February 2010

SECURING
RETIREMENT
INCOMES

The fairness of government support for retirement income

Consulting. Outsourcing. Investments.

Executive Summary

There has been much debate about the equity of the current tax concessions provided to superannuation funded retirement savings and in particular, whether middle and high income earners should pay the same 15% marginal tax rate as low income earners do, on their employer superannuation contributions.

Much of this analysis overlooks that it is in the public interest for individuals — where possible — to save for their own retirement, rather than be dependent on a government funded age pension. Furthermore, much of the criticism of tax concessions for retirement savings fails to take into account the direct link between the level of retirement savings and the subsequent reduction in the government age pension. That is, if an individual (or couple) can save adequately to fund their retirement, they will then not receive the government funded age pension.

The primary purpose of this research is to compare the relative level of government support for individuals and couples across a variety of income levels. The paper demonstrates the total government support for retirement income represented by the current arrangements taking into account both superannuation tax concessions and the government funded age pension is remarkably equal across a variety of income levels, including low, middle and high income earners.

Moreover, the paper demonstrates that contrary to popular opinion, high income earners do not receive a greater level of government support for retirement income than low income earners.

These results are because where individuals save for their own retirement, it is likely there will be a reduction in the level of future age pension costs.

In light of the pressures on the government budget resulting from an ageing population, it is imperative that any future tax changes do not reduce the taxation incentives available for Australians to save for their future retirement needs through superannuation.

Introduction

There has been much discussion about the equity of the current taxation concessions provided to superannuation. After all, the same tax rate of 15% is applied to all employer and salary sacrifice contributions, irrespective of the individual's marginal tax rate. It is obvious that this approach provides a much more generous concession to higher income earners (with a marginal tax rate of 39.5% or 46.5%, including the Medicare levy) than lower income earners with a marginal tax rate of just 16.5%.

But is this simple comparison the full story?

Superannuation tax concessions exist to encourage individuals to save for their retirement; in other words, to spread their earnings over their whole lifetime. A related objective is that if individuals receive higher post-retirement income due to superannuation, there will be less need for the Federal Government to support them through the means tested age pension. This must be a positive outcome over the long term for, as shown by the 2010 Intergenerational Report, our ageing population will require a material increase in our health expenditure which will place increased pressures on government budgets in future decades. The potential to reduce future expenditure on the age pension represents an important contribution to a more sustainable fiscal outcome in the coming decades.

The level and distribution of superannuation tax concessions should not be considered in isolation. Rather we need to consider the total support that the government provides towards the provision of retirement income.

After all, if there is less superannuation, there will be a need for greater expenditure on the age pension, and vice versa.

This research considers the present value of the total financial support the Federal Government provides over a person's lifetime for the provision of retirement savings. This support includes both superannuation tax concessions and the means tested age pension.
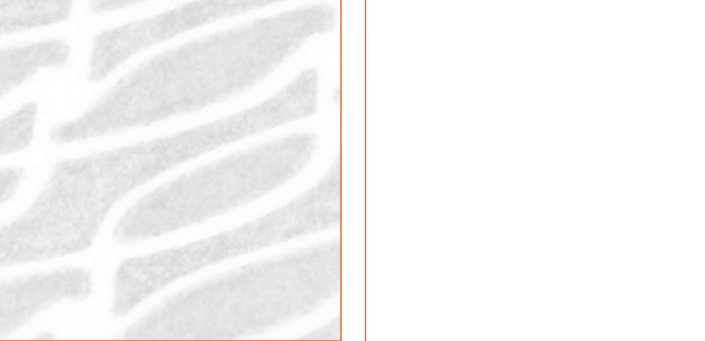
Levels of lifetime income

Seven individuals (and couples) with different lifetime income experience ranging from low to high incomes will be considered to assess the distribution of this financial support.

Three of these individuals will have an initial income of $40,000 (when they commence their careers), which represents about 75% of the median income for a full time worker. However their subsequent experience will differ as it is assumed they will experience salary increases of 4% pa, 6% pa or 8% pa resulting in final annual incomes after a 40 year career of $40,000, $84,079 or $174,296 respectively, when expressed in today's dollars.

The other four individuals will have an initial income of $62,500, which represents the average ordinary earnings for a full time worker in late 2009. Three of these individuals will experience different salary increases of 4% pa, 6% pa or 8% pa resulting in final annual incomes of $62,500, $131,374 or $272,337 respectively, when expressed in today's dollars. The seventh individual will experience very high salary increases of 12% pa for the first 20 years and 4% pa thereafter.

