



## Superannuation contributions—the soft option

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### Executive summary

- Soft compulsion is a method to increase retirement savings by automatically increasing the individual employee's superannuation contributions, but allowing the individual to opt out of this arrangement.
- It is based on the assumption that individuals, left to their own devices, will often fail to make sufficient superannuation contributions to ensure that they receive an adequate retirement income. It also assumes that most participants will not opt out of such a scheme if introduced.
- New Zealand, the United States and the United Kingdom have, or will have, a soft compulsion regime to boost retirement savings. Tasmania already has such arrangements in respect of its public sector workers, as do a number of private sector employers. The Commonwealth also has default member contribution arrangements in one of its superannuation schemes.
- There appear to be few practical obstacles to the introduction of such a regime elsewhere in Australia, though the success of such a regime would depend on its design.
- The introduction of a soft compulsion regime may significantly increase government outlays, depending on its design, and interaction with other parts of the retirement income and taxation systems, particularly the government superannuation co-contributions regime.
- Further research may need to be undertaken on the adequacy of current arrangements and the total resources available to retirees to clarify whether there is a need for a soft compulsion regime in Australia.

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## Glossary

Term	Meaning
Adequacy	The capacity of all parts of the retirement income system to produce an adequate retirement income. What an adequate retirement income may be is generally defined as either 60 per cent of pre retirement income or a certain amount of income per year.
After-tax contribution	Contribution made to a superannuation fund from an employee's salary, after income tax has been deducted from the gross salary. In Australia, this is often called a 'personal' contribution. Before 1 July 2007 such contributions were known as 'undeducted' contributions, as the amount was not deducted from a person's taxable income.
Auto-enrolment	Some US companies automatically enrol their employees in either the company pension program or some form of tax advantaged retirement savings account.
ASFA	Association of Superannuation Funds of Australia.
Before tax contribution	A contribution to a superannuation fund that is made before personal income tax is applied. Thus a before tax contribution reduces the amount of taxable income a person receives. In Australia, a before tax contribution can be an SG contribution and/or a salary sacrifice contribution.
Fringe Benefits Tax	Fringe benefits tax (FBT) is payable on certain non-cash benefits given by an employer to an employee, usually as part of a salary sacrifice arrangement. Superannuation benefits payable by the employer as a fringe benefit are generally exempt from FBT.
KiwiSaver	New Zealand's soft compulsion saving scheme.
Opt out	The ability of a person to cease participation in any soft compulsion regime i.e. they may choose to 'opt out' of these arrangements.
Portability	A superannuation account is portable when an employee can retain funds in it, commence work with a different employer, and SG or other contributions continue to be made to that account. Another dimension of portability is being able to transfer an account balance to another superannuation fund.
Replacement rate	The proportion of pre retirement income that is desirable to receive post retirement. Generally, a post retirement income of 60 per cent of immediate pre retirement income is considered a minimum adequate retirement income.
Retirement income system/regime	In Australia the retirement income system consists of the government Age Pension, the mandatory employer contributions under the Superannuation Guarantee regime and additional savings.
Salary Sacrifice	An arrangement between the employer and employee where the employee agrees to receive a lesser amount of salary in return for certain non-cash benefits, such as a car, payment of school fees or additional superannuation contributions. Additional superannuation contributions by way of salary sacrifice are 'before tax' contributions.

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Term	Meaning
SG or Superannuation Guarantee	Superannuation Guarantee. The SG regime requires that every employee earning over \$450 per month have superannuation contributions made on their behalf equal to nine per cent of their ordinary time earnings. SG contributions are ‘before tax’ contributions.
Soft compulsion	A soft compulsion regime is one where employers increase superannuation contributions made on behalf of the employees, and the employee’s wages are reduced accordingly. The soft part of these arrangements is that the employee has the option of not having these additional contributions made on their behalf. That is, they may opt out of this arrangement.
Tax Credit	An amount that reduces the tax payable. Not to be confused with a tax deduction - which reduces the amount of taxable income. Tax credits are sometimes known as a tax rebate or tax offset in Australia.
Vested/Vesting	Retirement savings are said to be vested in a person when those savings are beneficially owned by that person, and not some other party, such as their employer. In Australia superannuation contributions and associated earnings are generally automatically vested in the fund member when the contribution is made or the earnings accumulated.

## Introduction

Superannuation is an important component of the economic security for retirees. It not only increases national savings, provides a pool of capital for investment and development, but increasingly will be the major source of a person's retirement income. On the other hand, superannuation contributions are funds not in the hands of consumers and are not amounts available to a person to meet their day to day needs. Thus, proposals to make significant changes to arrangements for contributions to the superannuation system are of great importance to the Australian economy.

On 20 September 2007, Ms Pauline Vamos, the then newly appointed Chief Executive Officer of the Association of Superannuation Funds of Australia (ASFA), noted that one of the Association's priorities would be to discuss the introduction of 'soft compulsion' as a means of raising the level of personal superannuation contributions.<sup>1</sup> In a joint media statement on 5 November 2007 the Hon. Wayne Swan MP and Senator the Hon. Nick Sherry, stated that an incoming Labor government would not support raising the Superannuation Guarantee (SG) amount paid by employers above the current nine per cent of an employee's earnings. But they also noted that it would be desirable to see additional incentives leading to a total superannuation contribution rate of fifteen per cent of a person's earnings.<sup>2</sup> In a recent speech the Prime Minister, the Hon. Kevin Rudd noted the need to increase Australia's private savings in an effort to combat inflation.<sup>3</sup> The Australian Workers Union has signalled that increased superannuation contributions are part of its preferred policy approach in countering any trends towards increased inflation – even at the expense of part of the foreshadowed reductions in personal income tax to take effect from 1 July 2008.<sup>4</sup> Further,

