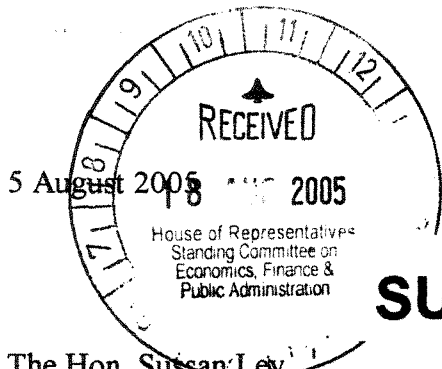

Howard J. Hinde
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5 August 2005

SUBMISSION 36

House of representatives Standing Committee on Economics, Finance and Public Administration
Submission No: 36
Date Received: 18/08/05
Secretary: SB

The Hon. Sussan Ley
520 Swift Street
Albury NSW 2640

Dear Sussan,

Enclosed is the submission on Improving Superannuation Savings – people under age 40.

I have included a number of additions and minor amendments. The major additions are

- Rural and Regional. This only draws attention to the fact that lower earnings makes the accumulation and contribution process less attainable.

- in the education area, suggesting an extensive web site for both retirement income education and to include a question and answer facility within the site. This facility is very relevant for rural and regional areas.

- in the contributions area, raising the possibility of people borrowing against the equity in their homes, contributing that borrowing as a contribution to their Super Fund, but making the interest on and the capital repayments of that specific borrowing, tax deductible spread over the period to normal retirement. It needs further examination but it is an area to be considered as it achieves the commitment to co-contribution in one major contribution which then materially assists the compounding growth factor.

Please give me a call if you wish to discuss, otherwise could you arrange for the submission to be sent to the committee.

Kindest Regards,
Yours Sincerely,

Howard

Howard J. Hinde
B.Com. (Melb), F.C.A., C.P.A.
Telephone [redacted]
Facsimile [redacted]

IMPROVING SUPERANNUATION SAVINGS OF PEOPLE UNDER AGE 40

There are a number of issues that need to be addressed. These include:

A. Co-contribution by the people themselves

B. Earning Rates on Funds contributed

C. Choice of Fund

D. Manner of Drawdown of Benefits on Retirement

E. Rural and Regional

A. CO-CONTRIBUTION

The most effective way of improving the retirement savings of individuals is for those individuals to save for their retirement through personal additional superannuation contributions during their working life.

There are a number of benefits of co-contribution:-

- the end amount available for retirement will be substantially greater due to the added compounding effect of income earned and capital growth.

- people will understand that financial planning for their retirement is more their own responsibility, rather than being only the responsibility of only the government and their employer.

- people making contributions themselves will take a greater interest in the performance of their superannuation manager and their ultimate retirement incomes.

The difficulty is how to encourage people co-contribute, given the Australian public record of relatively low savings by world standards. The existing incentive for individual additional contributions by the government also providing up to $1500 matching contributions under specific circumstances is welcome, but the restrictions and quantum involved with this initiative will not achieve the objective of self funded retirement.

1. **Barriers**
Barriers and/or disincentives to co-contribution

1.1 Alternative Spending Reduction

The principal barrier and/or disincentive to contributions by individuals is that the contribution would be made at the expense of alternative spending. This reduction in spending would fall into two primary categories, namely

- Capital – a reduction in a home purchaser's ability to pay off a mortgage earlier. It could be argued that this effect was merely a replacement of one form of savings with another, although extension of the time to repay a housing loan involves a higher level of non tax deductible interest.
- Consumption – people may be reluctant to forfeit some lifestyle benefits as a consequence of reduced available discretionary spending. The "live for today" syndrome. Why restrict enjoyments of today for a better lifestyle in the future. There are also the overall effects on economic activity and growth to be considered as a result of a re-direction in discretionary consumption spending.

In addition there will be an ever present barrier where the superannuants believes that they can invest any spare funds better themselves, as opposed to giving it to a manager by whom they will be charged fees. Many may have already started that process with personal equity investments or second properties. They will, however, be in the minority. Nevertheless, by undertaking these investment decisions they will be moving towards lessening their retirement dependence on the age pension and may encourage others to make similar investments.

1.2 Knowledge

There is undoubtedly a lack of knowledge and awareness of the necessity to self provide for retirement income. This is very understandable because the vast majority of Australians have not been directly exposed to the looming pension funding problems that will face the government if more people do not self provide for their retirement. Most 40 year olds will have parents whose primary experience in retirement income is to receive the aged pension, thus their children have never been exposed to the concept of saving significantly for their own retirement.

1.3 Forfeiture of other benefits

There is the physiological barrier of a self funded retiree not being eligible for the traditional age pension when they believe that is their right to receive. There will also be the disincentive if people believe, or it is a fact, that the added benefits which attach to being on an age pension and holding a pension card – i.e. rebates or a reduction in cost for a wide range of other benefits which accompany the receipt of the age pension, will be lost if the retiree is self funded. There is an inbuilt attitude that "I have paid my taxes all my life, so I deserve to get something back".