This variety of these lifetime income experiences means that the results in this research will cover the vast majority of

Australian workers, including low, middle and high income earners. We will therefore be able to consider the fairness of the total level of government support across all income levels.

Figure 1 shows the projected incomes that will apply to each individual during their assumed 40 years of full time work, expressed in today's dollars. It highlights that the highest earning individual will become a high income earner quickly and be subject to the top marginal tax rate for more than 60% of their career.

Figure 1: The projected incomes during each individual's working career
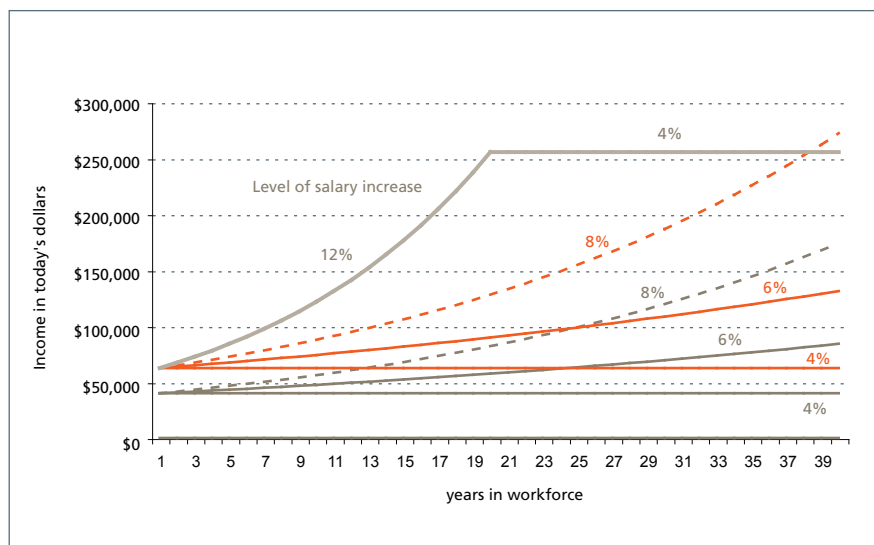
It is noted that these examples include full time workers only. This approach recognises that many part time workers will have limited superannuation and are therefore likely to receive the full age pension during retirement. This research concentrates on full time workers as it is designed to review the distribution of total government support for the provision of retirement income at different income levels and not consider every individual situation.

The types of taxation concessions for superannuation

As mentioned above, the initial superannuation tax concession is the difference between the individual's marginal tax rate and the 15% tax rate on concessional contributions, multiplied by the level of employer contributions. Two levels of employer contributions (capped at the existing levels[1], after allowing for indexation) will be used:

- 9% of earnings which represents the existing Superannuation Guarantee level, and

- 12% of earnings, which includes an additional 3% salary sacrifice contribution. This level also represents the recent proposal by the superannuation industry to increase superannuation contributions to 12% of earnings.

Clearly, this concession based on employer contributions is more valuable to higher income earners due to their higher marginal rate of tax and their potential to contribute at higher rates.

The second superannuation tax concession relates to the investment income earned by the superannuation fund. The average tax rate paid by superannuation funds in respect of their investment income is in the order of 8% after allowing for dividend imputation and available concessions in respect of capital gains. Hence the starting point

to value this concession is the difference between the individual's marginal tax rate and this 8% tax rate multiplied by the level of investment earnings received each year.

However this approach is unrealistic as most individuals would not pay tax at their full marginal tax rate on their non-superannuation investment income. The reasons include the availability of dividend imputation and capital gains tax concessions; the opportunity to invest through a lower income partner; the opportunity to invest in the tax exempt family home; and geared investment opportunities. Given these opportunities to reduce the tax on investment income, this research calculates the value of the investment tax concession as 50% of the difference between the individual's marginal tax rate and the superannuation fund's investment tax rate, multiplied by the level of investment income each year.

The concessions in respect of employer contributions and investment income are spread over 40 years of the individual's working career. The total value of these concessions is then expressed in today's dollars through the use of a discount factor, which is discussed below.