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1. Ms Pauline Vamos, CEO Association of Superannuation Funds of Australia, Speech at an ASFA Luncheon Event, Perth Western Australia, 20 September 2007. See also ASFA, ASFA Pre Budget: '[Lets lift private savings](#)', *media release*, 24 January 2008, and [Pre Budget Submission for the 2008–09 Budget](#), January 2008.
  2. Wayne Swan MP, Senator the Hon. Nick Sherry, '[Report on superannuation incorrect](#)', *joint media release*, Parliament House Canberra, 5 November 2007; See also Senator the Hon. Nick Sherry, Minister for Superannuation and Corporate Law, [Year in Preview](#), Speech to the Industry Super Network, 5 February 2008, p. 2 – Where the Minister noted the priority of achieving higher retirement incomes... against a clear goal.
  3. Hon. Kevin Rudd MP, Prime Minister, Address to Lord Mayor's Business Breakfast – Perth, 'Building Australia's Economic Future', 21 January 2008.
  4. P. Howes, National Secretary – Australian Workers Union, 'Address to the National Press Club', Canberra, 30 January 2008, Australian Workers Union, 'Protecting the financial security or working families in the financial environment of 2008', [Discussion paper](#), 30 January 2008, 'ACTU singles higher super claims, and warns Coalition on blocking transition bill', *Workplace Express*, 1 February 2008.

there has been some press speculation that the government is considering introducing a soft compulsion regime to boost the level of superannuation contributions.<sup>5</sup>

Soft compulsion as a means of raising the level of superannuation contributions appears to be an idea that should now be seriously considered. But what is it? Has it been tried elsewhere in the world? What has been the outcome of other countries' adoption of this approach? What are the main issues in adopting such a regime? This paper will attempt to address these questions.

### What is Soft Compulsion?

A soft compulsion regime is one where increased superannuation contributions are made and the employee's wages are reduced accordingly. The soft part of these arrangements is that employees have the option of not having these additional contributions made on their behalf. That is, they may opt out of this arrangement.

Why do it?

Within the superannuation industry the dominant view is that the current level of SG contributions, of nine per cent of wages, is insufficient to provide an adequate retirement benefit.<sup>6</sup> The Howard Government's Simplified Superannuation changes have improved the current retirement income system's ability to deliver an adequate retirement benefit.<sup>7</sup> But recent comment suggests that despite these changes the SG regime, by itself, will still not provide an adequate retirement income for many retirees.<sup>8</sup>

Of course, if individuals made additional voluntary contributions to their superannuation accounts this would not be a problem. However, the majority of fund members do not appear

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5. B. Dunstan, 'Super system in need of a tweak', *Australian Financial Review*, 15 January 2008; Laura Tingle, 'Trying to make everyone a super hero', *Australian Financial Review*, 8 February 2008, p. 83; R. Gittins, 'Cut taxes then ...cutting or increase super', *Sydney Morning Herald*, 11 February 2008, p. 17.
  6. See, for example, Association of Superannuation Funds of Australia (ASFA), *Submission to the House of Representatives Standing Committee on Economics, Finance and Public Administration Inquiry into Improving Superannuation Savings of People Under 40*, July 2005, pp. 1, 12; Investment and Financial Services Association (IFSA), *Retirement Savings Gap*, 2003. Access Economics Director, Chris Richardson, has argued that Australians need to save more for retirement, as reported in B. Dunstan, 'Lazy savers face rude shock', *Australian Financial Review*, 17 August 2005, p. 38; see also Citibank, *Retirement Index*, August 2005. It should be noted that not all commentators accept this view.
  7. Access Economics, *The AMP Superannuation Adequacy Index Report, January – June 2007*, January 2008, p. 3.
  8. H. Bateman and Geoffrey Kingston, 'Superannuation and personal income tax reform', *Australian Tax Forum*, vol. 22, no. 3, 2007, pp. 137–161.

to do so.<sup>9</sup> One of the reasons why individuals don't make regular additional superannuation contributions may be inertia and procrastination. That is, most individuals are inclined to accept current arrangements and to delay changing behaviour (such as making additional superannuation contributions) – even when it is manifestly in their interest to do so.<sup>10</sup>

Soft compulsion overcomes this obstacle by harnessing the forces of inertia and procrastination. The underlying assumption is that individuals will also procrastinate in opting out of a soft compulsion arrangement that automatically increases their superannuation contributions.

### Who has soft compulsion?

New Zealand and the United States of America have forms of soft compulsion to make, or increase, retirement savings. The United Kingdom is in the process of finalising its proposed scheme. Tasmania has implemented a soft compulsion regime in respect of its public servants. Further, the author understands that a number of private sector employers across Australia also have such arrangements. A short summary of these arrangements follows.

#### New Zealand

From 1 July 2007, all employees starting a new job in New Zealand are automatically enrolled in the KiwiSaver scheme (they will already be members of the government run New Zealand Superannuation Scheme). Features of the KiwiSaver scheme are:

- all employees, who are New Zealand citizens or permanent residents of the country who are under 65 years of age, must be automatically enrolled when starting a new job. Existing employees can choose to join the KiwiSaver scheme
- the self-employed may apply directly to nominated financial institutions to establish a KiwiSaver account
- each participant has a Kiwisaver account in their own name, if they do not already have another private retirement savings vehicle. Thus the savings are immediately vested in the member

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9. For example, in the September quarter of 2007 total superannuation contributions were \$19.2bn. Of that, employer contributions were \$12.2bn (63%) the bulk of which were SG contributions while member contributions were \$6.8bn (35.4%). This suggests that most superannuation fund members are not making additional contributions to superannuation. Source: APRA, *Quarterly Superannuation Performance Statistics*, September 2007 issued 27 December 2007, p. 8.

10. For a good discussion of this view see N. Gruen, [\*Design Defaults – How the Backstop Society can Failsafe Australia's Superannuation\*](#), 15 September 2005.

