of other issues were raised which could have the potential to affect the adequacy of retirement incomes. In addition, the adequacy of the Australian Prudential Regulation Authority's (APRA's) regulatory powers, were also raised.

14.2 This chapter therefore examines:

- other savings vehicles;
- the indexation of Commonwealth superannuation pensions; and
- APRA's powers.

Other savings vehicles

14.3 The Committee was informed during the inquiry that superannuation is the only tax effective long-term savings vehicle that exists in Australia. Some of the evidence, for example from Dr Vince FitzGerald, called for additional savings to be directed into areas such as health, education, or even in raising the deposit on a home. In the context of deciding not to recommend the use of superannuation savings in either health or any of the other areas, the Committee was interested to look at the potential for new purpose built tax effective savings vehicles to fill any identified gap. Some detail of the current tax treatment of savings vehicles in Australia is contained in **Appendix 14.**

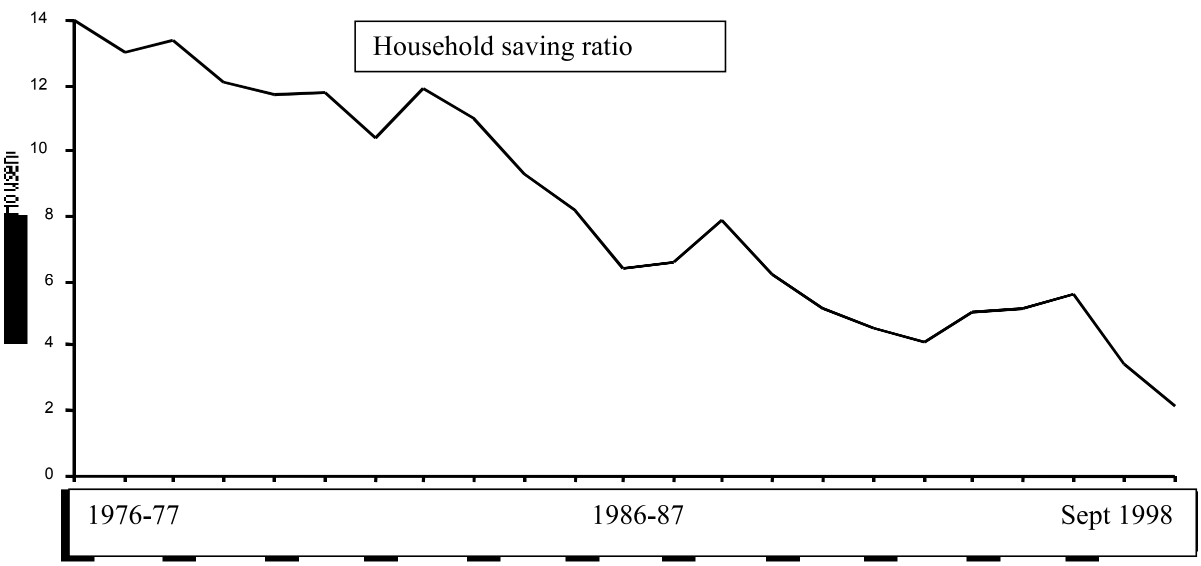
14.4 Dr FitzGerald put the issue of superannuation savings and non-superannuation savings into context in the following extract from his March 1999 paper *Refocussing and Reinvigorating Retirement Policy – A Stocktake and Suggested Agenda for Advance*:

> …it is important to place superannuation policy in the wider context of what is happening to total saving. For example, if people are responding to the requirement to contribute a minimum amount to superannuation by holding lower savings in other forms, and by carrying more debt until retirement, then at least part of the aims of compulsory provision will be nullified. On retirement, part of a superannuation benefit may simply go to reduce debt—and the balance, plus net other saving, may reflect little net effect from the Superannuation Guarantee policy.
>
> Unfortunately, despite what has been occurring in superannuation, private saving has weakened markedly over the late 1990s. The positive effect of increased compulsory superannuation has been more than offset by the

> cumulative effects of financial deregulation and, especially, the low inflation and low nominal interest rate environment of the mid/late 1990s.
>
> Australians now have much easier access to credit than ever before and the cost of servicing debt is at historically low levels. Australians are enthusiastically spending rather than saving—indeed around the later months of 1998 and running into the early months of 1999, there has been little short of a 'mini boom' in consumer spending. Where is that spending coming from? Australian households first significantly increased borrowing secured against housing over the mid 1990s; and then, more recently, have rapidly increased the use of other credit at about 18 per cent per annum (albeit on a base considerably smaller than housing debt[1]). Household debt has in just 5 years risen from under 50 per cent of disposable income to over 75 per cent (although interest costs have stayed around 8 per cent of income).[2]

14.5 According to Dr FitzGerald, the result is that the net proportion of household current disposable income being saved, *including via superannuation*, is down to just 2–3 per cent, which is an extraordinarily low figure historically. This is shown in **Chart 14.1** below.

Chart 14.1 Australia's household savings rate



Note: annual data except for September quarter 1998.

Source: ABS, cited in V.W.FitzGerald, *Refocussing and Reinvigorating Retirement Policy – A Stocktake and Suggested Agenda for Advance*, March 1999.

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1 Total household debt is now approximately $370 billion, of which $215 million is housing debt, whose growth has slowed to under 10 per cent per annum over the past two years. Other debt (including e.g. credit card debt) has at the same time accelerated, rising by 18 per cent over the latest year.

2 V.W.FitzGerald, *Refocussing and Reinvigorating Retirement Policy – A Stocktake and Suggested Agenda for Advance*, March 1999, p 12.

14.6 A number of submissions sought the introduction of a new tax advantaged medium to long-term savings vehicle to complement the current superannuation arrangements. For example, IFSA submitted that, while it supports the development of a simple, transparent long-term savings vehicle with tax benefits (in timing and possible final level of tax payable) as an adjunct to superannuation:

> Superannuation, particularly since the 1999 preservation rules, locks up money for retirement that individuals and families might require earlier access to. Insurance bonds currently provide for medium/long-terms savings, however the tax payable on these can be difficult for individuals to assess, particularly so for periods less than 10 years. At present, re-draw mortgages and re-gearing of housing equity appear to provide the only simple, tax-effective vehicle for such saving.
>
> IFSA research,[3] with a number of other studies, shows Australians are saving for their retirement outside as well as inside superannuation. A significant reason for this is that superannuation is preserved for a longer period and as such is less useful to individuals and families who need medium to long-term savings for other lifecycle needs, such as reduced employment income and higher costs in parenting, or unexpected loss of employment.
>
> A medium/long-term savings vehicle, based on managed investments principles, could easily be structured so that the tax differences were only in timing, and also allow a fiscal benefit to government from compounding investment earnings. Such a vehicle would contribute to a savings culture, as people could see more immediate outcomes for their savings decisions.[4]

14.7 The Financial Planning Association (FPA) raised in its written submission the need for new medium-term savings vehicle in the context of superannuation adequacy and debt levels as follows:

> … the current policy intent of making super a tax preferred vehicle for people to fund their retirement is being compromised by the application of super monies by those reaching retirement into funding debt accumulated prior to retirement.
>
> An ASFA report in 2001 showed that the main perceived disadvantage of super was the lack of accessibility to the money.[5] The latest ING - Melbourne Institute Household Savings Report also shows that potential future changes to tax law and government rules about when the money could be accessed was one of the main reasons people did not contribute to super. The report further illustrated that instead, many people would use

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3 IFSA, *Retirement Savings – Desires and Drivers Qualitative Report.*

4 Submission 70, IFSA, p. 20.

5 ASFA 2001 Conference in Cairns, "It's time for a retirement reality check", Rod Cameron, ANOP Research Services Ltd.

> that money to fund other lifestyle choices, such as education and mortgages.[6]
>
> Hence a gap exists in the national savings policy for a tax preferred medium-term savings vehicle. This vehicle would provide an incentive for individuals to fund large lifestyle expenditure items though equity rather than debt. This in turn would result in superannuation funds being used to fund retirement, hence improving the adequacy of the current system.[7]

14.8 The Committee notes that at a colloquium of superannuation researchers at the University of New South Wales, Mr Ross Clare from ASFA was somewhat critical of Treasury's line on household savings at the time. In commenting on the Spring 1999 Treasury Economic Round-Up Supplement, Mr Clare suggested that the Round-Up Supplement appeared to set out to demonstrate that household savings had not really declined, but that if they had, then 'it does not matter much'. While stating that the Round-Up Supplement contained a variety of useful material, which made it clear that some caution is needed in interpreting developments in national accounts measures of savings, Mr Clare interpreted this approach as a rather weak excuse.[8]

Committee view – other savings vehicles

14.9 The Committee notes the evidence from the savings and investment community proposing the introduction of a new medium to long-term savings vehicle to complement the superannuation arrangements. In this context the Committee is concerned about Australia's historically low, and declining, level of household savings.

14.10 The Committee is also aware that there have been sustained calls, which have accelerated since the early 1990s, to use compulsory superannuation savings for other purposes. These purposes include health, housing, education and unemployment.

14.11 The Committee has noted in Part II of this report that the current nine per cent Superannuation Guarantee (SG) system is unlikely to meet the retirement income needs of most Australians. Accordingly the Committee has not recommended access to the current level of superannuation savings for non-retirement purposes. Having said that, however, the Committee considers that the introduction of a tax preferred medium to long-term savings vehicle which could be accessed prior to retirement for purposes such as:

- health;
- savings for a home deposit; and

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6 ING, Melbourne Institute Household Saving Report, March Quarter 2002.

7 *Submission* 44, FPA, p. 8.

8 Ross Clare, Principal Researcher, ASFA, *National Household savings over the last decade,* paper presented at the Eight Annual Colloquium of Superannuation Researchers, University of New South Wales, July 2000.

- education

should be examined by the Government as means of increasing national savings and reducing the temptation for people to accumulate debt which is repaid with superannuation on retirement. The Committee also notes that access to additional savings for education may also assist older workers in retraining or gaining new or updated skills to stay relevant to the workforce and to stay in work for longer periods. If so the result would be higher superannuation savings and shorter periods of retirement.

14.12 The Committee emphasises that superannuation is an investment for the long term, that is, in excess of 30 years. While tax concessions assist in providing for retirement, other arrangements would need to be in place for those without a full working life, or those seeking to access superannuation funds for other purposes.

Recommendation

14.13 **The Committee recommends that, as means of increasing national savings and reducing the temptation for people to accumulate debt which is repaid with superannuation on retirement, the Government examine the introduction of a tax preferred medium to long-term savings vehicle which could be accessed prior to retirement for purposes such as:**

- **health;**
- **savings for a home deposit; and**
- **education.**

Indexation of Commonwealth superannuation pensions

14.14 In 2001, the former Senate Select Committee on Superannuation and Financial Services, presented a report on the benefit design of Commonwealth public sector and defence force unfunded superannuation funds and schemes. The report was entitled, *A Reasonable and secure retirement*? In that report, the Committee drew attention to the need to examine the feasibility of adopting an indexation method other than the CPI for Commonwealth public sector and defence force superannuation schemes, to more adequately reflect the actual increases in the cost of living.

14.15 During that inquiry, the Committee was advised that the CPI is not a measure of the cost of living and its application to Commonwealth public sector and defence force superannuation pensions has not enabled Commonwealth and defence force superannuants to maintain parity with living standards in the community. The majority of evidence to that inquiry suggested that the application of AWOTE or the CPI, whichever is the greater, would deliver a more reasonable standard of living in retirement.

14.16 The issue of the indexation arrangements applying to Commonwealth public sector superannuation pensions was raised again during the current inquiry. Organisations such as the Australian Council of Public Sector Retiree Organisations (ACPSRO) and the Superannuated Commonwealth Officers' Association (SCOA) advised the Committee that their members' living standards had been eroded through the use of the CPI, rather than a wage-based index such as AWOTE or Male Total Average Weekly Earnings (MTAWE).

14.17 The Association of Independent Retirees (AIR) also pointed out that the benefits of Commonwealth public sector and defence force retirees have 'significantly lost relativity with those at equivalent levels retiring now.' For this reason, the Association supported changes to the indexation arrangements for Commonwealth public sector and defence force retirees, to more adequately reflect the actual increases in the cost of living.[9]

14.18 In its written submission to the inquiry, ACPSRO submitted that it was convinced that changing the indexation to CPI/MTAWE, whichever is the higher, is 'entirely manageable', and that, according to the Commonwealth actuary, in the long term, 'is not a matter for concern'. One of the reasons for this, according to the Commonwealth actuary, is that the Commonwealth's liabilities in respect of defined benefit schemes are diminishing significantly when expressed as a percentage of Gross Domestic Product.[10]

14.19 According to Mr Johnson from ACPSRO, at 30 June 2001, there were 116,000-plus Commonwealth Superannuation Scheme (CSS) and Public Sector Superannuation (PSS) pensioners of whom 62 per cent receive $20,000 per annum or less; while of the 57,500 military superannuants, 80 per cent receive $20,000 per annum or less.[11]

14.20 In answer to a Question on Notice from Senator Sherry, tabled on 14 March 2002, the Minister for Finance and Administration, Senator Minchin, provided costings from the Department of Finance and Administration for a change to indexation of Commonwealth superannuation pensions using AWOTE. These are cited in **Table 14.2** below.

Table 14.2: Costing of the indexation of Commonwealth superannuation pensions using AWOTE

	2002-03 ($m)	2003-04 ($m)	2004-05 ($m)
Fiscal balance	**-605**	**-595**	**-630**
Underlying cash	**-25**	**-65**	**-105**
Operating balance	**-7,505**	**-595**	**-630**

Source: Answer to Question on Notice, Senate, 14 March 2002

14.21 The Minister also provided costings for a change to indexation of Commonwealth superannuation pensions using male total average weekly earnings (MTAWE). These are cited in **Table 14.3** below.

9 *Submission* 16, AIR, p. 6.

10 *Submission* 66, ACPSRO, pp. 3, 14-15.

11 *Committee Hansard*, 1 July 2002, p. 60.

Table 14.3: Costing of the indexation of Commonwealth superannuation pensions using MTAWE

	2002-03 ($m)	2003-04 ($m)	2004-05 ($m)
Fiscal balance	**-370**	**-365**	**-385**
Underlying cash	**-20**	**-45**	**-70**
Operating balance	**-4,670**	**-365**	**-385**

Source: Answer to Question on Notice, Senate, 14 March 2002

14.22 In a report commissioned by the SCOA on the *Impact of indexation change on the Commonwealth's superannuation schemes*, NATSEM found that, although the introduction of a superannuation indexation based on earning growth rather than CPI will increase Budget outlays, a large proportion of these outlays (between 37-58 per cent) will be returned to government through reduced age pension outlays, increased income taxation and greater GST receipts.[12] **Table 14.4** below demonstrates the effect on Budget outlays and clawback.

Table 14.4: Impact on Budget outlays and clawback, various years

	2002-03 $m	**2003-04 $m**	**2004-05 $m**
DOFA underlying cash	-25	-65	-105
Upper clawback	15	38	61
Typical clawback	9	24	39
SCOA underlying cash – upper	-10	-27	-44
SCOA underlying cash – typical	-16	-41	-66

Source: NATSEM, *Impact of indexation change on the Commonwealth's superannuation schemes,* Report for the Superannuated Commonwealth Officers' Association, 23 August 2002, p.5.

14.23 The Committee requested the Department of Finance and Administration (DOFA) to evaluate the NATSEM report. In response to this request, DOFA questioned in its supplementary written submission the validity of the clawback approach adopted by NATSEM, indicating that it was not the usual practice of the Department to make an allowance for second order effects, such as future reduced social security payments and increased taxation revenue, when preparing cost estimates for policy proposals.

14.24 Further, DOFA advised:

> Even if a reliable clawback estimate could be produced, the net financial impact of a change in indexation could still be expected to be very large when the cumulative impact is taken into account.[13]

12 NATSEM, *Impact of indexation change on the Commonwealth's superannuation schemes,* Report for the Superannuated Commonwealth Officers' Association, 23 August 2002, p. 6.

13 *Submission* 143, DOFA, p. 2.

Committee view – indexation of Commonwealth superannuation pensions

14.25 The Committee notes the evidence it has seen, in both the current and previous inquiries, that Commonwealth public sector and defence force superannuants are having their living standards eroded through the use of the CPI alone, rather than the higher of the CPI or a wage-based index such as AWOTE or MTAWE.

14.26 The Committee notes that the Reserve Bank of Australia's Officers Superannuation Fund Board of Trustees has recently reviewed the method of indexing the pensions of its members, and that the RBA has changed from an annual indexation linked to the CPI to half-yearly indexation based on the change in MTAWE. The Committee commends the RBA on this initiative.

14.27 The Committee notes the advice from DOFA that there are difficulties in quantifying for the clawbacks expected to be derived from the NATSEM figures. However, the Committee considers that under favourable fiscal conditions the cost of such a change could be absorbed.

Recommendation

14.28 **The Committee recommends that the Government consider indexing Commonwealth funded superannuation benefits to Male Total Average Weekly Earnings (MTAWE) or the Consumer Price Index (CPI), whichever is the higher, in order that recipients share in the increases in living standards enjoyed by the wider community.**

14.29 Related to this issue, the Committee acknowledges the dichotomy which exists between the closed public sector and defence force schemes, and those which remain open. The former have their preserved benefits linked to the fund earning rate, while the latter are linked to the CPI. The Committee considers that deferred beneficiaries of Commonwealth public sector and defence force schemes should be able to share in the growth of the fund in the same way as the beneficiaries of the closed schemes.

APRA's powers

14.30 During the inquiry a number of issues relating to the safety of small superannuation funds and the supervisory role of the regulator, APRA, came to the Committee's attention.

14.31 Mr Graeme Thompson, Chief Executive Officer of APRA, during an interview on *Business Sunday* on 7 July 2002, said that APRA had been stepping up the intensity of its supervision of superannuation, had visited every fund and completed a risk assessment of each of the 3,000 or so funds that it regulates. Of these, according to Mr Thompson, about 150 funds were rated as being 'high risk' and these were under close supervision by APRA. Mr Thompson also identified that a further 200-300 funds, or ten per cent of APRA regulated funds, would have difficulty meeting the sorts of entry tests that APRA hoped to impose to help protect retirement savings.

14.32 The Committee was concerned that such statements could give rise to a crisis of confidence in the superannuation industry and that care was needed in reporting these matters. In order to discuss these matters with the regulator, the Committee invited APRA to give evidence at a public hearing in Sydney on 8 August 2002.