It should be noted that no allowance is made for any tax concession in the post-retirement period. Although it is assumed that most of the superannuation benefit will be invested in an account-based pension for this period, the amount of income tax paid by most older Australians is very low due to a combination of factors including the Senior Australian Tax Offset, the presence of dividend imputation and the concessions on capital gains. Hence, the fact that the account-based pension pays no tax on its investment income almost replicates the situation that would occur if these investments were made outside the concessionally taxed superannuation environment. Of course, the more important issue for most retirees is the application of the means test for the age pension.

The government co-contribution has been excluded from this model to keep it simple and improve understanding as this model concentrates on employer contributions only. In fact, allowing for the co-contribution increases the level of support received by some lower income individuals but has no effect on individuals with a starting salary of $62,500.

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1   These caps affect the two higher income earners after 17 and 34 years respectively when a 12% contribution rate is used. It is assumed that contributions in excess of the cap will be saved in a non-superannuation savings vehicle.

Value of the age pension

The means tested age pension represents a fundamental pillar in Australia's retirement income system. It is subject to both an income test and an assets test with the most severe test applying to the calculation of the pension payable.

For the purposes of this research we will initially consider a single male and assume that:

- 85% of the superannuation benefit will be rolled over into an account-based pension from age 65 – that is, 15% of the accumulated benefit will be spent immediately on retirement
- The individual is age 65 when the superannuation benefit is received
- The individual is a home owner and will live according to the life expectancy of 65 year olds shown in the latest Australian Life Tables[2] which is 18.5 for males. The corresponding female life expectancy is 21.6
- The pension will be payable from age 65[3]
- The existing income and assets tests will continue to apply and the various thresholds will be indexed at 4% pa
- The individual will draw down the minimum percentage required each year, commencing with 5% of the balance at age 65
- The retiree has no other assets or income, apart from the home, except for the higher income earner when the contribution cap is reached.

The value of the projected means tested age pension payments will then be expressed in today's dollars through the use of a discount factor.

The total value of the financial support provided by the government will be the sum of the value of the superannuation tax concessions and the value of the age pension payments, expressed in today's dollars (ie 40 years before retirement).

Modelling assumptions

The underlying assumptions used in the calculations are described below.

Investment earning rate (after fees and taxes)

- Accumulation period (pre age 65) 7% pa
- Post retirement period 6.5% pa[4]
- Non-super savings for high income earners 5% pa

Discount rate 4% pa

This rate was chosen as it reflects the expected growth of average wages over the longer term, representing a combination of inflation and productivity increases.[5]

Age pension levels

- $17,469 pa (single)
- $26,338 pa (couple)
- This means that the value of the full age pension in today's dollars (ie discounted at 4% pa) paid to a single male or couple for their life expectancies is $331,919 or $552,338 respectively.

Income tax scales

- As will apply from 1 July 2010 with the marginal tax thresholds indexed at 4% pa.

Administration fees

- No administration fees have been allowed as they are relatively minor and make no material difference to the comparative results between individuals.

It should be stressed that the primary purpose of this research is to compare the relative level of government support at different income levels. It is not about projections of post-retirement income for individuals. Hence, although the assumptions are broad, they are sufficiently accurate to gauge the relative strengths of total government support for retirement income at different income levels.

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2. Australian Government Actuary (2009), Australian Life Tables 2005-07, Canberra

3. The Government is increasing the eligible pension age to 67 over time. However age 65 has been used in these calculations as the life expectancy figures that have been used make no allowance for any increase in life expectancy which is very likely to occur in the coming years.

4. Although the account-based pension pays no tax, a slightly lower rate of investment earnings has been assumed due to the higher level of conservatism adopted by many retirees.

5. Discount rates of 2.5% (the midpoint of the Reserve Bank's inflation range) and 6% (the government's long term borrowing rate) are alternatives but it is considered that 4% represents a realistic rate and sits between the other two rates.

The results for a single person

Table 1 expresses the results for the seven individuals described earlier using the assumptions described above for both a 9% and 12% level of employer contribution. The table also shows the value of the total support expressed as a percentage of the support that would be received by an individual who receives the age pension only and the expected age at which a part age pension would commence.