- all employees can choose not to participate within four weeks of being enrolled in the scheme. If employees do not opt out within this time period, they cannot leave the scheme after that time. Contributory membership ceases when the member leaves their employer and automatically restarts again with a new employer
- contributions are either four or eight per cent of the member's gross salary, as the member chooses. Employers may contribute towards these amounts and these latter contributions can count towards the total of the member's contributions (i.e. be part of the four or eight per cent contributions)
- the government adds NZ\$1000 to the member's account upon joining. The member also qualifies for up to NZ\$1042 in tax credits (about NZ\$20 per week), and a fee subsidy of NZ\$40, per annum
- the member may choose to have KiwiSaver contributions paid to an existing occupational pension account or simply paid into their employer's default fund or choose an account from a list of KiwiSaver accounts offered by government nominated providers
- New Zealand Inland Revenue collects all KiwiSaver contributions and forwards these contributions to the appropriate fund or account
- after twelve months participation a member may take a contributions 'holiday' of between three months and five years. There is no limit on the number of contributions holidays a member may take.

Normally KiwiSaver amounts are not accessible until the member qualifies for their New Zealand Superannuation Benefit – at age sixty five. However, most of the savings and associated investment earnings may be accessed/withdrawn, as follows:

- after twelve months membership, up to half of the contributions can be used to repay a mortgage on the member's own home
- after three years membership, the full amount can be used to buy a member's first home
- if the member experiences significant financial hardship or a serious illness
- if the member emigrates permanently from New Zealand, or
- on the member's death, the accumulated benefits will be paid to the member's estate.

The benefits will be paid as a lump sum only. Members have the option of purchasing a private sector annuity with these amounts.<sup>11</sup>

In addition, from April 2008, employers will be required to contribute additional amounts to the employee's KiwiSaver accounts or complying superannuation funds. This will be phased in over four years, starting at one per cent of the employee's gross earnings from 1 April 2008, reaching four per cent from 1 April 2011. An employer tax credit will reimburse employers for these contributions - up to a maximum of NZ\$20 a week for each employee participating in the scheme.<sup>12</sup>

As at 31 December 2007, 381 000 New Zealanders were participants in the KiwiSaver scheme. Over NZ\$300 million had been transferred to KiwiSaver or other retirement savings accounts since 1 July 2007, of which NZ\$104 million were payments from the New Zealand government.<sup>13</sup>

The employee's contributions, in effect, come from the after-tax salary. Matching contributions up to four per cent by the employer are tax free. Investment earnings of the KwiSaver accounts/funds are taxed at a rate of either nineteen point five per cent or three three per cent depending on the employee's taxable income in the preceding two years.

#### United Kingdom

In its May 2006 White Paper entitled *Security in Retirement – towards a new pension system* the UK government proposed the automatic enrolment of all employees into personal, portable, pension savings accounts.<sup>14</sup> The UK Pensions Policy Institute has summarised this proposal as follows:

- employees would automatically be enrolled into qualifying work-based pension schemes or Personal Accounts if they are
  - aged between 22 and State Pension age (currently 65 for males, 60 for females increasing to 65 from 2010, depending on date of birth), and

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11. New Zealand Department of Inland Revenue, [Your introduction to KiwiSaver – Employee information pack](#), June 2007.

12. New Zealand Department of Inland Revenue, [The new KiwiSaver legislation](#), 21 December 2007, p. 1.

13. The Hon. Dr Michael Cullen MP, New Zealand Minister for Finance and the Hon. Peter Dune MP, New Zealand Minister for Revenue, [‘KiwiSaver numbers pass 380,000 in first six months’](#), media release, 9 January 2008.

14. United Kingdom Department of Work and Pensions, [Security in Retirement – Towards a New Pensions System](#), May 2006, and [Personal accounts: a new way to save](#), December 2006.

- earning above £5000 p.a.
- employees not meeting these initial qualifications may choose to be enrolled in these schemes. The self employed would not be eligible for enrolment
- a minimum combined contribution level of 8 per cent of ‘band’ earnings (initially £5000 - £35 000 p.a.)
  - four per cent from the individual
  - a minimum of three per cent from the employer, and
  - at least one per cent from the state through tax relief
- contributions would be phased in over three years
  - at one, three and then five per cent of earnings for individuals (including tax relief), and
  - and one, two and then three per cent of the employee’s earnings for employers.

The government proposes to introduce low cost individually owned personal retirement savings accounts.<sup>15</sup>

There has been no firm proposal for the ‘opt out’ provisions of the UK arrangements. However, the UK government intends that such provisions will be enacted.<sup>16</sup>

The legislation enacting this system is currently before the UK Parliament.<sup>17</sup> As the details of the proposed changes are not yet finalised (such as the opt out provisions) their impact is unclear. However, initial estimates suggest that the proposed regime will result in between four and nine million additional persons with retirement savings accounts.<sup>18</sup>

#### United States

In the United States both employers and employees contribute to the United States Social Security Fund. Most US retirees are entitled to receive payments from this fund. However,

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15. United Kingdom Pensions Policy Institute, [Will Personal Accounts increase pension savings](#), November 2007, p. 2.

16. United Kingdom Department of Work and Pensions, op. cit.

17. The United Kingdom [Pensions Bill 2008](#).

18. United Kingdom Pensions Policy Institute (PPI), [‘Will personal accounts increase pension savings?’](#), *PPI Briefing Note Number 42*, December 2007.

employers may also offer their employees participation in a company sponsored retirement savings scheme.<sup>19</sup>

With the passing of the *Pensions Act 2006*, the American Congress cleared the way for the automatic enrolment of all employees in a company's retirement savings plan, where these plans are offered by the company.<sup>20</sup> Where offered, such a regime must have the following features:

- the employee's contribution must be between three and ten per cent of their overall compensation (i.e. total remuneration)
  - the contributions must be three per cent in the first year and rise to at least six per cent during the fourth year of an employee's participation in the scheme
- the employer makes a contribution equal to a lower paid employee's contribution, or in respect to certain highly paid employees, a matching contribution of at least three and no more than six per cent of that employee's compensation
- the employer's contributions vest in the employee after, at the most, a two years service period. They may vest in the employee after a shorter period of time
- the matching employer contributions have the same restrictions on withdrawal as those of the employees contributions
- each employee participant must receive a notice explaining that they may opt out of this arrangement and how the particular scheme they are in operates, including investment options and the right of the employee to give investment directions in respect of their account, and
- the employee must be given a reasonable period of time before the first contribution is made to opt out of this arrangement. The author understands that a reasonable period of time is thirty days after first becoming a member of the scheme.<sup>21</sup>

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19. The employer sponsored retirement savings and pension schemes are in addition to the government Social Security Fund. Payments from this latter fund are means tested.