2. **Encouragement of Co-Contribution**

2.1 Compulsory Contribution

Make co-contribution compulsory. It would become a payroll deduction and paid across by the employer with the Superannuation Guarantee Levy. This would probably be politically unpalatable, and the Committees terms of reference specifically refer to voluntary contributions. Nevertheless, it would be a highly effective fiscal way of achieving the desired outcome.

2.2 Tax Deductibility

Make the co-contribution eligible for tax relief. There are a number of alternatives:

- set as a rebate of 17% which results in the lowest paid individuals receiving 100% tax relief on the earnings directed to co-contribution.

- set as a rebate of 30% which gives 100% relief to a much wider range of individuals, gives added tax relief on other income to the lower paid (and improves their ability to co-contribute) and gives a meaningful relief to all other income levels.

- make the contribution fully tax deductible. This is probably unpalatable politically by favouring the higher income earners who are not really the target of the policy and it has greater revenue loss implications.

- consider encouraging people to utilize equity in their home by borrowing and contributing that borrowing to superannuation. Then provide tax relief against income for the annual interest paid on the borrowing and the principal repayments of the loan, (subject to annual limits)

Without personal tax relief it is difficult to see any progress with the objective of co-contribution. The benefit of tax relief should not be effectively reduced by taxing the contributions in the Superannuation funds. That would be just self defeating. It is within this context that the concept of the government foregoing current revenue to lessen the pension demand on future revenue streams must be realistically addressed.

2.3 Education

There is a undoubtedly a serious deficiency in the knowledge of retirement income requirements and the associated education of the community on this subject. It should be recognised that the majority of the working population have never been exposed to such education processes and if it is expected that these people will co-contribute through the balance of their working life, on a voluntary basis, they must be educated to accept the vital necessity that they take the co-contribution step to secure their retirement lifestyle.

This will not be easily achieved and will be a long process. It will need to be funded by the government and the education process should probably start in the school system. The temptation to leave the education process to the private sector driven by the fee and commission motive must be avoided.

With the growth in access to the Internet and the increasing ability of people to explore the web, this education process could be greatly enhanced by a very comprehensive web site designed not only to educate but provide a question and answer forum.

B. FUND EARNING RATES

Because Superannuation contributions are very long term investments, the compounding effect on earnings to produce the required retirement benefits is nearly as important as additional co-contributions. The simple compounding equation shows that a sum invested today at 10% tax free compound interest will increase the base capital sum by 100% in 7 years, with a reduction in real terms by the compounded rate of inflation over the same period. Thus compound net earnings must stay well ahead of compound inflation to maintain and enhance the retirement benefit capital base.

The effective earning rates of the contributions invested depends on:
- the actual earnings from the investments
- the administrative and management costs charged
- the tax levied, not only on the income but on the contributions made.

1. Earnings

The Australian Superannuation industry earnings record over the last 5 years has very much mirrored the Stock Market in Australia and in many cases overseas. The overall performance has been volatile and not encouraging. One of the difficulties in projecting future earning rates to be factored into long term future retirement benefit levels is this dependence on the equities market. Many superannuation fund managers have a high dependence on market index based investments. This type of utilization of contributions is open to question as to whether or not it is investment of the long term nature required.

The quandary is that without the sheer weight of the forced superannuation guarantee levy being lodged in the equities market, the level of the market index and hence at least part of the earnings growth of the superannuation funds would be lower than has been achieved. To some extent it can be argued that the weight of the guarantee levy has underpinned the market growth over the past few years. This is of significant concern, particularly with those funds that have a high level of investment in the market as opposed to fixed interest securities and property. Placing additional funding into the equation will exasperate this problem.

It is therefore very important that the earnings reporting process is separated into earnings from actual dividend, interest, property and other income on the one hand and earnings from the movement in the capital value of the investments. In other words, actual cash earnings should be separated from paper earnings. Otherwise one sector can disguise the poor performance of the other.

If we expect with the advent of choice of superannuation fund and co-contribution that people will take a greater interest in the performance of their fund of choice, it must be certain that the performance information provided by the funds is presented in an understandable and consistent manner.

2. **Costs**

The eventual retirement benefit for a person can be significantly affected by the level of fees and costs charged to that person over the period of contribution. The advertising by the industry funds showing the difference between the retirement benefits where financial advisors are, or are not, used graphically illustrates this long term effect.

The growth in superannuation contributions arising from the guarantee levy has spawned a very large financial planning and services industry. There have been enquiries that have been critical of the standard of advice being rendered. There still exists a system of percentage commissions and long term trailing commissions, which reduce not only earnings but also current and future contributions. The system is a hangover from the old life assurance company days – it was not in the consumers' interest then and it is not today. Where "advisors" are paid commissions by the fund chosen, irrespective of whether or not the commission is disclosed, the advice cannot be independent nor will it be competitive for the consumer.

