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Regulatory overview

Australia’s retirement income system

2.1 Australia has a multi-pillar approach to retirement income, which has been broadly endorsed by the World Bank. The three pillars of Australia's retirement income system are:

- a means-tested Age Pension and associated social security arrangements
- compulsory superannuation savings through the Superannuation Guarantee (SG)
- voluntary superannuation and other private savings.

2.2 The Age Pension is a core component of the retirement income system in Australia. It is unusual amongst developed countries in that it is non-contributory, funded from general revenue, paid at a flat rate, and means tested.

2.3 Its key objective is to provide an adequate basic level of income in retirement, and to provide a supplement to those with modest superannuation and private savings. In contrast, most other Organisation for Economic Co-operation and Development (OECD) countries administer insurance-based, contributory schemes.

2.4 As Australia's Age Pension is not based on previous earnings or contributions, it provides a significant degree of protection for individuals and families at risk or not able to accumulate significant savings for retirement (for example through superannuation).

2.5 The government will spend approximately $20.8 billion in 2005–06 providing Age Pension to over 1.9 million recipients (which equates to 2.9 per cent of Australia's Gross Domestic Product (GDP)). Projected expenditure in 2041–42 is 4.6 per of GDP.

2.6 The projected increase over this period is relatively modest compared with most other OECD countries and will remain affordable to the budget.[1]

2.7 The Age Pension is payable to men who are at least 65 years of age and women who are at least 63 (the Age Pension age for women is being increased gradually from 60 and will be 65 in 2014, making it the same for men and women).

2.8 The full pension rate for a single person is set at a minimum of 25 per cent of male total average weekly earnings which currently amounts to a payment $499.70 per fortnight. Each person in a couple receives $417.20 per fortnight. A person receiving the Age Pension also receives a pensioner concession card which entitles them to reduced cost medicines under the Pharmaceutical Benefits Scheme.

2.9 They may also be entitled to extra concessions from state and local government authorities, which may include:

- reductions in property and water rates
- reductions in energy bills
- a telephone allowance
- reduced fares on public transport
- reductions on motor vehicle registration
- one or more free rail journeys within the state each year.

2.10 Consistent with its safety net role, eligibility for the Age Pension is restricted according to an assets test and an income test, which are collectively referred to as the means test. As a person's income and/or assets exceed certain thresholds, the Age Pension that they are eligible to receive is reduced.

2.11 The means test reflects the basic principle that individuals should be required to draw on their own resources in retirement before calling on the support of the general community through the social security system.

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1 Department of Family and Community Services, *Submission no. 38*, p. 5.

2.12 The SG directs some of an employee's current remuneration into a superannuation fund, by means of a compulsory employer contribution. The minimum level of employer superannuation support is generally nine per cent of an employee's ordinary time earnings (see *Superannuation Guarantee* within this chapter). Although paid by the employer, this contribution is essentially part of an employee’s remuneration package.

2.13 The third pillar encourages individuals to make additional savings, including into superannuation. This is particularly relevant to groups that may not benefit or fully benefit from the SG, such as the self-employed, people with broken working patterns (including the injured, ill, sole parents and women who have historically been the main carers for children and other family members), mature workers and those with higher retirement income expectations.

2.14 The third pillar is supported by taxation concessions for voluntary superannuation contributions to encourage that part of the retirement income system (see *Taxation* within this chapter).

2.15 During the 2004–05 year, superannuation contributions totalling $65.9 billion were made. Total superannuation assets as at 30 June 2005 were $761.9 billion (an increase of 18.5 per cent on 30 June 2004).

2.16 The number of superannuation entities increased by 6.9 per cent during the 2004–05 year to end on 311 000 (including 302 000 self-managed superannuation funds[2]). There were 28 million member accounts.[3]

International retirement income systems

2.17 Comparing the Australian retirement income system with its international counterparts is difficult, due to the differing policy frameworks and systems. The overseas jurisdictions examined below have multi-tier retirement income systems, of which private superannuation-type savings play only a minor role as a supplement to universally available public pension benefits.

2 A self managed superannuation fund (SMSF) is a superannuation fund that amongst other requirements has fewer than five members, where each of the fund members is a trustee of the fund and vice-versa. SMSFs are generally subject to less onerous prudential requirements than other funds due to the involvement of all members/trustees in the running of the fund.