20. Signed into United States law by President Bush on 17 August 2006.

21. United States Congress Joint Committee on Taxation, [\*Technical explanation of H.R. 4, the "Pension Protection Act of 2006", as passed by the House on July 28, 2006 and as considered by the Senate on August 3, 2006\*](#), 3 August 2006 (JCX-38-06), pp. 227–230. Additional information is in US Internal Revenue Service 2007 Tax Forum presentation '[Automatic Enrolment and Other Need – To - Know Provisions of the Pension Protection Act 2006](#)'.

An individual's contributions to a United States retirement savings scheme qualify them to receive a maximum tax credit of US\$1000 per annum, depending on amount contributed and the income of the person.<sup>22</sup>

This regime commenced operation on 31 December 2007. The most common form of United States retirement savings account is the 401(k) account. The term 401(k) refers to that section of the United States tax legislation that provides concessional taxation treatment for these accounts. The percentage of employers that offer 401(k) retirement plans that offer automatic enrolment had increased from nineteen per cent in 2005 to thirty four per cent in 2007.<sup>23</sup> This increase is possibly in response to the above mentioned *Pension Protection Act 2006*. Further, a number of employers surveyed in 2007 whose 401(k) plans do not have automatic enrolment plan to offer this feature in the near future.<sup>24</sup> These trends are reflected in recent press reports indicate that the above auto-enrolment features of the *Pensions Protection Act 2006* have found wide acceptance amongst both employers and employees.<sup>25</sup>

While the above comments are encouraging, this increase in employers offering auto-enrolment in 401(k) retirement savings plans has yet to significantly increase the overall participation rate of employees in these plans.<sup>26</sup> This may be due to the non-compulsory nature of the United States retirement savings system. Further, press reports indicate that the average rate of contribution via the auto enrolment is about five per cent of salary, which some American retirement income experts suggest is not enough to secure an adequate retirement income.<sup>27</sup> As noted above, employer and employee contributions are to automatically increase over the next few years and as the United States regime has just formally commenced it may be prudent to wait before coming to any definitive conclusions about the success or otherwise of these arrangements.

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22. P. Purcell, 'The retirement savings tax credit: A fact sheet', *United States Congressional Research Service – Library of Congress*, 20 December 2007.
  23. Hewitt Associates (a United States personal consulting firm) *Trends and Experiences in 401(k) Plans 2007*, November 2007, p.3.
  24. American Association of Retired Persons (AARP), *Employer Awareness and Attitudes About Automatic 401(k) Plans*, 2007, p. i.
  25. S. Roberts, 'More employers adopt 401(k) auto enrolment... and employees like it', *Financial Week*, 28 December 2007, Alex J. Tarquinio, 'In Search of Savers: 401(k) Rules Are Changing', *the New York Times*, 11 November 2007.
  26. Hewitt, op. cit., p. 2.
  27. K. Glass, 'Auto Enrolment Makes 401(k)s Easy, but Experts Say its Not Enough', *FoxBusiness*, 28 February 2008.

### Australian experience – Tasmania

Since May 1999 all newly employed Tasmanian public servants automatically contribute five per cent of their after-tax salary to the Tasmanian Accumulation Plan. Existing employees in May 1999 were automatically enrolled in this arrangement. All participants may:

- opt out of, or choose to participate in, this arrangement at any time
- vary the percentage of salary contributed at any time (as long as it is a multiple of one per cent),<sup>28</sup> or
- elect to contribute a fixed dollar amount from their after-tax salary.<sup>29</sup>

Initially, most existing employees in May 1999 opted out of this arrangement. However, since its introduction thirty three per cent of new full-time and twenty seven per cent of new part-time workers opted to participate in this scheme. About ninety per cent of participants contribute five per cent of their after-tax salary.<sup>30</sup>

### Selected Policy Issues

The success of any soft compulsion regime will in part depend on its features. The following section discusses some design aspects of any potential soft compulsion regime and some associated issues.

Every employer or only some employers?

A common feature of overseas soft compulsion schemes in New Zealand and the United Kingdom is that all employers, irrespective of their size, have to offer participation in their country's scheme.

Smaller employers may argue that the administrative burdens of a soft compulsion regime are excessive and that they should be exempt from this requirement.

However, in Australia exempting small business from any such regime may also deny about four million employees (about forty six per cent of total employees) from the opportunity to participate.<sup>31</sup> Further, all employers are required to make SG contributions on the behalf of

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28. Subsections 5(2)&(3) *Public Sector Superannuation Reform Act 1999* (Tas.).

29. Clause 5.4.6 Tasmanian Accumulation Scheme Trust Deed.

30. S. Gills - Retirement Benefit Fund Tasmania, Presentation at ASFA Conference Super 007, November 2007, 'Taking the soft option', *Herald Sun*, 19 November 2007.

31. Data for the end of June 2006. Source: Australian Bureau of Statistics, *Australian Industry 2005–06*, ABS Cat 8155.0.

their employees earning more than \$450 per month. Employers already have to set the amount of superannuation contributions when a new employee starts, and generally review wage and superannuation amounts on an annual basis, at least. The additional administration task should therefore not be too onerous given these existing requirements.

Everybody in or new employees only?

New Zealand's scheme requires only that new employees be automatically enrolled in KiwiSaver arrangements. Should the same rules apply in Australia?

