SUBMISSION 47

Australian Government

The Treasury

House of Representatives Standing Committee on Economics, Finance and Public Administration

Inquiry into Improving Superannuation Savings of People under Age 40

Submission by the Australian Treasury

September 2005

CONTENTS

INTRODUCTION

Treasury's role

Treasury's mission is to improve the wellbeing of the Australian people by providing sound and timely advice to the Government. This includes advising on retirement income policy, including superannuation and superannuation taxation policy.

Scope of the submission

The terms of reference for the Committee's inquiry into improving the superannuation savings of people under age 40 are:

- barriers and/or disincentives to contribute to superannuation;
- current incentives in place to encourage voluntary superannuation contributions; and
- improving their awareness of the importance of saving early for their retirement.

This submission describes the key features of Australia's retirement income system. The submission focuses on the implications of the current superannuation arrangements and taxation regimes for the superannuation savings of people under age 40. It also presents results of quantitative analysis of features of the superannuation system.

This submission has four chapters. Chapter 1 provides background on Australia's retirement income system and outlines relevant policy considerations, recent trends in superannuation contributions and the adequacy of the system.

Chapter 2 examines incentives to contribute to superannuation including the concessional taxation arrangements and recent initiatives such as the co-contribution scheme, the abolition of the superannuation surcharge, removal of the work test and choice of superannuation fund.

Chapter 3 discusses potential barriers to contributing to superannuation for those under age 40, such as lower income and labour force participation levels, and possible disincentives such as complexity, the preservation rules, tax deduction limits and arrangements for self-employed people.

Chapter 4 outlines Government initiatives aimed at raising awareness that contributing early to superannuation can significantly improve retirement incomes and discusses the role of the Financial Literacy Foundation.

SUMMARY OF MAIN POINTS

The superannuation system encourages individuals to accumulate savings for their retirement to achieve a higher standard of living in retirement than would be possible from the age pension alone. Improving superannuation savings is an integral part of retirement income policy. The taxation system offers significant incentives for voluntary superannuation savings. The total value of superannuation tax concessions is estimated at about $13.3 billion in 2004-05 and is the largest single tax expenditure.

The coverage of superannuation in Australia has grown significantly since the introduction of compulsory superannuation and now extends to around 90 per cent of employees and 67 per cent of self-employed people. People entering the workforce from 2002 will benefit from a fully mature Superannuation Guarantee (SG) system. For Australians on median earnings with SG contributions over a full working life, the age pension and SG system combine to provide relatively high spending replacement rates.

However, for people with higher retirement income expectations or for people who may not fully benefit from the SG system, such as the self-employed, older employees and those with broken periods of labour force participation, voluntary superannuation contributions are the key to ensuring these groups' retirement income expectations are met.

Australian Taxation Office (ATO) data shows strong growth in superannuation contributions with estimated SG employer contributions increasing about 59 per cent and additional contributions increasing about 10 per cent between 1999-2000 and 2002-03. For those under age 40, estimated SG employer contributions increased about 51 per cent and additional contributions decreased about 7 per cent over the same period.

The difference in retirement savings behaviour of people under age 40 may reflect that this group is unlikely to have seriously considered retirement issues, have competing expenditure pressures and the long time horizon associated with retirement investment (compared to other investment options). Some aspects of the superannuation system, such as its complexity, the preservation rules, and limits on tax concessions may also act as disincentives to contribute to superannuation for those under age 40. However, the main barriers to contributing to superannuation for this group are lower levels of income and workforce participation, particularly for women.

In this context, recent Government initiatives, such as the co-contribution have assisted this group. ATO data for 2002-03 show that more women than men under age 40 benefited from a co-contribution and the largest average benefit for those under age 40 was gained by those with income for co-contribution purposes of $25,000 to $30,000. Treasury projections indicate a reversal in the downward trend of post-tax contributions made by those under age 40, with the co-contribution a major factor in this reversal.

Concessional taxation and Government initiatives, such as the abolition of the superannuation surcharge, choice of fund, removal of the work test and capital gains tax exemptions for small business owners, offer substantial incentives for people under age 40 to make voluntary contributions to superannuation.

Several initiatives have also been introduced to improve financial awareness and literacy. These include the introduction of a uniform licensing, conduct and disclosure regime for all financial service providers, and the establishment of the Financial Literacy Foundation. Improved financial literacy and awareness is expected to result in better engagement with superannuation by people under age 40 and a better understanding of how the decisions they make now will affect their retirement income and lifestyle.

CHAPTER 1: BACKGROUND ON THE RETIREMENT INCOME SYSTEM

Introduction

Superannuation enables individuals to achieve a higher standard of living in retirement than the age pension alone would allow, by accumulating savings over their working life. Increasing superannuation savings is integral to retirement income policy.

People can achieve higher retirement incomes by contributing to superannuation earlier in life. The low-tax environment and long-term investment opportunities available to superannuation funds can result in contributions growing many times over prior to retirement.

However, people under age 40 have to balance saving for retirement against expenses such as education, housing and family commitments and saving options outside the superannuation system. Consideration of how current saving and consumption choices of people under age 40 may affect their standard of living in retirement is relevant to this decision.

Our retirement income policy

Australia's retirement income policy addresses and responds to dynamic life cycle, demographic and fiscal challenges.

A key challenge of retirement income policy is to build awareness of the need to save sufficient to meet retirement income expectations.

Many individuals underestimate the amount they need to save during their working lives to achieve their desired level of retirement income.[1] Individuals typically exhibit short-sighted behaviour and value present consumption higher than future consumption. People may choose to consume when younger, and then lack the capacity later in life to accumulate sufficient savings to meet their retirement income expectations.

Income and expenditure vary over a life cycle and affect saving capacity. Generally, incomes are relatively low during a person's early working years, increase and plateau during the later working years and decline on retirement. Housing, education and family expenses also impact on many households in their formative years.

Also, work patterns are changing. Working arrangements are more flexible, including part-time and casual work. These arrangements provide scope for students, those with caring responsibilities and those approaching retirement to continue to participate in the labour force and to save for their retirement.

Another key challenge of Australia's retirement income policy is the ageing of the population, due to lower fertility levels and increased life expectancies. Longer life expectancies and improved health can increase the length of a traditional retirement and income expectations during those years.

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1 See for instance the May 2003 ANZ Bank Survey of Adult Financial Literacy in Australia and discussion in Chapter 4. The Investment & Financial Services Association Ltd (IFSA) and the Association of Superannuation Funds of Australia Ltd (ASFA) also have survey evidence on this point.

The Australian Government's *Intergenerational Report* projected that over the next 40 years, the proportion of the population over age 65 will almost double to about 25 per cent.[2] The recent *Economic Implications of an Ageing Australia: Productivity Commission Research Report* confirmed this projection.[3] At the same time, growth of the traditional labour force aged 15 to 64 is expected to slow to less than 1 per cent.[4]

The reduction in the proportion of workers has implications for the Government's ability to provide services like health, aged care and the age pension in the future. Improving productivity and sustaining labour force participation are integral to reducing this fiscal pressure. Improving retirement savings will also assist in reducing the fiscal pressure.

Our retirement income system

Australia's retirement income system encourages people to achieve a higher standard of living in retirement than would be possible from the age pension alone, while ensuring Australians have security and dignity in retirement. 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 SG; and
- voluntary superannuation and other private savings.

The age pension[5] is a minimum income level for those with limited opportunity or capacity to save fully for their retirement and is funded from current revenue. While age pension outlays are expected to increase significantly over time as the population ages, Australia is well-placed compared with other Organisation for Economic Co-operation and Development (OECD) countries to meet its age pension obligations. Australia's age pension system is sustainable largely because the pension is paid at a flat rate and is subject to a means test.

The second pillar of the retirement income system is the SG, which directs some of an employee's current remuneration into a superannuation fund, by means of a compulsory employer contribution. Some employees also receive employer superannuation support through award entitlements. The SG was introduced in 1992 and a ten-year phase-in of the minimum contribution was completed on 1 July 2002. For 2002-03 and subsequent years, the minimum level of employer superannuation support is 9 per cent of an employee's notional earnings base.[6]

The third pillar encourages individuals to make additional savings. 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 many women), mature workers and those with higher retirement income expectations. The third pillar is supported by taxation concessions for voluntary savings.

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2 Australia, Intergenerational Report 2002-03: Budget Paper no 5 (Canberra: Australian Parliament, 2002).
3 Productivity Commission, Economic Implications of an Ageing Australia: Productivity Commission Research Report, (Melbourne, Productivity Commission, 2005).
4 Australia, Intergenerational Report 2002-03: Budget Paper no 5 (Canberra: Australian Parliament, 2002).
5 The age pension is indexed every 6 months in line with movements in the Consumer Price Index. In addition, the maximum single rate of pension is maintained at (at least) 25 per cent of male total average weekly earnings, with flow-ons to the partnered rate.
6 Subject to a maximum contribution base of $134,880 for the 2005-06 financial year.

Higher labour force participation may also improve retirement incomes. More flexible working arrangements, including part-time and casual work, offer the opportunity for people to continue working and making contributions to superannuation beyond age 55. This smooths the transition from full-time employment to retirement and allows the prospect of higher retirement incomes later in life.

The Mature Aged Worker Tax Offset provides an incentive to stay in the labour force and save for retirement. In addition, the recently introduced 'transition to retirement' measure increases access to superannuation for those still working, giving people more options in moving from work to retirement and removing the incentive to retire simply in order to access superannuation.

Our retirement income system — policy considerations

Australia's three-pillar retirement income system seeks to balance five areas that affect a person's wellbeing. These areas are the:

- level of opportunity and freedom people enjoy;
- level of consumption possibilities;
- distribution of those consumption possibilities;
- level of risk that people are required to bear; and
- level of complexity that people are required to deal with.

The Government makes retirement income policy decisions that involve tradeoffs between these elements of wellbeing and require careful judgment. There are also tradeoffs with other priorities of the Government such as spending on defence, social welfare and education. Government spending also needs to be fiscally responsible over the short and long term.

Retirement income policy must also be considered in the context of the long-term policy challenges posed by Australia's ageing population. Changes would need to be consistent with other policies designed to address these challenges, such as encouraging labour force participation, maximising productivity and ensuring long-term fiscal sustainability.

Level of opportunity and freedom that people enjoy

Opportunity and freedom enable people to choose the lives they want to live. A retirement income system should seek to maximise the opportunity and freedom available to individuals throughout their lives by assisting them to make informed choices about their retirement.

Savings can improve opportunity over time by providing individuals with resources for lifestyle choices. Savings increase the stock of wealth which can generate increased future incomes. Government policies such as compulsory superannuation may affect individual freedom. However, reduced opportunity or freedom associated with mandatory savings needs to be weighed against the tendency for individuals to exhibit short-sighted behaviour. To the extent that mandatory saving is able to address this, the level of opportunity and freedom lost during the working stage of an individual's life may be more than offset by improved opportunities in retirement.

Consumption possibilities

Savings allow individuals to smooth their consumption possibilities over time. As noted above, savings also increase the stock of wealth, which can lead to increased incomes and greater future consumption possibilities. Improvements in economic efficiency can also increase consumption possibilities.

