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Submission to the Inquiry into Improving Superannuation Savings of People under Age 40

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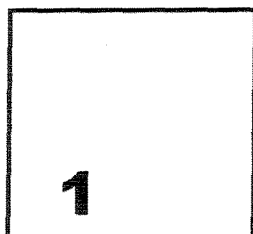

Recommendations for change

Mercer Human Resource Consulting (**Mercer**) welcomes the opportunity to make a submission to the Inquiry by the House of Representatives Economics Committee into "Improving Superannuation Savings of People under Age 40".

Mercer agrees with Mr Bruce Baird, Chair of the Committee, that this is a very important inquiry and that we need to better understand the effects of both the existing barriers and current incentives which affect the voluntary superannuation contributions from the under 40s.

The submission discusses the major barriers and disincentives which affect the under 40s and recommends the following three actions to encourage a greater level of voluntary superannuation contributions by this group:

- **That 50% of the personal (after tax) contributions made by individuals under age 35 be able to be withdrawn at any time for any purpose;**
- **That the separate limit on deductible contributions for members under age 35 be abolished and that the same contribution limit apply to all members under age 50;**
- **That the rate of superannuation fund taxation be reduced from 15% to 10%.**

These changes would

- Improve the attractiveness of superannuation contributions by improving access to half the member contributions in the future; and
- Improve the incentives to contribute by improving and clarifying the tax advantages of superannuation when compared to alternative investments.

This submission considers the existing barriers and disincentives with direct feedback from the under 40s and then explains the rationale for the recommendations highlighted above.

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Current barriers and disincentives

There are several significant barriers which discourage or prevent many people under age 40 from contributing to superannuation. The major barriers can be summarised as:

- The lack of future access to their contributions due to the preservation rules relating to superannuation;
- The desire to repay debts (eg mortgage);
- The greater relative attraction of other forms of savings (eg shares, property);
- The lack of clear incentives to saving, including the taxation arrangements, the cap on deductible contributions, especially for those under age 35, and the Reasonable Benefit Limits;
- The perceived risk of change associated with the lack of long term confidence in the current rules and framework.

The following comments from younger people are direct quotes when they were asked about their attitude towards superannuation. These comments were made in response to an open ended question, after they were made aware of this Inquiry. The comments provide clear insights into the attitudes of this generation towards superannuation. All the individuals work within the financial services industry and are therefore more aware of superannuation than many of their age group.

Problem 1: The lack of access

> "We're all scared to lock our savings away until we're 65 (so preservation will probably be more like 75 by the time I get there) in case we need it for an emergency or even a mortgage."
>
> Emma, 24

> "I don't really feel any incentive to put anything extra into my superannuation. This is mainly due to the fact that I won't be able to touch it until I am 60"
>
> Vanessa, 26

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> "We are not prepared to contribute anything of our own money to super due to the preservation laws. Liquidity of investments is high on our list of priorities and I know most of our friends of a similar age group feel the same way."
>
> Lorin, 26

> "My investment time horizon is long, but the feeling of having my money 'locked up' by preservation in super for many years is the most off-putting aspect of this kind of savings."
>
> Anna, 34

> "... we don't have huge savings. We need to know that we can access the money we have saved (for example if my car broke down) if we need to. Superannuation doesn't offer this freedom."
>
> Richard, 21

> "The big disincentive for people of my age is the preserved status of the accumulated amount"
>
> Anthony, 35

> "I don't put money into super as it's trapped once I do."
>
> Sue, 37

The current preservation requirements are acting as the major disincentive for people under 40 from making voluntary contributions to superannuation. Even where co-contributions are available, this lack of access for more than two decades acts as the major disincentive. There is no doubt that these preservation requirements, which have a very understandable motive, are proving a major barrier for people under 40. An important consequence of this negative attitude towards superannuation is that it may remain with these individuals throughout their working years.

Problem 2: The desire to repay debts

> "... why would I want to put more money in super at my age...It will be at least 30 years before I can touch it, and I would rather direct my money towards paying off the mortgage I am about to take out."
>
> John, 30

> "My husband and I are focusing on reducing our mortgage as a wealth accumulation strategy"
>
> Kate, under 30

> "As a married couple under 30, we've decided that paying off our mortgage is more valuable than investing in our superannuation."
>
> Miriam

Problem 3: The greater attractiveness of other investments

> "I feel more incentive to put extra money on my home loan as well as invest my money in other areas (eg shares, managed funds, property) where I feel it will be more accessible to me with fewer restrictions and probably more of a chance to make more money."