14.33 In evidence at the public hearing, Mr Venkatramani from APRA elaborated on Mr Thompson's remarks. Mr Venkatramani indicating that, in APRA's experience, at any one time 'about 150 small to medium funds have serious weaknesses warranting close surveillance and possibly active enforcement', while another 150 or so funds managing less than $1 million 'would arguably be too small to satisfy the minimum requirements of a prudent licensing test'.[14]

14.34 Mr Venkatramani continued that the introduction of a licensing test might see some 300 or so small or problematic funds exit the industry and that 'this would do much to improve the overall safety of the industry'.[15]

14.35 The Superannuation Industry Supervision Act currently requires licensing for approved trustees offering retail superannuation to the general public, but not for trustees managing standard employer superannuation for particular workplace and industry groups. This means that only about 400 superannuation funds run by approved trustees need a licence, leaving more than 2,500 funds that have not gone through any licensing approval process. In the wake of the collapse of HIH insurance and Commercial Nominees Australia Ltd, APRA has been giving consideration to increasing the standards by which funds are allowed to operate. The key ingredient which is missing from the regulator's 'toolkit', according to APRA, is licensing.

14.36 Mr Venkatramani from APRA advised the Committee that APRA has proposed the extension of its licensing powers to trustees managing standard employer superannuation for workplace and industry groups, and that the proposal is under consideration by a government working group.[16]

Committee view - APRA's powers

14.37 The Committee considers it imperative to take all reasonable steps to instil confidence in the superannuation system and to ensure that the retirement savings of individuals are safe. As the adequacy of superannuation in retirement is directly related to the safety of its investments, the Committee sees merit in APRA's proposal to seek an extension of its licensing powers. Firstly, because extending new licensing requirements would allow unsuitable parties to be kept out of the industry, and secondly, because it would constrain industry players by formal conditions.

14.38 However, the Committee is concerned to ensure that the equal representation of employers and members is maintained on boards of trustees. The Committee would be

14 *Committee Hansard*, 8 August 2002, p. 632.

15 *Committee Hansard*, 8 August 2002, p. 632.

16 *Committee Hansard*, 8 August 2002, p. 631.

concerned if licensing of trustees as individuals, rather than as notional collective trustee entities or trustee corporations, proceeded as this may result in changing this balance, to the disadvantage of the member representatives.

14.39 The Committee notes that, following the release of the Superannuation Working Group report,[17] the Government has recently announced the requirement for all trustees of APRA-regulated superannuation funds to obtain a superannuation trustee licence.[18] The Committee commends this initiative and welcomes the Government's approach to enhancing the safety of superannuation through the other measures outlined in its response to the Working Group's report.

14.40 The Committee also notes that the Organisation for Economic Cooperation and Development has recently released a set of voluntary guidelines, which are the first international standards to be set for the governance of pension funds. The initiative followed the collapse of the USA company Enron, and mounting concern that corporate pension schemes elsewhere are underfunded. The new 12-point guidelines state that trustees should be accountable to pension fund members and their beneficiaries, and cannot absolve themselves of responsibility by using external service providers. Under the guidelines, auditors are also encouraged to act as 'whistleblowers'.

14.41 The Committee commends these new guidelines to APRA for consideration and notes that the financial services regulator is giving consideration to the guidelines.[19]

14.42 While considering the robustness of the governance framework, the Committee takes this opportunity to support ASIC's stronger focus on meeting higher level corporate governance standards.

Overall conclusions – other issues

14.43 The Committee notes that, in order to improve the safety of superannuation, the Government has recently announced the requirement for all trustees of APRA regulated superannuation funds to obtain a superannuation trustee licence and has proposed a number of other measures designed to provide greater protection of employee retirement savings.

14.44 While the Government's initiative is to be commended, the Committee considers that there are some other issues which the Government should consider in a

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17 Superannuation Working Group, *Options for improving the safety of superannuation*, Report of the Superannuation Working Group (Don Mercer, Chair), 28 March 2002, released by the Government 28 October 2002.

18 This excludes self-managed superannuation funds and exempt public sector superannuation schemes.

19 Australian Financial Review, '*Liability threat to fund trustees*', 26 October, 2002.

timely manner to ensure that people have confidence in the superannuation system and that they have adequate savings and incomes in retirement. These include:

- developing alternative savings vehicles, to maximise the potential for increasing national savings and to assist long-term savings for purposes such as health, housing and education;
- considering indexing Commonwealth funds superannuation benefits to the CPI or MTAWE, whichever is the higher, to maintain parity with community living standards for Commonwealth public sector and defence force retirees and considering linking the preserved benefit to the fund earning rate, rather than the CPI.

14.45 Finally, as some of the matters raised in the report have the potential for significant impacts on the budget, the recommendations would have to be viewed in the light of the budget position at the time.

Senator John Watson

Committee Chair

ALP Additional Comments

Labor senators endorse the Committee report but believe that additional emphasis must be placed on the priorities for policy changes.

The groups facing inadequate retirement incomes must be the focus of initiatives to boost superannuation savings. These groups are essentially: women, the self-employed, those over 40 (who have only had 10 years of Superannuation Guarantee contributions at less than 9 per cent) and middle income earners.

Labor has already proposed policy options that would largely assist these groups including:

- Reducing the contributions tax by either 2 per cent for all members or 3.5 per cent for those aged 40 years and over;

- Capping fees and charges at 1.2 per cent or appropriate dollar amount to reduce the reduction in end benefits;

- Providing full compensation for funds lost due to theft or fraud.

Labor senators do not agree that cutting the Liberal Government's superannuation surcharge tax, which would only benefit approximately 5 per cent of the working population (those who earn surchargeable income of $90,527 or more a year) at a cost of $370 million over 3 years is appropriate at this time.

Labor proposals are far fairer and would have a much bigger impact on the retirement savings of all Australians, particularly those at greatest risk of not having an adequate income in retirement.

Senator the Hon Nick Sherry

Senator Geoffrey Buckland

Senator Penny Wong

Supplementary statement

Australian Democrats Senator John Cherry

The Australian Democrats endorse this report and all of its recommendations, except recommendations 6 and 8 which propose the shifting of taxation from up front contributions taxes to end benefit taxes.

The Democrats do not rule out supporting such a policy objective in the future. But, we do not believe that a model has been developed that ensures that this can be delivered in a way which is fiscally sound, socially equitable and economically progressive.

Superannuation is a fundamental part of income. It is taxed more concessionally than other parts of income because the consumption of the income is deferred until retirement. The concessional taxation, costs around $10 billion a year, twice the actual cost of superannuation up front and investment taxes ($4.6 billion). This highlights the high degree of concessionality already present in superannuation.

In the view of the Democrats, the key priority for superannuation must be ensuring that the concessions are more progressive and fair between income groups. As the evidence from ACOSS showed, the current concessions overwhelmingly favour high income earners. Indeed, the Democrats estimate that, in 1999-2000, the 58% of taxpayers earning less than average weekly earnings ($35,000) received just 20.2% of superannuation tax concession, while the 18.4% of taxpayers on the top marginal tax rate received over 46.5% of concessions. This is grossly unfair given that superannuation concessions are supposed to be about reducing reliance on the age pension, which is more likely to be an issue at lower incomes than higher incomes. It is also grossly unfair considering the evidence of this inquiry that a higher income replacement rate will be needed for lower incomes than higher incomes to achieve adequacy of retirement income.

The Democrats favour as an early tax priority abolishing the superannuation contributions tax and the high income earners surcharge, and instead taxing contributions at marginal tax rates less a flat rebate, common to all income groups. This would provide greater equity across all incomes, restructure concessions from high to low income earners, and still provide a high and transparent degree of concession on the taxation of superannuation.

Senator John Cherry

Appendix 1

Submissions

1	Mr/s Mo Dickson
2	Mr Les Brien
3	Dr Juliette Goldman
4	Mr Michael S Duff
5	Mr Ross Christie BE BCom DipFP CFP
6	Mr Ron Brons
7	Ms Patricia Collins
8	Greenwood BKT Services Pty Limited
9	Mr C R Grenfell FIA FIAA FASFA
10	Australian Institute of Superannuation Trustees (AIST)
11	Bankstown Community College
12	Mr J J Kenna
13	Third Son Financial Services
14	Confidential
15	Confidential
16	Association of Independent Retirees, Inc
17	Dr R J S Hickman
18	Ms Janet Beale
19	Confidential
20	Mr Geoffrey J Blore
21	Mr Barry Nankervis
22	Mr William Ferguson

23	Mr Tom Adams
24	Superannuated Commonwealth Officers' Association (Federal Council) Inc
25	Australian Industry Group
26	Mr R J Hall
27	PricewaterhouseCoopers Actuarial
28	Industry Funds Forum
29	Professor Jocelyn Horne
30	Forsythes Financial Planning
31	The Institute of Chartered Accountants in Australia
32	Australian Medical Association Limited (AMA)
33	Women in Super
34	Mr Scott Hyams
35	Professor John McCallum, University of Western Sydney
36	Mr Michael Cass
37	Job Futures
38	Trustee Corporations Association of Australia
39	The Paull Group Financial Strategies Pty Ltd
40	Supermaster
41	Corporate Super Association
42	Cbus
43	CPA Australia
44	Financial Planning Association of Australia Limited
45	Catholic Health Australia
46	Superpartners Pty Ltd
47	Small Independent Superannuation Funds Association
48	Mr Peter Craig

49 Society of Superannuants

50 Financial Services Consumer Policy Centre

51 Australian Bankers' Association

52 Australian Health Insurance Association Ltd

53 Dr R J S Hickman

54 Taxation Institute of Australia

55 Mr Gordon Quantock

56 Mr and Mrs P & H Beach

57 ACTU

58 Mr F W Heuke

59 National Institute of Accountants

60 National Seniors Association

61 Mr Geoffrey Hart

62 Mr Homer Paxton

63 Council on the Ageing (Australia)

64 AMP

65 Australian Council of Social Service

66 Australian Council of Public Sector Retiree Organisations Inc.

67 Australian Institute of Company Directors

68 Mr Peter Mair

69 Mr David Dunnet

70 Investment & Financial Services Association Ltd (IFSA)

71 Mr/s Sacha Vidler

72 Dr Mike Gilligan

73 The Association of Superannuation Funds of Australia Ltd (ASFA)

74 Institute of Actuaries of Australia

75 Women's Economic Policy Analysis Unit, Curtin University of Technology

76 Australian Consumers' Association

77 Society of Superannuants (Supplementary Submission)

78 Department of the Treasury

79 Department of Family and Community Services

80 Department of Health and Ageing

81 Australian Institute of Company Directors

82 Centre for Pensions and Superannuation, UNSW

83 Mr Tony Furse

84 Mr Rob Partington

85 Mr Claus Salger

86 Australian Bankers' Association (Supplementary Submission)

87 Corporate Superannuation Strategies Pty Ltd

88 Mr Jim Hamilton

89 Department of Finance and Administration

90 Mr Ross Christie (Supplementary Submission)

91 Maurice Blackburn Cashman

92 Supermaster(Supplementary Submission)

93 Mr C R Grenfell FIA FIAA FASFA(Supplementary Submission)

94 Mr Sander Vandeth

95 Third Son Financial Services (Supplementary Submission)

96 Mr Claus Salger (Supplementary Submission)

97 Mr Michael Andersson

98 National Institute of Accountants (Supplementary Submission)

99 Australian Institute of Company Directors (Supplementary Submission)

100 Australian Prudential Regulation Authority (APRA)

101 Mr Bob Stephens

102 Australian Council of Social Service (Supplementary Submission)

103 National Seniors Association (Supplementary Submission)

104 Centre for Pensions and Superannuation, UNSW (Supplementary Submission)

105 Australian Industry Group (Supplementary Submission)

106 Ms Fiona Galbraith

107 Superpartners Pty Ltd (Supplementary Submission)

108 The Association of Superannuation Funds of Australia Ltd (ASFA) (Supplementary Submission)

109 Women in Super (Supplementary Submission)

110 PricewaterhouseCoopers Actuarial (Supplementary Submission)

111 Department of Health and Ageing (Supplementary Submission)

112 Australian Institute of Superannuation Trustees (AIST) (Supplementary Submission)

113 Australian Council of Social Service (Supplementary Submission)

114 Cbus (Supplementary Submission)

115 Mr Daryl Peace

116 Mr Peter Gorecki

117 Corporate Super Association (Supplementary Submission)

118 Society of Superannuants (Supplementary Submission)

119 Sunsuper Pty Ltd

120 Mr John Currie

121 CPA Australia (Supplementary Submission)

122 The Association of Superannuation Funds of Australia Ltd (ASFA) (Supplementary Submission)

123 Corporate Super Association (Supplementary Submission)

124 Mr David Cowan

125 Investment & Financial Services Association Ltd (IFSA) (Supplementary Submission)

126 Australian Prudential Regulation Authority (APRA) (Supplementary Submission)

127 AMP (Supplementary Submission)

128 Sunsuper Pty Ltd (Supplementary Submission)

129 Department of Family and Community Services (Supplementary Submission)

130 Australian Taxation Office

131 Confidential

132 Mr Charles R Bradbury

133 Mr Trevor Constable

134 Australian Taxation Office (Supplementary Submission)

135 Department of Finance and Administration (Supplementary Submission)

136 Australian Bankers' Association (Supplementary Submission)

137 The Association of Superannuation Funds of Australia Ltd (ASFA) (Supplementary Submission)

138 Department of the Treasury (Supplementary Submission)

139 Department of Family and Community Services (Supplementary Submission)

140 Department of Health and Ageing (Supplementary Submission)

141 Confidential

142 Department of the Treasury (Supplementary Submission)

143 Department of Finance and Administration (Supplementary Submission)

144 Department of Health and Ageing (Supplementary Submission)

145 Mr Norman Hoy

146 Mr David Cowan (Supplementary Submission)

147 Society of Superannuants (Supplementary Submission)

148 Australian Taxation Office (Supplementary Submission)

149 Australian Licenced Aircraft Maintenance Engineers Association

150 Superannuated Commonwealth Officers' Association (Federal Council) Inc (Supplementary Submission)

151 Department of Employment and Workplace Relations

152 Department of the Treasury (Supplementary Submission)

Appendix 2

Public hearings

Monday, 1 July 2002, Canberra

Australian Bankers' Association

Mr David Bell, Chief Executive Officer

Ms Ardele Blignault, Director

Mr Gary Healey, Director

Supermaster Investments Pty Ltd

Mr Tony Kincaid, Chairman

Access Economics

Mr Geoff Carmody, Director

National Seniors Association

Mr David Deans, Chief Executive

Australian Council of Public Sector Retiree Organisations Inc

Commodore (Rtd) Harold Adams, National Vice President

Mr Gordon Johnson, National President

Mr Frank Morony, Councillor and President, South Australian Superannuants

Air Vice Marshal John Paule, National Secretary

Superannuated Commonwealth Officers Association

Mr John Coleman, National Secretary

Mr Terry Fawl, Federal President

Mr Peter Hurley, Vice President

Society of Superannuants

Mr Noel Davis, Legal Adviser

Mr Peter Somerville, Treasurer

Mr Donald Steel, Actuarial Adviser

Captain Ian Woods, President

Tuesday, 9 July 2002, Sydney

Mr Ross Christie (Private Capacity)

Australian Council of Social Service

Mr Peter Davidson, Senior Policy Officer

Mr Michael Raper, Immediate Past President

Australian Consumers Association

Ms Catherine Wolthuizen, Senior Policy Officer

Third Son Financial Services Pty Ltd

Mr Peter Binetter, Director

Professor Jocelyn Horne (Private Capacity)

Institute of Chartered Accountants in Australia

Mrs Susan Orchard, Superannuation Technical Consultant

Mr Richard Rassi, Chairman, National Superannuation Committee

Financial Services Consumer Policy Centre

Mr Chris Connolly, Director

Mr Khaldoun Hajaj, Director of Policy and Research

Financial Planning Association of Australia

Mr Kenneth Breakspear, Chief Executive

Mr Con Hristodoulidis, Government Relations Manager

Australian Institute of Company Directors

Mr Robert Elliott, Policy Manager/Company Secretary/Legal Counsel

Mr Stephen Hopley, Taxation and Economics Committee Member

Mr Simon Marks-Isaacs, Chairman, Taxation and Economics Committee

Wednesday, 10 July 2002, Sydney

Association of Superannuation Funds of Australia

Dr Michaela Anderson, Director, Policy and Research

Mr Ross Clare, Principal Researcher

Ms Philippa Smith, Chief Executive Officer

Investment and Financial Services Association

Mr Richard Gilbert, Deputy Chief Executive Officer

Miss Lynn Ralph, Chief Executive Officer

Mr William Stanhope, Senior Policy Manager

AMP Financial Services

Mr Ian Brown, Superannuation and Pensions Strategy Consultant

Ms Suzanne Doyle, National Manager, Superannuation and Retirement Policy

Mr John Drabble, Director, Product Development and Integration

Small Independent Superannuation Funds Association

Mr Michael Lorimer, Director, and Chair of Policy Development Committee

Mr Graeme McDougall, Chief Executive Officer

Institute of Actuaries of Australia

Ms Catherine Beall, Chief Executive Officer

Mrs Helen Martin, President

Mr Michael Rice, Member

Allen Consulting Group

Dr Vince FitzGerald

Centre for Pensions and Superannuation, Faculty of Commerce and Economics, University of New South Wales

Professor John Pigott, Director

Wednesday, 17 July 2002, Melbourne

Taxation Institute of Australia

Mr Daniel Butler, Chair, National TIA Superannuation Committee

Miss Jacinta Summer, Policy Officer

Australian Industry Group

Mrs Heather Ridout, Deputy Chief Executive

Mr Grahame Willis, Executive Director, Finance, Administration and Superannuation

PricewaterhouseCoopers

Dr David Knox, Director

Women in Super

Ms Rosalind Bennett, Research Officer

Ms Marie Sullivan, Chair, Women in Super New South Wales Management Committee

Industry Funds Forum

Mr Ian Silk, Convenor

Association of Independent Retirees Inc

Mr Donald Carlos, Chair, Superannuation Committee

Mr Francis Rogan, Executive Secretary

Mr Colin Grenfell (Private Capacity)

Thursday, 18 July 2002, Melbourne

Australian Institute of Superannuation Trustees

Mr David Coogan, Treasurer

Ms Helen Dyson, Vice President

Ms Fiona Reynolds, Executive Officer

Australian Council of Trade Unions

Mr Gregory Combet, Secretary

Ms Linda Rubinstein, Senior Industrial Officer

Council on the Ageing (Australia)

Mr Denys Correll, National Executive Director

Ms Veronica Sheen, Deputy Director

CPA Australia

Ms Jane Barrett, Superannuation Policy Adviser

Ms Noelle Kelleher, Member, Superannuation Centre of Excellence

Mr Murray Wyatt, Chairman, Superannuation Centre of Excellence

Mr Michael Andersson (Private Capacity)

Ms Fiona Galbraith (Private Capacity)

Mr Robin Partington (Private Capacity)