Efficiency requires that government intervention in the economy, including intervention to influence retirement incomes, should minimise the disturbance to the economy. Ideally, the market should be allowed to develop products to meet consumer needs without undue interference. Efficiency creates a healthier and faster growing economy, with all the attendant benefits that has for employment, investment and individuals' income.

Notwithstanding these considerations, some government intervention in the retirement income system has been necessary to promote the prudent management of superannuation entities, promote consumer understanding and awareness, and to ensure that superannuation tax concessions are not misused for other purposes. However, superannuation funds are predominantly managed by the private sector in a competitive market.

The distribution of consumption possibilities

Distribution is the spread of consumption possibilities across the population and is related to economic equity. Equity has horizontal, vertical and intergenerational dimensions.

Horizontal equity requires that people in similar economic circumstances be treated similarly.

Vertical equity requires that those in a position to make a comparatively greater contribution to raising revenue do so. Tax systems across the world vary widely in their interpretation of 'vertical equity' and in the way they achieve it.

Intergenerational equity requires that the present generation not be an unreasonable burden on future generations. Those under age 40 will have access to the benefits of a fully mature SG system, expanded co-contribution arrangements, and other incentives (outlined in Chapter 2) to meet their own retirement income expectations. Many members of these cohorts will continue to access the means tested age pension, but the cost to the community per retiree will be lower because many will have accumulated higher savings.

The risk that people are required to bear

A retirement income system should reduce the risk that individuals bear by empowering them with the skills and information to achieve their desired level of retirement income.

Risk refers to the uncertainty inherent in potential outcomes. Risk is present in almost all decisions and is prevalent in superannuation and retirement decisions because of the long time horizons.

Government policies to reduce risk in relation to retirement income address the market failures of inadequate information and low financial literacy.

Risk can be an important motivator in individual decisions to save. Savings insure against the consequences of unforseen events, however, the general transfer of risk from individuals to government over recent decades (eg from increases in social security and health expenditures) may have reduced incentives to save for this purpose. The age pension means test also reduces and transfers risk for most Australians. Typically, people who obtain lower superannuation balances will receive a relatively higher age pension. Conversely, people who obtain higher superannuation balances will receive a relatively lower age pension.

Complexity

Retirement income policy should be formulated with a view to minimising complexity and compliance costs.

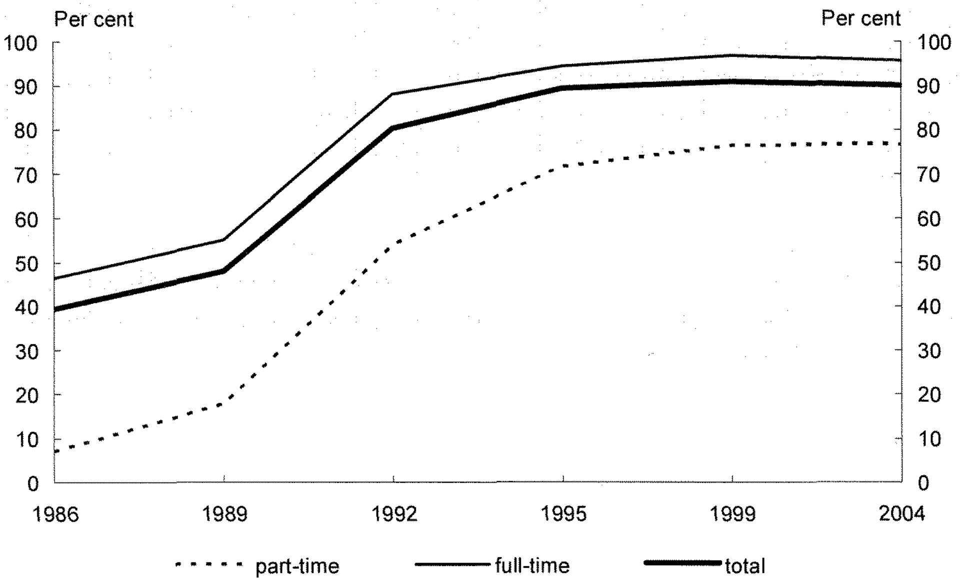
A retirement income system should be easily understood, consistent and stable. Individuals can make the best choices about their retirement income if the implications of their choices are clear to them (although unforseen events can have significant positive or adverse impacts on the outcomes of those decisions). Policy should be consistent internally and with broader economic and social policy. Stability requires that the policy be supportable in the current and projected economic environment, and that the broad policy intention is maintained over time.

However, as with most policy, retirement income policy has often involved tradeoffs between complexity and equity. For example, efforts to provide certainty and fairness for individuals nearing retirement have resulted in 'grandfathering' of older rules, which adds legislative complexity.

Trends in superannuation coverage

The uptake of superannuation in Australia has grown significantly since the introduction of compulsory superannuation. Award superannuation was introduced from 1 September 1986 and the SG followed on 1 July 1992. Chart 1 illustrates that in 1986, prior to the introduction of compulsory superannuation, only about 40 per cent of Australian employees had superannuation. Superannuation coverage now extends to about 90 per cent of employees.

Chart 1: Historical changes in percentage of employees with superannuation coverage



Source: Australian Bureau of Statistics, Employment Benefits Surveys 6334.0, 6310.0.
Note: The 2004 coverage estimates have been affected by a change in methodology for non-respondents.

The increase in coverage since the introduction of the SG in 1992 reflects increasing community awareness of obligations and entitlements under SG legislation.[7] The continued growth in coverage for part-time employees is also partly attributable to the combination of the fixed SG earnings threshold and ongoing growth in wages.

The SG rate increased from 3 per cent to 9 per cent over the period 1 July 1992 to 1 July 2002.

Superannuation coverage for self-employed people is considerably lower than for employees. The last Australian Bureau of Statistics Survey of Employment Arrangements and Superannuation found that only 67 per cent of the self-employed had superannuation, with an even smaller proportion making regular contributions. However, many self-employed people may regard their business as their retirement 'nest egg'. Chapter 2 discusses capital gains tax relief provided to small businesses, where proceeds from selling a business are rolled into superannuation or used for retirement.

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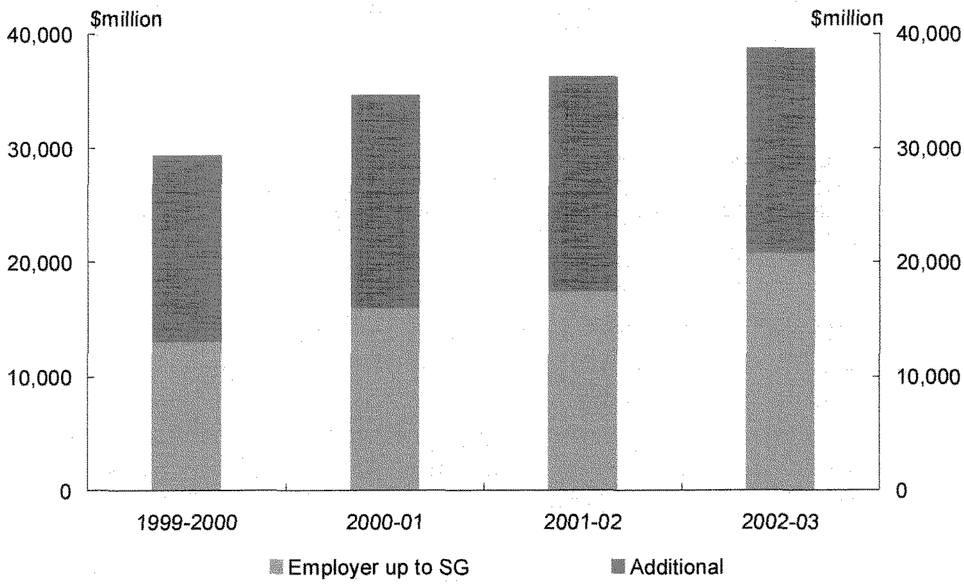
7 Overall compliance by employers with the SG system is high. The ATO conducts a range of communication, education and proactive audit activities in relation to SG compliance. The ATO also follows up all complaints received from employees who believe that the appropriate amount of superannuation support has not been paid by their employers.

Trends in superannuation contributions

There is no reliable published data on trends in superannuation contributions by those under age 40. In this submission, unpublished ATO sample data is used to analyse contribution levels for the period 1999-2000 to 2002-03.[8] Trends in contribution levels over this period should be interpreted cautiously given the short time series. The main advantage of using this data is that it can be disaggregated by age, gender and taxable income. There are limited alternative data sources, and none which contain such disaggregated superannuation contribution information. A more detailed discussion of available superannuation data is at Appendix A.

The ATO data show strong growth in superannuation contributions, with estimated SG employer contributions increasing from $13 billion to about $21 billion (or by about 59 per cent) between 1999-2000 and 2002-03, and additional contributions (total of employer contributions above SG, member post-tax contributions and self-employed contributions) growing from $16 billion to nearly $18 billion (or by about 10 per cent) over the same period (Chart 2). The total number of people with employer and/or self-employed contributions was about 7.3 million in 2002-03.

Chart 2: Growth of employer and additional contributions for all ages



Source: ATO anonymous sample tax file data.
Note: The SG rate increased from 7 to 9 per cent over this period. Additional contributions include employer contributions above SG, post-tax contributions and contributions by the self-employed. The post-tax contributions have been restricted to those with employer support to reduce the impact of asset-switching by those approaching retirement age.

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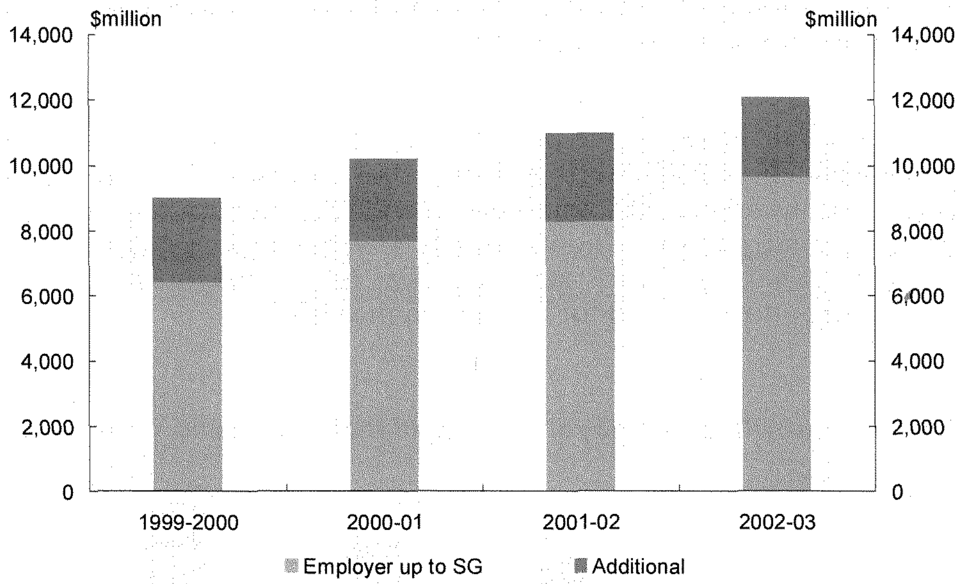
8 More recent tax file sample data is not currently available. A longer time-series of tax file data was also not available as employer contributions per individual member data were not collected until the introduction of the superannuation surcharge in 1996-97. Due to data reliability concerns, only data from 1999-2000 onwards has been used.