Requiring only new employees to be automatically enrolled in such a scheme avoids suddenly disrupting existing arrangements. Further, when a person changes employment they have the option to participate in a soft compulsion regime, or reassess their needs in the light of current circumstances. This could be particularly relevant to higher income earners if their superannuation contributions, either before or after-tax, approach the recently implemented superannuation contribution limits.<sup>32</sup>

Against that, restricting participation in any soft compulsion regime to only new employees would deny the majority of the workforce the option to participate in these arrangements. Of the approximately ten million people aged fifteen years and over working at in February 2006 about twelve per cent had changed their employment in the previous twelve months.<sup>33</sup> Further, some employees never or infrequently change their job. Limiting the scheme to new employees only may not be the best way to rapidly increase retirement savings. If participation in this regime is not in an individual's best interest they have the opportunity to opt out.

Inclusion of low income employees?

By its very nature, a soft compulsion regime that has a flat percentage of earnings rate of contributions is arguably regressive in its effect, at least in regard to its initial impact on disposable income. That is, the contributions will have a higher impact on a lower income person than on a higher income person. On the other hand low income earners are more likely to attract the co-contribution should the contributions made come from after-tax income. Should low income persons be exempt from such a regime with the option to participate? The proposed UK scheme has this feature.

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32. From 1 July 2007 a person may contribute up to \$50 000 per annum in before tax and up to \$150 000 per annum (after-tax) to superannuation without incurring the superannuation excess contributions tax. This tax generally brings the tax on superannuation contributions up to the top marginal rate, but in the case of after-tax contributions the tax rate can be far higher, over ninety per cent in extreme cases.

33. Australian Bureau of Statistics, *Labour Mobility, Australia*, February 2006 (Reissue), ABS Cat 6209.0, 6 December 2007, p. 4.

Generally, the lower a person's income the greater the ability of the current retirement income regime to produce an adequate retirement income, if adequacy is measured as a percentage of immediate pre-retirement income received after retirement. If this view is adopted there is a reduced need for very low income earners to participate in such a regime. Generally, a replacement rate of sixty per cent for a person on Average Weekly Earnings, and up to one hundred per cent for a person who received social security benefits before retirement, are considered an adequate retirement income.<sup>34</sup>

However, the adequacy of a person's retirement income can also be measured by the ability of the current retirement income system to produce income in retirement that affords the retiree a modest standard of living. The current budgetary standards for a modest but adequate retirement income, for those owning their own homes outright, are:

- \$18 742 p.a. for a single person, and
- \$26 339 p.a. for a couple.

ASFA have also calculated a 'comfortable' budgetary retirement standard, which currently is:

- \$36 319 per annum for a single person, and
- \$48 684 for a retired couple.<sup>35</sup>

Should a person have to rent in retirement the required amount of income to meet either the 'modest but adequate,' or 'comfortable' retirement standards is considerably higher.

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34 ASFA, *Policy Principles*, June 2007, Principle 2.1.2.

35 The Westpac/ASFA Retirement Standard in ASFA, '[Retirement living costs up in September Quarter](#)', *media release*, 20 December 2007.

**Box 1 – A note on current adequacy**

The adequacy of the retirement income system is very difficult to determine. Following is an estimation of current retirement income for a newly retired Age Pensioner **home owning** couple.

Commonly, average superannuation balances at retirement, together with assumed rates of investment returns and age pension entitlements are used to undertake these calculations.

Average balances are potentially misleading, due to the upward biases that may exist due to greater than average contributions by wealthier individuals, and the tendency of superannuation balances to increase rapidly later in a person's working life due to the effect of compounding investment earnings. Median superannuation balances at retirement would be more helpful, but these are not usually calculated.

Recently, the average superannuation balance at retirement as at January 2008 was calculated by ASFA as \$155 000 (male) and \$73 000 (female). To compensate for possible upward biases the following calculation assumes that most retiree couples will have total superannuation assets of \$150 000 at age 65. They are assumed to have no other assets outside their superannuation benefits.

The average earnings rate on a balanced superannuation fund over the 10 years to 30 June 2007 is about 8.4 per cent. The following calculation assumes that the superannuation benefits at retirement are kept in the superannuation fund and only the earnings are withdrawn. The couple's income would be:

Income Source	Amount \$ p.a.
Superannuation fund	12 600
Age Pension	14 965
Total	27 565

Source: Parliamentary Library

As can be seen this amount is above the current modest but adequate budgetary standard noted in the text. However, it is less than clear that most current retiree couples will have even \$150 000 in superannuation assets at their disposal at retirement. Further, if the retiree couple had to pay rent then the above amount would be inadequate, even allowing for the receipt of rental assistance as part of their Age Pension payments.

Some industry commentators consider it unlikely that low income earners will be able to generate such regular amounts of income in retirement on the back of the current Superannuation Guarantee contributions and age pension alone.<sup>36</sup> If this is the case then it

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36. R. Clare, *The interaction of the Age Pension and Superannuation in the provision of Australian retirement incomes*, forthcoming in 2008, p. 8.

might be desirable for low income earners to be included in any Australian soft compulsion regime.

Before or after-tax?

In New Zealand, most KiwiSaver contributions are made on an after-tax basis.<sup>37</sup> The same appears to be true to the proposed British scheme. In the United States a member of a government sanctioned retirement scheme may have their contributions made on either a before-tax, or after-tax basis depending on the type of scheme to which the contributions are made.<sup>38</sup>

In Australia, before-tax contributions would be undertaken through a salary sacrifice arrangement. ASFA has recently called for access to salary sacrifice arrangements for additional superannuation contributions to be available to all employees.<sup>39</sup>

At first glance there are two main difficulties with a before-tax approach. Firstly, it appears that it involves a loss of revenue. These amounts would not be subject to either personal income tax, or Fringe Benefits Tax (FBT), as additional employer superannuation contributions are generally exempt from FBT.<sup>40</sup> Secondly, such an approach would disqualify these additional contributions from being eligible for a government superannuation co-contributions payment (see below). Without a government co-contributions payment, it is doubtful whether the total contributions would reach the identified desirable total contribution target of fifteen per cent of wages.