3 Australian Prudential Regulation Authority, *Annual Superannuation Bulletin*, Sydney, April 2006.

2.18 The United Kingdom (UK) has a basic state pension. Each tax year that an individuals pays (or is treated as having paid) enough National Insurance is called a 'qualifying year'. Generally speaking, the more qualifying years an individual has, the more basic state pension they will get when they reach state pension age.

2.19 In addition, there is a second UK state pension. Employees can choose to 'contract out' of this second state pension by joining an occupational plan, a personal pension or a stakeholder plan.

2.20 The United States of America (USA) has a two-tier retirement income system comprising government retirement income benefits and private retirement income options, namely tax-preferred retirement savings accounts and private pension funds.

2.21 The USA federal government social security programme provides a retirement income benefit to retirees between age 65 and 67 depending on their year of birth. Benefits can be received as early as age 62, but at reduced rates. The programme is funded by a compulsory social security contribution, which is levied as a tax on both employers and employees.

2.22 All employees in the USA, with few exceptions, contribute and all receive a benefit, which is not subject to either an income or asset test. The programme has a strict preservation rule of age 62.

2.23 All residents in New Zealand are eligible to receive the universal benefit, New Zealand Superannuation, at age 65. All other superannuation schemes are required to be registered under legislation which requires the schemes to be principally for the purpose of retirement. Few tax concessions are available and no preservation age is prescribed.

2.24 The New Zealand Government has also introduced legislation in order to commence KiwiSaver from 1 April 2007. Under Kiwisaver, employees will automatically have four per cent of their gross salary and wages before tax paid to Inland Revenue, which then forwards it to the investment vehicle of the employee's choosing.

2.25 Contributions to the scheme are preserved, with minimal exceptions including financial hardship and access for a deposit on a first home.

2.26 Employees can opt out of the scheme within a certain timeframe, although each time new employment is commenced, they are automatically enrolled again. They can also elect to increase their contributions to eight per cent. See Chapter 3 for further discussion on KiwiSaver.

2.27 Canada has a three-tier retirement income system which includes means-tested Old Age Security, the Canada Pension Plan and Registered Private Pensions and savings.

2.28 The Canada Pension Plan is financed by mandatory contributions from workers in all types of jobs and aims to replace up to 25 per cent of the average industrial wage. The standard preservation age is 65, with reduced amounts available if the pension is taken between the ages of 60 and 64.

2.29 In Chile, workers must contribute ten per cent of their monthly salary plus an additional amount to cover the premium for compulsory term life and disability insurance and the operating costs of the management companies to privately managed funds.

2.30 There is a minimum retirement age of 65 years for men and 60 years for women, before which the account balance cannot be cashed out. Early retirement is possible but subject to certain legal requests, and 20 years of work are required to qualify for a minimum pension (guaranteed by the State) after their pension account runs out.

The regulatory regime

2.31 The regulatory regime that superannuation operates under is renowned as one of Australia's most complex. There are a number of Acts, over which several bodies have regulatory powers.

2.32 The primary Acts are:

- The *Superannuation Industry (Supervision) Act 1993* (SIS Act)
- The *Retirement Savings Accounts Act 1997* (RSA Act)
- The *Income Tax Assessment Act 1936* (ITAA 1936)
- The *Income Tax Assessment Act 1997* (ITAA 1997)
- The *Superannuation Guarantee (Administration) Act 1992* (SG Act)
- The *Corporations Act 2001* (Corporations Act).

2.33 There is significant other legislation concerning a variety of matters including the government co-contribution (see Chapter 7), resolution of complaints, collection of data, imposition of levies and splitting of superannuation on marriage breakdown (see Chapter 6).