Corporate Superannuation Association

Mrs Elizabeth Goddard, Head of Research

Ms Jennifer Guthrie, Member

Mr Angus McKenzie, Committee Member

National Institute of Accountants

Mr Reece Agland, General Counsel

Mr Gavan Ord, Technical Policy Manager

Cbus

Ms Helen Hewett, Fund Secretary

Friday, 19 July 2002, Canberra

Department of the Treasury

Mr Roger Brake, General Manager, Superannuation, Retirement and Savings Division

Mr Phil Gallagher, Manager Specialist, Retirement and Income Modelling Unit

Department of Family and Community Services

Ms Leonie Corver, Director, Retirement Policy, Seniors and Means Test Branch

Ms Kerry Flanagan, Executive Director, Strategic Cluster

Ms Hilarie Kemp, Acting Director, Seniors and Means Test Branch

Mr Eric Rojahn, Director, Financial Markets, Seniors and Means Test Branch

Department of Health and Ageing

Dr David Graham, First Assistant Secretary, Ageing and Aged Care Division

Mr Mark Thomann, Assistant Secretary, Office for an Ageing Australia

Mr Robert Wells, First Assistant Secretary, Health, Industry and Investment Division

Australian Medical Association Ltd

Mr Michael Saunders, Senior Policy Adviser, Workplace Policy Department

Department of Finance and Administration

Mr Phil Bowen, General Manager, Budget Group

Mr Gregory Coombs, Team Leader, Long Term Budget Policy Branch, Budget Group

Mr John Ignatius, Acting Manager, Family Services AAV, Budget Group

Ms Sandra Wilson, Branch Manager, Superannuation Branch, Business Services Group

Australian Health Insurance Association

Mr Russell Schneider, Chief Executive Officer

Thursday, 8 August 2002, Sydney

Association of Superannuation Funds of Australia

Dr Michaela Anderson, Director, Policy and Research

Mr Ross Clare, Principal Researcher

Ms Philippa Smith, Chief Executive Officer

Investment and Financial Services Association Ltd

Mr Richard Gilbert, Chief Executive Officer

Mr William Stanhope, Senior Policy Manager

Australian Prudential Regulation Authority

Mr Roger Brown, Senior Manager, Rehabilitation and Enforcement

Mr Greg Brunner, General Manager, Policy Development and Statistics

Dr Darryl Roberts, General Manager, Central Region

Mr Senthamangalam Venkatramani, General Manager, Diversified Institutions Division

Tuesday, 8 October 2002, Canberra (Roundtable)

Dr Michaela Anderson, Director, Policy and Research, Association of Superannuation Funds of Australia

Ms Jane Bailey, Acting First Assistant Secretary, Ageing and Aged Care Division, Department of Health and Ageing

Mr Roger Brake, General Manager, Superannuation, Retirement and Savings Division, Department of the Treasury

Mr Peter Davidson, Senior Policy Officer, Australian Council of Social Service

Mr Alex Dolan, Assistant Secretary, Seniors and Means Test Branch, Department of Family and Community Services

Ms Suzanne Doyle, National Manager, Superannuation and Retirement Policy, AMP Financial Services

Dr Vince FitzGerald, Co-Chairman, Allen Consulting Group

Mr Philip Gallagher, Manager, Retirement and Income Modelling, Department of the Treasury

Mr Simon Kelly, Senior Research Fellow, National Centre for Social and Economic Modelling

Dr David Knox, Director, PricewaterhouseCoopers

Mr Christopher Lewis, Senior Vice President, Institute of Actuaries of Australia

Mr Don Luke, Chief Executive Officer, Sunsuper

Mr John Maroney, Member and Consultant, Institute of Actuaries of Australia

Ms Linda Rubinstein, Senior Industrial Officer, Australian Council of Trade Unions

Ms Philippa Smith, Chief Executive Officer, Association of Superannuation Funds of Australia

Mr Bill Stanhope, Senior Policy Manager, Investment and Financial Services Association

Mr Robert Wells, First Assistant Secretary, Health Industry and Investment Division, Department of Health and Ageing

Ms Catherine Wolthuizen, Senior Policy Officer, Australian Consumers Association

Appendix 3

Documents tabled, incorporated or received as exhibits

Date Received	Provided by	Document	Tabled/ Incorporated/ Received as exhibit
1/7/02	Mr Kincaid, Supermaster Investments Pty Ltd	Allocated pensions - an introduction	Incorporated
1/7/02	Mr Kincaid, Supermaster Investments Pty Ltd	Capital balance - $400,000 at start. $1000s	Incorporated
1/7/02	Mr Kincaid, Supermaster Investments Pty Ltd	Total income $1000s	Incorporated
1/7/02	ACSPRO	CPI and AWE - cumulative 6 months movements since 1988 % increase 1990-2001	Incorporated
1/7/02	Society of Superannuants	'Super over the long haul', *Superfunds* magazine, November 2001	Tabled
1/7/02	Society of Superannuants	Federal Government to tackle discrimination	Tabled
9/7/02	Mr Christie, Private capacity	Table 5: The difference between a taxed not for profit fund and an untaxed retail fund - from page 15 of Mr Christie's submission	Incorporated
9/7/02	Mr Raper, Australian Council of Social Service	Article by Joseph Quinn, 'The Labour market, retirement and disability'	Tabled

9/7/02	Mr Raper, Australian Council of Social Service	Article by Bruce Bacon, 'Work, retirement and dependency'	Tabled
9/7/02	Mr Raper, Australian Council of Social Service	Article by Sue Richardson, 'Households, individuals and low wages	Tabled
9/7/02	Mr Binetter, Third Son Financial Services Pty Ltd	A 10 page booklet entitled, *The Home Exchange Program - HOMEX,* presentation to Senate Select Committee on Superannuation 9 July 2002	Tabled
9/7/02	AICD	A supplementary non-confidential submission (Submission no. 81)	Tabled
10/7/02	IFSA	Slide presentation	Incorporated
10/7/02	Prof Piggott, UNSW	**Table 1** Percentage reduction in retirement accumulation (and effective contribution rates)	Incorporated
17/7/02	Mr Grenfell, Private capacity	'An example of an expense deduction table'	Incorporated
19/7/02	Senator Watson	ABS census data: Median weekly individual income, statistical local areas in Tasmania Statistical subdivisions, ranked by median weekly income (2 pages) Weekly individual income by age by sex, persons aged 15 years and over	Incorporated
19/7/02	Mr Saunders, AMA	AMA Public Hospital Financing Forum, *Grasping the Hot Potato*, 13 April 2002	Tabled
19/7/02	Mr Schneider, Australian Health Insurance Association Ltd	Number of members with PHI aged over 65 years of age, Australia, December 1990 to 2002	Incorporated

19/7/02	Mr Schneider, Australian Health Insurance Association Ltd	Private Health Insurance – average drawing rates by 5 year age cohorts, year ending March 2002	Incorporated
19/7/02	Mr Schneider, Australian Health Insurance Association Ltd	Lifetime health cover membership - persons insured who pay a loading - as at 31 March 2002 by certified age of entry	Incorporated
8/8/02	Mr Gilbert, IFSA	*Government co-contribution to superannuation market research*, Eureka Strategic Research, July 2002, IFSA Project number 2669	Tabled
8/8/02	Dr Roberts, APRA	*Ansett superannuation plans*	Tabled
20/8/02	IFSA	AM Corporation - List of Available Investments - Life Track Superannuation Fund	Received as exhibit
20/8/02	IFSA	AM Corporation – Superannuation Investment Choices	Received as exhibit
20/8/02	IFSA	AM Corporation - Key Features Statement - Life Track Cashback Pension	Received as exhibit
20/8/02	IFSA	AM Corporation - Key Features Statement - Life Track Personal Superannuation	Received as exhibit
20/8/02	IFSA	Clearview (NRMA Retirement Plan) - Superannuation and Roll-Overs; Pre-Retirement Service; Allocated Pension	Received as exhibit

20/8/02	IFSA	Royal & Sunalliance Financial Services - Connelly Temple Super Savings Plan (Investment Strategy Brochure)	Received as exhibit
20/8/02	IFSA	Royal & Sunalliance Financial Services - Connelly Temple Super Savings Plan (Key Features Statements and Customer Information Brochure)	Received as exhibit
20/8/02	IFSA	IPAC - Strategic Retirement Service - Customer Information Brochure and Key Features Statement for Superannuation, Rollover and Allocated Pension	Received as exhibit
20/8/02	IFSA	MLC - MasterKey - Allocated Pension Customer Information Brochure Incorporating a Key Features Statement	Received as exhibit
20/8/02	IFSA	MLC - MasterKey – Superannuation Customer Information Brochure for individuals and small businesses Incorporating a Key Features Statement	Received as exhibit
20/8/02	IFSA	Optimum - Allocated Annuity Customer Information Brochure	Received as exhibit
20/8/02	IFSA	Optimum - Superannuation Master Plan - *Corporate* Customer Information Brochure	Received as exhibit
20/8/02	IFSA	Optimum - Superannuation Master Plan - *Personal* Customer Information Brochure	Received as exhibit
20/8/02	IFSA	The Portfolio Service - Superannuation Plan	Received as exhibit

15/10/02	The Allen Consulting Group	*Rethinking Work and Retirement Better Balance, Better Choices for Australians,* Report to the National Australia Bank by Dr Vince FitzGerald and Catherine Rooney, September 1999	Received as exhibit
15/10/02	The Allen Consulting Group	*Economic Implications of the Greying of the Baby Boomers* presented by Dr Vince FitzGerald to a Business Symposium on The Economic and Business Implications of the Ageing Baby Boomers, Adelaide, 4 October 2002	Received as exhibit
15/10/02	The Allen Consulting Group	*The Future Costs of Health and Aged Care in Australia* by Dr Vince Fitzgerald and Dr W Haebich. Paper presented to a forum on The Australian Health Care System: Directions for Reform, Melbourne Business School, 19 September 2002	Received as exhibit
15/10/02	Financial Planning Association of Australia	*Levels, patterns and trends of Australian household saving*, a report prepared for the Financial Planning Association of Australia by NATSEM	Received as exhibit
22/10/02	SCOA	NATSEM Report for the Superannuated Commonwealth Officers' Association 23 August 2002 – *Impact of indexation change on the Commonwealth's superannuation schemes*	Received as exhibit

Additional information

A report was received on 27 September 2002 from the Institute of Actuaries of Australia on *Superannuation and Standards of Living in Retirement - Modelling Assumptions* - September 2002. The IAA report is reprinted as **Appendix 4** of this report.

Appendix 4

Report on modelling assumptions from the Institute of Actuaries of Australia

Institute of Actuaries of Australia

Report
to the
Senate Select Committee
on
Superannuation

SUPERANNUATION AND STANDARDS OF LIVING IN RETIREMENT

Modelling Assumptions

September 2002

Level 7

Challis House

4 Martin Place

SYDNEY NSW 2000

Tel: (02) 9233 3466 Fax: (02) 9233 3446

Email: insact@actuaries.asn.au Web site: www.actuaries.asn.au

EXECUTIVE SUMMARY

1. The Senate Select Committee on Superannuation is currently conducting an inquiry into "the adequacy of the tax arrangements for superannuation and related policy to address the retirement income and aged and health care needs of Australians". The Committee, in its letter of 22 August 2002, has requested the Institute of Actuaries of Australia (IAAust) to assist in assessing the relative strengths and merits of the alternative modelling approaches used by ASFA and Treasury in their submissions to this inquiry. The IAAust has also been requested to provide the Committee with its views on the validity of the assumptions used by ASFA and Treasury and the most appropriate assumptions to be used for such modelling.

2. The attached report provides the IAAust's views on the issues raised in the Committee's request, based on a detailed review of both submissions including discussions with representatives of both ASFA and Treasury.

3. The IAAust is of the view that, when assessing the adequacy of retirement incomes generated by the Superannuation Guarantee (SG) system and the age pension, it is most appropriate to consider the level of retirement income relative to the level of earnings in the period immediately prior to retirement. This measure is often referred to as the replacement rate and, as the Committee will be aware, is a common target used by those in the superannuation and financial planning industries when advising individuals regarding their income needs in retirement. Replacement rates are more robust and less subject to distortion by the choice of modelling approach than dollar levels of retirement income.

4. The net of tax retirement replacement rates from the Treasury and ASFA models are quite close. For example, the net replacement rates for a single male retiring on AWOTE at age 65 after a 30-year career and receiving a pension benefit are shown in the table below.

Model	Net retirement replacement rates[1]	Age pension component	Superannuation pension component
Treasury	60%	35%	25%
ASFA	57%	32%	25%

5. Two points to note in relation to the above results are that:

   (i) over half the net replacement rate is provided by the age pension; and

   (ii) in this example, and others considered by ASFA and Treasury, the retiree continues to be entitled to very close to the full age pension.

[1] The net retirement replacement rate is defined as the expenditure in the first year of retirement as a percentage of the after tax income in the prior year

This confirms the view previously expressed by the IAAust (and others) regarding the need to address the interaction between the superannuation and age pension arrangements to achieve a financially sustainable retirement income system that also meets reasonable retirement income expectations.

6. The key reasons for the differences between the net replacement rates from the ASFA and Treasury modelling are detailed in Table 2 and discussed in this report. Essentially the differences in net replacement rates arise from variations in the more detailed modelling assumptions that underpin the projected results.

7. The IAAust has estimated net replacement rates using the ASFA model and what we believe is a reasonable range of assumptions within the current economic environment. These assumptions are:

Recommended IAAust Assumptions for Projections		
	Best Estimate Assumption	Sensitivity – lower & higher
CPI	2.5%	No change
Investment earnings before retirement	7.0% per annum after fees and tax	Low 6.0% per annum High 8.0% per annum
Admin and insurance expenses before retirement	$2.00 per week indexed	No change (as investment return has fee adjustment also)
Wage Inflation	3.5% per annum	Low 4% per annum High 3% per annum
Effective conversion of lump sum to 1st year pension	5.5%	Low 5% High 6%

8. The projections using this range of assumptions and the example of a male retiring on AWOTE at age 65 after 30 years are set out in Table 7 and result in estimated net retirement replacement rates that vary between 52% and 70%. The range of net replacement rates is necessarily broad due to the variability of outcomes to which individuals are subject, and which are reflected in the range of assumptions used.

9. Variability of outcomes for individuals is a major issue in its own right, and some of the factors that contribute to the variability of retirement incomes are outlined in Appendix B. In addition to the variability of private retirement incomes there is also a large degree of variability in age pension outcomes depending on individual circumstances. Both of these aspects create major problems in projections of total retirement incomes, and hence the assessment of the adequacy of outcomes from the SG and age pension arrangements.

10. The ANOP research undertaken by ASFA and referred to in the Committee's letter of 22 August 2002 indicated that around 70% of people desire retirement incomes in excess of $30,000 per annum. For someone on average weekly ordinary time earnings (AWOTE), that would represent a net replacement rate of 88%. This level of net replacement rate is higher than generally accepted perceptions of appropriate net retirement income targets, which would be closer to 70% or 80% for those on "average" levels of earnings. (Gross of tax replacement rates of 60% to 70% would often be used.) A higher level of net replacement rate would be appropriate for those on lower earning levels.

11. As noted by the Committee, there is a significant difference in the current dollar levels of retirement incomes indicated in the submissions from ASFA and Treasury - $19,322 in the case of ASFA for the example referred to above compared to Treasury's figure of $28,308.

12. The reason for this large apparent difference is because Treasury uses an explicit price deflator (CPI) to discount its projected retirement benefits into current (2001/02) dollars. ASFA, on the other hand, implicitly uses a wages deflator (AWOTE). Treasury's figure for the contribution of the age pension to total retirement income is inflated by the assumed difference between increases in AWOTE and CPI over 30 years. That is, the Treasury model assumes that the current maximum age pension will increase in real terms over the next 30 years from $10,966 to around $16,800 (expressed in current dollars). If a wages deflator rather than price deflator is applied to the Treasury calculations, the current dollar level of retirement income for this example case reduces from $28,308 to $18,348 and would reflect the current maximum level of the age pension.

13. As indicated above, the IAAust view is that adequacy of retirement income is best viewed as a relative concept, comparing retirement income to living standards and earnings at the time of retirement. The alternative approach of viewing adequacy as an absolute concept based on current living standards projected 30 or more years ahead is problematic because of the general change (usually an increase) in living standards that occurs over such periods. Increased community living standards lead to expectations of increased retirement incomes to maintain adequacy.

14. The use of a CPI deflator (as has been used in the Treasury model) will produce results that are consistent with other Government projections. However other Government projections are usually undertaken over relatively short time frames (less than five years or so). For longer-term projections, such as are required when assessing adequacy of retirement incomes, IAAust believes it is more consistent to use an AWOTE deflator to ensure comparability with living standards at the time of retirement.

INTRODUCTION

The Senate Select Committee on Superannuation is currently conducting an inquiry into “the adequacy of the tax arrangements for superannuation and related policy to address the retirement income and aged and health care needs of Australians”. The Committee, in its letter of 22 August 2002, has requested the Institute of Actuaries of Australia (IAAust) to assist in assessing the relative strengths and merits of the alternative modelling approaches used by ASFA and Treasury in their submissions to this inquiry. The IAAust has also been requested to provide the Committee with its views on the validity of the assumptions used by ASFA and Treasury and the most appropriate assumptions to be used for such modelling.

The attached report provides the IAAust’s views on the issues raised in the Committee’s request, based on a detailed review of both submissions including discussions with representatives of both ASFA and Treasury.

Differences in modelling approaches

There are two major areas of difference between the financial projections in the ASFA and Treasury submissions. The first area is the set of detailed modelling assumptions that each adopts, either explicitly or implicitly. While many of the individual assumptions used in the ASFA and Treasury models differ, the overall impact of these differences on the projected net replacement rates is not large. The impact on the estimated dollar levels of retirement income is more significant.

The second, and more significant, area of difference between the ASFA and Treasury models is the basis of deflating the results into current dollars. Treasury uses an explicit price deflator, the Consumer Price Index (CPI), while ASFA uses an implicit wages or earnings deflator, Average Weekly Ordinary Time Earnings (AWOTE). It is this difference that accounts for most of the variation between the results from the alternative models when they are expressed in current dollars.

The Committee’s letter of 22 August 2002 highlighted the example that the retirement income in the first year for a single male retiring at age 65 after 30 years of Superannuation Guarantee contributions at 9% would be $28,308 using the Treasury model and $19,000 using the ASFA model. Both of these figures are in 2001/02 dollars. The Treasury figures assume earnings of AWOTE (currently $44,746) whereas the ASFA figures were based on pre-retirement earnings of $40,000 (as given in evidence by their CEO). Using the ASFA model that has been provided to us for this scenario, but with pre-retirement earnings of $44,746 rather than $40,000, produces a first year retirement income of $19,322.

The difference in results is quite significant given that, prima facie, the two models could be expected to give similar answers. The subsequent sections of this report explain in further detail the key reasons for the differences in results from the ASFA and Treasury models. We have also included the IAAust's suggestions regarding appropriate assumptions in the current economic environment that are consistent with the focus of the Committee’s terms of reference regarding adequacy of retirement income.

For simplicity we have focussed in this report on the projected outcome for the example cited in Senator Watson’s letter of 22 August 2002 and referred to above. This example is based on a male retiring at age 65 after 30 years of Superannuation Guarantee (SG) contributions of 9%. However, it is very important to note that there is a high degree of inherent variability in the range of retirement incomes that individuals will receive, both in terms of absolute dollars and net replacement rates. This issue was highlighted in the IAAust submission to the Committee, an extract of which has been reproduced in Appendix B.