The first of these objections does not appear to be a significant problem. In respect of foregone revenue, it should be remembered that all before-tax superannuation contributions are subject to a flat fifteen per cent tax on their payment into a superannuation fund. Thus there would be a limited revenue loss.

An additional contribution of six per cent of earnings would be required to lift a person's total superannuation contributions to fifteen per cent of wages.<sup>41</sup> Taking six per cent from a

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37. The tax credit available to the individual in respect of KiwiSaver scheme contributions goes a long way to making such contributions tax neutral from the individual.

38. Normally, contributions to a scheme are made on a before tax basis but the benefits are tax free. However, there are many variations See James R. Story, 'Retirement Plans with Individual Accounts: Federal Rules and Limits', *Congressional Research Service, Library of Congress*, 27 February 2003, updated in 2006, pp. 5–6.

39. ASFA Pre Budget: '[Lets lift private savings](#)', *media release*, 24 January 2008.

40. See definition of a fringe benefit in s.136(1)(j) *Fringe Benefits Tax Assessment Act 1986*.

41. That is nine per cent of SG contributions plus an additional 6 per cent in soft compulsion contributions gets the person to the identified target of fifteen per cent of earnings total contributions.

person's gross income can be a significant impost, especially to those on a low income. The prospect of such a reduction in take home pay may cause a large number of individuals to opt out of any proposed arrangements. This particular problem may, in part, be addressed by the manner in which such contributions are introduced (see the following discussion).

Taking account of the imposition of a fifteen per cent tax on before-tax contributions, the person's actual total contribution to a superannuation fund from both the SG and before-tax soft compulsion contributions is about thirteen per cent of wages. Such an outcome may be acceptable if it allows most retirees to generate at least a modest but adequate income in retirement from all sources.

A gradual lift or a set percentage?

A feature of both the British and American schemes is a gradual increase in the level of both employer and employee contributions. What would be an appropriate approach for Australia should it adopt such a scheme?

ASFA, in its advocacy of a soft compulsion regime in Australia has suggested a gradual lift in contributions, from 1 per cent to a maximum of three per cent of earnings.<sup>42</sup> The House of Representatives Standing Committee on Economics, Finance and Public Administration in its report, *Improving the superannuation savings of people under 40*, recommended that a default rate of three per cent of earnings through salary sacrifice arrangements be adopted.<sup>43</sup>

Whether a gradual lift in the contributions rate or a set contributions rate is preferred will depend on the desired overall level of superannuation contributions (see next section) and the source of these contributions. For example, say that the desired overall level of contributions was twelve per cent of a person's ordinary time earnings. Further, that the individual, and the government, were to be the sources of the additional contributions. Then, the additional three per cent coming partly via a soft compulsion regime and partly from an enhanced government co-contribution scheme, on top of the existing nine per cent coming from compulsory SG contributions, may not seem like a large requirement for most employees. In these circumstances it may be appropriate to set the required percentage of earnings to be contributed at, say, one point five per cent of earnings (the other one point five per cent coming from the co-contributions scheme) upon such a scheme's commencement.

However, if the desired overall superannuation contribution rate was higher, say six per cent of earnings, and the individual was to be the only source of these contributions, then a gradual increase in the annual rate of contributions may be desirable.

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42. ASFA, [Pre-Budget Submission for the 2008–09 Budget](#), January 2008, p. 8.

43. The House of Representatives Standing Committee on Economics, Finance and Public Administration, ['Improving the superannuation savings of people under 40'](#), May 2006, p. xxi

What should the overall rate of superannuation contributions be?

As previously mentioned, the Treasurer and Minister for Superannuation and Corporate Law noted that it would be desirable for the overall rate of superannuation contributions to move towards fifteen per cent of earnings. This target would be met by the current nine per cent of earnings SG contributions, additional personal contributions and an enhanced government superannuation co-contributions regime.<sup>44</sup>

The notion that a person's superannuation total contributions should be a total of fifteen per cent of their earnings appears to have its origins during the Keating government. It was proposed to raise overall superannuation contributions to fifteen per cent of the individual's wages.<sup>45</sup> The source of the extra six per cent was to be additional personal contributions of three per cent of wages and a matching co-contribution from the government. It is interesting to note that this proposal opted for a gradual rise in personal contributions, from one to three per cent of wages over a number of years and was to be compulsory for all employees.<sup>46</sup> This gradual rise was to accompany the gradual rise in SG contributions to nine per cent of earnings over the same period.

The appropriate level of superannuation contributions over a normal working life to provide an 'adequate' retirement income is the subject of sometimes intense disagreement. Some commentators suggest that the current level of SG contributions, plus additional personal contributions and government superannuation co-contributions are all that are required to achieve this goal.<sup>47</sup> Other commentators consider that this is not the case.<sup>48</sup>

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44. Wayne Swan MP and Senator the Hon. Nick Sherry, 'Report on superannuation incorrect', *Joint media release*, 5 November 2007.

45. The Hon. Ralph Willis MP, Treasurer, Budget Speech, House of Representatives, *Debates*, 9 May 1995, p. 68.

46. Further details of this legislated, but never implemented, scheme see The Hon. Ralph Willis MP, Treasurer, *Saving For Our Future*, 9 May 1995.

47. Dr G. P Rothman, [\*The adequacy of Australian retirement incomes – New estimates incorporating the Better Super reforms\*](#), Paper presented to the Fifteenth Colloquium of Superannuation Researches, UNSW, 19 July 2007, Watson Wyatt, *The superannuation guarantee - is nine per cent enough? Watson Wyatt View*, December 2006. Most recently T. Morrison and S. Kelly, *Superannuation – the right balance post June 2007?*, paper prepared by the National Centre for Social and Economic Modelling on behalf of the CPA Australia, February 2008, p. iv. This paper notes that current arrangements will produce a fundamentally adequate retirement income for most family types. However, the paper also assumes that the retiree has a 40 year working life, owns their own home, part of the retirement income comes from the Age Pension and that the person remains healthy for a substantial proportion of their retired years!