2.34 The primary regulators are:

- The Australian Prudential Regulation Authority (APRA). The role of APRA in respect of superannuation is to:

  > Enhance the security of interests of superannuation entity members or depositors and retirement savings accounts (RSA)[4] holders and to assist in maintaining the Government's retirement incomes policy by:
  >
  > - regulating superannuation entities and RSA providers and related parties in accordance with the requirements of the relevant legislation and prudential requirements; and
  > - developing the policy to be applied in performing the regulatory role[5];

- The Australian Taxation Office (ATO). The ATO is responsible, in relation to superannuation, for matters including the operation of structural mechanisms to support the superannuation system, administration of Superannuation Guarantee arrangements and administration of the tax laws that govern the tax treatment of superannuation contributions and benefits[6]. The ATO is the primary regulator of self managed superannuation funds (SMSF) and also manages a register of inactive or 'lost' superannuation accounts; and

- The Australian Securities and Investments Commission (ASIC), which outlined its role as follows:

  > Amongst other things, one of ASIC's aims is to promote the confident and informed participation of investors and consumers in the financial system. We do this in a number of ways, including: enforcing financial services and company laws; checking compliance with those laws through on-site inspections of financial services licensees and desk audits; regulating the industry; keeping a vigilant watch on financial investment markets; working with the

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4 An RSA is an alternative to a superannuation fund account. It is simpler, less costly and has a lower risk (and generally lower returns) due to it being capital guaranteed. It is not in the form of a trust, such as a superannuation fund, but more like a bank account and can be provided by RSA institutions which include banks and life insurance companies. However, it is still subject to the same taxation and superannuation rules as a superannuation fund account, for example, it must be preserved until a condition of release has been met.

5 APRA and ATO, *Memorandum of Understanding,* April 1999, paragraph 2.2, http://www.apra.gov.au/Media-Releases/loader.cfm?url=/commonspot/security/getfile.cfm&PageID=3479.

6 APRA and ATO, *Memorandum of Understanding,* April 1999, paragraph 2.3, http://www.apra.gov.au/Media-Releases/loader.cfm?url=/commonspot/security/getfile.cfm&PageID=3479.

> financial services industry to raise standards where relevant, including supporting the development of industry codes; taking compliance and enforcement action against any breaches of the law; and providing accurate and impartial consumer education and information to raise standards of financial literacy and help consumers make confident and informed decisions about their finances.[7]

Significant rules

2.35 The main provisions that will directly and most overtly affect the superannuation savings of a person under the age of 40 are those dealing with:

- Superannuation Guarantee (SG)
- taxation
- preservation.

Superannuation Guarantee

2.36 Superannuation coverage was largely restricted to white-collar professional workers until the introduction of productivity award superannuation (PAS) in 1986.

2.37 PAS created industrial agreements which provided for up to three per cent of wage increases to be contributed to approved superannuation funds. While the initiative successfully increased superannuation coverage to approximately two thirds of the population, administration and implementation problems, particularly with respect to the monitoring and enforcement of employer compliance, were rife. The Industrial Relations Commission cited these problems as the basis for its refusal to increase the provision by a further three per cent.

2.38 The SG was then announced in the 1991–92 Budget. It provides for a percentage of an eligible employee's remuneration to be directed into a superannuation fund by means of a compulsory employer contribution.

2.39 The motivation for the SG was twofold: to provide a mechanism through which employer contributions could be gradually increased, consistent

7 Mr M Larbey, ASIC, *Transcript*, 14 October 2005, p. 49.

with retirement income policy objectives and the economy's capacity to pay; and to extend superannuation coverage to a larger proportion of the population. Each of these objectives has been broadly satisfied: the SG rate was successfully phased up from three per cent to nine per cent from 1992–2002; and superannuation coverage now extends to approximately 90 per cent of employees.

2.40 In 2002–03 the SG represented an estimated 80 per cent of superannuation contributions made with respect to people under the age of 40.[8]

2.41 There are a number of exceptions to an employer's liability to pay the SG including:

- where the other party is in fact an independent contractor and not an employee
- employees who receive salary or wages of less than $450 per month
- part-time employees under 18 years of age (defined as working less than 30 hours per week).

2.42 From 1 July 2005 choice of fund legislation allows employees, rather than employers, to choose the fund that SG is paid into. It is hoped that this will bring about a change in people's attitude towards their retirement savings and encourage them to take greater ownership of their superannuation and consequently their futures.

2.43 The government also believes that being involved in the decisions about where their superannuation contributions are paid may mean that employees will start to consider the adequacy of their retirement savings sooner rather than later.