Current values of projected retirement incomes

The most significant difference in the modelling approach and assumptions between the ASFA and Treasury submissions is how each party chooses to present its results in current dollar (2001/02) terms.

Treasury has a complex model to project future cash flows (incomes, pensions, superannuation contributions and benefits, taxes, etc) for 30 or 40 years and then discounts the results to current dollars using the Consumer Price Index (CPI) as the deflator. This is consistent with other Government analyses and reports, although most such projections are for much shorter periods of no more than 5 years. Because incomes are assumed to increase at a faster rate than prices, the approach in the Treasury model capitalises 30 or 40 years of real increases (that is, increases in excess of the CPI) in pensions and retirement incomes into the current dollar result.

This means that Treasury's figure for the contribution of the age pension to total retirement income is inflated by the assumed difference between increases in AWOTE and CPI over 30 years. That is, the Treasury model assumes that the current maximum age pension will increase in real terms over the next 30 years from $10,966 to around $16,800 in current dollars.

ASFA has a simpler model that uses a hypothetical reconstruction of the last 30 or 40 years as a proxy for future outcomes. This avoids the need to project future cash flows and then discount the results. This approach is broadly equivalent to projecting all future cash flows based on a suitable index such as AWOTE and then discounting the results by the same index. This avoids capitalising any real increases in pensions and retirement incomes into the current dollar result.

The following table illustrates the different approach to constructing current dollar results:

Table 1 Components of projected retirement incomes		
	Treasury $	ASFA $
Age pension	16,717[2]	10,851
Pharmaceutical allowance	0	151
Superannuation pension	14,558	8,320
Tax	(2,967)	0
Total	28,308	19,322

The two results can be roughly reconciled in arithmetic terms by replacing the CPI deflator (2.5% per annum) with an AWOTE deflator (4.0% per annum) in Treasury's result or vice versa for the ASFA result:

> *$28,308 x {CPI deflator (210%) / AWOTE deflator (324%)} = $18,348, which is close to ASFA's figure of $19,322. The remaining variance is readily explained by the different projection assumptions, as outlined later in this report.*

Further comments on the alternative approaches to discounting retirement incomes to current dollars are included in Appendix A.

In both cases, the age pension component represents 99% of the maximum rate of age pension (either the current maximum pension for the ASFA model or the adjusted maximum pension for the Treasury model, as explained above and in the footnote).

One implication of this is that, for this example person and scenario, there is almost no impact on reducing Government outlays on age pensions even after 30 years of SG contributions at 9%. Similar results arise for other examples and scenarios. This confirms the view previously expressed by the IAAust (and others) regarding the need to address the interaction between the superannuation and age pension arrangements to achieve a financially sustainable retirement income system that also meets reasonable retirement income expectations.

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2 Treasury includes an age pension component of $16,717 compared to the current maximum age pension of $10,966 because age pensions are expected to increase by 55% over the next 30 years in real terms.

DIFFERENCES IN ASSUMPTIONS

The other area of difference between the ASFA and Treasury modelling is in the detailed assumptions used. The following table summarises the main assumptions used in the Treasury and ASFA models:

Table 2

Differences in assumptions – excluding indexation of tax scales

Assumption	**Treasury**	**ASFA**
Investment earnings before retirement	7.0% per annum after fees but before tax	7.0% per annum after fees and tax (Note 1)
Investment earnings after retirement	6.0% per annum after fees	No explicit assumption
Admin and insurance expenses before retirement	$2.00 per week not indexed	Nil
Expenses of purchasing life pension	4%	Nil
Wage Inflation	4.0%	3.75%
Effective conversion of lump sum to 1st year pension	6.47%	5.0%

Note 1 The ASFA investment return is 7.0% per annum although the CEO actually advised "about 6.0%" to the Committee.

Both sets of assumptions are within the range that we would expect given recent and expected future experience. The Treasury model is more sophisticated and uses a greater number of explicit assumptions than the ASFA model. The difference between the assumptions that has the most significant effect on the results from the model is the approach to converting a lump sum at retirement into an income stream.

ASFA assumes that a $100,000 lump sum invested in a lifetime annuity will give a first year annuity payment of $5,000 per annum, which will be indexed with CPI. ASFA advises that this is equivalent to the going rate in the market for immediate annuities.

Treasury, on the other hand, assume that the individual will be able to purchase a lifetime annuity from a life office based on a 6% per annum future earning rate, the average expectation of life for that age and with 4% of the lump sum being used for expenses. The Treasury approach gives a first year retirement income of $6,470 for a $100,000 lump sum.

The current immediate annuity market gives results between the two approaches. For example, one competitive life office quotes $5,960 as the first year income for a single male at age 65 and $5,212 for a reversion to a surviving spouse from a $100,000 lump sum with no commission payable.

The use of a CPI indexed annuity from a life office is a conservative basis on which to convert a lump sum to an income stream. In practice many retirees will purchase an allocated pension rather than a conventional lifetime annuity.

The impact of the different assumptions is shown below, based on varying each of the ASFA assumptions to reflect the corresponding Treasury assumption and showing the impact on the ASFA current dollar retirement expenditure and the first year net replacement rate.

Table 3

Application of Treasury Assumptions to ASFA Model

	Assumption applied to ASFA model	**Impact on ASFA results**	
		Retirement Income	**Net Replacement Rate**
Baseline results		$19,322	56.4%
Investment earnings before retirement	6.51% per annum after fees and after 7% tax	-$611	-1.8%
Admin and insurance expenses before retirement	$2.00 per week not indexed	-$491	-1.4%
Wage Inflation	4.0% per annum	-$328	-1.0%
Effective conversion of lump sum to 1st year pension	6.47%	+$2,446	+7.1%
Overall impact		$20,010	+2.0%

DIFFERENCE IN INDEXATION OF TAX SCALES

Treasury calculates tax on their projected figures in 2032 using assumed tax thresholds in that year. Over the next 30 years, Treasury indexes the tax scales at CPI while assuming that average earnings increase at a higher rate. This means that individuals who remain on AWOTE are pushed into higher tax brackets. For example, the tax currently payable (including Medicare levy) by someone on AWOTE is 23.4% of earnings whereas in the Treasury submission the tax payable by someone on AWOTE in 2032 is 29.8% of earnings. It seems unlikely that the effective rate of tax for someone on AWOTE would increase over the next 30 years by more than one-quarter. This, however, is the outcome from indexing tax scales over a long period at a lower rate than indexing average earnings.

The Treasury model indexes the Reasonable Benefit Limits and the tax-free thresholds, as well as the income tax scales. However it does not index the Senior Australian Tax Offset at all over the next 30 years. According to a Treasury official, as reported in Hansard for 19 July 2002, the Senior Australian Tax Offset ceases to have an effect after 15 or so years. -

The ASFA model, on the other hand, assumes that the person retires in 2002 and they have used the current tax scales and thresholds. Therefore, they have allowed for the actual tax payable in the current environment including the allowance for the Senior Australian Tax Offset.

Treasury has reviewed the impact of their method of indexation of tax scales and concludes that use of AWOTE indexation in tax scales, but not the Senior Australian Tax Offset, would not have a significant impact on replacement rates as the tax scales apply to income before and after retirement. Indexation by AWOTE would, however, produce a higher absolute level of retirement expenditure ($30,806 compared to the $28,308 figure for the first year shown above).

Assessing the adequacy of projected retirement incomes

The IAAust is of the view that, when assessing the adequacy of retirement incomes generated by the SG system and the age pension, it is most appropriate to consider the level of retirement income relative to the level of earnings in the period immediately prior to retirement. As the Committee will be aware, this measure (the replacement rate) is a common target used by those in the superannuation and financial planning industries when advising individuals regarding their income needs in retirement.

The Assistant Treasurer also suggested in her media release of 5 August 2002 that ideally the focus should be on replacement rates rather than specific dollar targets. Replacement rates are more robust and less subject to distortion by the choice of modelling approach than dollar levels of retirement income.

A particular dollar level of retirement income is based on a single scenario and is less readily able to be translated to a more general target level of retirement income. For example, the figures referred to in the Committee's letter (of $28,308 from the Treasury model and $19,000 from the ASFA model) are based on a single set of assumptions. They are also only relevant for the example of a male retiring on a particular level of earnings, at age 65, after a 30-year projection period. While there will also be variability of net replacement rates based on individual circumstances, the variability is likely to be less than is the case for dollar outcomes.

The net of tax retirement replacement rates from the Treasury and ASFA models are quite close. For example, the net replacement rates for a single male retiring on AWOTE at age 65 after a 30-year career and receiving a pension benefit are shown in the table below.

Table 4

Net Replacement Rates

Model	Net retirement replacement rates[3]	Age pension component	Superannuation pension component
Treasury	60%	35%	25%
ASFA	57%	32%	25%

One point note in relation to the above results is that over half the net replacement rate is provided by the age pension.

The Treasury model calculates net replacement rates by comparing first year retirement expenditure (assumed equal to both income and capital withdrawals) with final year after tax income. Treasury also compare average expenditure over the expected period in retirement with final year after tax income. We have focused in this report on the results based on the first retirement year figure as that allows comparisons with ASFA's results and is the more traditional measure. When calculating replacement rates, Treasury is comparing pre and post retirement after tax incomes and expenditure, both in 2032 dollars, and ASFA is making the same comparison using 2002 dollars.

There is a valid concern that many people will relate more closely to a specific dollar target than a net replacement rate. The Committee has indicated that the desired retirement income level of $30,000 suggested by the ANOP research undertaken for ASFA may be useful in identifying an appropriate retirement income target. Effective communication of a dollar retirement income target may encourage workers to check whether their expected retirement income falls short of this target and, if so, take steps to close the gap.

If a target retirement income of $30,000 is used then, based on the Treasury modelling result, workers earning around AWOTE may conclude that there is only a small gap to be closed and that they can rely on higher than expected investment performance to achieve the desired level of benefits. However based on the ASFA modelling result, those same workers may conclude that additional contributions are necessary to achieve the desired level of benefits.

Hence, reconciling the two modelling results in terms of their ability to be communicated clearly and effectively to the broader community and their suitability for assessing achievement of an appropriate retirement income target is important. If a dollar target is to be adopted it is very important to ensure that any modelling approach reflects the objective of the exercise and allows those relying on the results of the modelling to draw appropriate conclusions regarding retirement income adequacy.

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[3] The net retirement replacement rate is defined as the expenditure in the first year of retirement as a percentage of the after tax income in the prior year

The dollar level of retirement income generated by the Treasury model relies upon future real increases in the age pension to help meet the retirement income target (adjusted by CPI increases). The result is, however, only applicable to people retiring in 2032 and beyond, as it requires 30 years of real increases in age pension above CPI increases. Under the ASFA modelling approach, future real increases in the age pension are effectively assumed to enable workers to maintain their relative standard of living compared to the broader community.

As indicated above, the IAAust view is that adequacy of retirement income is best viewed as a relative concept, comparing retirement income to living standards and earnings at the time of retirement. The alternative approach of viewing adequacy as an absolute concept based on current living standards projected 30 or more years ahead is problematic because of the general change (usually an increase) in living standards that occurs over such periods. Increased community living standards lead to expectations of increased retirement incomes to maintain adequacy.

The use of a CPI deflator (as has been used in the Treasury model) will produce results that are consistent with other Government projections. However these are usually undertaken over relatively short time frames (less than five years or so). For longer-term projections, such as are required when assessing adequacy of retirement incomes, the IAAust believes it is more consistent to use an AWOTE deflator to ensure comparability with living standards at the time of retirement.

RECOMMENDED IAAUST ASSUMPTIONS

In response to your request for the IAAust's views on the most appropriate assumptions, we have examined the experience of fund investment returns, average weekly earnings and CPI changes over the past 40 years. We have also briefly examined the market for annuities as discussed above.

Table 5

Average Differential Between Investment Return, Wages & Prices

Per annum rates averaged over periods ending in 1993 to 2002

Averaging period	Average Investment Return	Average real wage increases	Average CPI Increase	Average real return over CPI	Average real wage increases over CPI
5 years	10.3%	3.5%	2.6%	7.4%	0.9%
10 years	11.4%	4.3%	3.9%	7.3%	0.4%
15 years	13.2%	5.6%	5.2%	7.5%	0.3%
20 years	14.0%	7.0%	6.4%	7.1%	0.5%
30 years	12.1%	8.4%	6.9%	4.8%	1.4%

Source – ABS website and ASFA Superfunds magazine adjusted for the expected experience to the year to June 2002 based on latest published results.

Table 6 below sets out suggested best estimate assumptions, and also a range of reasonable assumptions to allow the sensitivity of the projections to variations in particular assumptions to be assessed. The suggested assumptions are not unique and alternative sets of assumptions may also be reasonable. We have constructed the set of assumptions to provide a basis that is realistic, internally consistent and focussed on the objective of helping determine adequacy of expected retirement benefits rather than consistency with other government forecasts.

Our rationale for the key assumptions is:

- The CPI estimate of 2.5% per annum is based on the midpoint of the Reserve Bank's target range of 2% to 3% per annum
- Over the last 40 years, average real investment returns (net of tax where applicable and wholesale fees) have ranged between 5% and 7% per annum
- Retail fee levels would generally be at least 1% per annum above wholesale levels
- A reasonable range for the assumed level of investment earnings before retirement after fees and tax would hence be 6.0% to 8.0% per annum, with a best estimate of 7.0%
- Over the last 30 years, average real wage increases have generally ranged from 0.5% to 1.0% per annum and only exceeded 1.0% over 30 to 40 years
- A reasonable range for the assumed level of wage increases would be 3% to 4% per annum, with a best estimate of 3.5%
- Allowing for commission payments and the spread of market prices for annuities, a first year conversion factor of 5% to 6% is appropriate, with a best estimate of 5.5%

Table 6

Recommended IAAust Assumptions for Projections

	Best Estimate Assumption	Sensitivity – lower & higher
CPI	2.5%	No change
Investment earnings before retirement	7.0% per annum after fees and tax	Low 6.0% per annum High 8.0% per annum
Admin and insurance expenses before retirement	$2.00 per week indexed	No change (as investment return has fee adjustment also)
Wage Inflation	3.5% per annum	Low 4% per annum High 3% per annum
Effective conversion of lump sum to 1st year pension	5.5%	Low 5% High 6%

Results using IAAust Assumptions

Using the IAAust assumptions in Table 6 with the ASFA model gives the following results:

Table 7 IAAust Results and Sensitivity Analysis		
Assumption applied to ASFA model	**Impact on ASFA results** **Retirement Income & Net Replacement Rate**	
ASFA Baseline results	$19,322	56.4%
IAAust best estimate assumptions	$20,290	59.2%
IAAust lower estimate assumptions	$17,687	51.6%
IAAust higher estimate assumptions	$23,971	69.9%

These results show the sensitivity of the forecasts to the selection of assumptions. Adequacy of retirement income will be affected significantly by each of the factors considered: real investment performance (net of tax and management fees), real wage increases and the basis by which retirees can convert lump sums to income streams either via the annuity market or via substitute products.

Additional variability of retirement incomes will also arise due to different individual circumstances, such as contribution periods and levels, wages or earning levels, retirement ages and so on. We have not considered these factors in any detail in this report, however they are very important when considering appropriate adequacy targets.

For the particular example used in this report (i.e. a single male retiring on AWOTE at age 65, after 30 years of 9% SG contributions), using ASFA's model and the IAAust's suggested assumptions gives a range of current dollar retirement incomes between $17,687and $23,971, with a best estimate of $20,290. The corresponding first year net replacement rates are 52%, 70% and 59% respectively.

The ANOP research referred to in your letter found that 70% of respondents indicated that an income of at least $30,000 per annum would be necessary for most people in retirement. Your Committee considered that this figure might be useful in identifying an appropriate retirement income target for future modelling.

It should be noted, however that a retirement income target of $30,000 per annum would represent a net replacement rate of 88% for someone on average weekly ordinary time earnings (AWOTE). This level of net replacement rate is higher than generally accepted perceptions of appropriate retirement income targets, which would be closer to 70% or 80% for those on “average” levels of earnings. (Gross of tax replacement rates of 60% or 70% would often be used.) A higher level of net replacement rate would be appropriate for those on lower earning levels.

The range of projected results, based on the IAAust’s assumptions, of between $17,687and $23,971 gives a clear indication that additional contributions may be required to achieve this target unless unexpected high levels of investment performance are achieved.

The Treasury projection of a first year retirement expenditure of $28,308 is not comparable with the ANOP research finding. A more appropriate comparison would be to consider the figure of $28,308 in the context of expected real AWOTE in 2032 of $67,615. The corresponding net replacement rate is 60%, which is well short of the 88% target referred to above (based on a target retirement income of $30,000).

APPENDIX A

Discounting – CPI or AWOTE?

Treasury assume that the Superannuation Guarantee contributions commence in 2002 and continue for 30 years until 2032. In their projection they assume CPI increases of 2.5% per annum, future AWOTE increases of 4.0% per annum, future age pensions are indexed with increases in AWOTE rate and future tax scales are indexed with increases in the CPI. Treasury express their results in 2001/02 dollars by discounting the 2032 year results by the CPI rate or 2.5% per annum.

ASFA, on the other hand, assumes that contributions have been made at the 9% Superannuation Guarantee contribution rate for the last 30 years and that the individual is retiring in 2002. Earnings and contribution figures for the earlier years are discounted back in line with the assumed growth in wages over that period ie at the AWOTE assumption not the CPI assumption.

Traditionally average increases in AWOTE have been greater than CPI by 0.5% to 1.5% per annum, as shown in Table 5 of this report. If the Treasury 1st year retirement income of $28,308 had been discounted using the Treasury AWOTE assumption of 4% per annum, rather than the CPI assumption of 2.5% per annum, and all other items were unaltered, the 1st year retirement income reduces to $18,265. If, on the other hand, the ASFA AWOTE assumption of 3.75% per annum was used for discounting in the Treasury model, then the 1st year figure would reduce to $19,678.

Treasury and ASFA comments on the appropriate rate to discount future dollars are contained in the following papers:

i) Treasury submission,
ii) ASFA submission,
iii) Supplementary ASFA submission,
iv) Further Supplementary ASFA submission,
v) Hansard Proof for 19 July 2002 (Treasury statement and questioning),
vi) Hansard Proof for 8 August 2002 (ASFA statement and questioning),
vii) Press Release from Senator Coonan 5 August 2002 headed "Minister rejects ASFA's claims"
viii) Treasury e-mail "Comparison of RIM methodology of projecting the retirement income for hypothetical individuals with that used by ASFA" 5 September 2002

The arguments presented in the above papers are summarised below:

(a) By Treasury

- It is appropriate to use CPI as it reflects actual spending power or what people can afford to buy with their retirement income ((i), (v) and (vii) above).