48. R. Clare, Head of Research, Association of Superannuation Funds of Australia, *Are Retirement Savings on Track?*, June 2007. See Also, ASFA, [\*Pre-Budget Submission for the 2008–09 Budget\*](#), January 2008, p. 5. ASFA calculate that additional contributions of between 1 and 22 per

The SG contribution rate reached nine per cent only in 2002. Clearly, the SG regime is far from mature and those about to retire cannot be expected to have accumulated sufficient superannuation benefits to allow the generation of an adequate retirement income, without receiving the Age Pension, as defined above.<sup>49</sup> Further, the introduction of a soft compulsion regime would have little if any effect on this generation of retirees. Rather it is the long-term effect of any changes in the retirement income system that should be the focus of any consideration of the introduction of a soft compulsion regime.

There is significant disagreement amongst experts on the adequacy of the current retirement income system. This appears to be based on conflicting evidence on the effects of current arrangements to produce an adequate retirement income. These factors underline the need for additional study of the ability of current retirement income arrangements to produce an adequate retirement income for the majority of retirees, before undertaking further major changes.

#### Opting out

A significant issue is whether the employee should have the choice to opt out at any time, or only during a set period after first being automatically enrolled.

It could be argued that the acceptability of a soft compulsion regime in large part rests on the ability to stop these contributions at any time should a person's circumstances require it. If this feature were not available initial participation in a soft compulsion regime might be less than it might otherwise be due to members' fears of being 'trapped' in this arrangement. This notion of being 'trapped' would also be lessened if the current arrangements for limited access to superannuation funds on financial hardship and compassionate grounds were emphasised.

#### Linkage with Co-contributions

As noted above, the government appears to favour additional contributions being made on an after-tax basis together with an expanded government superannuation co-contribution regime.<sup>50</sup> Briefly, a government superannuation co-contribution is payable if a person is

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cent on earnings per annum would be required, depending on a person's income and years to retirement, to achieve a total retirement income of 60 per cent of the individual's income pre retirement. These calculations take into account access to the Age Pension and all relevant investment fees and taxes.

49. A recent estimate of the average superannuation benefits at retirement, for January 2008 are \$155 000 (male) and \$73 000 (female). Source: R. Clare, ASFA Research & Resource Centre, '[Retirement savings update](#)', February 2008, p. 8. These estimates are lower than other recent estimates but are based on data from the ABS Survey of Income and Housing and are thus based on a potentially wider sample of data than other recent estimates.

50. Wayne Swan MP and Senator the Hon. Nick Sherry, op. cit.

earning less than \$58 980 per annum in the 2007–08 year and they make personal contributions to their superannuation fund account. For the financial year ended 30 June 2007 the net amount of government superannuation co-contributions paid out was about \$1.9 billion.<sup>51</sup> This included a special one-off additional payment in regard to contributions made in the preceding year which led to a doubling of expenditure. It is reasonable to expect that a soft compulsion regime would significantly increase the amount of personal contributions that would attract such a matching payment. Obviously, this would increase the cost of the co-contributions regime to the government in excess of the current \$1 billion or so a year.

Of course, this issue does not arise if the additional contributions made via any soft compulsion regime are made via salary sacrifice arrangements before-tax. As already noted, such contributions do not give rise to a co-contribution matching payment.

It's not just an individual's superannuation alone

The above discussion assumes that an individual's superannuation balance alone is the key to achieving a reasonable standard of living in retirement. While for many that will be the case there are many other factors that may contribute to a person's standard of living in retirement. Some of these are:

- as noted above a significant proportion of employers make SG contributions on behalf of their employees at a higher rate than the nine per cent minimum, although these employees tend to be those in the higher pay ranges.<sup>52</sup> Some commentators expect that employer superannuation contributions above the nine per cent minimum will become more wide spread in future years<sup>53</sup>
- in recent years there has been a steady rise in the labour force participation rates of older workers.<sup>54</sup> This trend can dramatically increase the superannuation benefits of older workers<sup>55</sup>
- the majority of Australians enter retirement as a couple. It is a couple's combined resources that are important, not the average individual superannuation balance alone

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51. Commissioner of Taxation, [\*Super Co-contributions Annual Report – 1 July 2006 to 30 June 2007\*](#), 13 August 2007.

52. C. Bingham op. cit., p. 6.

53. S. Davidson and R. Guest, 'Superannuation tax reform: Fiscal consequences', *Agenda*, Vol. 14, no. 1, 2007, pp 12–13.

54. S. Kennedy and A. Da Costa, 'Older men bounce back: the re-emergence of older male workers', *Economic Roundup*, Spring 2006, p. 32.

55. Watson Wyatt, op. cit.

- many retirees have savings outside the superannuation system – such as investment property or privately held shares. These resources contribute to the achievement of an adequate retirement income
- some retirees will benefit from bequests left by their parents or others
- for many retirees the Age Pension is a sufficient retirement income and provides a range of fringe benefits such as a health card and discounts on some government charges – it's not luxury, but neither is it absolute poverty if the retiree also owns their own home, and
- commonly, what constitutes an adequate retirement income declines as retirees reach an advanced age.

The importance of these factors in a retiree's retirement income should also be assessed before further change to the current superannuation arrangements occurs.

The biggest issue

The purpose of superannuation is to provide some, or all, of a person's retirement income. Thus, the best way to assess the likely impact of increasing a person's superannuation contributions to fifteen per cent of their earnings is to consider what impact this may have on their retirement income, against the available standards income required for both an 'adequate' and 'comfortable' standard of living in retirement.

Initial projections undertaken by the Parliamentary Library suggest that, over a forty year working life, a person having total contributions of fifteen per cent of earnings made to a superannuation fund will indeed generate sufficient superannuation assets to provide an adequate, and one case a comfortable, retirement income, without receiving the Age Pension. After the Age pension has been taken into account every person achieves an income above the ASFA 'comfortable' retirement income standard.