For those under age 40, estimated SG employer contributions increased from about $6.4 billion to $9.6 billion (or by about 51 per cent), while additional contributions fell from about $2.6 billion to $2.4 billion (or by about 7 per cent) over the period 1999-2000 to 2002-03 (Chart 3). The total number of people under age 40 with employer and/or self-employed contributions was about 3.8 million in 2002-03.

Chart 3: Growth in employer and additional contributions for under 40s

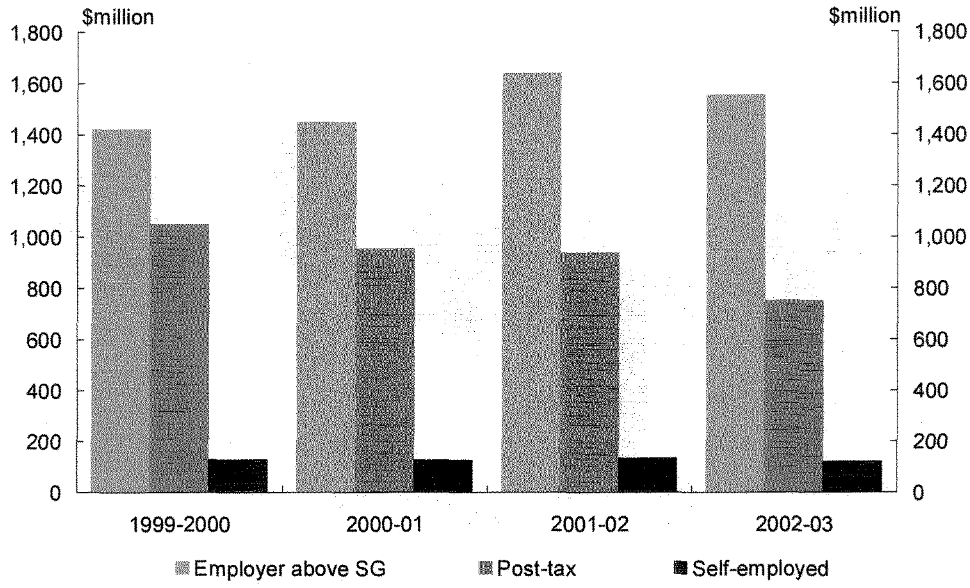


Source: ATO, anonymous sample tax file data.
Note: the SG rate increased from 7 to 9 per cent over this period. Additional contributions include employer contributions above SG, post-tax contributions and contributions by the self-employed. The post-tax contributions have been restricted to those with employer support to reduce the impact of asset-switching by those approaching retirement age.

Over the period 1999-2000 to 2002-03, a small increase in the amount of salary sacrifice and other additional employer contributions made by the under age 40 group was offset by a decline in contributions made by the self-employed and from post-tax monies (Chart 4). However, it is projected that the co-contribution scheme will increase the amount of post-tax contributions (including co-contribution payments) for those under age 40 to about $1.5 billion by 2008-09 (see Chapter 2).

Over the same period, the number of people under age 40 with additional employer contributions increased from about 1,159,000 to nearly 1,237,000, and the number of people making post-tax contributions fell from about 655,000 to about 476,000. The number of self-employed people under age 40 making contributions also fell from over 41,000 to about 30,000.

Chart 4: Additional contributions made by under 40s

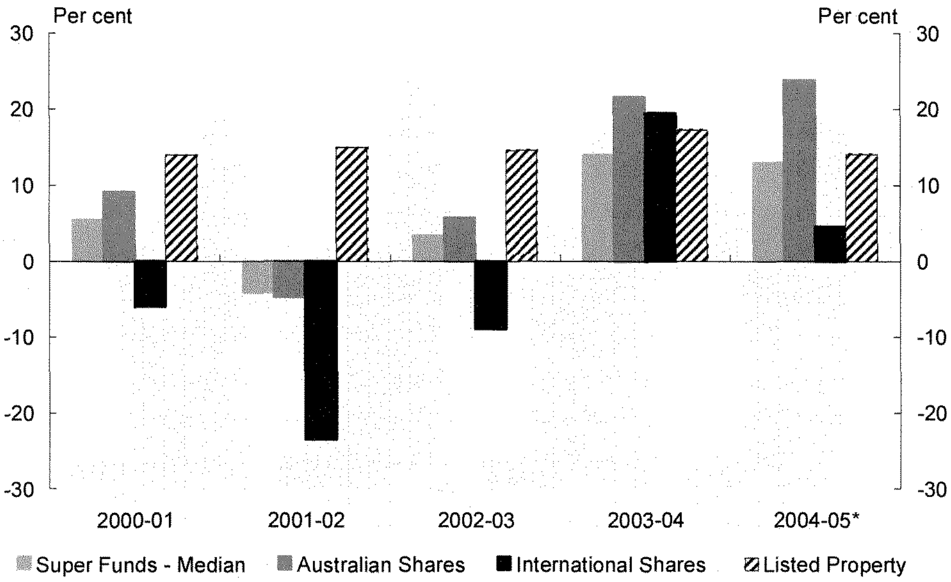


Source: ATO, anonymous sample tax file data.
Note: the SG rate increased from 7 to 9 per cent over this period. Additional contributions include employer contributions above SG, post-tax contributions and contributions by the self-employed. The post-tax contributions have been restricted to those with employer support to reduce the impact of asset-switching by those approaching retirement age.

It is worth noting that in 2001-02 and 2002-03, superannuation fund returns were low, whilst property investment returns were relatively high. These market conditions may have reduced the number of people under age 40 making additional superannuation contributions over the 1999-2000 to 2002-03 period (Chart 5). Another factor is that many public sector and corporate defined benefit schemes have recently been closed to new employees. These schemes typically require employees to make post-tax contributions. Personal marginal tax rates also fell over the period, which may have made superannuation less attractive.

The difference in retirement savings behaviour of individuals under age 40 may reflect that this group is unlikely to have seriously considered retirement issues. The long time horizon associated with retirement investment compared to other investment options, combined with competing expenditure pressures for this group may also reduce incentives to invest in superannuation.

Chart 5: Relative investment returns 2000-01 to 2004-05



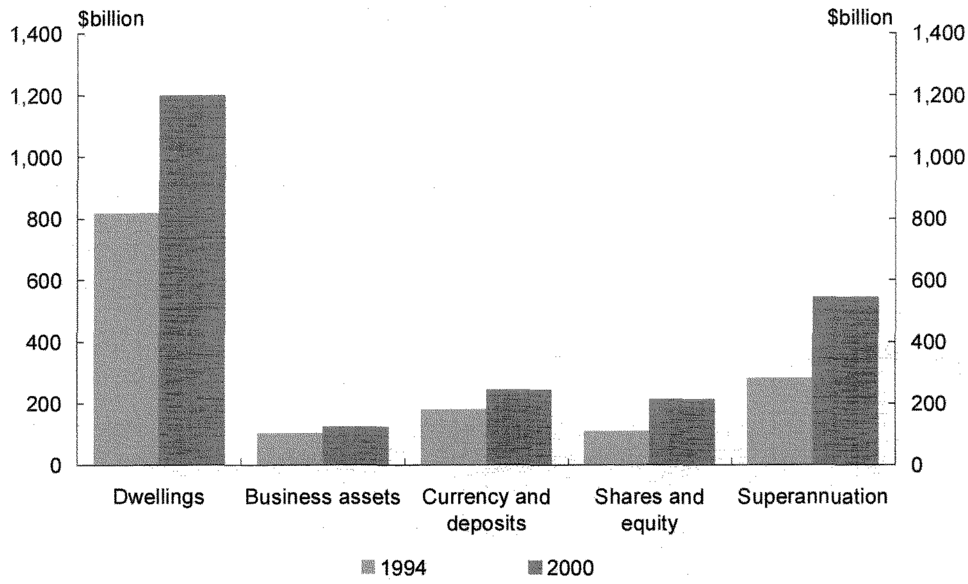
Source: Intech Investment Performance Survey
Note*: 2004-05 returns series taken for 12 months from 1 June 2004 to 31 May 2005.

Other savings options

People under age 40 have many options for voluntary saving including interest-bearing deposits, shares and other equity instruments, owner-occupied housing, investment property, their own business and superannuation. Non-superannuation forms of saving such as owner-occupied housing and negatively geared investment in either property or shares are also concessionally taxed. In addition, saving through a small business is recognised through capital gains tax exemptions (see Chapter 2).

Chart 6 shows the distribution of household wealth by asset type and the increase in wealth held by households over the 1994 to 2000 period. The Chart shows a large proportion of household wealth is held in dwellings and superannuation. However, the absolute increase in dwelling wealth exceeded the growth in superannuation assets over the 1994 to 2000 period. The further increase in house values since 2000 reinforces the importance of this broader pattern of asset-holding in the context of retirement income policy.

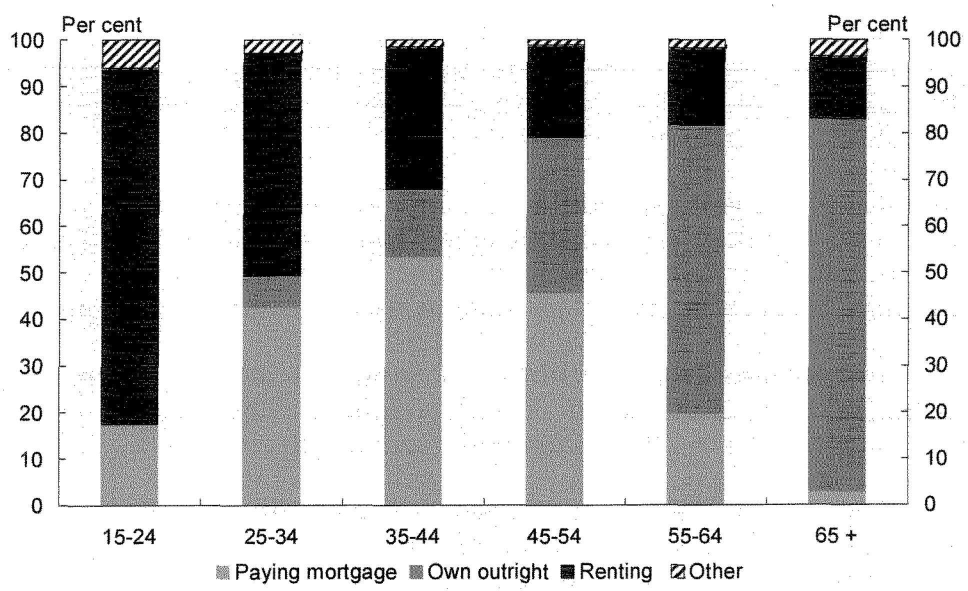
Chart 6: Household assets by type (constant prices)



Source: ABS Experimental Estimates of the Distribution of Household Wealth, 1994-2000 -1351.0

Chart 7 shows the proportion of households that own their home outright gradually increases with age, and that almost all home buyers own their home by age 65. It also shows changes to the number of households with home mortgages during the life cycle. Households in the younger age groups generally have low levels of home ownership and are predominantly renting. The proportion of households with a mortgage rises sharply in the 25-34 age bracket and peaks in the 35-44 age bracket. After this point the proportion of households with a mortgage declines to almost zero by age 65.