- Discounting by AWE is misleading as it does not capture the real growth in the value of the age pension over time, which is an important feature of government policy (vii).

- The ASFA approach of using AWE discounting is non-standard (vii): Deflating by the CPI "… is consistent with most Government reports (such as that on the New Tax System and the former Labor Government's *Saving for our Future*) which measure private living standards in terms of real spending power. This is also consistent with research reports which deal with trends in the standards of living of the aged, such as NATSEM's recent report *Trends in the Incomes and Assets of Older Australians*." (viii)

(b)` *By ASFA*

- Individuals will judge their living standards and adequacy of retirement incomes at the time they retire by community standards at that time rather than at the time they started contributing to superannuation. Current Age Pensioners would not be happy with an Age Pension about 40% less than what it is now, on the basis that a pension set at that level would be the same in real terms after adjusting for price inflation as the Age Pension in 1960 ((ii) and (iii)

- The Treasury measures inflate both the absolute and the relative levels of retirement income.

- The use of an AWE deflator is the standard approach of researchers, and it is Treasury which is the odd one out (iv).

Comparison between the Treasury and ASFA figures

Both figures purport to be the retirement income in 2001/02 dollars for a single male age 65 who has been receiving 9% Superannuation Guarantee contributions for 30 years. The Treasury figure is made up as follows:

	$
Age pension	16,717 (98.7% of adjusted age pension)
Life pension from Super account	14,558
Total before tax	31,275
Less tax	2,966
Total after tax	28,309

In 2001/02 the total age pension used in the submission is $10,966 although the Treasury retirement income shown above from a part age pension is $16,717. This result is because the Treasury model inflates the current age pension for 30 years at 4% and discounts the result back to 2001/02 at 2.5%.

The equivalent ASFA figures are

	$
Age pension	11,002 (99.0% of full age pension)
Life pension from Super account	8,320
Total before tax	19,322
Less tax	Nil
Total after tax	19,322

APPENDIX B

Adequacy of SG Contributions

(Reproduced from the IAAust submission to the Senate Select Committee dated June 2002)

In July 2002 the Superannuation Guarantee Contribution reaches 9% of salaries and wages. There is debate about whether that is sufficient to provide a reasonable level of retirement benefit.

In practice there are many variables that determine a person's total retirement income. Contributions of 9% of salary might be sufficient for some, but totally inadequate or too much for others. It is not possible to set a single optimum SG contribution rate that will provide an appropriate or adequate retirement income for the majority of retirees. Many factors affecting the individual will influence their actual and desired level of retirement income, including:

- the period over which contributions are made (which is reduced for time out of the work force);
- the number of dependents;
- the impact of part time work;
- retirement age;
- future longevity in retirement (which is higher for females);
- likely fund earnings;
- the impact of fees and taxes on benefits;
- the capacity to make additional voluntary contributions;
- financial support outside superannuation from personal wealth or government benefits;
- the structure of retirement products; and
- expectations of living standards in retirement.

It is fair to conclude that a 9% SG contribution alone, even over a lengthy career, will *not* provide most people with an income in retirement that will meet their expectations. Additionally, based on current retirement income policies and eligibility rules for the Age Pension, most Australian retirees today *and in the future* will receive some or all of their retirement benefit through the Age Pension.

Appendix 5

Objectives of the superannuation system

This appendix provides an outline of characteristics for three possible objectives of Australia's superannuation system. It is based on the written submission of PricewaterhouseCoopers to the inquiry.[1]

Table: An outline of characteristics for three possible objectives of Australia's superannuation system

	Basic	Adequate	Replacement
Objective - explained	To provide a basic income to all retired Australians and thereby relieve the Government of future age pension cost for these retirees.	To provide an adequate income to all retired Australians and thereby provide a level of comfort and security.	To provide a replacement income to all retired Australians that is linked to their pre-retirement income thereby ensuring a continuation of their living standards.
Retirement Income – goal	An income slightly greater than the age pension (say 50% AWE) for all retired workers. However, once this limit is obtained, no additional retirement income is encouraged.	Replacement income that varies by income. For example, it could be 90% for low income workers declining to 40%-50% for very high income workers.	At least 75% of the individual's pre-retirement income for all retired workers.
Conseq-uences for incentives	Significant incentives are provided to reach the prescribed minimum level of retirement income. Limited or no incentives are provided once the retirement income goal is achieved.	Ongoing and flexible incentives are required for all income earners, with a target towards low and middle income earners. Flexibility is also required as income levels can change significantly during a working career.	Ongoing, flexible and significant incentives are required for all income earners. Contribution and benefit limits linked to income levels would be reduced or removed.
Contrib-ution limits	Significant limits, once income objective is obtained.	Limits should be related to both income and current accumulation. Flexibility should recognise changes in life experience.	Very generous, if any, limits. Flexibility should recognise changes in life experience.

1 *Submission* 110, PricewaterhsouseCoopers, Attachment I.

	Basic	Adequate	Replacement
Benefit format rules	Once the minimum income is achieved, no further prescription of benefit format is needed.	The majority of the benefit should be taken as income.	The majority of the benefit should be taken as income.
Possible outcomes in respect of participation in future age pension payments			
Full pension	30-40%	25-35%	20-30%
Part pension	40-50%	30-40%	25-35%
No pension	20-30%	30-40%	40-45%

Source: *Submission* No 110, PriceWaterhouse Coopers, Attachment I

PWC expanded on each of the Basic, Replacement, and Adequate approaches in the following terms:

> In the **Basic** approach, the goal of superannuation would be to replace future age pension payments only. This would mean that once an individual's accumulated superannuation benefit is sufficient to exclude them from receiving the age pension, the Government would not require or encourage any further superannuation contributions. The consequences would include reduced superannuation contributions and lower superannuation benefits. However, if the objective is limited to 'replace future age pension costs', it is probable that a higher proportion of retired Australians would receive a part age pension. This result is due to several reasons including the lower contribution levels and the fact that with increasing longevity, any fixed amount (in current values) is unlikely to be sufficient to prevent retirees from receiving any age pension in the future.
>
> The **Replacement** approach represents the other extreme where the superannuation system, through a combination of compulsion and encouragement, promotes a continuation of pre-retirement living standards at <u>all</u> income levels. In view of the significant changes in the labour market, this approach would require significant flexibility and encourage substantial 'catch up' contributions to be made, particularly at later ages. Whilst this approach is likely to have the largest impact on future age pension costs and superannuation savings, intra-generational equity concerns may arise. It should also be recognised that even with the most generous system, it is likely that at least 20% of aged Australians will receive a full aged pension due to their previous limited work experience due to sickness, unemployment or family and other responsibilities.
>
> We recommend that the **Adequate** approach is the best way forward. Under this objective, twin goals exist; namely:
>
> . To reduce future age pension costs; and

- To encourage most Australians to save during their working years so that their retirement is comfortable and, within reason, bears some relationship to their pre-retirement living standards.

To achieve these goals, a number of changes are needed. These include:

- A continued combination of a compulsory and voluntary structure, but with the complementary roles of both clearly spelt out;
- Greater flexibility in the incentives to make voluntary contributions, recognising that superannuation savings should be assessed over many years and not considered to be a single year proposition; and
- Stronger controls over the form of benefit payments, thereby encouraging the provision of income streams.

Appendix 6

Previous proposals to increase the Superannuation Guarantee

As part of the 1995-96 Budget the then Government announced a proposal to increase the Superannuation Guarantee from 9 per cent of earnings to 15 per cent by 2002. In his statement of 9 May 1995 the then Treasurer (the Hon Ralph Willis, MP) indicated:

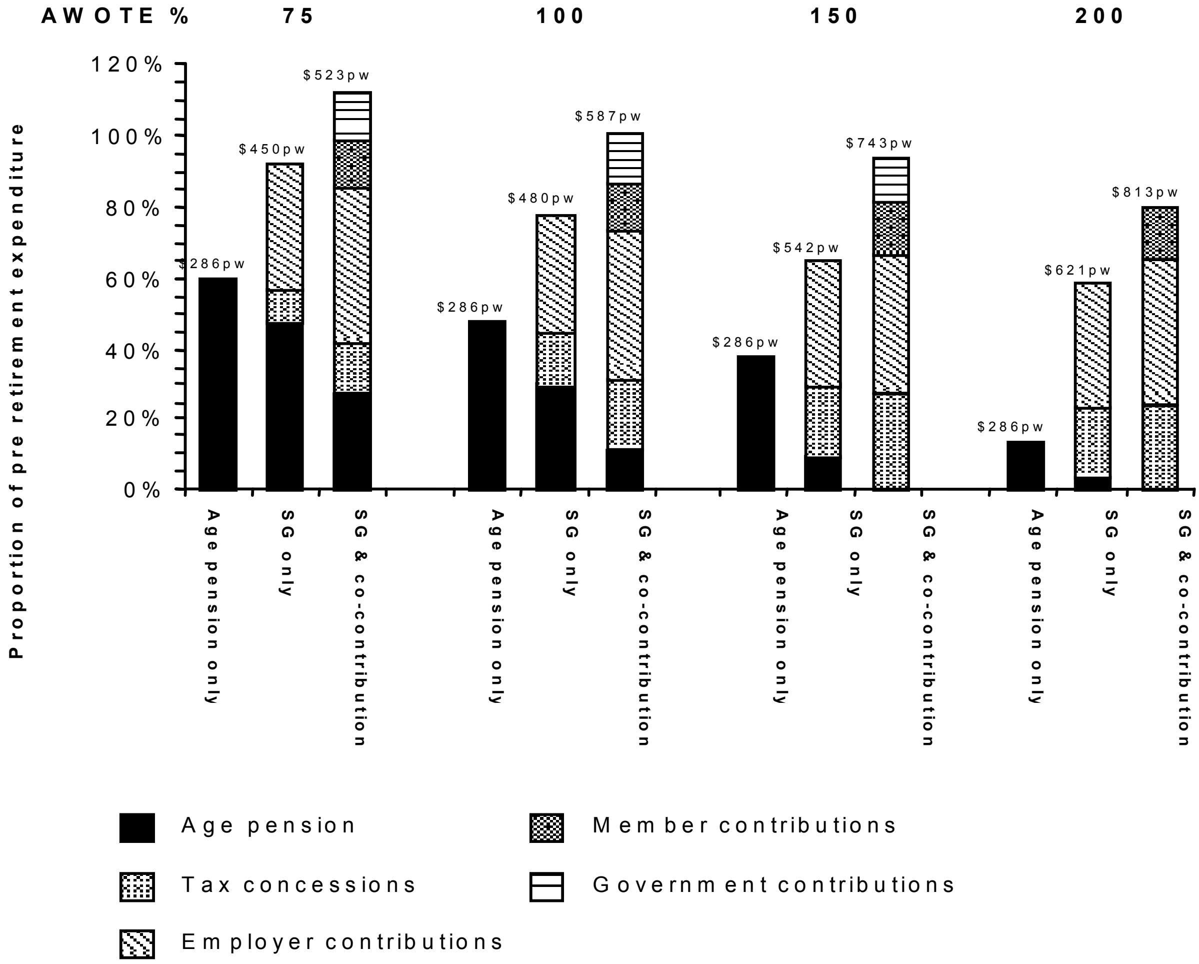
> The Government will support the phased introduction through industrial agreements and awards, where employee benefits are improved, of a requirement for employees to contribute 3 per cent of their earnings to superannuation by the year 2000.
>
> The Government will make means tested superannuation contributions matched to those made by employees (and by the self employed out of their after tax income), in lieu of proceeding with the second tranche of the personal tax cuts announced in the 1992 *One Nation* statement.
>
> It is anticipated that from 1 July 1997 all awards will provide for a stepped introduction of employee contributions, at the rates of 1 per cent in 1997-98, 2 per cent in 1998-99 and 3 per cent in 1999-2000.
>
> The introduction of employee contributions through awards will, as part of the broader wage bargaining process, be timed to coincide with wage increases that otherwise would have been received wholly in cash. This will avoid any decrease in employees' existing disposable incomes.
>
> Concurrently with the stepped introduction of the award provisions, the Government will phase in direct contributions to the superannuation accounts of employees and the self employed, matched to the actual contributions they make from after tax income. The Government's contributions will for all purposes be treated as employer contributions (ie subject to a 'notional' 15 per cent contributions tax, full preservation, and subject to taxation when paid as superannuation benefits). The Government's contributions will be capped ultimately at 3 per cent of 'Average Weekly Ordinary Time Earnings' (AWOTE) and, under a means test, will reduce to zero at taxable incomes of twice AWOTE.
>
> Employees and the self employed will be able to claim the direct Government contribution through their annual taxation returns.[1]

---

1 *Saving for Our Future*, Statement by the Treasurer, May 1995, p. 3.

The following chart shows the results of the proposal for a people at various income levels following 40 years of work.

Chart: Projected Outcomes from 1995 Budget Proposals (Single Male, in Scheme 40 years from Age 25 after 2002)



Source: *Saving for Our Future*, Statement by the Treasurer, May 1995.

The proposed compulsory member contributions and the matching Government contributions were not implemented. Instead the Government introduced a savings rebate, which in turn, was replaced by personal tax cuts associated with the introduction of the GST from 1 July 2000.

Appendix 7

Treasury 'cameo' modelling

This appendix reproduces 'cameo' modelling of the retirement income of a single male, retiring in 2032 at various ages, income levels and after various periods in the workforce. It is based on Treasury's submission to the inquiry.[1]

Table A1
Scenario: Single Male
Retirement Year = 2032 **Benefit taken as LIFE PENSION**
CPI = 2.5%, Wage Inflation = 4%, Projected Fund Earning Rate = 7%
Tax Indexation = CPI **Pension Indexation = AWE**
Life Expectancy = 83 (84 if retiring at 70)

Retirement Age	70	70	70	65	65	65
Career Length (Years)	25	30	40	25	30	40
Multiple of AWOTE:	0.75	0.75	0.75	0.75	0.75	0.75
PARAMETER in $2001-02 (CPI deflated)						
Final salary	50,711	50,711	50,711	50,711	50,711	50,711
Tax on Final salary	12,404	12,404	12,404	12,404	12,404	12,404
Exp last year at work	38,307	38,307	38,307	38,307	38,307	38,307
Average salary	42,832	41,420	38,808	42,832	41,420	38,808
Average tax on salary	9,855	9,411	8,640	9,855	9,411	8,640
Expenditure avg working life	32,977	32,010	30,168	32,977	32,010	30,168
Gov Pension 1st year	16,923	16,923	16,923	16,923	16,923	16,714
Gov Pension avg	18,623	18,414	17,989	19,076	18,771	18,203
Full Age Pension 1st year	16,923	16,923	16,923	16,923	16,923	16,923
Full Age Pension avg	18,709	18,709	18,709	19,266	19,266	19,266
Private Income including drawdowns (pa)	9,629	12,333	16,634	8,447	10,818	14,592
1st year retirement expenditure	24,925	26,844	29,898	24,085	25,768	28,330
Avg retirement expenditure $2001-02 (CPI deflated)	26,617	28,419	31,235	26,260	27,773	30,134
1st year retirement income tax	1,628	2,412	3,659	1,285	1,973	2,975
Average income tax in retirement	1,635	2,328	3,388	1,263	1,816	2,661
Average Pension as percentage of maximum pension	100%	98%	96%	99%	97%	94%

REPLACEMENT RATIOS							
Retirement Concept	**Working Life Concept**						
Average Retirement Expenditure	Final Working Life Expenditure	69%	74%	82%	69%	73%	79%
Average Retirement Expenditure	Average Working Life Expenditure	81%	89%	104%	80%	87%	100%
First Retirement Year Expenditure	Final Working Life Expenditure	65%	70%	78%	63%	67%	74%

IMPROVEMENT FROM SUPERANNUATION							
Retirement Concept	**Working Life Concept**						
Average Retirement Expenditure	First Year Full Rate Pension	157%	168%	185%	155%	164%	178%
Average Retirement Expenditure	Average Full Rate Pension	142%	152%	167%	136%	144%	156%
First Retirement Year Expenditure	First Year Full Rate Pension	147%	159%	177%	142%	152%	167%

1 *Submission* 78, Treasury, p.40.

Table A2

Scenario: Single Male

Retirement Year = 2032 **Benefit taken as LIFE PENSION**

CPI = 2.5%, Wage Inflation = 4%, Projected Fund Earning Rate = 7%

Tax Indexation = CPI **Pension Indexation = AWE**

Life Expectancy = 83 (84 if retiring at 70)

Retirement Age	70	70	70	65	65	65
Career Length (Years)	25	30	40	25	30	40
Multiple of AWOTE:	1	1	1	1	1	1
PARAMETER in $2001-02 (CPI deflated)						
Final salary	67,615	67,615	67,615	67,615	67,615	67,615
Tax on Final salary	20,127	20,127	20,127	20,127	20,127	20,127
Exp last year at work	47,488	47,488	47,488	47,488	47,488	47,488
Average salary	57,109	55,227	51,745	57,109	55,227	51,745
Average tax on salary	15,273	14,527	13,391	15,273	14,527	13,391
Expenditure avg working life	41,837	40,700	38,353	41,837	40,700	38,353
Gov Pension 1st year	16,923	16,923	16,726	16,923	16,717	16,228
Gov Pension avg	18,358	17,993	17,341	18,694	18,208	17,419
Full Age Pension 1st year	16,923	16,923	16,923	16,923	16,923	16,923
Full Age Pension avg	18,709	18,709	18,709	19,266	19,266	19,266
Private Income including drawdowns (pa)	12,953	16,596	22,452	11,362	14,558	19,694
1st year retirement expenditure	27,284	29,871	33,918	26,155	28,308	31,681
Avg retirement expenditure $2001-02 (CPI deflated)	28,828	31,210	35,003	28,116	30,113	33,318
1st year retirement income tax	2,592	3,648	5,260	2,131	2,966	4,241
Average income tax in retirement	2,483	3,379	4,790	1,940	2,653	3,795

Average Pension as percentage of maximum pension	98%	96%	93%	97%	95%	90%

REPLACEMENT RATIOS							
Retirement Concept	**Working Life Concept**						
Average Retirement Expenditure	Final Working Life Expenditure	61%	66%	74%	59%	63%	70%
Average Retirement Expenditure	Average Working Life Expenditure	69%	77%	91%	67%	74%	87%
First Retirement Year Expenditure	Final Working Life Expenditure	57%	63%	71%	55%	60%	67%

IMPROVEMENT FROM SUPERANNUATION							
Retirement Concept	**Working Life Concept**						
Average Retirement Expenditure	First Year Full Rate Pension	170%	184%	207%	166%	178%	197%
Average Retirement Expenditure	Average Full Rate Pension	154%	167%	187%	146%	156%	173%
First Retirement Year Expenditure	First Year Full Rate Pension	161%	177%	200%	155%	167%	187%

Table A3

Scenario: Single Male
Retirement Year = 2032 **Benefit taken as LIFE PENSION**
CPI = 2.5%, Wage Inflation = 4%, Projected Fund Earning Rate = 7%
Tax Indexation = CPI **Pension Indexation = AWE**
Life Expectancy = 83 (84 if retiring at 70)