2.44 The new 'choice of fund' and 'portability' regimes (see Chapter 7 for detailed discussion) should provide an advantage to people who change jobs on a regular basis or are involved in casual work. Instead of having superannuation contributions paid into a different fund each time they change jobs, these people can choose a fund that suits their needs and ask each new employer to contribute to that fund. Rather than having multiple accounts with small balances being eroded by fees and charges, contributions may be combined into the one account, producing a better return for the employee.

8 SG contributions estimated to be $9.6 billion and additional contributions estimated to be $2.4 billion, The Treasury, *Submission no. 47*, p. 10.

2.45 The competition benefits from choice of funds have been seen in the market already. Superannuation funds have been cutting fees, improving services and introducing new products, in particular, low cost products. According to the Investment and Financial Services Association (IFSA) there have also been new players entering the market.

> The number of accounts is likely to contract because of the backpacker effect—that is, people combining their super. The competition in the marketplace is increasing. There is a lot of competition for money and a lot of competition on price and service.[9]

2.46 Studies have shown however, a tendency for inertia. A recent survey commissioned by the Association of Superannuation Funds of Australia (ASFA) showed that during the first thee months of the operation of choice of fund legislation only four per cent chose a new fund as a conscious act of choice. There is also anecdotal evidence to suggest that some funds have made changing to another fund difficult.[10]

Taxation

2.47 Superannuation is generally concessionally taxed. Superannuation taxation concessions are estimated to be $16 billion in 2005–06.

2.48 The overall tax treatment of superannuation depends on a number of factors, including:

- who contributed to the fund (for example, employer, employee, self employed)
- whether the fund is taxed or untaxed[11]
- the type of benefit paid out (that is, pension or lump sum)
- the amount of the benefit
- the components of the benefit (for example undeducted contributions)
- the age of the member

9 Mr R Gilbert, IFSA, *Transcript*, 28 July 2005, p. 38.

10 Mr R Clare, *The Introduction of Choice of Superannuation Fund - Results to Date*, ASFA, Sydney, February 2006.

11 Untaxed funds include certain Commonwealth and state government run funds. These are a small minority of funds and members and will not be elaborated on for the purposes of this report other than to explain that while the contributions tax does not apply, benefits tax is increased correspondingly and the pension rebate generally does not apply.

- the type and amount of benefits previously received.

2.49 The government announced a number of proposed changes to the laws governing superannuation in the 2006–07 budget handed down by the Treasurer on 9 May 2006. This included changes to the taxation of superannuation benefits, which were outlined in the government's *Plan to Simplify and Streamline Superannuation* (the superannuation plan).[12]

2.50 The proposals in the plan are subject to public consultation and being passed by parliament. As a result, the following paragraphs address the current superannuation tax system initially. Relevant elements of the budget will then be discussed.

2.51 Employer superannuation contributions (including salary sacrifice) and deductible member superannuation contributions are taxed in the fund at 15 per cent in the year in which they were contributed (known as taxable contributions).

2.52 It should be noted, however, that the effective tax rate of a fund can be reduced by imputation credits attached to dividends received by the fund and the concessional treatment of capital gains in the fund. As a result, the average rate of tax paid by funds on assessable income (which includes taxable contributions) is somewhat less than 15 per cent at 9.7 per cent.[13]

2.53 Undeducted superannuation contributions, for example, amounts paid 'out of a person's pocket' after their income has been taxed, are not taxed again when they enter (nor when they are later withdrawn from) the superannuation system.

2.54 Investment earnings on accumulated benefits are taxed at 15 per cent in the fund. However, due to imputation credits and capital gains tax concessions discussed above, the effective rate of tax paid on investment earnings (which do not include taxable contributions) is estimated to be around 6.5 per cent for a typical fund. [14]

2.55 In the case of a lump sum benefit withdrawn on or after the member's preservation age (60 years of age for anyone born after 30 June 1964, see *Preservation* below), the first $129 751 attributable to post-June 1983 is tax free. Any remaining post-June 1983 component below the individual's

12 The Treasury, *A Plan to Simplify and Streamline Superannuation*, Canberra, May 2006.

13 Superannuation funds paid tax of $5.37 billion on total income of $54.71 billion in 2002-03, meaning that the average tax rate on total income (including taxable contributions) was 9.8 per cent. ATO, *Taxation Statistics 2002–03*, 2005, pp. 105–106.