Chart 7: Distribution of housing occupancy by age of reference person



Source: Australian Bureau of Statistics Cat No. 4130.0.55.001 Housing Occupancy & Costs, Australia, 2002-03.

This pattern of home ownership illustrates the saving priorities of younger Australians. Saving for a deposit for a home loan and paying mortgage repayments are a priority, particularly for individuals under age 40. Home ownership combined with the SG system and the age pension can improve financial security in retirement.

This, however, does not suggest that access to superannuation should be permitted for a house deposit. As a long-term investment vehicle, superannuation is designed to grow over an individual's working life through regular contributions and compounding interest. Allowing access to a relatively large amount of superannuation in the early growth phase would reduce the total amount of superannuation available in retirement.

Adequacy of retirement incomes

The adequacy of Australians' income in retirement has been the subject of considerable debate over recent years, including notably by a Senate Select Committee.[9] Much of the debate has centred on setting a benchmark for an adequate retirement income. However, the adequacy of retirement incomes depends on an individual's own circumstances, needs and expectations and the Government has not set a benchmark.

Two ways of measuring the adequacy of retirement incomes are:

- a replacement basis (which compares spending capacity on a pre- and post-retirement basis); or
- a fixed benchmark such as a 'modest but adequate' living standard.

The adequacy of retirement incomes is commonly assessed using the replacement rate concept. Replacement rates are defined as the ratio of a person's income or spending power after retirement to before retirement. The proposition underlying the replacement rate concept is that a person's standard of living in retirement should be a reasonable proportion of their standard of living during their working life.

Analysis of replacement rates and associated policy should take account of people's needs in their retirement and pre-retirement years. Increasing savings in pre-retirement years to increase retirement income involves trading off lower consumption while working for higher consumption in retirement.

People's optimal replacement rates differ. It is generally accepted that for most people a replacement rate of less than 100 per cent is appropriate. This is because (most) retirees avoid major expenses incurred by people of working age and especially by those under age 40 (for example, education, mortgage, raising children and work related costs).

For Australians on median earnings with SG contributions over a full working life, the age pension and SG systems combine to provide relatively high replacement rates. Those entering the labour force from 2002 will benefit from a fully mature SG system.

Chart 8 shows that the SG system in conjunction with the age pension is projected to provide a spending replacement rate of 82 per cent for an individual aged 25 now, who is on median earnings (approximately $40,000 per annum) and who makes 40 years of future contributions.

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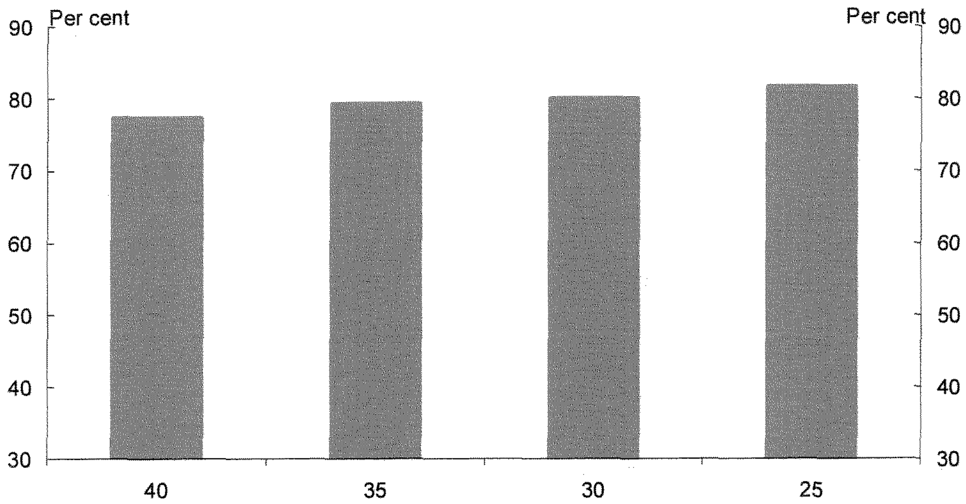
9 Senate Select Committee, Superannuation and Standards of Living in Retirement - Report on the adequacy of the tax arrangements for superannuation and related policy, December 2002. Note also the submission by the Commonwealth Treasury to the Inquiry into Superannuation and Standards of Living in Retirement.

Chart 8: Projected replacement rates by age



Source: Treasury projections
Note: The examples assume current incomes of $40,000 per annum, SG contributions from age 25 (or from 1992 for those aged 40 now) to retirement at age 65, and that benefits are taken as an eligible termination payment with annuity drawdown.

Replacement rates are also relatively high for those under age 40 with a working life from age 25 to 65, but who have not fully benefited from a mature SG system. For example, someone who is aged 30 now and makes 35 years of future contributions is projected to have a spending replacement rate of 80 per cent. A person aged 35 now who makes 30 years of future contributions is projected to have a spending replacement rate of 79 per cent and a person aged 40 now who makes 25 years of future contributions is projected to have a spending replacement rate of 77 per cent.

At higher income levels replacement rates are lower. Generally, this is because a lower part age pension is received (which is a smaller proportion of total retirement income) and taxation in retirement is more significant. However, as income rises, absolute retirement income also rises. At higher income levels, additional superannuation contributions above SG or savings outside the superannuation system may be necessary to meet higher retirement income expectations.

CHAPTER 2: INCENTIVES TO CONTRIBUTE TO SUPERANNUATION

Term of reference

Current incentives in place to encourage voluntary superannuation contributions.

The ability and willingness of Australians under age 40 to make voluntary superannuation contributions are influenced by various factors, including Government policy.

For those with higher retirement income expectations than the current SG and the age pension provide, early contributions to superannuation can help meet these expectations. Other groups who may not benefit or fully benefit from the SG system, such as the self-employed, older employees and those with broken periods of labour force participation, such as many women, may also benefit from making additional superannuation contributions. Incentives for voluntary superannuation contributions are keys to ensuring these groups' retirement income expectations are met.

Recent research confirms that the superannuation taxation system is projected to deliver very good expected outcomes across the range of income levels for those saving even moderate amounts above SG.[10]

The superannuation taxation system and recently introduced Government initiatives (such as the co-contribution scheme), offer substantial incentives for people under age 40 to make voluntary contributions to superannuation.

Concessional tax treatment of superannuation

Concessional taxation of superannuation contributions, fund earnings and benefits paid is the largest single tax expenditure. The total value of superannuation tax concessions is estimated at about $13.3 billion in 2004-05.[11]

The taxation system offers significant incentives for voluntary superannuation savings. Funded superannuation in Australia is taxed at three stages:

- when contributions are made to a superannuation fund;
- when investments in superannuation funds earn income; and
- when superannuation benefits are paid out.

A concessional tax rate of 15 per cent applies to contributions made from pre-tax income to a superannuation fund. This compares favourably with most marginal income tax rates. Investment income from superannuation is also taxed at 15 per cent, which again

10 Bingham, C and Rothman G, Incentives to save more in superannuation, paper presented to the Thirteenth Colloquium of Superannuation Researchers, University of New South Wales, 4 and 5 July 2005. Available at www.rim.treasury.gov.au.

11 2004 Tax Expenditures Statement. This figure estimates the value of the overall concessionality of employer contributions, deductible contributions by the self-employed, the concessional taxation of fund earnings (including CGT discounts), spouse contributions and rebates, taxes on lump sums and pensions and the impact of the Government co-contribution not being taxed. It does not include co-contribution payments or the removal of the surcharge.

compares favourably to the tax rates that apply to most other investment income. Superannuation benefits are also taxed concessionally, however, the taxation treatment depends on whether the benefits are taken as a lump sum or a pension. A detailed summary of the taxation arrangements for superannuation is at Appendix B.

Concessional taxation arrangements make superannuation relatively attractive compared to other investments and help to boost superannuation savings.

Table 1 details the superannuation taxation concessions and their associated costs. It is difficult to analyse the incidence of these concessions due to limited data on the distribution of assets and earnings. The largest proportion of concessions can be attributed to contributions and investment earnings. It follows that those individuals who make bigger contributions, have higher marginal tax rates and have larger account balances will benefit the most from these concessions.

Table 1: Concessional taxation of superannuation

Tax Expenditures	2004-05 ($millions)
Under taxation of employer contributions	6,680
Deductions for contributions by the self-employed	240
Under taxation of fund earnings	5,830
Measures for low-income earners	70
Spouse contributions and rebates	15
Capital gains tax discounts for funds	270
Sub total	**13,105**
Less offsets	
Tax on funded pensions	*
Tax on funded lump sums before 1 July 1983	-20
Tax on funded lump sums from 1 July 1983	-330
Sub total	**-350**
Taxation of unfunded superannuation lump sums	530
Total tax expenditures	**13,285**

Source: 2004 Tax Expenditures Statement
* Indeterminate but unlikely to be significant

Revenue from taxes on superannuation

Revenue from the taxation of superannuation funds' contributions and earnings is reported regularly in the Budget papers.[12] Additionally, some revenue is derived under the company tax head, reflecting the superannuation business of life insurance companies, and some end benefit taxes are collected as part of the personal tax revenue head. In 2005-06 revenue of about $5.1 billion is expected from the taxation of superannuation funds' contributions and earnings, a growth of about 9 per cent in 5 years. The aggregate level of total revenue from superannuation taxes is much lower than the tax expenditure for superannuation (see Table 1).

Abolition of the surcharge

In the 2005-06 Budget the Government announced that the superannuation surcharge would be abolished for contributions and relevant termination payments made or received in the 2005-06 and later financial years. The legislation to give effect to this measure was passed by the Parliament on 10 August 2005. The abolition of the surcharge is expected to

12 Budget Paper No 1, Statement 5.

boost superannuation savings, provide incentives for individuals to make additional superannuation contributions and simplify the operation of the superannuation system.

About 31 per cent of those liable for the surcharge in 2002-03 were under age 40 — about 185,000 people. About half these people were in the 35 to 39 age range and about 37 per cent were in the 30 to 34 age range.

Recent research shows that the abolition of the surcharge will improve the incentive to invest in superannuation in absolute terms and to invest in superannuation relative to other forms of savings.

It is estimated that an additional $3.5 billion per annum will flow into superannuation once the co-contribution (discussed below) and abolition of the surcharge measures are fully mature.[13]

Low-income spouse rebate

An 18 per cent tax rebate can be claimed for contributions up to $3,000 per annum to a superannuation fund or Retirement Savings Account made on behalf of a low-income or non-working spouse. The eligible spouse contribution limit is reduced at the rate of one dollar for each dollar of spouse income exceeding $10,800, so that the maximum rebate phases out when the spouse's income reaches $13,800.