Retirement Age	70	70	70	65	65	65
Career Length (Years)	25	30	40	25	30	40
Multiple of AWOTE:	1.5	1.5	1.5	1.5	1.5	1.5
PARAMETER in $2001-02 (CPI deflated)						
Final salary	101,422	101,422	101,422	101,422	101,422	101,422
Tax on Final salary	36,524	36,524	36,524	36,524	36,524	36,524
Exp last year at work	64,899	64,899	64,899	64,899	64,899	64,899
Average salary	85,664	82,841	77,617	85,664	82,841	77,617
Average tax on salary	28,853	27,488	25,372	28,853	27,488	25,372
Expenditure avg working life	56,811	55,353	52,245	56,811	55,353	52,245
Gov Pension 1st year	16,901	16,563	16,013	16,466	16,005	15,257
Gov Pension avg	17,665	17,038	16,022	17,803	17,059	15,851
Full Age Pension 1st year	16,923	16,923	16,923	16,923	16,923	16,923
Full Age Pension avg	18,709	18,709	18,709	19,266	19,266	19,266
Private Income including drawdowns (pa)	19,599	25,123	34,086	17,193	22,038	29,900
1st year retirement expenditure	31,931	35,890	42,870	30,039	33,220	38,984
Avg retirement expenditure $2001-02 (CPI deflated)	33,159	36,755	43,061	31,757	34,780	39,828
1st year retirement income tax	4,510	5,796	7,230	3,620	4,822	6,173
Average income tax in retirement	4,105	5,406	7,047	3,239	4,317	5,923
Average Pension as percentage of maximum pension	94%	91%	86%	92%	89%	82%

REPLACEMENT RATIOS							
Retirement Concept	**Working Life Concept**						
Average Retirement Expenditure	Final Working Life Expenditure	51%	57%	66%	49%	54%	61%
Average Retirement Expenditure	Average Working Life Expenditure	58%	66%	82%	56%	63%	76%
First Retirement Year Expenditure	Final Working Life Expenditure	49%	55%	66%	46%	51%	60%

IMPROVEMENT FROM SUPERANNUATION							
Retirement Concept	**Working Life Concept**						
Average Retirement Expenditure	First Year Full Rate Pension	196%	217%	254%	188%	206%	235%
Average Retirement Expenditure	Average Full Rate Pension	177%	196%	230%	165%	181%	207%
First Retirement Year Expenditure	First Year Full Rate Pension	189%	212%	253%	178%	196%	230%

Appendix 8

Taxation treatment of superannuation

Introduction

This appendix provides a description of the taxation treatment of superannuation. The material, provided by the ATO, updates the information published in a previous Committee publication, *Super Taxing – an information paper on the taxation of superannuation and related matters*, February 1998.[1]

Current thresholds and limits relating to superannuation

In accordance with the *Income Tax Assessment Act 1936* (the Act), *Superannuation Guarantee (Administration) Act 1992* (SGAA*),* the *Superannuation Contributions Tax Imposition Act 1997* (SCTIA), the *Termination Payments Tax Imposition Act 1997* (TPTIA) and the *Termination Payments Tax (Assessment and Collection) Act 1997* (TPT(AC)A) there are a number of thresholds and limits that require indexation each year by movements in full-time adult Average Weekly Ordinary Time Earnings (AWOTE).

The AWOTE amount is an estimate by the Australian Statistician of the full-time adult average weekly ordinary time earnings for persons in Australia. The estimate for February 2002 was $860.50 and the estimate for February 2001 was $810.60. This produces an indexation factor of 1.062.

This factor is applied against the 2001-2002 thresholds and limits. The new thresholds and limits that apply from 1 July 2002 are set out below.

Bona fide redundancy tax free amounts

For the purposes of subsection 27A(20) of the Act, the tax free amounts of a bona fide redundancy payment or of an approved early retirement scheme payment are:

	2002/03	2001/02
Base Limit	$5,623	$5,295
Per completed year of service	$2,812	$2,648

Source: *Taxation Determination 2002/11*

SG maximum contributions base

For purposes of the SGAA the maximum contribution's base for a contribution period was $27,510 in 2001/02 and is $29,220 in 2002/03.

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1 *Submission* 130, ATO.

Age based deduction limits

For the purposes of subsections 82AAC(2B) and 82AAT(2B) of the Act, the age based deduction limits for superannuation contributions by employers and eligible persons are:

	2002/03	**2001/02**
Under age 35	$12,651	$11,912
Age 35 to 49	$35,138	$33,087
Age 50 and over	$87,141	$82,054

Source: *Taxation Determination 2002/11*

Reasonable Benefit Limits

For the purposes of subsection 140ZD(3) of the Act, the RBL limits are:

	2002/03	**2001/02**
Lump sum RBL	$562,195	$529,373
Pension RBL	$1,124,384	$1,058,742

Source: *Taxation Determination 2002/11*

Upper limit for tax on lump sum ETP payments

The upper limit for determining the residual amount for the purposes of section 159SG of the Act, i.e., the threshold on the post-June 1983 component of an ETP was $105,843 in 2002/02 and is $112,405 in 2002/03.

Surcharge limits

A superannuation contribution surcharge of up to 15% is levied on the surchargeable contributions of a member whose adjusted taxable income exceeds the surcharge threshold. Under section 6 of the TPTIA the surcharge thresholds for the following financial years are:

	2002/03	**2001/02**
Denominator	$1,295	$1,219
Lower threshold limit	$90,527	$85,242.
Age 50 and over	$109,924	$103,507

Source: *Superannuation Contribution Determination 2002/4*

Surcharge contributions threshold for Pre-7 May 1997 members and TFN not known

Under subsection 6(1) of the SCTIA, the surcharge thresholds for 2002/02 was $3,248, and the threshold for 2002/03 is $3,880.

Income taxation of superannuation funds

The rates of tax payable by superannuation funds, RSAs, ADFs and PST are shown below:

Type of fund	**Tax rate**
Complying superannuation fund assessable income	15%
Complying superannuation fund special income	47%
Non complying superannuation fund	47%
Complying ADF assessable income	15%
Complying ADF special income	47%
Non complying ADF	47%
PST assessable income	15%
PST special income	47%
RSA providers other than life companies	
-standard component of taxable income	30%
-RSA component of taxable income	15%

Appendix 9

International pension taxes

Introduction

This appendix presents a comparison of the international taxation of pensions. It is based on the written submission to the inquiry by the AMP.[1]

International taxation arrangements for retirement savings

The taxation arrangements for retirement savings in most OECD countries are based on consumption tax principles. That is, retirement savings are only taxed when taken out of the retirement saving scheme to be used for consumption purposes. Essentially, the contributions and earnings are not taxed, while the benefits are taxed at the individual's personal income tax rate.

Returns on the retirement saving investment (usually referred to as fund earnings) are untaxed under such arrangements because otherwise, income would effectively be taxed twice, and the costs of future consumption increased.

However, it is possible to tax pensions at three points: on contributions, on fund earnings, and on benefits. Some countries tax contributions, but only a few tax earnings. Table 9A below reports current practice for a number of countries.

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1 *Submission* 64, AMP, Appendix B.

Table 8: Taxation of Private Pensions in Selected Countries

Country	Income tax treatment of contributions	Fund Income		Benefits	
		Contrib-utions	Earnings	Pensions	Lump sums
Australia	Employer conts tax deductible	taxed at 15% to 30%	taxed at 15%; tax credits available on Australian equities	Taxed, with 15% rebate	Taxed at 15% above threshold
Belgium	Tax deductible		Taxed	Taxed (with tax credit)	Taxed at 16.5%
Canada	Tax deductible		Exempt	Taxed	Taxed
Chile	Tax deductible		Exempt	Taxed	Lump sum tax
Denmark	Tax deductible		Taxed	Taxed	Taxed at 40%
France	Tax deductible		Exempt	Taxed (some deductions).	No lump sums
Germany	Employer conts tax deductible		Exempt	Taxed	Taxed
Ireland	Tax deductible		Exempt	Taxed	Taxed with some exemptions
Italy	Tax deductible		Taxed	Taxed	Taxed at 12.5%
Japan	Employer conts tax deductible		Taxed	Taxed	Taxed
Luxemb-ourg	Employer conts tax deductible			Exempt	Taxed
Netherlands	Tax deductible		Exempt	Taxed	Taxed

Country	Income tax treatment of contributions	Fund Income		Benefits	
		Contrib-utions	Earnings	Pensions	Lump sums
New Zealand	No tax deduction		Taxed	Exempt	Exempt
Portugal	Employer conts tax deductible		Exempt	Taxed (subject to specific rules)	Taxed at income tax rates on 20% of benefit
Spain	Tax deductible		Exempt	Taxed	Taxed
Sweden	Tax deductible		Taxed	Taxed	Taxed
Switzerland	Tax deductible		Exempt	Taxed	Taxed
UK	Tax deductible		Exempt	Taxed	Taxed with some exceptions
USA	Tax deductible		Exempt	Taxed	Taxed but eligible for concessions
Singapore	Exempt		Exempt	Taxed	Taxed

Appendix 10

Operation of superannuation taxes on end benefits – some examples

Introduction

This appendix presents four examples on the operation of superannuation taxation arrangements upon retirement end benefits. It is based upon evidence provided to the Committee by the ATO.[1]

Example A: Under age 55 and takes a lump sum of unrestricted non-preserved elements

Carlee changed employers and received a cash eligible termination payment (ETP) of $20,000 from her employer-sponsored superannuation fund.

The amount of tax withheld is calculated on the amount of the components as follows:

ETP components		**Tax withheld**
CGT exempt component	$0	$0
Non-qualifying component	$0	$0
Undeducted contributions	$0	$0
Concessional component	$0	$0
Pre-July 83 component	$4,950	$0
Post-June 83 (Untaxed element)	$0	$0
Post-June 83 (Taxed element)	$15,050	$3,236 (21.5% of $15,050)
Post-June 1994 invalidity component	$0	$0
Gross amount of this cash payment	**$20,000**	
Total tax withheld	$3,236	
Net ETP cash payment	**$16,764**	

The tax withheld rate applicable to the taxed element of the post-June 83 component of an ETP, where the recipient is under 55 years of age, is 21.5% (i.e. a rate of 20% plus Medicare levy of 1.5%). In Carlee's case, the tax withheld of $3,236 was calculated by applying 21.5% to $15,050.

If Carlee had not provided her tax file number to her superannuation fund, tax would have been withheld at a rate of 48.5% from both the pre-July 83 component and the post-June 83 component.

1 *Submission* 134, ATO, pp. 2-6.

In her income tax return for the year in question, Carlee would have to include in her assessable income the whole amount of the post-June 83 component ($15,050) and 5% of the Pre-July 83 component ($248). That is, an assessable amount of $15,298 should be declared.

Example B: Rolls-over a superannuation eligible termination payment (ETP) to purchase an allocated pension at age 55. Commutes pension at age 58

John retired on 1 July 1999 at the age of 55. He was a member of the Public Sector Superannuation (PSS) Scheme. He rolled-over his super benefit to purchase an allocated pension. He has not previously received any superannuation or employer ETPs.

His eligible service period was made up of 4,018 pre-July 1983 days and 5,844 post-June 1983 days. The ETP was broken up into a pre-July 83 component based on the ratio of pre July 1983 days to total days. Undeducted contributions and the post-June 83 component form the remaining components of the ETP.

The ETP rolled-over was made up of the following components:

ETP components	
CGT exempt component	$0
Non-qualifying component	$0
Undeducted contributions	$63,000
Concessional component	$0
Pre-July 83 component	$159,139
Post-June 83 (Untaxed element)	$110,375
Post-June 83 (Taxed element)	$58,086
Post-June 1994 invalidity component	$0
Gross amount of this cash payment	**$390,600**

The untaxed element of $110,375 represents income to the receiving roll-over fund, upon which that fund pays income tax at a rate of 15% (i.e. $16,556).

The purchase price of the allocated pension was $374,044 (assuming no superannuation fund entry fees). As an allocated pension does not meet the pension reasonable benefit limit (RBL) standards, and as John had not received any previous payments which were assessed against the RBL, John's allocated pension is assessed against the lump sum RBL. The undeducted contributions are not counted towards the RBL. The amount that was assessed against the RBL was therefore $311,044.

As this was less than the lump sum RBL of $485,692 for the year ended 30 June 2000, there was no excessive amount.

John elected to receive a payment of $26,000 in the first year. As John is single and has not nominated a reversionary beneficiary for his allocated pension, his deductible amount is worked out by dividing the undeducted purchase price

(UPP) of his pension by his life expectation factor. The relevant factor for John was 23.13 years when the pension commenced and his UPP is the amount of his undeducted contributions. The deductible amount is therefore $2,724.

The pension/annuity rebate applying to this pension is calculated by subtracting the deductible amount from the annual pension income, then multiplying that result by 15%. The pension/annuity rebate in the first year was $3,491 (i.e. 15% of [$26,000 - $2,724]).

On 1 July 2002 John elected to commute the allocated pension to a lump sum of $375,200.

His eligible service period is now made up of 4,018 pre-July 1983 days and 6,940 post-June 1983 days.

The lump sum is made up of the following components:

ETP components	
CGT exempt component	$0
Non-qualifying component	$0
Undeducted contributions	$54,828
Concessional component	$0
Pre-July 83 component	$137,576
Post-June 83 (Untaxed element)	$0
Post-June 83 (Taxed element)	$182,796
Post-June 1994 invalidity component	$0
Gross amount of this cash payment	**$375,200**

As John has reached age 55 the low rate threshold of $112,405 for the year ended 30 June 2003 applies to the post-June 83 component. This amount is effectively tax free. The remainder of the taxed element ($70,391) is taxed at a rate of 15% plus Medicare levy of 1.5%. The tax payable on this portion is therefore $11,615.

Five percent of the pre-July 83 component ($6,879) is included in John's assessable income for the year ended 30 June 2003 and taxed at his marginal tax rate.

The undeducted contributions are tax free.

The ETP is also counted for RBL purposes, but as the original pension was not excessive, the ETP is not excessive.

Example C: Invalidity eligible termination payment (ETP) due to permanent incapacity

Derek terminated employment because of an invalidity (a permanent disability). He has been a member of Comfort Life Company since the 1970's. Comfort Life Company is paying Derek his superannuation savings of

$100,000. Derek can choose to have all of his ETP paid in cash to him or rolled-over to another superannuation entity (i.e. it is all 'unrestricted non-preserved').

Derek's ETP Pre-Payment Statement shows his payment has a post-June 1994 invalidity component of $40,980. Derek elects to take all of his invalidity benefit as cash (as it is unrestricted non-preserved). Derek has received no other ETPs.

The statement shows the ETP also has:

- a pre-July 83 component because Derek's membership started before 1 July 1983; and
- a post-June 83 component because Derek's membership period is also after 30 June 1983.

Extract of Derek's ETP Pre-Payment Statement

ETP components	
CGT exempt component	$0
Non-qualifying component	$0
Undeducted contributions	$0
Concessional component	$0
Pre-July 83 component	$18,775
Post-June 83 (Untaxed element)	$0
Post-June 83 (Taxed element)	$40,245
Post-June 1994 invalidity component	$40,980
Gross amount of this cash payment	**$100,000**

Derek is paid the gross amount of the ETP cash payment which is $100,000. Derek's super fund does not withhold any tax from his ETP payment. The pre-July 83 component and the post-June 1994 invalidity component are not subject to having tax withheld when they are paid. As Derek has reached age 55 the low rate threshold of $112,405 (for the year ended 30 June 2003) applies to the post-June 83 taxed element. This amount is effectively tax free.

Therefore, Derek's actual ETP payment would be $100,000. If Derek had not provided his tax file number to his super fund then the tax withheld rates applicable to his ETP would be greater (i.e. tax would have been withheld at the rate of 48.5% from both his pre-July 83 component and post-June 83 component).

In his income tax return for the year in question, Derek would have to include in his assessable income the whole amount of the post-June 83 component ($40,245) and 5% of the Pre-July 83 component ($938). That is, an assessable amount of $41,183 should be declared.

Although the post-June 83 component is included as income, in Derek's case an ETP rebate will operate which will effectively make that amount tax free.

Example D: Payment of a lump sum death benefit to a dependant of the deceased

Bob dies at age 60 while still a contributing member of his super fund. The death benefit is paid to his wife, as his dependant. She receives the benefit in the form of a lump sum payment.

The payment is made up of the following components:

ETP components	
CGT exempt component	$0
Non-qualifying component	$0
Undeducted contributions	$230,000
Concessional component	$0
Pre-July 83 component	$621,636
Post-June 83 (Untaxed element)	$0
Post-June 83 (Taxed element)	$630,727
Post-June 1994 invalidity component	$0
Gross amount of this cash payment	**$1,482,363**

As it is a death benefit payment and not related to a pension that had already commenced, the lump sum is assessed against Bob's pension reasonable benefit limit (RBL). His pension RBL is $1,124,384 for the year ended 30 June 2003.

The undeducted contributions are not assessable against the RBL. This leaves $1,252,363 that is counted for RBL purposes. The excessive component of the ETP is therefore $127,979 (i.e. $1,252,363 - $1,124,384).

The excessive component is taxed at a rate of 47% plus Medicare levy of 1.5%. The tax payable is $62,070 (i.e $127,979 * 0.485).

The rest of the lump sum is not taxable, as it is a death benefit paid to a dependant and is under the pension RBL of the deceased.

Appendix 11

Pension income and assets test arrangements

Introduction

1.1 This appendix summarises the provisions of the income test and assets test, and their impact on the availability of the age pension. It is based on Attachment D of the submission of FACS to the inquiry.[1]

The income and asset tests

1.2 Income and assets tests (collectively referred to as the 'means test') work together to target pension payments to those most in need of assistance, and to ensure that the pension system remains affordable for Australian taxpayers. The means test also helps to reinforce the message that people are expected, where possible, to use their own resources before calling on the community for support.

1.3 The rate of pension payable to an individual is calculated under both the income test and the assets test. Payment is made under the test that provides the lower rate of pension.

1.4 People can have substantial income and assets before there is any effect on their pension. These "free areas" are indexed each July in line with cost of living increases.

1.5 Income and assets above these "free areas" reduce pension payments. Reduction rates are set to strike a balance between targeting the pension to those most in need and ensuring that people are better off from self-provision. The following tables set out the income test and assets test free areas and reduction rates as at 1 July 2002.

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1 *Submission* 79, FACS, Attachment D.

Table: The income test

Family situation	Maximum pension is payable under income test if assessed income does not exceed	No pension is payable under income test if assessed income reaches
Single pensioner	$116 per fortnight	$1,185 per fortnight
Pensioner couple (combined)	$204 per fortnight	$1,979 per fortnight
The rate of pension is reduced by 40 cents for every dollar of income over the free area threshold amounts.		