14 G Rothman, *Tax Advantages of Investment in Superannuation*, 2003, Canberra, p. 16.

lump sum reasonable benefit limit (RBL) of $648 946 is taxed at a maximum rate of 15 per cent.

2.56 The post-June 1983 component that exceeds the individual's lump sum RBL is taxed at 38 per cent. Of the 308 000 lump sums paid in 2002–03, 518 had excessive components.[15]

2.57 In the case of a lump sum taken before preservation age (see paragraph 2.60), the post-June 1983 component below the individual's lump sum RBL is taxed at a maximum rate of 20 per cent. Any excessive component is taxed in the same way as for a lump sum taken after preservation age except that the RBL threshold reduces by 2.5 per cent for every year that the person is below preservation age.

2.58 Five per cent of the pre-July 1983 component of a lump sum payment is subject to tax at a taxpayer's marginal tax rate while the remainder of this component is tax free. It is highly unlikely that someone currently under the age of 40 would have a significant pre-July 1983 component given that the oldest person in that age group would have been 17 in 1983.

2.59 That part of a lump sum benefit which represents the return of an individual's undeducted contributions is not subject to further tax.

2.60 The superannuation plan includes a proposal to make lump sum superannuation payments exempt income when paid to an individual aged over 60 after 1 July 2007. This means they would not incur any tax, nor would they push other income into higher tax brackets.

2.61 Under the plan, a lump sum payment to a person aged under 60 would still be subject to tax. However the calculation of the tax liability would be far simpler as the lump sum will be split into fewer components for tax purposes. As a result, some of the components that currently exist would be taxed at a lower rate than at present. A person aged under 55 would pay tax on the post-June 1983 component at the rate of 20 per cent, while a person aged 55–59 would pay zero per cent tax on the first $129 751 of the post-June 1983 component and 15 per cent on the remainder.

2.62 Superannuation pensions are taxed as ordinary income at marginal tax rates. A 15 per cent rebate applies to the proportion of the pension that does not exceed the individual's RBL. If more than half of a person's benefits are taken as a pension then the pension RBL applies ($1 297 886 in 2005–06).

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15 ATO, *Taxation Statistics 2002-03*, 2005, Canberra, p. 14.

2.63 Undeducted contributions are not subject to tax again when they are returned to the individual as pension payments (this is known as the undeducted purchase price and the amount returned each year is called the deductible amount).

2.64 The 2006–07 budget superannuation plan would make pension payments from a taxed source exempt income when paid to an individual aged over 60. Once again, this means the individual would not incur any tax, nor would his/her other income be pushed into higher tax brackets. While this would commence on 1 July 2007, it would apply from that date to pensions that commenced previously.

2.65 Under the plan, a pension paid to a person under the age of 60, would still be subject to tax. However, for pensions that commence after 1 July 2007, more components would be classified as part of the undeducted purchase price and would not be subject to tax (for example the pre-July 1983 component). A person aged 55–59 would continue to be eligible for the pension rebate. Once the recipient turns 60, their pension would be tax free.

Preservation

2.66 The preservation arrangements for superannuation, which generally restrict a member's access to their superannuation benefits until retirement, on or after they have attained preservation age, ensure that concessionally taxed superannuation is used for retirement income purposes.

2.67 The preservation age is increasing from 55 to 60 on a phased basis between the years 2015 and 2025. The preservation age will remain at 55 years for a person born before 1 July 1960, while for someone born after 30 June 1964, the preservation age will rise to 60.

2.68 The legislation provides for the early release of superannuation benefits only in certain limited circumstances, such as retirement due to incapacity, severe financial hardship and in a limited number of compassionate circumstances.

2.69 Individuals can access their preserved benefits before reaching preservation age on termination of employment where such benefits are taken in the form of a non-commutable life-time pension or annuity.

2.70 Furthermore, from 1 July 2005, fund members who have reached their preservation age but not retired are able to access their superannuation in the form of a non-commutable income stream.