The following table shows:

- projected superannuation fund balances given a fifteen percent of earnings superannuation contributions both before, and after, tax (down the left hand side of the table)
- the relevant ASFA retirement income standard (across the top of the table)
- the projected income arising from both the fund balance and Age Pension entitlements (in each separate box of the table), and
- the difference between the relevant ASFA retirement income standard and the projected total income (again, in each separate box of the table).

These results have been discounted for inflation (see Box 2) and are in 2007 year dollars. The calculated income is in the first year after retirement when qualified to receive the Age Pension (on or after Age 65).

Table 1: Difference between ASFA Retirement Income Standards and Total Income in Retirement

	Modest but Adequate Single ASFA Standard \$18 742 p.a.	Modest but Adequate Couple ASFA Standard \$26 339 p.a.	Comfortable Single ASFA Standard \$36 319 p.a.	Comfortable Couple ASFA Standard \$48 684 p.a.
<b>Steady Income Before Tax contributions - Total Balance at Retirement \$541 164</b>	Total Income \$45 458 p.a. – Difference \$26 716 p.a.	Total Income \$56 935 p.a. – Difference \$30 596 p.a.	Total Income \$45 458 p.a. – Difference \$9139 p.a.	Total Income \$56 935 p.a. – Difference \$8287 p.a.
<b>Steady Income After Tax Contributions - Total Balance at Retirement \$630 295</b>	Total Income \$52 945 p.a. – Difference \$34 203 p.a.	Total Income \$60 952 p.a. – Difference \$34 613 p.a.	Total Income \$52 945 p.a. – Difference \$16 626 p.a.	Total Income \$60 952 p.a. – Difference \$12 304 p.a.
<b>Increasing Income Before Tax Contributions - Total Balance at Retirement \$518 265</b>	Total Income \$43 805 p.a. – Difference \$25 063 p.a.	Total Income \$55 909 p.a. – Difference \$29 570 p.a.	Total Income \$43 805 p.a. – Difference \$7486 p.a.	Total Income \$55 909 p.a. – Difference \$7261 p.a.
<b>Increasing Income After Tax Contributions - Total Balance at Retirement \$554 848</b>	Total Income \$46 607 p.a. – Difference \$27 865 p.a.	Total Income \$57 558 p.a. – Difference \$31 219 p.a.	Total Income \$46 607 p.a. – Difference \$10 288 p.a.	Total Income \$57 558 p.a. – Difference \$8910 p.a.

Sources: Parliamentary Library - Age Pension Rates as at February 2008 and the Westpac/ASFA Retirement Standard in ASFA, '[Retirement living costs up in September Quarter](#)', media release, 20 December 2007

**Box 2 – Projections of Retirement Income**

These projections took into account all fees and taxes and included both before and after-tax contributions. One set of projections held the income steady at \$40 000 p.a. and the next set increased income by four per cent (before inflation) a year from an initial \$30 000 a year. Taking into account the expected inflation rate of 2.5 per cent per annum gross income was increased by 1.01 per cent p.a. The average balanced superannuation fund returned 8.4 per cent p.a. over the 10 years to 30 June 2007. Allowing for the expected inflation rate, a real earnings rate of 5.75 per cent p.a. was applied to annual balances after all relevant fees and taxes. Superannuation based retirement income was calculated by applying a rate of 8.4 per cent p.a. to the resulting superannuation balance in all cases. No drawdown of capital in retirement was assumed. These projections assume that couples only have one superannuation benefit available to them in retirement. Increasingly this is not the case due to the higher female workforce participation rates and for couples at least access to two superannuation benefits on retirement.

In all cases retirees achieve an income above the relevant ‘comfortable’ retirement income standard. However, should such an outcome be the explicit objective of government policy?

The most significant source of the projected gap between government revenues and expenditure after 2036–37, as the population ages, is the projected rise in health costs.

The second highest source of this fiscal gap is the rising cost of the Age Pension<sup>56</sup> Larger superannuation balances and consequent higher retirement incomes would make a significant contribution to reducing these fiscal pressures. On this basis it is in the government’s interest to increase the overall level of retirement savings.

On the other hand, it could also be argued that it is an individual’s responsibility to provide for a higher standard of living in retirement and that the government’s role in providing a retirement income simply rests with the current goal of providing a higher income in retirement than available from the Age Pension alone.<sup>57</sup> Further, it is likely that any soft compulsion regime could end up providing higher income earners with a disproportionate benefit, both through the higher dollar contributions they would make and the lesser need they may have to opt out of such arrangements for financial reasons. On this basis a government may choose not to implement arrangements to increase the overall level of retirement savings.

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56. The Hon. Peter Costello MP, Treasurer, [Intergenerational Report 2007](#), April 2007, p. xiv.

57. For the most recent restatement of the government’s aim for retirement income policy See: Australian government, *A Plan to Simplify and Streamline Superannuation – Detailed Outline*, May 2006, p. 1.

## Conclusions

It's better to be richer than poorer in retirement, and the introduction of a soft compulsion regime in Australia may significantly increase many a person's level of retirement savings. And there seems to be no practical reasons why a soft compulsion regime to increase superannuation savings could not be introduced in Australia. Further, at the time of writing, it appears to be desirable to increase superannuation savings as a way of withdrawing fiscal stimulus from the broader economy; and thereby assist in reducing inflationary pressures over the long term.

But these points are not sufficient reason to say that a soft compulsion regime should be introduced. Rather, the ability of current arrangements to produce an acceptable level of retirement income should first be considered. If current arrangements will produce such an income for the majority of retirees it may not be wise to introduce such a regime. After all, its not as if increasing superannuation contributions is the only option for the government to achieve its boarder economic goals.

Due to the disagreement amongst experts and the conflicting evidence on the effects of current arrangements the ability of the current retirement income system to produce an adequate retirement income for the majority of retirees should be clarified, before undertaking further major changes to that system.

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