Table 1: Total level of government support for a single male at different income levels

	Initial salary = $40,000						Initial salary = $62,500							
Salary growth rate (% pa)	4%	6%	8%	4%	6%	8%	4%	6%	8%	12%/4%	4%	6%	8%	12%/4%
Employer contribution rate	9%	9%	9%	12%	12%	12%	9%	9%	9%	9%	12%	12%	12%	12%
Present value of super tax concessions	$53,737	$76,650	$131,721	$71,649	$102,201	$175,628	$83,964	$147,930	$249,455	$387,598	$111,952	$197,240	$323,726	$459,444
Present value of future age pension payments	$331,445	$309,975	$247,834	$313,993	$263,781	$175,839	$293,419	$229,400	$126,343	$29,225	$237,760	$151,261	$37,821	$502
Total level of government support for retirement income	$385,182	$386,626	$379,554	$385,643	$365,982	$351,467	$377,384	$377,331	$375,798	$416,823	$349,712	$348,502	$361,547	$459,946
Total support expressed as a percentage of the full age pension costs	116.0%	116.5%	114.4%	116.2%	110.3%	105.9%	113.7%	113.7%	113.2%	125.6%	105.4%	105.0%	108.9%	138.6%
Age at which part age pension begins	65	65	65	65	65	65	65	65	65	69	65	65	74	83
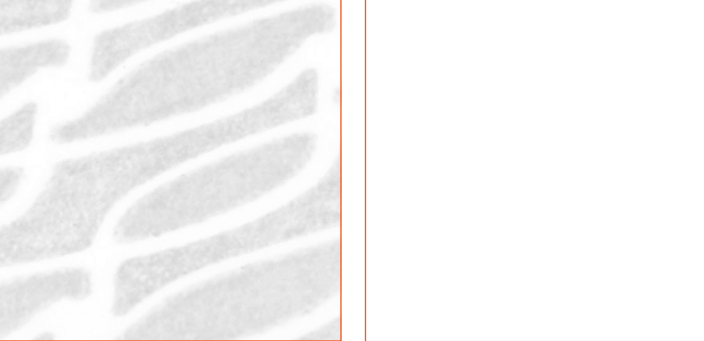
Figures 2 and 3 show the results for the seven individuals assuming employer contributions of 9% and 12% respectively.

Figure 2: The level of total government support for a single male assuming an employer contribution rate of 9% pa
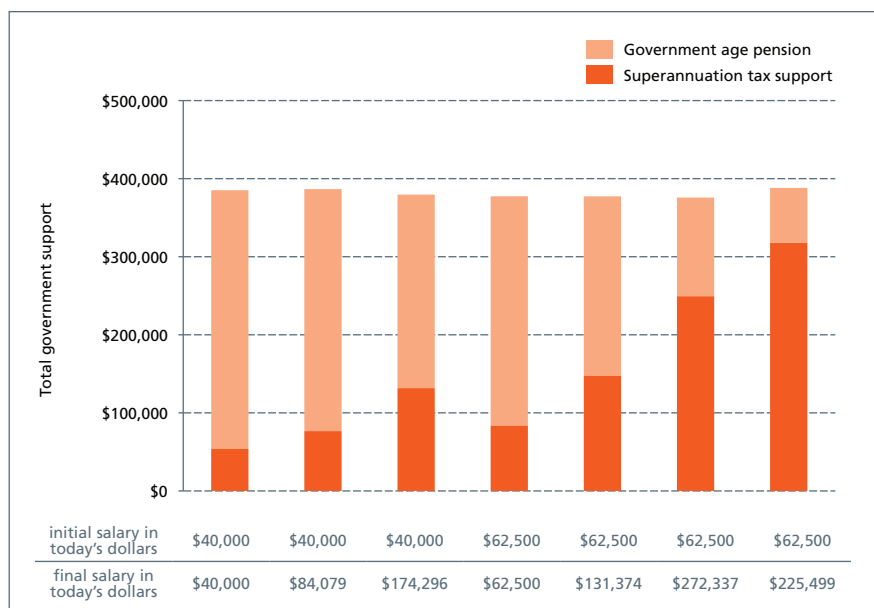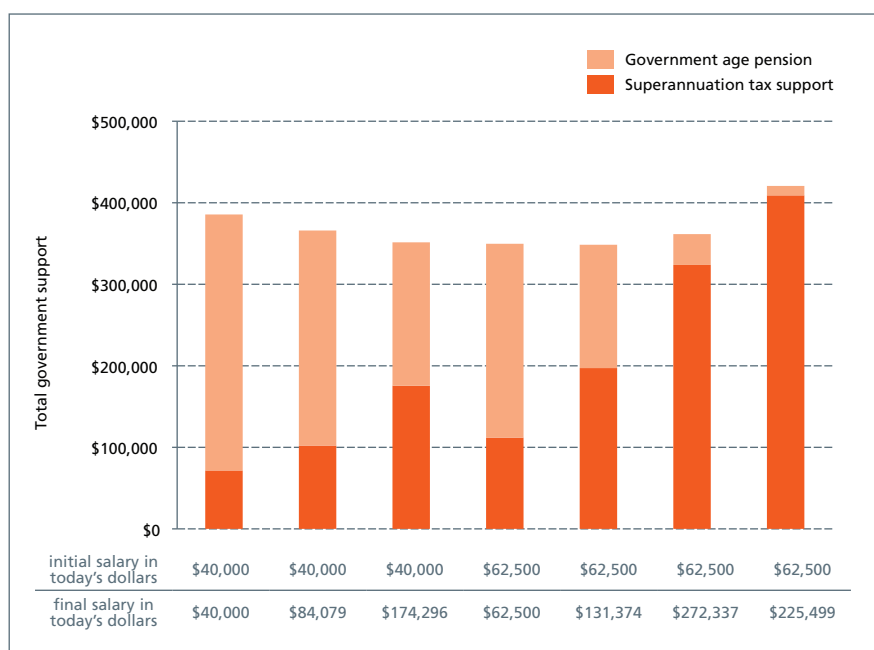