The rebate is an additional incentive for individuals to make voluntary contributions on behalf of low-income or non-working spouses who would otherwise have little or no retirement savings.

Superannuation splitting

In the 2005-06 Budget the Government restated its intent to deliver the superannuation contribution splitting policy, as announced in its 2004 election policy *Super for All and Understanding Money*. The policy will allow members of eligible funds to split personal and employer superannuation contributions with their spouse. Superannuation splitting will allow low-income or non-working spouses to accumulate their own superannuation, and give families more choices in how they prepare for their retirement.

Superannuation splitting broadens access to superannuation for non-working individuals and gives single-income families access to two eligible termination payment tax-free thresholds and two reasonable benefit limits (RBLs). It will assist low-income spouses to hold superannuation assets in their own name and under their own control, creating better incentives to contribute to superannuation.

Co-contribution scheme and other initiatives

The superannuation co-contribution scheme was established in 2003. It is designed to enhance the retirement savings of middle and low-income employees and to increase the incentive for this group to contribute to superannuation. It replaced the taxation offset for personal superannuation contributions made by low-income employees. The offset applies

13 Bingham, C and Rothman G, Incentives to save more in superannuation, paper presented to the Thirteenth Colloquium of Superannuation Researchers, University of New South Wales, 4 and 5 July 2005. Available at www.rim.treasury.gov.au.

to eligible personal contributions made prior to 1 July 2003. The co-contribution is not subject to tax when paid into or withdrawn from a superannuation fund.

To qualify for the co-contribution a person must have 10 per cent or more of their total income attributable to eligible employment and be under the co-contribution upper income threshold. A person must also be under age 71 on 30 June of the year in which the personal contributions are made and not be a temporary resident.

Co-contribution payments for the 2003-04 income year

For the 2003-04 income year, the maximum co-contribution of $1,000 was available for those on incomes for co-contribution purposes of $27,500 per annum or less. The maximum co-contribution was reduced by 8 cents for each dollar of total income (defined as assessable income and reportable fringe benefits) over $27,500 per annum, with some co-contribution available for those with incomes up to $40,000 per annum. A minimum co-contribution of $20 also applied, providing the person's income was below the upper income threshold and they had made some personal superannuation contributions during the year.

The total value of co-contribution determinations made for the 2003-04 income year is currently about $327 million, with about 31 per cent of this total (or nearly $103 million) being determined in respect of those under age 40. Over 605,000 people have had a co-contribution determined for the 2003-04 income year, about 219,000 (or around 36 per cent) of whom are under age 40. [14]

In general, more females than males benefited from a co-contribution and the numbers of people who benefited tended to increase with age (Chart 9). For those under age 40, the numbers of people who benefited increased as income increased and again more women benefited than men (Chart 10). The largest average benefit was gained by those with income for co-contribution purposes of $25,000 to $30,000. Chapter 3 discusses the main barriers and disincentives to contribute to superannuation for those under age 40, which include lower incomes.

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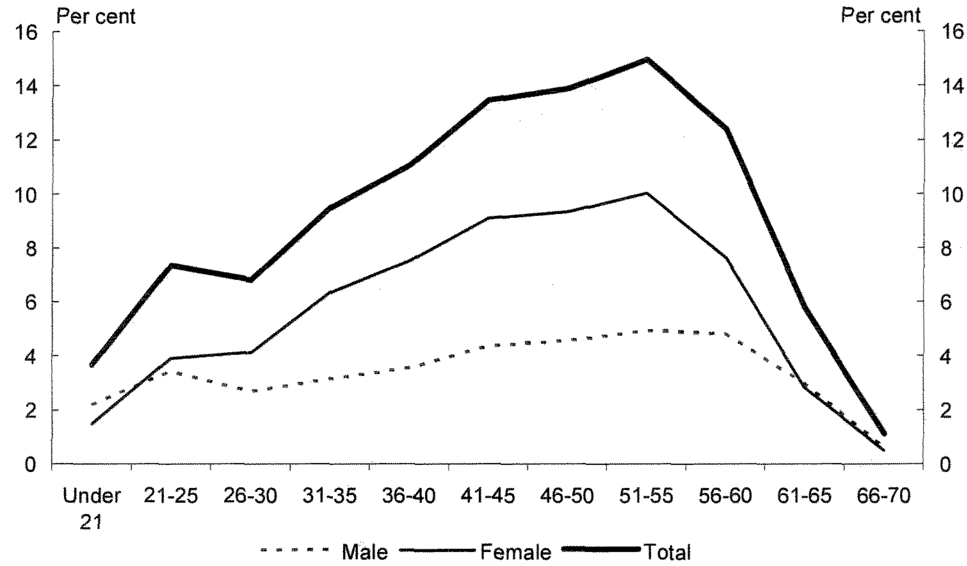
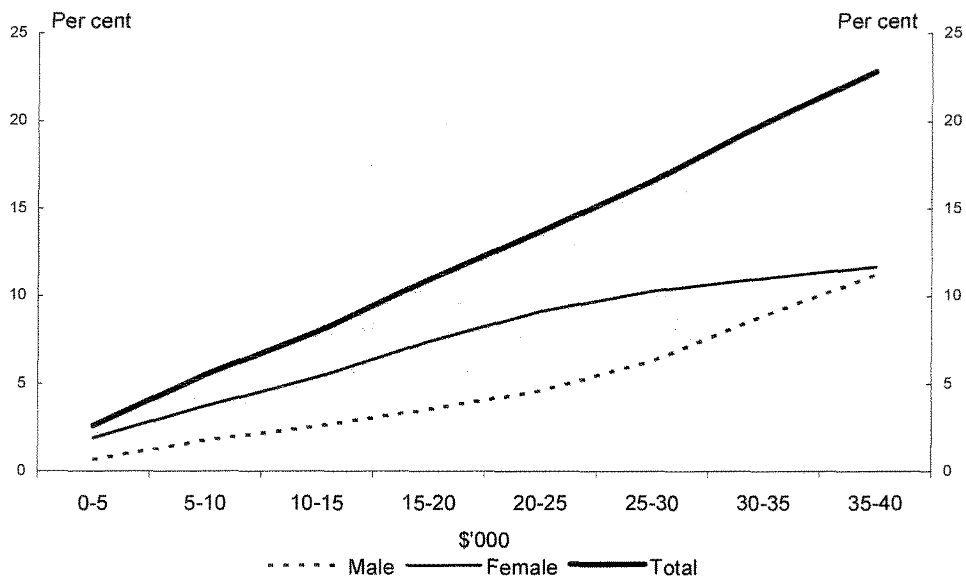
14 The under 40 figures are Treasury estimates based on ATO data for those aged 40 and under. The 36 to 40 age range data has been adjusted to get an estimate of beneficiaries aged 36 to 39.

Chart 9: Distribution of co-contribution beneficiaries by age 2003-04



Source: ATO

Chart 10: Distribution of under 40s co-contribution beneficiaries by income for co-contribution purposes 2003-04



Source: Treasury estimates based on ATO data

Co-contribution payments for the 2004-05 to 2006-07 income years

For the 2004-05 to 2006-07 income years, the co-contribution has been expanded to match eligible personal superannuation contributions made by qualifying employees with incomes for co-contribution purposes up to $58,000 per annum.

Eligible personal superannuation contributions made by a person in the 2004-05 and later income years are matched at $1.50 for every dollar contributed (compared to dollar-for-dollar for the 2003-04 income year).

This is subject to the maximum co-contribution of $1,500 (up from $1,000 for the 2003-04 income year) for those people on incomes up to the increased lower threshold of $28,000 per annum. The maximum co-contribution is reduced at a rate of 5 cents for every dollar of income for co-contribution purposes over the lower threshold, and phases out at the increased upper threshold of $58,000 per annum. Table 2 shows the maximum benefit available under the co-contribution scheme by an eligible member's income for co-contribution purposes.

From 1 July 2007, the co-contribution lower income threshold will be indexed in line with the growth in average weekly ordinary time earnings. The upper income threshold will also be increased to maintain the same income range over which the maximum is reduced.

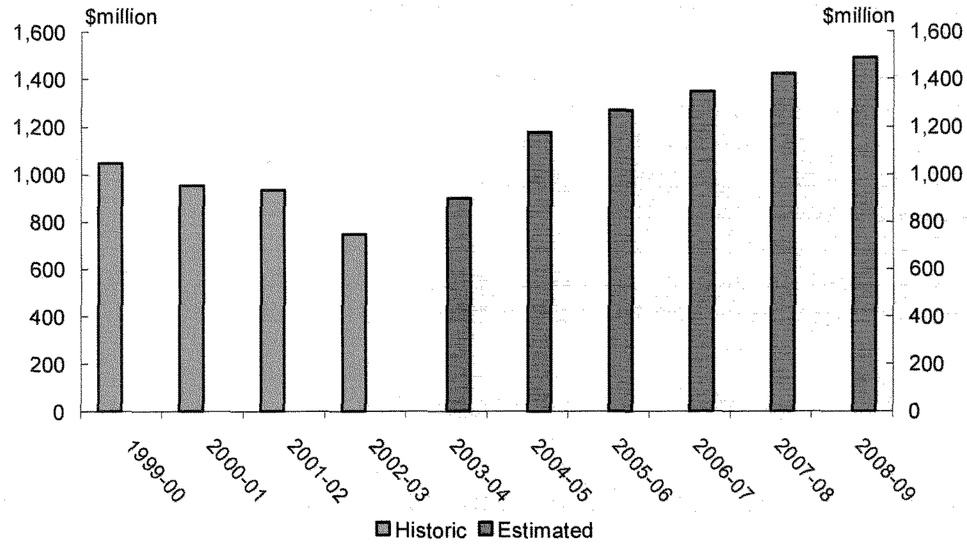
Table 2: Maximum co-contribution benefit for eligible members

Income for co-contribution purposes	Maximum co-contribution benefit available	Post-tax personal contribution required to receive maximum
Up to $28,000	$1,500	$1,000
$31,000	$1,350	$900
$34,000	$1,200	$800
$37,000	$1,050	$700
$40,000	$900	$600
$43,000	$750	$500
$46,000	$600	$400
$49,000	$450	$300
$52,000	$300	$200
$55,000	$150	$100
$58,000 and above	$0	$0

The expansion of the co-contribution policy is projected to increase significantly the total value of co-contributions made for 2004-05 and later income years. The total value of co-contribution payments for the first year of the expanded policy is estimated to be about three times the value of the co-contributions made under the original legislation.

Chart 11 illustrates a decline in post-tax member contributions by those under age 40 between the 1999-2000 and 2002-03 income years. Chart 11 also shows a projected reversal of this downward trend for the 2003-04 to 2008-09 income years, with the total of post-tax contributions and co-contribution payments increasing from about $900 million to nearly $1.5 billion over this period.

Chart 11: Projected growth in post-tax contributions (including Government co-contribution payments) made by under 40s from 2003-04 to 2008-09



Source: ATO, Sample Tax File Data 1999-00 to 2002-03; Treasury projections.
Note: Projections have regard to projected co-contribution uptake (which takes into account increase in matching rate from 100 to 150 per cent, extension of the income eligibility range and gradual increase in awareness of the policy) and expenditure with under 40s retaining a 31 per cent share; underlying growth in wages and workforce; and the closure of some defined benefit schemes where post-tax member contributions are compulsory.