Vanessa, 26

"We have a number of investments but we can access them whenever we like"

Lorin, 26

"I think people are more money savvy these days and invest elsewhere. Property and shares spring to mind."

Sue

"People realise the importance of saving early but the above issues (high prices of houses and unclear tax incentives) means that super is not where they consider investing. It's nearly always in property or sometimes direct shares."

Michael, 29

Many workers perceive that other investment alternatives or wealth accumulation strategies, including the repayment of debt, are more attractive than making additional contributions to superannuation. Whilst non-superannuation savings will always be part of an overall savings and investment strategy for many individuals, it is observed that the lack of access to superannuation savings represents an important part of this decision process.

Problem 4: The lack of incentive

If you are in a 30 cents tax bracket, 15% in and possibly 16.5% on exit is actually a tax increase and very little incentive for saving in super, I'd rather pay it off my mortgage.

Jess, 30

My concern about the current system is the capping of the amount that can be put into super in one year. I am capped at a low figure ... this has meant that putting in a monthly salary sacrifice amount and then trying to put my bonus into super as well was impossible. I don't understand why young people are being disincentivised from adding to our super. Surely putting in as much as one can at a young age is a wise thing to do? Once we have children, we won't be putting much money into super other than the SG, so NOW is the time, NOW when I can afford to do it, but now is when I'm being stopped from doing it. Yet again, the government appears to have decided on a one-size-fits-all approach to things.

Robin, 32

Australian superannuation is taxed in a concessional manner. However, there are significant issues in the current arrangements that adversely affect many younger members. These include:

- the perception that there is no concession
    1. for those earning under $21,600, as the 15% marginal income tax rate is now the same rate of tax paid on employer contributions;
    2. for those earning up to $63,000, as the 30% marginal tax rate is perceived to be the sum of the tax paid on employer contributions and the tax paid on lump sum benefits above the threshold.

  This lack of a clear tax concession, together with preservation, means that additional superannuation contributions by the employer (eg as part of a remuneration package) is perceived as unattractive.

- The maximum deductible superannuation contribution in 2005-06 for members under age 35 is $14,603. This means that for higher income earners, there is no opportunity to salary sacrifice and increase the level of the employer's contributions. For example, this limit is equivalent to a 9% employer contribution for an income of $162,256. Furthermore, the limit prevents many young professionals from increasing their superannuation contributions when they have the capacity to do so.

Problem 5: The risk of change

> "With so many changes I do not have a great deal of confidence in super."
>
> Angela, 30s

> "...super is an enormous pot of gold and the government just can't resist changing the rules including tax rules. Who knows what taxes will apply 30 years from now."
>
> Sue, 37

Superannuation has seen significant changes during the last two decades and these have not stopped with recent events such as:

- the introduction of Fund Choice;
- the introduction of greater portability provisions;
- the abolition of the superannuation surcharge;
- the introduction of the transition to retirement policy and regulations;
- the extension of co-contributions; and
- the proposed introduction of contribution splitting.

There is no doubt that there will be further changes given the importance of superannuation to both the Australian economy and Australian households. Whilst some of these changes may have very positive effects, the continual change promotes uncertainty and lack of confidence over the long term.

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Recommended solutions

Solution 1: Ease preservation requirements for contributions by under 35s

The current preservation requirements subject all contributions and investment income to preservation. This means that all voluntary member contributions by those born after 30 June 1964, which includes all those under age 40, must be preserved until age 60. That is, we are requiring these individuals to contribute to a system for at least two decades with, in effect, no possibility of accessing their contributions. It is not surprising that such a requirement acts as major disincentive.

Preservation represents a critical component of the Australian superannuation system in meeting its primary objective of providing financial resources to retired individuals. However it is apparent that the current requirements are providing a very strong disincentive to younger Australians. As such, it acts as a major impediment in the establishment of a long term savings culture and behaviour.

Mercer therefore recommends that the preservation requirements be modified in the following way:

> **That 50% of the personal (after tax) contributions made by individuals under age 35 be able to be withdrawn at any time for any purpose**

The benefit available would not be increased with investment earnings and therefore would represent undeducted contributions only. As such, the benefit would not be taxable and therefore not require any significant amendment to the taxation arrangements.

The advantages of this proposal are many, including

- All investment earnings from these contributions are preserved until age 60;
- At least 50% of the member's contributions are preserved until age 60;

- Young members would begin to perceive superannuation as an attractive savings vehicle as not all their savings are locked away for 25-40 years;
- A savings culture would be established at an early age which represents a key change from our community's existing attitude to superannuation;
- There is no requirement concerning the use of the benefit. This is much simpler than requiring the use of the funds for a particular purpose. Hence this proposal would involve no intrusion into the personal financial affairs of the individual.