Table: The assets test

Family situation	Maximum pension is payable under assets test if assessable assets do not exceed	No pension is payable under assets test if assessable assets reach
Single homeowner	$145,250	$288,000
Single non-homeowner	$249,750	$392,500
Partnered homeowner (combined)	$206,500	$443,500
Partnered non-homeowner (combined)	$311,000	$548,000
The rate of pension is reduced by $3 per fortnight for every $1,000 of assessable assets above the free area amounts.		

1.6 The maximum amounts of income and assets that people can have and still receive a pension payment have increased substantially in recent years, as a result of indexation arrangements and also the July 2000 one-off liberalisation of the income test and assets test as part of *A New Tax System* arrangements. The July 2000 liberalisation reduced the maximum rate at which pension is withdrawn under the income test from 50 cents per dollar of assessed income to 40 cents per dollar. This meant that from July 2000 there was a substantial increase in the amount of income people could earn and still be paid some pension (for a single person, this amount increased by around $6,000 a year).

1.7 As noted earlier, 33.5 per cent of age pensioners receive a reduced pension because of their income or assets. Of age pensioners granted in the last 12 months, 51.8 per cent received a full rate pension and 48.2 per cent received a part rate pension. This suggests that people recently moving on to the age pension have, on average, higher levels of income and / or assets that the total group of people currently on age pension, some of whom have been receiving the pension for many years.

Means test policy principles

1.8 While the income and assets tests target payments to those most in need, these tests must also provide incentives for self-provision. The means test should encourage pre-retirement accumulation of private savings (including through superannuation), because higher pre-retirement accumulations should translate into increases in retirement incomes. The means test should also encourage people to maximise their total post retirement income (comprising private income and income support) rather than maximise their age pension payments in isolation.

1.9 A number of means test policy settings support the achievement of these outcomes.

a) Firstly, the means test free areas and withdrawal rates ensure that people are better off from self-provision, even if the additional assets or income causes some reduction in pension.

b) Secondly, the assets test is an important measure in encouraging customers to maximise their total income. This is because the assets test reduces the income support paid to customers with substantial assets that produce little or no income. Hence the assets test encourages better utilisation of assets. More broadly, the assets test reflects the principle that customers with non-home assets of high value should not be able to draw on the limited public funds available for social security expenditures.

c) Thirdly, the income test deeming rules further encourage customers to use their savings to produce market-related levels of income. Under these rules, savings placed in financial investments such as bank accounts, term deposits, and shares are deemed to earn market-related rates of income, irrespective of the actual income from the investments. Before the deeming rules were introduced, many pensioners elected to place their savings in no income or low-income investments, in order to maximise their pension. While increasing incentives for self-provision, the deeming rules also considerably simplified the income test.

d) Fourthly, the means test also contains "deprivation" rules that act as a disincentive for customers to gift, or give away, assets that they could use for self-provision. Under these rules amounts gifted in excess of $10,000 per year (or $30,000 over 5 years) are taken into account under the income test and the assets test.

Means test treatment of superannuation

1.10 Accumulation phase superannuation (superannuation that has not been drawn on and is not being used to generate an income stream) is exempt from the income test and the assets test until a person is of age pension age. It is then assessed under both the income and assets tests. This reflects the principle that superannuation should be used to provide income in retirement.

1.11 Superannuation can generally be drawn on retirement after age 55, and this means that most people have made decisions about how to draw on their superannuation before they reach age pension age. These decisions determine the extent to which their accumulated superannuation affects their income support entitlements (both before age pension age and from age pension age).

1.12 Superannuation may be taken in lump sum form or via an income stream. The social security means test implications follow:

- the extent to which superannuation taken as a lump sum results in assessable income or assets depends on the way in which the lump sum is used. For example, if the proceeds are invested in assets such as shares and managed investments, then these are assessed under the means test, and pension reductions can result. To the extent that the proceeds are used for expenditure on the home (an exempt asset) or on lifestyle spending (eg travel) there can be no impact on pension entitlements; and
- where superannuation is used to purchase an income stream, the income stream is assessable under the means test. (The form of the means test rules that apply depend upon the characteristics of the income stream.)

1.13 The Government has encouraged greater take-up of income streams by providing an assets test concession where the customer has given up access to capital in return for an income stream payable for life (or for life expectancy).

Assessable income for the income test

1.14 The intention of the social security definition of income is to capture a broad range of incoming amounts. “Income” is defined in the legislation as meaning “an income amount earned, derived or received by the person for the person’s own use or benefit”. The reason for such a broad definition is that social security income support payments are intended as a to assist those in need, which is measured by assessing the resources available to the person for their own support. Consequently, very few types of income are excluded. There are also special rules for assessing income from some sources, for example financial investments. Some of the most common types of assessable income include:

- deemed income from financial investments (refer below for more information);
- gross income from wages and salaries (including fringe benefits);
- net income from rental property and businesses (including farms);
- family trust distributions and dividends from private company shares; and
- income from income stream products such as annuities and allocated products.

1.15 Deeming rules are used to assess a pensioner’s income from financial investments. Under these rules, as at 1 July 2002 a deeming rate of 2.5 per cent applies for the first:

- $34,400 of total financial assets held by a single pensioner; and

- $57,400 of total combined financial assets held by a couple where at least one member is a pensioner.

1.16 A deeming rate of four per cent applies to amounts above these thresholds.

1.17 The actual income from financial investments is not assessed. If a person's financial assets earn higher income than the deemed rates, the extra income earned above the deeming rate is not counted as income.

1.18 Financial investments include bank, building society and credit union accounts, term deposits, loans and debentures, managed investments, listed shares and assets tested income streams (short term). Financial investments also include "accumulation phase" superannuation investments held by social security customers over age pension age.

1.19 These deeming rules were introduced in 1996 after an independent review of the income and assets tests. Consultations with pensioners and pensioner organisations had indicated major concerns about the complexity of the previous income test rules for financial investments, and about the frequent changes they caused to pension payments. The deeming rules are a simple and fair way of assessing income from financial investments, because they treat all types of financial investments in the same way. They also increase incentives for self-provision.

1.20 The deeming thresholds (the maximum amount of financial investments that is assessed at the lower deeming rate) are also indexed to increases in the Consumer Price Index in July each year.

Assessable assets for the assets test

1.21 Some of the most common types of assessable assets are:

- bank, building society or credit union accounts, term deposits, bonds, debentures, shares, property trusts, and managed investments;
- income stream products that do not meet all the characteristics for assets test exemption (refer section on means test treatment of income streams);
- household contents and personal effects;
- motor vehicles, boats and caravans (not used as homes);
- the value of real estate (e.g. a holiday home or a bush block);
- the refundable amount of an accommodation bond paid on entry to an aged care home;
- the value of businesses and farms, including goodwill; and
- superannuation investments from which an income stream has not been drawn (investments such as approved deposit funds) held by social security customers over age pension age.

1.22 The principal home is exempt from the assets test.

1.23 Gifted assets over a $10,000 limit in any year (or over $30,000 over five years) are assessed as an asset for five years from the date of the disposal.

1.24 Pensioners who are assessed under the assets test, and who are in severe financial hardship, may be eligible for extra payment under special hardship provisions if they:

- own an asset that they cannot sell or reasonably be expected to sell; and
- cannot borrow against the asset or reasonably be expected to borrow against it.

Appendix 12

Other government concessions and allowances for pensioners and self-funded retirees

Introduction

1.1 This appendix summarises other government concessions for pensioners and self-funded retirees other than the age pension. It is based on Attachment C of the submission of FACS to the inquiry.[1]

Rent assistance

1.2 Rent assistance is a supplementary benefit paid to age pensioners who pay private rent. Private rent includes caravan park site fees, mooring fees and some retirement village fees. People paying rent to a state or territory government housing authority for the rental of government housing or residing in Commonwealth funded aged care are not eligible for rent assistance.

1.3 Before rent assistance becomes payable, a minimum amount of rent (rent threshold) must be paid. Rent assistance is then paid at 75 cents for every dollar of rent paid above the rent threshold, up to a maximum rate.

1.4 Rent thresholds and maximum payment rates (without dependent children) as at 20 March 2002 were:

	Single ($ a fortnight)	**Partnered couple combined ($ a fortnight)**
Rent threshold before rent assistance is paid	80.40	131.00
Minimum rent to get maximum payment	201.20	244.87
Maximum rent assistance	90.60	85.40

Pensioner Concession Card (PCC)

1.5 The PCC is issued to persons receiving a pension including age pension, Disability Support Pension and Parenting Payment (Single), Mature Age Allowance, Mature Age Partner Allowance and Bereavement Allowance. The PCC is also issued to people over 60 who have been getting the Newstart Allowance, Sickness

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1 *Submission* 79, FACS, Attachment C.

Allowance, Widow Allowance, Partner Allowance, Parenting Payment (Partnered) or a Special Benefit continuously for the previous nine months.

Commonwealth Seniors Health Card (CSHC)

1.6 The CSHC is targeted at self-funded retirees of age pension age (currently 62 years for women, and 65 years for men) who meet certain eligibility criteria, that is:

- the person is not receiving another income support payment from Centrelink or the Department of Veterans' Affairs;
- the person meets an income test of under $50,000 a year (single person) or $80,000 a year (couple, combined income); and
- they are an Australian resident.

1.7 The Government announced in 2001 that the Commonwealth would negotiate with State and Territory governments to extend some or all of the concessions currently available to pensioners to holders of the CSHC.

1.8 As a result of ongoing negotiations, the Commonwealth recently offered the States and Territories around $65 million per annum in total to assist with the cost of extending core pensioner concessions to CSHC holders. When negotiations are finalised, eligible CSHC holders will be able to receive concessions on essential services, including council, water and sewerage rates, electricity, and motor vehicle registration.

Rail concessions

1.9 PCC holders are entitled to at least one free rail journey within their State/Territory of residence (except for Tasmania/Northern Territory) on rail services provided by State/Territory Governments.

1.10 The Commonwealth funds Great Southern Rail (GSR) to provide concessions to PCC holders and CSHC holders on GSR services that were formerly Commonwealth owned. These services are the Indian Pacific, the Ghan, and the Overland. These concessions can range between $25-$500 per journey.

Hearing concessions

1.11 Certain PCC holders will also be able to receive hearing services. This includes free hearing assessment and hearing rehabilitation, supply and fitting of hearing aids, and other hearing aid concessions.

Pharmaceutical allowance

1.12 Pharmaceutical Allowance is paid to help PCC holders and some allowees with the cost of certain prescriptions listed under the PBS. Pharmaceutical Allowance forms part of the rate payable to all pensioners, sickness allowance recipients, certain allowance recipients with temporary incapacity exemption from activity testing requirements, and long term allowees, who are over 60 years of age, and have been receiving income support for at least 9 months.

1.13 Concession cardholders currently pay only $3.60 for medicines listed on the PBS, excluding any premium for higher cost alternatives. After spending $187.20 (52 scripts) on prescription medicines in a calendar year, cardholders are entitled to free PBS prescription medicines for the rest of that calendar year.

State and Territory concessions

1.14 The Commonwealth has in place arrangements with the states to ensure that all pensioners receive certain 'core' concessions (council and water and sewerage charges, electricity, motor vehicle registration and public transport). This is done through an annual Specific Purpose Payment to all State and Territory Governments that ensures that all holders of the Pensioner Concession Card receive these concessions without discrimination.

1.15 The agreement does not specify the level of concession that must be offered, as State and Territory governments determine these matters.

1.16 The benefits obtained from concessions differ significantly between States and Territories- eg. the annual average value of motor vehicle registration concessions in Tasmania is $33; in ACT it can be over $200.

1.17 The value of a concession card to any individual is determined by their circumstances. For example, they may not be eligible for rates concessions if they do not own their home; they would be ineligible for vehicle registration concessions if they don't own a car, which may in turn impact on their accessing of public transport concessions.

1.18 In addition a wide variety of secondary concessions are available to PCC holders including dog registration, dental concessions, various education allowances or concessions, ambulance services, certain eye care programs and spectacles. The value of these will vary between state and local jurisdictions. In addition companies such as Telstra and Australia Post may offer concessions or rebates to cardholders.

1.19 FACS estimates that the overall annual value of concessions through the card is between $300 and $1,000 a year (depending on state of residence and the person's circumstances).

Telephone allowance

1.20 Telephone Allowance (TAL) is a quarterly payment to assist with the rental of a domestic telephone or mobile phone line. To be eligible for TAL, a person must have a phone connection in their name or their partner's name, and be receiving either an eligible pension or allowance payment through Centrelink or the Department of Veterans' Affairs, or the Commonwealth Seniors Health Card.

1.21 The amount of TAL payable is dependent upon the person's circumstances. Both an eligible single person and an eligible couple receive the full amount of TAL ($18.00 per quarter), as the costs to rent a telephone line are the same for one person or a couple. Where only one member of the couple is receiving an eligible benefit, the allowance is paid at the half-married rate of $9.00 per quarter.

State Government seniors cards

1.22 These cards are issued by each state to their residents who are (generally) aged over 60 and no longer working full time. Eligibility varies slightly from state to state, and the benefits available are generally offered by the private sector, and may include travel, dining and entertainment, and financial products. Some states governments also target a limited range of concessions at holders of State Government Seniors Cards. The Commonwealth has no influence over these concessions.

Appendix 13

Grandfathered/sunset provisions relating to taxation of superannuation

Introduction

This appendix summarises the grandfathered/sunset provisions relating to the taxation of superannuation. It reproduces Attachment C of the supplementary submission of the ATO to this inquiry.[1]

Eligible termination payments

The position prior to 1 July 1983:

- Prior to 1 July 1983, only 5% of certain lump sum benefits, including superannuation, were included in the recipient's assessable income and taxed at marginal rates.

The position after 30 June 1983:

- From 1 July 1983, the term eligible termination payment was introduced and effectively apportioned certain lump sum payments made on retirement, and termination from employment over the eligible service period (ESP) between pre-July 1983 and post-June 1983 service (or fund membership).
- The measures were aimed at encouraging taxpayers to save for their retirement by deferring taxation on their payments through the introduction of roll-over funds. By rolling-over a payment into an Approved Deposit Fund (ADF), a taxpayer was able to defer payment of tax on the payment. Subsequent withdrawal of the payment at or after age 55 resulting in more generous tax concessions becoming available.
- The result of these changes was that, five per cent of the amount identified as the pre-July 1983 component continued to be assessable at the taxpayer's marginal rate and the post-June 1983 component became fully assessable. The rate of tax payable on the fully assessable amount can range from 0-30 per cent depending on the source of the payment, the ESP and the age of the recipient.

Note: If a Tax File Number (TFN) is not supplied, the payment may be subject to the highest marginal rate of tax.

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1 *Submission* 148, ATO, Attachment C.

The position after 30 June 1988:

- As a result of the then Treasurer's May 1988 Economic Statement, a tax on the earnings of superannuation funds was introduced. This tax meant that superannuation funds, ADFs and life organisations which had previously been virtually free from tax, would be taxed on their earnings.
- The rate of tax was 15 per cent for funds which complied with the relevant legislation and the highest marginal rate for those funds which did not comply.

Concessional component:

- The concessional component of an ETP is that part of an ETP which was made before 1 July 1994 and was attributable to a bona fide redundancy payment, approved early retirement scheme payment or an invalidity payment.
- Only five per cent of the concessional component is included in the taxpayer's assessable income and taxed at marginal rates.

Post-30 June 1994 invalidity component:

- From 1 July 1994, an invalidity payment (previously included as a concessional component) is included as part of an ETP as the Post 30 June 1994 Invalidity component.
- This component is tax free to the payee and can be rolled-over.
- The post-June 1994 invalidity component of an ETP that has been rolled over to purchase an annuity or pension forms part of the UPP of the annuity or pension.

Undeducted contributions:

- Undeducted contributions represents the amount of contributions paid by an individual, or by any other person (other than an employer of the person), to a superannuation fund after 30 June 1983.
- Undeducted contributions are not included in the taxpayer's assessable income, ie they are tax free.

Non-qualifying component:

- This ETP component commenced from 1 July 1985.
- A non-qualifying component arises as a result of the commutation or residual capital value of an immediate annuity which was purchased partly with non-ETP money.
- The non-qualifying component is the part of the ETP that represents investment income accruing between the time of purchasing the annuity and the time of the payment.
- The amount is included in assessable income and is subject to the taxpayer's marginal rate of tax. The non-qualifying component cannot be rolled-over.

Excessive component:

- The excessive component of an ETP is the amount of the ETP which the Commissioner has determined to be in excess of the individual's RBL.
- Any excessive component of an ETP is fully assessable and taxed at the top marginal rate of tax. This is regardless of the taxpayer's level of income. Prior to 1 July 1994, the excessive component was taxed at the taxpayer's marginal rate.
- Where the person receiving an ETP fails to provide the payer with their tax file number the total amount of the payment will be treated as an excessive component.

Reasonable benefit limit

There is a limit to the value of these benefits that a person can receive over their lifetime at reduced tax rates. This limit is called the RBL. RBLs were introduced to prevent excessive exploitation of the concessional tax rates accorded to these payments, and to provide a more equitable distribution of these tax concessions.

RBLs are therefore the maximum amount of retirement and termination of employment benefits that a person can receive at concessional (reduced) tax rates over their lifetime.

Prior to 1 July 1985:

- any benefits paid by superannuation funds had to be reasonable in accordance with a scale based on the member's salary. Funds that breached this rule, lost their tax exempt status as complying funds were tax exempt at this time.

1 July 1985 to 18 December 1987:

- The ATO determined if benefits were reasonable using Income Tax Ruling 2201 (IT2201).

18 December 1987 to 30 June 1988:

- The Insurance and Superannuation Commissioner administers RBLs still applying IT2201.

1 July 1988 to 30 June 1990:

- The May 1988 Economic Statement included:
  - a new RBL salary scale;
  - a review of administrative arrangements; and
  - Insurance and Superannuation Commission (ISC) Circular replaces IT2201.

1 July 1990 to 30 June 1994:

- *Occupational Superannuation Standards Act 1987* (OSSA) and Occupational Superannuation Standards Regulations (OSSR) amended to include RBL legislation (Part IIIA) RBL regulations (Part 1A). RBLs based on Highest Average Salary (HAS) and Eligible Service Period (ESP).

29 May 1993 to 30 June 1994:

- ATO administers RBLs under delegation from the ISC.

1 July 1994 to present:

- The ATO takes over from the ISC the administration of RBLs. *The Income Tax Assessment Act 1936* (ITAA) and *Income Tax Regulations* (ITR) amended to include the RBL legislation (Part III, Div 14), and RBL regulations (Part 5A). The HAS-based system of calculation for RBLs was replaced by flat dollar limit RBLs with effect from 1 July 1994. Although fixed amounts were introduced as RBLs from this date to all individuals regardless of the level of their HAS, the HAS-based method of RBLs did not become obsolete because it applied in calculating a person's Transitional RBL.
- Transitional RBLs were introduced at the same time as flat dollar limits to minimise any disadvantage created through any possible reduction of an individual's RBLs resulting from the new legislation. It provided a means for protecting individuals who had made their retirement plans based on the previous system by allowing them a greater RBL than the new flat dollar limits.
- The eligibility for a TRBL is determined in accordance with the age of the person as at 1 July 1994. The various categories are:
  - individuals aged under 45 years on 1 July 1994 (born after 1 July 1949);
  - individuals aged at least 45, but under 50 years on 1 July 1994 (born after 1 July 1944 and on or before 1 July 1949); and
  - individuals aged at least 50 years on 1 July 1994.
- Individuals who wished to have a TRBL registered had to apply for one in the prescribed manner by the 31 December 1996. This date was subsequently extended to 4 April 1997. Under the Income Tax Regulations a taxpayer may request the Commissioner to register their TRBL's at later time (AAT Case AT1999/49).