Recent research shows an employee on median earnings (about $40,000 per annum) who saves an extra 3 per cent in superannuation over a 30-year working life will have 44 per cent more private accumulation at retirement than could be achieved by the SG alone, with part of this coming from the co-contribution.[15]

Choice of superannuation fund

Choice of superannuation fund commenced on 1 July 2005 and allows employees to choose the fund to which their employer makes compulsory superannuation contributions on their behalf. Employers are required to offer choice of fund to an employee unless superannuation contributions for that employee are made under a certified agreement, Australian Workplace Agreement or a state award or industrial agreement. Some public servants and some members of defined benefit schemes will not be offered choice.

Choice of fund enables employees to choose a superannuation fund based on matters of value to them, for example, fees and charges, death and disability insurance or ethical investments. It encourages people to take more active ownership of their superannuation and their retirement future and allows them to have a better connection with their superannuation savings throughout their life.

Individuals who experience broken work patterns and those who change jobs on a regular basis will benefit from choice of fund. 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 can ask each new employer to contribute to that fund.

15 Bingham, C and Rothman G, Incentives to save more in superannuation, paper presented to the Thirteenth Colloquium of Superannuation Researchers, University of New South Wales, 4 and 5 July 2005. Available at www.rim.treasury.gov.au.

Choice of fund is expected to improve the competitiveness of the market, putting downward pressure on fees and charges (including cost-reflective pricing) and improving the services funds offer to attract and retain members.

Portability for inactive superannuation accounts, which commenced on 1 July 2004, allows members of most superannuation funds to move their superannuation benefits into a fund of their choice, subject to some limited exceptions. On 1 July 2005 the exception which enabled funds to reject a portability request if an employer had contributed to the fund in the past six months was removed.

Together, choice and portability allow employees to consolidate their superannuation benefits in one account, avoiding multiple sets of fees and charges.

Removal of the employment nexus for under 65s

Prior to 1 July 2004, subject to a limited range of exceptions, superannuation providers generally only accepted contributions for individuals who were gainfully employed.

The removal of the work test from 1 July 2004 improved access to the superannuation system for individuals and reduced red tape for the superannuation industry by no longer requiring funds to monitor the employment status of their members.

Removing the work test for those under age 65 is a significant shift away from the traditional role of superannuation as solely an employment related benefit. It allows every Australian under age 65 to take advantage of the concessional tax treatment of superannuation. This is particularly important for individuals with broken work patterns, for example, parents who leave the labour force to raise children.

Capital gains tax exemptions

Many small business owners may choose to save for their retirement by building up the value of their business in addition to, or instead of, contributing to superannuation.

A number of initiatives allow small business owners to reduce significantly, or eliminate, their capital gains tax liability when selling a small business. For example, a small business owner can disregard a capital gain when an active asset that has been held continuously for 15 years is sold upon reaching age 55 and retiring. Furthermore, a small business owner can disregard a capital gain where the proceeds of the sale of an asset are used for retirement (up to a lifetime limit of $500,000).

These exemptions recognise that small business owners often put all their resources into their businesses and, as a result, cannot contribute to a superannuation fund in the same way as other workers. In many cases their business is their sole asset and 'nest egg' for retirement.

In 2002-03, approximately 5000 taxpayers utilised the small business retirement exemptions with total tax expenditure of $95 million.[16]

The Board of Taxation is currently conducting a post-implementation review of the quality and effectiveness of the small business capital gains tax concessions including the retirement exemptions.[17]

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16 ATO and 2004 Tax Expenditures Statement. Available at http://www.treasury.gov.au.

17 More details on the review can be found at http://www.taxboard.gov.au.

CHAPTER 3: BARRIERS OR DISINCENTIVES TO CONTRIBUTE TO SUPERANNUATION

Term of Reference

Barriers or disincentives to contribute to superannuation.

A number of factors influence the ability and willingness of Australians to make voluntary superannuation contributions. These factors include, for example, the level of participation in the labour force, the amount of disposable income and Government policy in relation to superannuation and the age pension.

Lower levels of income and labour force participation are significant barriers to contributing to superannuation for people under age 40. The incomes of those under age 40 are likely to be relatively low and some experience broken periods of employment due to education and caring responsibilities. The decision to invest in superannuation often competes with education, family and housing-related expenses. For example, in 2003-04 for people aged 25 to 34 and 35 to 44 average housing costs represented a large proportion of total household expenses at about 21 per cent and 17 per cent respectively. This compares to about 15 per cent for all households.[18]

Some aspects of the superannuation system may act as a disincentive for those under age 40 to make voluntary contributions. These may include overall system complexity, the preservation rules, deduction limits and aspects of the voluntary contribution concessions for the self-employed. However, some of these disincentives may reflect tradeoffs for meeting other policy objectives.

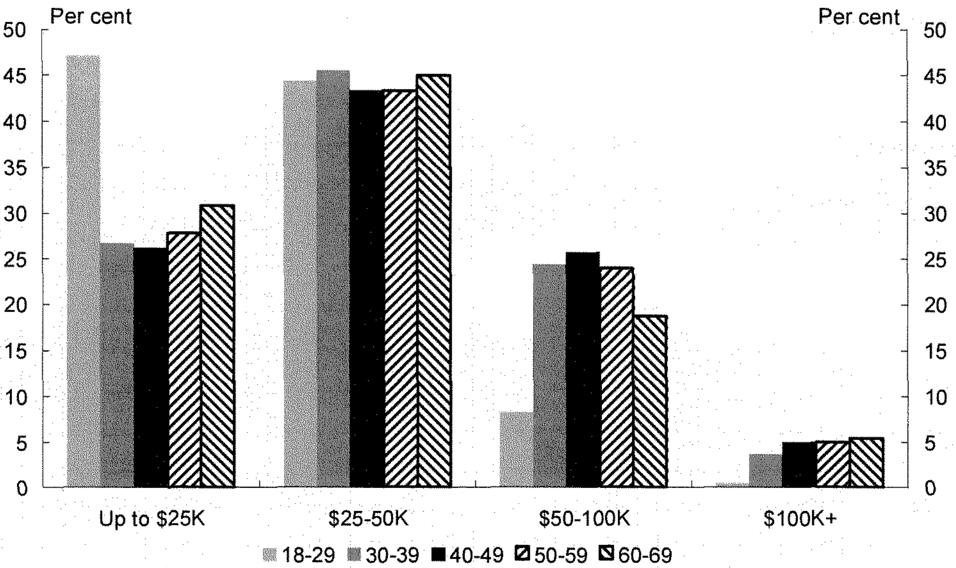
Barriers to contributing to superannuation

Income levels

Generally, individuals with higher incomes are better able to save voluntarily for their retirement. ATO data shows that almost half of people under age 30 who filed a tax return in 2002-03 had taxable incomes of less than $25,000 per annum. Incomes improved significantly for those between age 30 and 39, with about 45 per cent of individuals having taxable incomes in the $25,000 to $50,000 per annum income range and a further 28 per cent in higher income ranges.

18 Australian Bureau of Statistics, Household Expenditure Survey, 2003-04, Catalogue No. 6530.0.

Chart 12: Distribution of taxable income and age 2002-03



Source: Australian Taxation Statistics 2002-03.

Incomes for women were typically lower, with about 38 per cent of women between the ages of 30 and 39 having taxable incomes under $25,000 in 2002-03. While many women in this age group had incomes between $25,000 and $50,000 per annum (about 45 per cent), there were fewer women in higher income ranges (about 18 per cent).

Table 3: Distribution of taxable incomes by age and gender 2002-03

	Up to $25K		$25 – 50 K		$50 – $100K		$100K +	
	Male per cent	Female per cent	Male per cent	Female per cent	Male per cent	Female per cent	Male per cent	Female per cent
18 - 29	43.2	51.5	45.9	42.5	10.3	5.8	0.5	0.2
30 - 39	18.3	37.6	46.1	44.6	30.7	16	4.9	1.9
40 - 49	17.7	35.9	41	46	33.9	16.2	7.4	2
50 - 59	20.5	36.6	41.2	45.7	30.9	15.7	7.4	2
60 - 69	27.3	37	45.2	44.5	21.1	14.8	6.4	3.7

Source: Taxation Statistics 2002-03.

Labour force participation

Labour force participation has a major impact on the ability of individuals to save and to make superannuation contributions. While some people have 40 years or more of stable full-time employment, others may have interrupted labour force participation associated with caring responsibilities, long periods of unemployment, or long periods of casual and part-time work. Time spent in higher education can also delay entry to the labour force, or restrict a person's labour force participation to part-time or casual work.

Appendix C sets out labour force participation rates for males and females from age 15 to age 44 for the years 1999-2000 to 2004-05. The data shows the total of full-time and part-time labour force participation rates in 2004-05 for males between age 25 and age 34 was about 91 per cent, compared to about 72 per cent for females in the same group. However, the part-time labour force participation rate for males between age 25 and 34 was about 8 per cent compared to about 25 per cent for females in this age group.

Labour force participation rates fell by about 1 per cent for males in this group over the six-year period but improved by about 3 per cent for females. The growth in female participation is largely due to an increase in part-time employment for this group. The data also shows a shift from full-time to part-time labour force participation over the last six years, particularly for those under age 25.

The lower incomes and lower levels of labour force participation for women under age 40 identify them as a particular group who may need to improve their savings to meet their retirement income expectations. The initiatives outlined in Chapter 2, such as the low-income spouse rebate, the co-contribution scheme, removal of the employment nexus for contributions by people under age 65 and superannuation contributions splitting may encourage the superannuation savings of women. Recent initiatives also now allow separating couples to split their superannuation.

Disincentives to contribute to superannuation

Complexity

Individuals are less likely to contribute to superannuation if the system is complex and difficult to understand.

The superannuation system is complex for a number of reasons. First, there is inherent complexity in dealing with financial matters over long time periods. It is difficult for individuals to compare a long-term investment to shorter term options that are more flexible and have more transparent returns.

Second, there are complex rules for the taxation of superannuation. Superannuation taxation has developed incrementally in response to changing circumstances and government priorities. Many taxation rules have been grandfathered in this process so existing members are not disadvantaged. Specific examples of taxation complexity include having three concessional taxing points, various deduction limits and benefit components that receive different tax treatment. A more detailed summary of the taxation arrangements for superannuation is at Appendix B.

Much of the complexity lies at the benefits end. A decision to take a benefit as a lump sum, pension or a combination of the two can have a significant impact on the tax paid and the age pension received. These arrangements may penalise people who fail to obtain financial advice. End benefits taxation also imposes a large administrative burden on both superannuation funds and the ATO.

For most employees, including those under age 40, making superannuation contributions is less complex. For employees who only interact with the superannuation system through the SG, superannuation is relatively straightforward.

Employees making additional contributions can choose to have these deducted from their after-tax pay, or arrange with their employer to have contributions made from their pre-tax salary. Superannuation requires little or no involvement from fund members once contributions are paid. Unlike other investments, earnings on superannuation investments are not included in a person's annual tax return, but are subject to a concessional taxation regime inside the fund.