It is also noted that this recommendation will need some modification in cases where younger members are contributing to a defined benefit plan or where the fund's rules do not permit such a benefit payment. It is therefore suggested that this proposal be encouraged whilst not being compulsory for all funds to implement.

It could be suggested that younger Australians are unlikely to respond to such an innovation. However, the introduction of Lifetime Health Cover in 2000 (where health insurance rates increase for entry after age 30) show that this age group does respond to financial incentives. Hospital insurance cover is about 67% higher for those aged 30-34 compared to those aged 25-29.

Finally, it has been suggested that younger members could 'arbitrage' this proposal by receiving the withdrawal payment and then re-contribute the amount and thereby receive additional co-contributions. It is theoretically possible to limit such an outcome but the administrative rules would be very complex when one allows for the presence of choice, portability and members belonging to more than one fund. Rather, it needs to be acknowledged that only 50% of past contributions could be withdrawn, that the co-contributions are capped and that there would normally be a fee for each benefit payment. Hence, the attractiveness to members of such an action would be limited.

<u>An illustration of the outcome from this recommendation</u>

Let us consider a 22 year old earning $35,000 per year who contributes 5% of their salary (i.e. $1,750) for 8 years and then withdraws the available benefit at age 30. No further member contributions are made after age 30, due to personal financial needs, such as a family.

In this case, the member would also receive some co-contributions from the Government under the current arrangements.

Assuming that the fund earns 7% pa (after fees and taxes) and that the member's salary increases by 4% pa, the following results occur:

Total member's contributions from age 22 to 30:	$16,125
Benefit withdrawn at age 30:	$8,062.5
Co-contributions received (allowing for indexation):	$8,775

Additional lump sum benefit at age 60:	$182,592
Additional benefit as a multiple of the salary received in the final year:	**1.22**

The additional retirement benefit is significant. Even though the member contributes only 5% of salary for 8 years, and then withdraws 50% of these contributions, the member's available retirement benefit is increased by 1.22 times the member's final salary.

This example highlights the power of compound interest over 30 years, with more than 90% of the additional benefit arising from investment earnings.

The following table shows the additional benefit available at 60, expressed as a multiple of the member's final salary, for a range of scenarios in terms of the member's initial salary and contribution rate. In each case, it is assumed that the member will contribute for 8 years from age 22 and then withdraws the available benefit at age 30.

Additional multiple of final salary available at age 60

Initial salary	$25,000	$35,000	$45,000
Contribution: 3%	1.30	0.96	0.61
Contribution: 5%	1.73	1.22	0.88
Contribution: 7%	1.99	1.49	1.14

The higher multiples occur at the lower salaries due to the stronger impact of the co-contribution at these salaries.

In view of the attitudes of younger Australians, which were highlighted earlier, it is suggested that these voluntary member contributions are unlikely to be made if the current preservation requirements remain. The suggested policy is likely to make a significant difference to the retirement benefits available to Australians in 30 or 40 years time, as the current evidence suggests that a very small proportion of younger Australians make voluntary contributions to superannuation. Whilst hard evidence is unavailable, it is likely that less than 5% of young Australians currently make voluntary contributions to superannuation, and in many schemes it is less than 1% of younger members.

The Government may argue that the use of co-contributions provides an unreasonable advantage to certain individuals if 50% of their contributions are subsequently withdrawn. However, the co-contributions are limited and the investment earnings, compounded over decades, mean that it is likely that these savings will generate significant savings to the Government in the future.

Solution 2: Increase the maximum deductible contribution for under 35s

The maximum tax deductions available for superannuation contributions in 2005-06 have the following limits:

Age of member	Limit
Under 35	$14,603
35-49	$40,560
50 and over	$100,587

Given the existence of Reasonable Benefit Limits at retirement, and the associated tax penalties for exceeding these Limits, the existence of limits on annual contributions should be seriously questioned. They impose major disincentives for some individuals wishing to save for retirement as well as imposing administrative costs on superannuation funds which are borne by all members.

However, this inquiry is concentrating on members under age 40.

Mercer therefore recommends, as a minimum:

> **That the separate limit on deductible contributions for members under age 35 be abolished and that the same contribution limit apply to all members under age 50.**

The current annual limit of $14,603 for members under age 35 represents a major disadvantage for higher income earners in this age bracket.