	Legend
▦	Government age pension
▦	Superannuation tax support

initial salary in today's dollars	$40,000	$40,000	$40,000	$62,500	$62,500	$62,500	$62,500
final salary in today's dollars	$40,000	$84,079	$174,296	$62,500	$131,374	$272,337	$225,499

Figure 3: The level of total government support for a single male assuming an employer contribution rate of 12% pa

	Legend
▦	Government age pension
▦	Superannuation tax support

initial salary in today's dollars	$40,000	$40,000	$40,000	$62,500	$62,500	$62,500	$62,500
final salary in today's dollars	$40,000	$84,079	$174,296	$62,500	$131,374	$272,337	$225,499

The results from this modelling highlight the following facts:

- As expected, higher income individuals receive a higher level of superannuation tax concessions but are also likely to receive a lower level of age pension;
- Similarly, those individuals who receive higher salary increases during their career receive a higher level of superannuation tax concessions but a lower level of age pension payments;
- Most individuals who receive a higher level of employer contributions (either through salary sacrifice or a higher Superannuation Guarantee) receive a lower level of total government support due to the effect of superannuation on the projected age pension payments.

However the most important result is that the total level of government support towards retirement income is almost constant across most individuals, notwithstanding their different lifetime incomes. Indeed the lowest support is for the individual who commences earning the average wage, makes additional superannuation contributions and receives a salary increase of 6% pa throughout their career so that their final income is about twice average earnings.

These results contradict the commonly held myth that the government support for retirement income increases as incomes rise.

In addition, these results probably overstate the cost of government support for many high income earners as no allowance is made for savings in excess of contributions of 9% or 12% of earnings, which would reduce future age pension costs.

Another key result is that the current arrangements may discourage some individuals from making additional superannuation contributions through salary sacrifice. That is, the level of government support reduces for many individuals as they make more voluntary contributions.

This result is contrary to the government's long term objective to encourage additional savings for retirement.

Results for a couple

For ease of understanding, we presented the initial results for a single male income earner. However the more common household arrangement is a couple.

Therefore we will now consider a couple with one (male) income earner working full time for 40 years and the other (female) income earner working full time for 25 years in two periods — initially 10 years and then 15

years at the end. The same income assumptions are used for each individual within a couple except that the income immediately after the break is kept at the same real level (ie 4% pa increase) as before the break commenced. Again it should be stressed that the actual assumptions are not that important; it is the relativity between different lifetime income levels that is being considered.

Table 2 together with Figures 4 and 5 show the results for couples, again allowing for superannuation contributions of 9% and 12% respectively.