ITAA 1936 Part IX Taxation of Superannuation and Related Business

Pre 1 July 1998 funding credits:

- Complying superannuation funds previously exempt from income tax until 30 June 1988 may exclude employer contributions from their assessable income if the contributions relate to unfunded liabilities accrued up to 30 June 1988. (Ref s 275A & 275B ITAA 1936).

Increased death benefits:

- A fund is able to claim a deduction, the benefit of which is passed to a death beneficiary, so that the death benefit amount is not reduced because of tax on contributions. (Ref s 279D).

Amounts accrued before 1 July 1988:

- Income accrued to a complying superannuation fund before 1 July 1988 but derived after that date is not included in assessable income. (Ref s282 ITAA 1936).

Taxation of annuities and pensions

An annuity or pension that commenced before 1 July 1983:

- Assessed under former section 26AA (as opposed to section 27H). This gives rise to some differences when calculating the deductible amount for the pension or annuity, particularly when the pension or annuity reverts to a death beneficiary.

A pension commencing after 1 July 1994:

- When a pension commencing after 1 July 1994 is purchased wholly with roll-over amounts arising from the commutation of pensions or annuities which commenced before 1 July 1994, the more generous calculation of the related undeducted purchase price (which applied before 1 July 1994) applies to the new pension or annuity. (Ref s27AAAA ITAA 1936)

Appendix 14

Tax treatment on savings vehicles

	Acquisition/ Contribution	Investment Returns[1]	Disposal
Deposits (eg bank cash deposits)	Acquired from after-tax income or borrowings, unless provided by an employer, such that Fringe Benefits Tax (FBT) is generally payable.	Taxed at saver's marginal rate.	Exempt unless assigned to another person, in which cast Capital Gains Tax (CGT) can apply.
Consumer durables	As per deposits.	Not applicable. Neither interest payments nor capital payments are tax deductible.	CGT may apply if cost is more than $10,000.
Family home (main residence) **a) deposit on a principle residence** **b) reducing existing mortgage**	As per deposits.	As per consumer durables.	Exempt.
Investment property **a) Negative gearing** **b) Positive gearing**	As per deposits.	Net losses (negative gearing) reduce taxable income. This reduces tax payable according to the taxpayer's marginal tax rate. Net income (positive gearing) taxed at taxpayer's marginal tax rate.	CGT applies. Net gains brought to account at the taxpayer's marginal tax rate. Application of CGT discount means that gains will be taxed at no more than 24.25% if property owned for at least one year.
Other assets	As per deposits.	As per investment property.	As per investment property.
Equities (shares)	As per deposits (unless provided under an employee share scheme).	Dividends taxed at marginal tax rate, however, dividend imputation provides a	As per investment property.

1 Excludes capital gains.

		tax-offset entitlement in respect of the franked entitlement, recognising tax paid at the company level.	
Life insurance	As per deposits.	Taxed at 30% in the life office's hands.	Exempt if held for more than 10 years. Where held for less than 10 years, investors receive a 30% rebate for the portion of investment returns they are assessed on.
Superannuation-employer contributions	Made from gross earnings, not after tax income of saver. A 15% tax on contributions applies. Surcharge (of up to a maximum of 15%) applies to higher income earners.	Reduced tax - fund earnings taxed at 15%. Maximum CGT rate for super funds is 10%.	See superannuation benefits.
Superannuation-employee contributions	Made from after tax income – not taxable (except deductible contributions made by the self-employed).	Reduced tax – fund earnings taxed at 15%. Maximum CGT rate for super funds is 10%.	See superannuation benefits.

The following taxation arrangements for superannuation benefits apply for individuals who have reached age 55. For those aged 55 years and below, less concessional tax rates apply.

Superannuation benefits	
Lump sums	. Return of employee contributions (ie capital) is untaxed. . Balance is tax free up to $112,405. . Balance between $112,405 and lump sum RBL of $562,195 is taxed at 15%. . Excessive ETP tax applies for lump sum amounts above RBL.
Pensions	. Taxed at marginal rates. However, 15% rebate available for that component that represents the return of the employee's own contribution. . Allocated pensions (tax not payable of fund returns). Pension RBL is $1,124,384. At least 50% of an individual's superannuation benefit must be taken as a complying pension to access the pension RBL.

Appendix 15

Chronology of superannuation policy announcements, events and inquiries[1]

1983-2002

1983 – July

TERMINATION PAYMENTS

New tax treatment for bona fide redundancy early retirement and invalidity payments. Tax instalments from Eligible Termination Payments (ETPs) pre-July 83 and post-June 83 components. Tax relief on roll-overs within 90 day roll-over period Statement of Termination Payment. Tax rates on post-June 83 component limited by means of rebate. New tax rules for rebates on pre-15 August 1978 unused long service and annual leave.

1985 – September

AWARD BASED SUPERANNUATION

Government/ACTU agreement reached on productivity (award) based superannuation for the majority of workforce.

1985 – December

JOINT MINISTERIAL STATEMENT

Released for comment on proposed operating standards that occupational superannuation schemes must meet to qualify for income tax concessions.

1986 – June

TREASURER'S STATEMENT

Establishment of the Insurance and Superannuation Commission announced.

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1 For more detail on legislative amendments to superannuation, 1988-2001, see *Submission* 148, ATO, Attachment B.

Operating standards for access to tax concessions by super funds. Approved Deposit Funds (ADFs) and pooled super trusts announced.

1987 – November

INSURANCE AND SUPERANNUATION COMMISSION (ISC)

Legislation establishing the ISC enacted. Functions transferred from Treasury and ATO to ISC Australian Actuary. Insurance Commissioner and Life Insurance Commissioner amalgamated.

1988 – May

ECONOMIC STATEMENT

New regime for limiting tax concessions on ETPs pensions and annuities Reasonable Benefit Limits (RBLs) announced. New taxation arrangements for superannuation funds announced.

1988 – July

INCOME TAX

New rules to limit marginal tax rate on ETPs, including concessional components, pre-July 83 and post-June 83 components limited by means of rebates based on age, year of receipt and period of service or fund membership.

Part IX of ITAA commences new regime for taxing the income of complying superannuation funds. ADFs and pooled superannuation trusts taxation of employer contributions.

Complying status determined by ISC.

1990 – July

REASONABLE BENEFITS LIMITS

New regime managed by ISC. Reporting by payers of ETPs above threshold, pensions and annuities. Measurement of aggregated benefits against highest average salary based limits. Concepts of counted amounts qualifying amounts, excessive components. ISC Determinations required for completion of tax returns. Compulsory commutation of excessive pensions and annuities to ETPs. Grandfathering of pre-July 1990 reasonable benefit multiples and 15 February 1990 roll over balances.

1991 - February

1991/92 BUDGET

Superannuation Guarantee announced. Information paper released. Changes to access deductions for personal contributions announced.

TREASURY/ATO/ISC REVIEW

Development and review of proposals to simplify tax treatment of ETPs pensions and annuities.

1991 – June

SENATE SELECT COMMITTEE

Senate Select Committee on Superannuation established on 5 June 1991 to inquire into 17 issues including the taxation of superannuation vesting of benefits, prudential controls, superannuation simplification, adequacy of public education and the Superannuation Guarantee.[2]

61 reports and papers issued from June 1991 to November 2002 **(see Appendix 16).**

1992 – June

SECURITY IN RETIREMENT[3]

Statement made 30 June 1992. New RBL regime administration moves to ATO. Preservation of benefits, new pension and annuity standards to be met for access to tax concessions by payers and payees. New rules for tax concessions on contributions by employers self employed and employees. Pension and annuity rebate changes exclusion of excessive benefits from rebates, removal of 90 day roll-over period, modification of roll-over elections revised rules for tax and RBL treatment of invalidity, bona fide redundancy, early retirement payments and death benefits.

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2 Select Committee on Superannuation also appointed 13 May 1993, 29 May 1996, and 14 March 2002; Select Committee on Superannuation and Financial Services appointed 22 September 1999, with effect from 11 October 1999.

3 *Security in Retirement – Planning for Tomorrow Today*, Statement by the Hon John Dawkins, MP, Treasurer, 30 June 1992.

1992 – July – ongoing

SUPERANNUATION GUARANTEE

Legislation effective from 1 July 1992. The legislation generally required employers to provide a minimum superannuation contribution of 3 per cent of earnings where the employee earned more than $450 in a month. The rate increased from 3 to 9 per cent by 1 July 2002.

1992 – October

STRENGTHENING SUPER SECURITY

New policy announced on prudential requirements to be met by super funds etc for complying status, increased investigative powers for the ISC, higher standards of duty on fund trustees and managers.

1993 – June

FITZGERALD REPORT ON NATIONAL SAVINGS[4]

Public recommendations on increasing national savings include extensions of super guarantee to personal contributions, self-employed with SGC, raising preservation ages, restrictions on ETPs general incentives to encourage household savings.

1993 – July

EPAC[5]

Commissioned study for Economic Planning Advisory Committee (EPAC) on the economic and social consequences of Australia's ageing population, including the Superannuation Guarantee and taxation of retirement benefits.

1994 – June

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4 *National Saving, A Report to the Treasurer*, V W FitzGerald, Allen Consulting Group, June 1993.

5 Arising from *Economic and social consequences of Australia's ageing population – preparing for the 21st century,* papers presented to an Office of EPAC seminar held in Canberra on 25 September, 1992.

TREASURER STATEMENT ON SUPERANNUATION POLICY

New policy to prevent erosion of small amounts of superannuation. Establishment of member protection rules for accounts of less than $1,000, and of an ATO holding mechanism to assist employers making small superannuation contributions on behalf of their employees. New rules proposed on extended use of Tax File Numbers (TFNs) for identification, amalgamation and transfer of superannuation accounts, capital gains tax relief and retention of fund earnings bases where superannuation funds merge. Improvements to SG rules. Rejection of some recommendations of Fitzgerald report.

1994 – July

COMMENCEMENT OF SUPERANNUATION INDUSTRY SUPERVISION ACT (SIS)

Commencement of SIS legislation (as proposed in 1992 'Strengthening Super Security'), providing the ISC with increased regulatory powers.

COMMENCEMENT OF SUPERANNUATION COMPLAINTS TRIBUNAL

Tribunal provides avenue for resolution of members/funds disputes.

NEW RBL RULES START

New 'flat dollar' RBLs start (as announced in 1992 'Security in Retirement'), providing a higher level of RBLs for most people, and Transitional arrangements. Formal administration of RBL in ATO.

1995 – May

SAVING FOR OUR FUTURE[6]

Government support for the phased introduction through industrial awards and enterprise agreements, where employee benefits are improved, of employee personal contributions at 3% by the year 2000, (1% in 1997-98 and 2% in 1998-99).

Government means tested contributions to match undeducted personal contributions by employees and the self employed at 1% of Average Weekly Ordinary Time Earnings (AWOTE) for 1997-98, 2% of AWOTE for 1998-99 and 3% of AWOTE for 1999-2000.

6 *Saving for our Future*, Statement by the Treasurer, the Hon Ralph Willis, MP, May 1995.

1996 – February

COALITION POLICY – 19 February 1996

‘Super for all – Security and Flexibility in Retirement’.

Range of measures to open up the system including through member choice of super fund.

1996 – August

SUPERANNUATION CONTRIBUTIONS TAX (SURCHARGE)

The surcharge was effective from 20 August 1996 and originally applied to contributions made by, or on behalf of, people who had annual income (taxable income plus employer and tax deductible personal contributions) exceeding $70,000.

The surcharge was phased in over the income range $70,000 to $85,000 where the maximum 15 percent rate applied. The annual income range is indexed annually to movements in AWOTE. Advance instalments were originally required.

1997 – March

WALLIS REPORT[7]

Wallis Report led to major program of restructuring and rationalisation in regulation of financial sector

1997 – May

SAVINGS: CHOICE AND INCENTIVE

The introduction of a broadly based savings rebate available to people who make personal (undeducted) superannuation contributions, and/or who earn net personal income from other savings and investments.

The rebate was to be phased in at a rate of 7.5 percent from 1 July 1998, rising to 15 per cent from 1 July 1999, resulting in a maximum tax rebate of $225 in 1998-99 and $450 the following year.

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7 *Australian Financial System Inquiry, Final Report* (Wallis Report), March 1997.

1997 – July

RETIREMENT SAVINGS ACCOUNTS (RSAs)

RSAs are provided by banks, building societies, credit unions, life offices and prescribed financial institutions. RSAs are intended as a low cost, low risk, savings product which employers can use as an alternative for employee super contributions. Individuals may also make contributions.

1998 – July

NEW REGULATORY BODIES

Legislation establishing the Australian Prudential Regulation Authority (APRA) and the Australian Securities and Investments Commission (ASIC) enacted. Functions transferred from the ISC.

1999 - July

SPOUSE REBATE

From 1 July 1999 taxpayers have been provided with rebates in respect of super contributions for low-income spouses. The maximum $3,000 rebate applies for spouse contributions where the spouse earns less than $10,800. The rebate is reduced by $1 for each $1 of income until phased out at income $13,800.

1999 – July

PRESERVATION

From 1 July 1999 all contributions (employer and member) have been preserved within the superannuation system until at least age 55.

1999 - October

SMSFs TRANSFERRED TO ATO

In 1999, the SIS Act was amended to establish a new category of small superannuation funds with fewer than five members, to be called self-managed superannuation funds (SMSFs). APRA's responsibility for the regulation of SMSFs was transferred to the ATO from October 1999.

2000 – July

A NEW TAX SYSTEM

As part of its 'New Tax System' policy the Government introduced a 10 per cent Goods and Services Tax (GST) and reduced personal income tax rates from 1 July 2000. The savings rebate was also abolished.

2001 – July

SENIOR AUSTRALIANS TAX OFFSET (SATO)

SATO ensures that every single Australian of age pension age can have income up to $20,000 without paying tax or the Medicate levy. Senior couples can have combined incomes of up to $32,612 without paying tax.

SPLITTING OF SUPERANNUATION BETWEEN DIVORCING COUPLES

Regulations were made that facilitated the splitting of super between a member of a super fund and their spouse when they separate.

2001 - September

FINANCIAL SERVICES REFORM (FSR)

The FSR Act 2001[8] introduced a regulatory framework covering a wide range of financial products, including general and life insurance, superannuation, deposit accounts, and means of payment facilities.

2001 – November

A BETTER SUPERANNUATION SYSTEM – COALITION POLICY NOVEMBER 2001

Proposed a range of measures designed to make superannuation more attractive and safer. These included co-contributions matching contributions from low income earners; reductions in the surcharge, splitting contributions between spouses; and increasing deduction limits for the self-employed.

8 Act No 122, 2001, assented to 27 September, 2001; some provisions to commence on a day fixed by a proclamation, namely 11 March 2002.

2001 – December

PRODUCTIVITY COMMISSION SIS REVIEW[9]

In December 2001, the Productivity Commission reported on its review of SIS in the context of National Competition Policy. The review proposed a number of measures to remove barriers to competition, reduce compliance costs, and enhance licensing of superannuation entities.

2002 – May

INTERGENERATIONAL REPORT[10]

Provided information of the budgetary implications of an ageing population in the health, social security and aged care areas over the next 40 years.

2002 – October

WORKING GROUP ON SAFETY OF SUPERANNUATION[11]

In October 2002 the Government responded to the recommendations of the Superannuation Working Group. The Government indicated that it supported the key recommendations relating to the APRA licensing of trustees of superannuation entities.

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9 *Review of the Superannuation Industry (Supervision) Act 1993 and Certain Other Superannuation Legislation,* Productivity Commission, Inquiry Report No 18, 10 December 2001.

10 *Intergenerational Report 2002-2003*, Budget Paper No 5, Circulated by the Hon Peter Costello, MP, Treasurer, 14 May 2002.

11 *Options for Improving the Safety of Superannuation*, Report of the Superannuation Working Group (Mercer Report), 28 March 2002, released 28 October 2002.

Appendix 16

List of committee reports 1991 - 2002

Reports and papers of the previous Select Committees on Superannuation

(1991-1998)

- *Super System Survey* - A Background Paper on Retirement Income Arrangements in Twenty-one Countries (December 1991)
- First Report of the Senate Select Committee on Superannuation - *Safeguarding Super* - the Regulation of Superannuation (June 1992)
- Second Report of the Senate Select Committee on Superannuation - *Super Guarantee Bills* (June 1992)
- *Super Charges* - An Issues Paper on Fees, Commissions, Charges and Disclosure in the Superannuation Industry (August 1992)
- Third Report of the Senate Select Committee on Superannuation - *Super and the Financial System* (October 1992)
- *Proceedings of the Super Consumer Seminar*, 4 November 1992 (November 1992)
- Fourth Report of the Senate Select Committee on Superannuation - *Super - Fiscal and Social Links* (December 1992)
- Papers relating to the Byrnwood Ltd, WA Superannuation Fund, 25 March 1992; Interim Report on Fees, Charges and Commissions in the Life Insurance Industry, 3 June 1992 (February 1993)
- Fifth Report of the Senate Select Committee on Superannuation - *Super Supervisory Levy* (May 1993)
- Sixth Report of the Senate Select Committee on Superannuation - *Super - Fees, Charges and Commissions* (June 1993)
- Seventh Report of the Senate Select Committee on Superannuation - *Super Inquiry Overview* (June 1993)
- Eighth Report of the Senate Select Committee on Superannuation - *Inquiry into the Queensland Professional Officers Association Superannuation Fund* (August 1993)

- Ninth Report of the Senate Select Committee on Superannuation - *Super Supervision Bills* (October 1993)
- Tenth Report of the Senate Select Committee on Superannuation - *Super Complaints Tribunal* (December 1993)
- Eleventh Report of the Senate Select Committee on Superannuation - *Privilege Matter Involving Mr Kevin Lindeberg and Mr Des O'Neill* (December 1993)
- A Preliminary Paper Prepared by the Senate Select Committee on Superannuation for the Minister for Social Security, *Options for Allocated Pensions Within the Retirement Incomes System* (March 1994)
- Twelfth Report of the Senate Select Committee on Superannuation - *Super for Housing* (May 1994)
- Thirteenth Report of the Senate Select Committee on Superannuation - *Super Regs I* (August 1994)
- Fourteenth Report of the Senate Select Committee on Superannuation - *Super Regs II* (November 1994)
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