For example, the limit restricts the tax deduction available on superannuation contributions under any of the following circumstances:

- An employee with a salary greater than $162,255 who receives an employer superannuation contribution of 9% or more of salary;
- An employee with a salary of $120,000, who then receives a bonus of $20,000 and wishes to salary sacrifice 20% of the bonus into superannuation;
- An employee with a salary of $75,000, who due to personal circumstances wishes to salary sacrifice 10% of their salary to superannuation, in addition to the required employer SG contribution. This example may represent an individual who plans to withdraw from the workforce for a period of years.

The negative effects of this contribution limit include

- the member's long term financial circumstances is likely to be worse as their retirement benefits have been limited;
- the long term savings behaviour as the members are discouraged from additional superannuation contributions; and
- the attitudes of these individuals towards superannuation and the broader implications of such a result, as many will be future leaders in the community.

Increasing the maximum deductible contribution limit for members under age 35 will:

- have significant benefits for some younger members;
- change the savings behaviour of some higher income earners, particularly in light of the abolition of the surcharge;
- remove one complexity from the superannuation system; and
- generate a positive attitude towards superannuation amongst our future leaders.

Solution 3: Reduce the tax rate on superannuation funds from 15%

In the 2005-06 federal budget the lowest personal income tax rate was reduced from 17% to 15%. This is the first time that the tax rate on superannuation funds has not been less than the lowest personal income tax rate.

Further, the 30% marginal tax rate is now affecting a much higher proportion of Australian workers. With superannuation contributions from employers taxed at 15% and lump sum benefits above $129,751 also taxed at 15%, many superannuation fund members perceive that superannuation is taxed at 30%. Whilst this is not strictly correct, this perception amongst members is strong and when added to the disadvantage of preservation, the concessional taxation treatment of superannuation is not readily appreciated.

Mercer does not oppose the reduction in personal income tax rates or the increase in income tax thresholds. However, whilst acknowledging that superannuation has become more attractive recently:

- for higher income earners through the abolition of the surcharge; and
- for low income earners through increasing the attractiveness of the co-contribution,

such changes are not significant for many younger workers. For example, if an employee has an income of $45,000 (which is less than 90% of AWOTE), the surcharge abolition has no effect and the maximum co-contribution is $650 where there is a member contribution of $434 or more. However, such a benefit does not offset the disadvantage of preservation for decades.

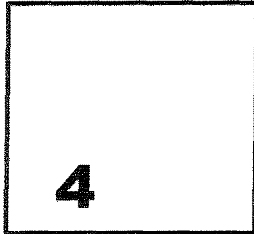
Therefore to improve the attractiveness of superannuation Mercer recommends

A reduction in the rate of superannuation fund taxation from 15% to 10%

This reduction in the level of taxation of superannuation for all members during the pre-retirement years could also be associated with a gradual increase in the level of taxation on the benefits subsequently received. Such a move would not only make superannuation more attractive immediately but would also defer the receipt of taxation to future years when there will be greater fiscal pressure on Government.

Such a change would have several advantages including:

- Providing a clear incentive to all workers between the difference in the tax rates that apply to superannuation funds and those that apply to personal income;
- Encouraging superannuation savings for younger Australians over the long term;
- Providing a clear message from the Government for **all** superannuation investors, which neither the removal of the surcharge nor the co-contribution provides;
- Increasing the level of superannuation contributions by at least 6% without imposing additional costs on employers.



Conclusion

Younger Australians are not currently attracted to make additional voluntary superannuation contributions as the advantages of such actions are not clear. In particular, the existing disincentives are significant and include:

- The lack of access to their contributions for decades;
- Their preference to repay debts;
- The attraction of other forms of medium to long term investments which remain more accessible;
- The lack of clear incentives in the tax system;
- The risk of future changes.

The current incentives to encourage voluntary superannuation contributions, including the co-contributions and the concessional taxation treatment of superannuation funds, are not sufficiently attractive for many Australians under 40 to make additional contributions.

Mercer therefore recommends the following changes:

> **That 50% of the personal (after tax) contributions made by individuals under age 35 be able to be withdrawn at any time for any purpose;**
>
> **That the separate limit on deductible contributions for members under age 35 be abolished and that the same contribution limit apply to all members under age 50;**
>
> **That the rate of superannuation fund taxation be reduced from 15% to 10%.**

These changes would

- Improve the attractiveness of member contributions by improving access to half these contributions in the future; and
- Improve the incentives to contribute by improving and clarifying the tax advantages of superannuation when compared to alternative investments.

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