Table 2 : Total level of government support for a couple at different income levels

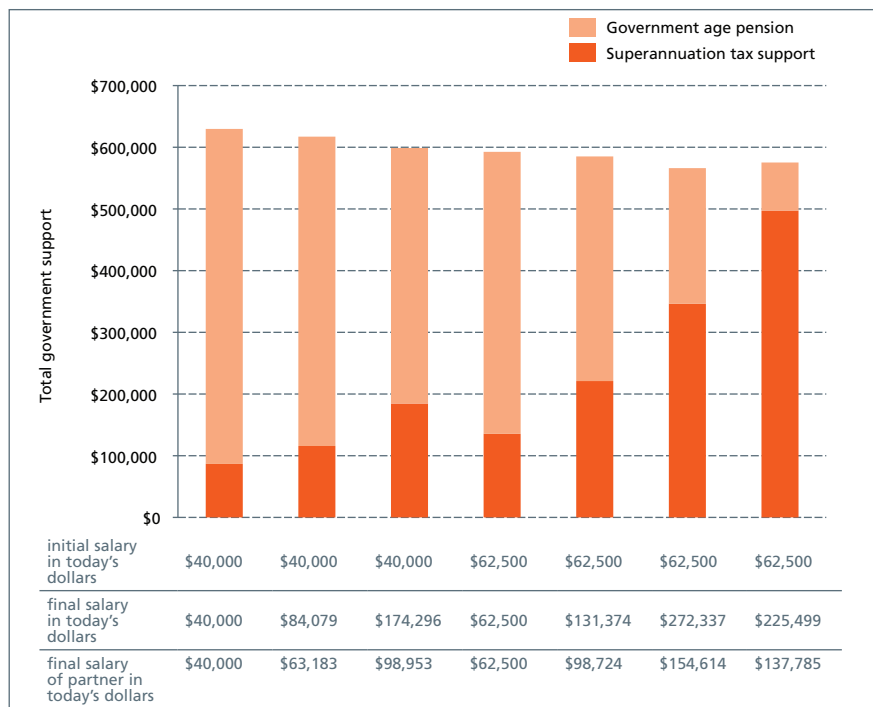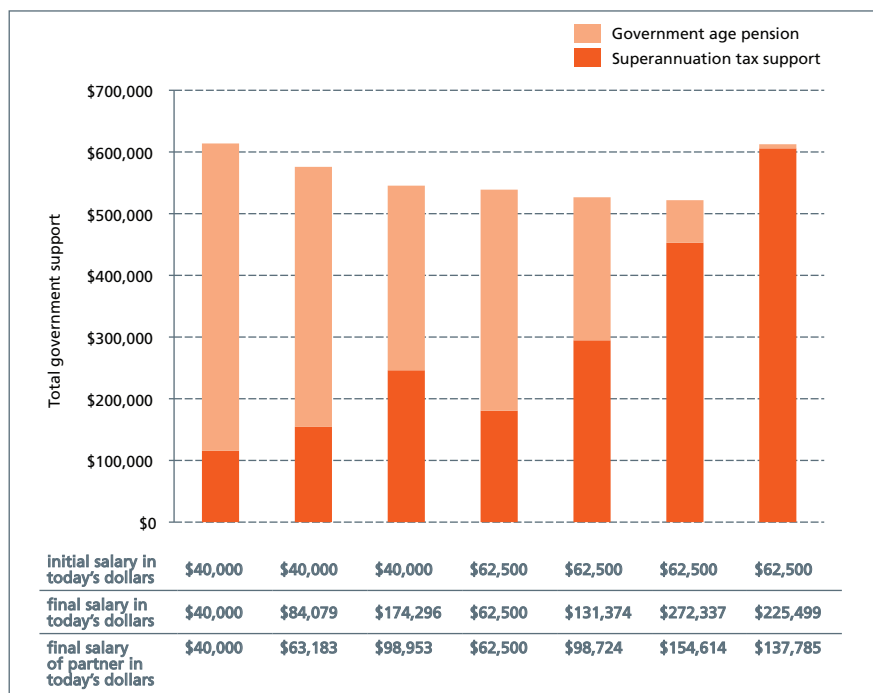|	Initial salaries = $40,000						Initial salaries = $62,500							
Salary growth rate (% pa)	4%	6%	8%	4%	6%	8%	4%	6%	8%	12%/4%	4%	6%	8%	12%/4%
Employer contribution rate	9%	9%	9%	12%	12%	12%	9%	9%	9%	9%	12%	12%	12%	12%
Present value of super tax concessions	$53,737	$76,650	$131,721	$71,649	$102,201	$175,628	$83,964	$147,930	$249,455	$387,598	$111,952	$197,240	$323,726	$459,444
Present value of super tax concessions for partner	$32,945	$39,114	$52,888	$43,926	$52,152	$70,517	$51,476	$73,111	$96,788	$109,830	$68,635	$97,481	$129,051	$146,440
Present value of future age pension payments	$543,042	$501,444	$414,200	$498,215	$421,536	$299,261	$457,134	$364,087	$219,941	$77,866	$358,350	$231,863	$69,083	$6,652
Total level of government support for retirement income	$629,723	$617,209	$598,809	$613,791	$575,889	$545,406	$592,574	$585,128	$566,184	$575,294	$538,937	$526,585	$521,860	$612,535
Total support expressed as a percentage of the full age pension costs	113.9%	111.6%	108.3%	111.0%	104.2%	98.7%	107.2%	105.8%	102.4%	104.1%	97.5%	95.3%	94.4%	110.8%
Age at which part age pension begins	65	65	65	65	65	65	65	65	65	67	65	65	73	81
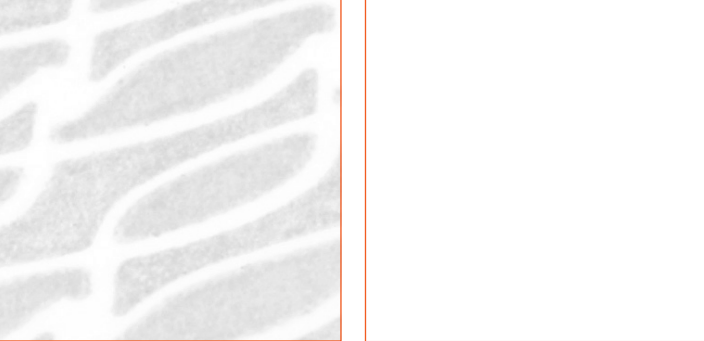
Figure 4: The level of total government support for a couple assuming an employer contribution rate of 9% pa