However, people may still be reluctant to contribute to superannuation because they do not fully understand it. Chapter 4 discusses financial literacy and awareness and the Financial Literacy Foundation, which aims to assist Australians to increase their financial knowledge and better understand how to use and manage their money.

Preservation rules

From 1 July 1999, all contributions to superannuation funds, including personal contributions and earnings, are held within the fund until the member reaches their preservation age (currently age 55, but progressively increasing to age 60, from 2015). Those currently under age 40 face a preservation age of 60.

The preservation arrangements are an important element of the superannuation system in Australia. They aim to ensure that concessionally taxed superannuation is available for genuine retirement income purposes and that retirement income expectations are achieved for a longer lived population. They also seek to encourage mature age workers to stay in the labour force longer, helping to address the challenges of an ageing population. Increasing the preservation age to 60 will allow for the accumulation of a larger retirement benefit, thus improving people's retirement income and, to a lesser extent, reducing their dependency on the age pension. It will also reduce the gap between the preservation age and the age pension age, thereby reducing the scope for dissipation of savings prior to age pension age.

For many young Australians the preservation rules can be a disincentive to making early contributions to superannuation. An individual who makes voluntary superannuation contributions at age 25 may not benefit directly from those contributions for 35 to 40 years. Some individuals under age 40 may choose to save in other ways that do not have access restrictions (see Chapter 1), but ultimately direct surplus savings into superannuation when they near retirement.

Some exceptions to the preservation rules allow for the early release of benefits in cases of genuine hardship. Grounds for early release of a member's superannuation benefits are limited and include:

- severe financial hardship;
- specified compassionate grounds; and
- permanent incapacity or death.

The early release provisions can benefit individuals with superannuation savings whose personal or financial circumstances subsequently change.

Deduction limits

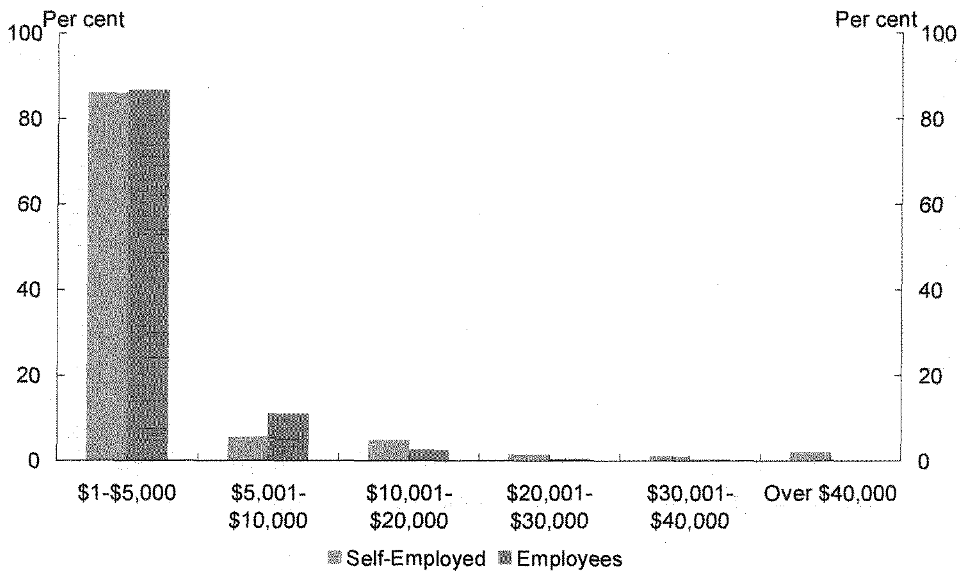
Because of the scale of the superannuation taxation concessions, limits apply to the amount of superannuation savings receiving these concessions. These limits are applied through the age-based contribution limits and reasonable benefit limits.

The age-based contribution limits cap the deductible superannuation contributions that can be made by or on behalf of an individual each year. For 2005-06, the age-based deduction limits are $14,603 for employees under age 35, $40,560 for those aged 35 to 49, and $100,587 for those aged 50 and over. These amounts are indexed annually to average weekly ordinary time earnings.

There is no limit on post-tax (non-deductible) contributions to superannuation; these contributions still benefit from tax concessions on fund earnings.

The age-based limits are not a barrier for most individuals under age 40 to contribute voluntarily to superannuation. Chart 13 shows that few people under age 40 made annual contributions greater than $5,000 (14 per cent of self-employed and 13 per cent of employees). For the 2002-03 financial year the average employer annual contribution for those under age 40 was about $3,000. Contributions made by the self-employed averaged about $4,000.

Chart 13: Distribution of employees and self-employed under age 40 making deductible contributions 2002-03



Source: ATO, sample tax file data.

Voluntary contributions by the self-employed

Taxpayers are generally not entitled to a deduction for personal superannuation contributions if during the year it was reasonable to expect they would receive significant amounts of superannuation support from an employer.

However, tax deductions are available to the self-employed (and others) to encourage this group to contribute to superannuation.

The fully deductible amount for superannuation contributions by self-employed people is $5,000 (increased from $3,000 on 1 July 2002). Contributions above this amount are 75 per cent deductible, with a maximum deduction equal to the taxpayer's age-based deduction limit.

For most self-employed people under age 40 annual contributions are within the $5,000 full deduction limit (Chart 13). ATO data for 2002-03 also shows an increase in the proportion of people making contributions at or near the new $5,000 threshold.

Chapter 2 discussed additional capital gains tax measures that accommodate self-employed people who save for retirement through their business.

The age pension means test

The age pension will continue to support living standards for the majority of people in retirement. However, the interaction of compulsory and voluntary superannuation savings with the age pension means test means that in the future relatively fewer people will qualify for a full-rate age pension and more people will receive a part-rate age pension.

The means test comprises separate income and assets tests. Both tests are applied and the age pension is calculated under the test which produces the lower rate of payment.

The means test is designed to target payments to those most in need while maintaining the affordability of the age pension. However, the design of the means test must achieve a balance between targeting government assistance and ensuring that there is an incentive for self-provision. This is particularly important in relation to the reduction rates which apply under the income and assets tests.

Under the income test a single person can earn over $34,000 per annum and still be eligible for a part-rate pension. The income test has a taper rate of 40 cents in the dollar on income above a free area of $3,224 a year for a single pensioner or $5,720 for a couple. This taper rate was reduced from 50 cents in the dollar on 1 July 2000.

Under the assets test a person's pension is reduced at $3 per fortnight for every $1,000 of assets above the threshold, starting at $157,000. For a single homeowner, the entire pension entitlement is withdrawn once assets exceed $317,750.[19] The $3 per fortnight assets test taper rate is equivalent to an annual reduction rate of 7.8 per cent. This high reduction rate limits access by wealthy individuals to the age pension, but may act as a disincentive to saving and an incentive to dissipate savings or invest in exempt assets such as housing.

19 Thresholds are current as at 14 September 2005.

CHAPTER 4: IMPROVING FINANCIAL LITERACY AND AWARENESS

Term of Reference

Improving awareness of the importance of saving early for retirement

People with higher retirement income expectations than the SG and the age pension will deliver, can close this gap by making early contributions to superannuation. The low-tax environment and long-term investment opportunities available to superannuation funds can result in these contributions growing many times over prior to retirement. Contributing to superannuation earlier in life will lead to a greater improvement in final retirement incomes than making equivalent savings at a later stage.

Appendix D contains a table comparing improvements in replacement rate projections where 3 per cent of salary is assigned to additional savings inside the superannuation system. For a person on median earnings (about $40,000 per annum), making additional superannuation contributions at the earlier age of 35 improves their spending replacement rate from 72 per cent to 82 per cent.[20] This compares to an improvement from 70 per cent to 76 per cent for a person who starts the extra superannuation contributions at age 50.

A key challenge of retirement income policy is to improve individuals' awareness of the benefits of making additional superannuation contributions. As discussed in Chapter 1, individuals tend to be short-sighted in that they underestimate the amount they need to save to match their retirement income expectations. For example, the ANZ Bank *Survey of Adult Financial Literacy in Australia* in 2003 found only 37 per cent of respondents had actually worked out how much they needed to save for their retirement.

Another challenge is improving individuals' understanding of the complex financial services sector. There are a multitude of financial products and services available. Differing regulatory frameworks and taxation arrangements add further layers of complexity, making it difficult for consumers to compare the risks and benefits of different financial products and to make optimal investment decisions.

The recent ANZ survey suggests there are still significant gaps in many Australians' financial knowledge. For example, the survey showed that:

- about 16 per cent of the adult population spend all their income as soon as they get it and do not plan for the future;
- only 5 per cent claimed to have no difficulty managing their finances; and
- only 67 per cent of adults claimed to understand the term 'compound interest' either 'very well' or 'fairly well'.

Improving financial literacy assists individuals to manage risk and attain financial security, as well as allowing financial markets to operate more efficiently. Better financial literacy will enable people to make more informed and confident financial decisions, including budgeting, saving and using financial products and services for banking, borrowing, and to plan for the future. Over time, this may create scope to review aspects

20 Projections are based on cases where benefits are taken as a pension.

of the prudential regulation and consumer protection regimes. Better financial decisions will improve resource allocation and allow individuals to achieve higher standards of living and wellbeing.

Initiatives improving financial awareness and understanding

Recent superannuation initiatives

Recent Government superannuation initiatives, such as the choice of fund and co-contribution policies, have been accompanied by substantial public education campaigns. These campaigns have drawn attention to the issue of superannuation and highlighted the importance of saving for retirement. The choice of fund policy has also stimulated increased activity by superannuation funds aimed at retaining existing members and attracting new members. These activities have included public advertising, which has helped to raise the profile of superannuation.

Australian Securities and Investments Commission — consumer website

The Australian Securities and Investments Commission has developed a consumer-oriented website that contains detailed superannuation-related information. The website (known as FIDO) provides access to useful tools that enable consumers to compare funds and better understand their retirement benefits.

The site contains specific links covering such issues as:

- facts about superannuation;
- choosing a fund/changing funds;
- judging your fund's performance;
- choosing your investment strategy; and
- moving towards retirement.

In addition, the website also contains a Superannuation Calculator, developed with the assistance of licensed actuaries, which allows individuals to estimate their retirement savings over the medium to long term by tailoring the model's assumptions to their personal circumstances. Specifically, the calculator lets consumers see the long-term effects of:

- the most common fees charged by various funds;
- making extra contributions;
- receiving co-contributions if eligible;
- breaking or reducing contributions as a result of time out of the workforce; and
- switching investment strategies or changing funds.

Importantly, the site alerts consumers to the fact that it is a 'model and not a prediction' and that it does not replace expert, licensed financial advice on retirement planning.

The Australian Securities and Investments Commission's consumer website, FIDO, can be accessed at: www.fido.asic.gov.au.

Financial services reform

The *Financial Services Reform Act 2001* (FSRA) introduced a uniform licensing, conduct and disclosure regime for all financial service providers. The disclosure requirements of the FSRA help to ensure consumers have adequate information to make informed financial decisions. For example, in relation to superannuation, consumers will receive upfront product disclosure, ongoing periodic disclosure and disclosure about material changes and significant events.