Legend:
- Government age pension
- Superannuation tax support

initial salary in today's dollars	$40,000	$40,000	$40,000	$62,500	$62,500	$62,500	$62,500
final salary in today's dollars	$40,000	$84,079	$174,296	$62,500	$131,374	$272,337	$225,499
final salary of partner in today's dollars	$40,000	$63,183	$98,953	$62,500	$98,724	$154,614	$137,785

The results for the couple with two income earners are even more remarkable than for the single person. With the single exception of the extreme high income earner, the total level of support provided by the government actually decreases as incomes rise or as superannuation contributions increase. Even the very high income earner receives less government support than the lowest income earner under both scenarios. There is certainly no general advantage to higher income earners when compared to low or middle income earners.

Figure 5: The level of total government support for a couple assuming an employer contribution rate of 12% pa

Legend:
- Government age pension
- Superannuation tax support

initial salary in today's dollars	$40,000	$40,000	$40,000	$62,500	$62,500	$62,500	$62,500
final salary in today's dollars	$40,000	$84,079	$174,296	$62,500	$131,374	$272,337	$225,499
final salary of partner in today's dollars	$40,000	$63,183	$98,953	$62,500	$98,724	$154,614	$137,785

Conclusions

The total government support for retirement savings represented by the current arrangements, taking into account both superannuation tax concessions and the age pension, is remarkably equal across a range of lifetime income levels.

They do not favour all higher income earners when both superannuation contributions and age pension payments are considered.

Furthermore, the current arrangements do not encourage individuals who earn about the average wage from making additional contributions to superannuation. At these income levels, the co-contribution is almost worthless and the negative impact of additional salary sacrifice contributions, together with the preservation requirements, is considerable.

It is likely the Henry Tax Review will recommend incentives to encourage non-superannuation savings. Such a change is to be welcomed in terms of an incentive to encourage savings. However, it must be recognised the current arrangements to save for retirement income are not overly generous and any additional incentive to save outside superannuation is likely to lead to lower levels of superannuation saving and a greater reliance on the age pension in the future. This is not a desirable outcome for Australia's increased fiscal sustainability and improved retirement incomes.

Increased superannuation contributions will provide higher superannuation benefits in the future, which should reduce future age pension outlays for the government. Our ageing population will place increased pressures on government budgets in future decades. As shown by the Government's 2010 Intergenerational Report, by 2050 there will be 2.7 people of working age to support each person over 65, compared with 5 people today.

It is therefore imperative that any future tax changes do not reduce the taxation incentives available for Australians to save for their future retirement needs through superannuation.

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