In addition, the recently introduced 'enhanced fee disclosure' regulations for superannuation and managed investment products (March 2005) have increased fee and cost disclosure requirements for these products, enabling consumers to make more informed comparisons.

The FSRA also provides a framework in which consumers can be assured that licensed financial advisors are competent and that the services they offer will be provided efficiently, honestly and fairly.

Financial Literacy Foundation

In recognition of the need for Australians to improve their skills to make informed judgments and effective decisions about the use and management of their money, the Government established the Consumer and Financial Literacy Taskforce (the Taskforce) in February 2004. In proposing an overarching national strategy to enhance financial literacy in Australia, the Taskforce considered a range of factors, including the availability and adequacy of financial education and information in schools, the availability of financial information and education to maximise superannuation and retirement savings, and the importance of saving and better communicating the need for a focus on retirement savings. These considerations were informed by over 60 submissions during the consultation phase, as well as other sources, including:

- the May 2003 ANZ Bank *Survey of Adult Financial Literacy in Australia* which showed that while most Australians have basic financial literacy skills, young consumers and those from lower socio-economic backgrounds are facing particular disadvantage in making informed decisions about the management of their money;
- the July 2003 Senate Select Committee on Superannuation report *Planning for Retirement*, which recommended that the Government increase efforts to educate the general population about the importance of planning for retirement; and
- the Investment and Financial Services Association 2003 policy paper on *Retirement Incomes and Long-Term Savings: Living Well in an Ageing Society*, which noted that education, information and quality advice are critical to the achievement of Australians' expectations of their retirement incomes.

In June 2004, the Government released the discussion paper (prepared by the Taskforce) *Australian Consumers and Money*, which highlighted the need for consumers to be better skilled at negotiating transactions and managing money. On 31 August 2004, the Taskforce presented its recommendations to the Government. A key recommendation was that a central coordinating body be established to improve the effectiveness of financial information and education in Australia.

The Government adopted the recommendation and established the Financial Literacy Foundation (the Foundation) under its 2004 election policy, *Super for All and Understanding Money*.

The Foundation was launched in June 2005. It aims to assist all Australians to increase their financial knowledge and better understand the choices they can make in using and managing their money.

The Foundation is delivering a national strategy to assist Australians to make more informed financial decisions and manage their money better.

Key elements of the national strategy include:

- an Australia-wide information and awareness-raising campaign;
- financial literacy programmes in schools and workplaces;
- a one-stop website to serve as a portal for financial literacy education and information resources; and
- original research to build understanding of influences on community attitudes to financial literacy and best practice approaches to extending and measuring literacy.

Programmes in schools to teach financial literacy early in life are a key element of the national strategy. This is expected to flow through to better decision-making in adulthood on a large number of financial issues and products, including superannuation.

In short, improved financial literacy should result in better engagement with superannuation by those under age 40, through recognising that the decisions they make now will affect their retirement income and lifestyle.

In 2005, the Foundation has played a key role in the implementation of superannuation choice of fund, leading the Choice Implementation Steering Committee. Implementation activities included a mass media campaign, the *Super Choices* booklet, a call centre and a website.

Consistent with the aims of the Foundation, the implementation activities for employees have focused on raising awareness of the availability of choice and on the importance of their superannuation.

APPENDIX A

Superannuation data sources

The majority of analysis evaluated in this submission is derived from unpublished sample ATO tax file data from 1999-2000 to 2002-03. There are a number of advantages associated with the use of this data. These include that:

- the sample size is significantly larger than for any Australian Bureau of Statistics (ABS) or Household, Income and Labour Dynamics in Australia (HILDA) survey datasets, which is particularly helpful for lessening the impact of small sample sizes when disaggregating data;
- the data represents the actual figures reported on tax returns, whereas some questions in various surveys require the participant to make estimates about their contribution levels, income, and so on;
- a number of different income variables are readily available, which assists in calculating estimates of SG employer contributions, eligibility for the co-contribution, and so on; and
- the sample data is on an annual basis, which assists in facilitating comparisons of results between years.

The primary limitation of using sample tax file data is that no data is available regarding superannuation balances held by individuals, as these do not have to be reported for tax purposes.

A number of other data sources are available, however, they typically have some limitations when compared to the sample tax file data that has been used.

The Australian Prudential Regulation Authority (APRA) releases quarterly superannuation trends data for funds. However, as this data is not disaggregated by age or other characteristics of individuals, it is difficult to use in establishing the characteristics exhibited by those under age 40.

The most recent ABS series of interest in the context of this submission is the 2000 Survey of Employment Arrangements and Superannuation (SEAS). This data does disaggregate by age, but as respondents did not have to answer questions (or give permission to approach their funds) about their superannuation contributions and balances, the survey results available do not provide a complete picture of superannuation for the under age 40 cohort. This data is also only currently available at a single point in time and therefore does not readily facilitate trend analysis.

The second wave of the Melbourne Institute of Applied Economic and Social Research HILDA Survey (2002-03) focused on wealth, including balances held in superannuation. However, the superannuation balance figures provided are the best estimate of the member rather than actual data from the fund. The estimate from this data of total funds held in superannuation is lower than the APRA quarterly aggregate figures for each quarter of the 2002-03 financial year. Again, this data is also only currently available at a single point in time and therefore does not readily facilitate trend analysis.

APPENDIX B

Summary of tax arrangements for superannuation

Contributions

There are tax deductions for employer and deductible member (self-employed) contributions to superannuation. Age-based limits apply to the amount of deductible contributions that can be made to superannuation. These limits are indexed annually to movements in Average Weekly Ordinary Time Earnings (AWOTE).

Tax is applied to employer and deductible member superannuation contributions at a rate of 15 per cent. A surcharge for high-income earners of up to 15 per cent has also applied until the 2004-05 income year. These tax rates compare favourably with most marginal tax rates which apply to equivalent amounts of earnings subject to income tax.

The surcharge has been abolished for superannuation contributions made and relevant termination payments made or received in the 2005-06 and later financial years.

Contributions made from post-tax monies are not subject to further taxation in the superannuation fund.

Earnings

A 15 per cent tax rate applies to the investment income of superannuation funds. This rate compares favourably with the rate of tax applying to earnings obtained from most other savings vehicles. Only two-thirds of qualifying capital gains are taxable, reducing the maximum effective capital gains tax rate for superannuation funds to 10 per cent. Superannuation funds are also entitled to imputation credits, which can be refunded when the fund's tax liability is reduced to nil.

Benefits

Retirees have the choice of taking their superannuation benefit either as a lump sum or as an income stream.

In the case of a lump sum taken on or after age 55, the first $129,751 (indexed) of the post-June 1983 component is tax-free if paid from a taxed fund, or taxed at a maximum rate of 15 per cent if paid from an untaxed fund. Any remaining post-June 1983 component (below the individual's lump-sum RBL) is taxed at a maximum rate of 15 per cent if paid from a taxed fund or 30 per cent if paid from an untaxed fund.

The Government legislated in 2003 to implement an election commitment that reduces the rate of tax payable on the amount of an ETP that is in excess of the RBL (the excessive component). Prior to the amendment the excessive component was not broken down into the various other ETP components such as pre- or post-June 1983, or amounts paid by taxed or untaxed funds, and was entirely taxed at the top marginal tax rate.

Following the amendment the portion of the excessive component that nominally represents the post-June 1983 component paid by a taxed superannuation fund is now taxed at 38 per cent. The member's surcharge liability for that year is also reduced. The remainder of the excessive component is taxed at the highest marginal tax rate.

In the case of a lump sum taken before age 55, the post-June 1983 component (below the individual's lump sum RBL) is taxed at a maximum rate of 20 per cent if paid from a taxed fund or 30 per cent if paid from an untaxed fund.

Any excessive component is taxed in the same way as for a lump sum taken after age 55.

That part of a lump-sum benefit which represents the return of an individual's undeducted contributions (that is, contributions made from post-tax income) is not subject to further tax.

Tax incentives are provided to encourage retirees to purchase income stream products which meet the Government's broad retirement income policy objectives. In particular, incentives are afforded to income stream products that provide for an orderly, regular draw down of capital over the expected duration of retirement.

Earnings on fund assets supporting income streams are generally not taxed and a 15 per cent tax offset also applies to the value of an income stream paid from a taxed source that is within a taxpayer's RBL. Where individuals take at least 50 per cent of their total benefits in the form of a 'complying' pension, they qualify for the higher pension RBL. 'Complying' pensions are also eligible for a 50 per cent exemption under the social security assets test.

In contrast, lump-sum benefits and other income streams, such as allocated pensions, are assessed against the lump-sum RBL. A higher tax rate also applies to lump-sum benefits that are in excess of the applicable RBL (the excessive component).

For the 2005-06 year of income, the lump-sum RBL is $648,946 and the pension RBL is $1,297,886. These amounts are indexed annually to AWOTE.

APPENDIX C

Labour force participation rates

Male full-time labour force participation rates

Age	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05
	Per cent	Per cent	Per cent	Per cent	Per cent	Per cent
15-19	28	26	27	26	26	27
20-24	70	69	67	65	65	65
25-34	86	85	84	83	83	83
35-44	86	86	85	84	85	84

Female full-time labour force participation rates

Age	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05
	Per cent	Per cent	Per cent	Per cent	Per cent	Per cent
15-19	18	18	17	16	17	17
20-24	52	52	49	49	48	48
25-34	46	47	47	46	46	47
35-44	38	39	37	38	38	38

Male part-time labour force participation rates

Age	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05
	Per cent	Per cent	Per cent	Per cent	Per cent	Per cent
15-19	31	33	33	33	33	32
20-24	17	17	19	20	20	20
25-34	6	7	8	8	8	8
35-44	5	5	7	7	6	7

Female part-time labour force participation rates

Age	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05
	Per cent	Per cent	Per cent	Per cent	Per cent	Per cent
15-19	42	43	43	45	45	45
20-24	25	27	28	29	30	30
25-34	23	23	24	25	25	25
35-44	33	33	34	35	34	34

Source: Treasury estimates based on Australian Bureau of Statistics, Labour Force Australia, Electronic Catalogue 6291.0.55.001

APPENDIX D

Replacement rate projections where 3 per cent of salary is assigned to additional saving in superannuation

Age	2005-06 Income	Superannuation Guarantee saving only (per cent)	Superannuation Guarantee saving plus 3 per cent additional saving within superannuation (per cent)
35	$20,000	114	132
	$40,000	72	82
	$60,000	58	65
	$80,000	51	58
	$100,000	47	54
	$150,000	38	46
50	$20,000	108	119
	$40,000	70	76
	$60,000	55	59
	$80,000	48	52
	$100,000	44	47
	$150,000	35	39

Source: Bingham, C and Rothman G, Incentives to save more in superannuation, paper presented to the Thirteenth Colloquium of Superannuation Researchers, University of New South Wales, 4 and 5 July 2005. The projections are based on cases where benefits are taken as a pension.

These replacement rate calculations have been based on the comparison of average real annual net retirement expenditure with the net expenditure in the final year of working life.