The method of establishing advisory and management fees within the superannuation industry requires a radical overhaul so as to place advisors on a "fee for service" system (like most other professional charges) and relate management fees to results. A system which permits a manager to extract a fee as a percentage of a capital investment every year when the actual investment may remain static apart from collecting income, is unreasonable and unfair. A results based system would be far more transparent and fair to all involved.

The system of charging and rewards based on a percentage of "funds under management" which has given rise to some huge, and as some might say obscene, payments to managers within this industry should be eliminated.

If costs are to be contained so as to prevent them from having an adverse effect on the compounding accumulation of contributions and earnings, and hence final retirement benefits, fees and charges must be reduced and the proliferation of financial planners culled by market competitive forces.

3. **Taxes**

Superannuation can suffer being taxed three times – on ingoing contributions, on earnings and on withdrawals (depending on how the withdrawal is structured).

3.1 Ingoing Contributions

Clearly the ingoing contributions tax of 15% reduces the compound growth of the funds more than any other factor. To eliminate this tax would have a major impact on government revenue, however, that in itself is not a valid reason to reject a thorough examination of the cost to revenue on a phased down or phased elimination basis, balanced against the potential substantial long term relief to government age pension demands.

The phase down could be structured as being proportionate to the quantum of the contribution so as to assist the lower paid who have the least ability to become self funded retirees.

As stated previously, voluntary co-contributions should be exempted from any contributions tax.

3.2 Earnings Tax

Funds that have a high proportion of funds invested in the equity market and are receiving fully franked dividends are advantaged by the 30% franking credits as against the 15% fund earnings tax. If properly managed this can reduce taxes on earnings to a minimum. Thus in many funds there will be little negative effect of this tax on growth.

However, on funds that are capital guaranteed and have the majority of funds invested in fixed interest securities these tax offsets are not available and taxes paid will have a negative effect on growth.

3.3 Withdrawal Tax

These taxes apply primarily to lump sum withdrawals and vary according to individual circumstances. If there is a policy objective of driving an incentive to take retirement benefits as pensions rather than lump sums the impact of withdrawal taxes will be minimal. With the incentives of tax rebates on pensions in existence, the promotion of the advantages of pensions as against lump sums should be undertaken.

C. CHOICE OF FUND

There is a concern to be considered with the newly introduced ability of people to nominate the Superannuation Fund of their choice. That concern is that the volatility of economic circumstances could result in decisions of choice that will impact on the long term benefits available.

The average superannuant is by and large relatively unsophisticated in the investment world. The results of funds will vary, and the types of funds will inevitably offer differing outcomes, with financial spin doctors attempting to justify results irrespective of the real performance.

Funds with a high proportion of investments in growth equities and property portfolios have a much greater potential to produce the growth required to self fund retirement. These funds are, however, subject to market volatility and whilst the long term trend upwards may be growth satisfactory, there will be periods of little growth or decline. This volatility will be of concern to many superannuants.

Funds that are "capital guaranteed" have little scope for growth as they are invested in fixed interest securities and long term bonds. These funds will require a higher injection of contributions to produce self funding retirement benefits.

With Choice of Funds there is a danger that in a period of equity/property market correction or volatility, superannuants will be tempted to switch funds to a capital guarantee type. Not only will this involve fees and costs, but it will severely limit the growth required over the long term.

Again, this is where it is very important that the advice the superannuant receives from a financial planner is independent, charged on a fee basis so as to eliminate any possible temptation to recommend a switch of Funds just to earn commissions.

D. MANNER OF DRAWDOWN

The manner of drawdown of retirement benefits is of crucial importance to the ability of retirees to remain self funded for the rest of their lives. As time passes and medical advances result in prolonged life after retirement, a process of drawdown that may have been accepted in the past, may not be desirable in the future. Prolonged life increases the risk of self funded retirees "running out" of accumulated benefits.

1. Lump Sum

The ability to take a lump sum on retirement up to the Reasonable Benefit Limit has advantages and disadvantages. The instant access to perhaps the largest sum of money the retiree has ever possessed, has a perceived advantage of self sufficiency and more importantly brings the lump sum capital to within the direct control of the retiree. If the retiree dies before anticipated, the capital will remain with his or her family and not be lost to the superannuation fund manager.

However, there is the danger that the funds will not be invested into safe income earning assets to provide retirement income, but will be lost in risky investments, be spent on overseas trips, new cars and other consumption items. This could destroy the objective of making that person free of, or less reliant on, a government age pension.

2. Pension

To achieve the objective of making more people self funded retirees, the pension option on withdrawal is superior to the lump sum option. The RBL is double that of the lump sum and there are tax concessions on the pensions paid. If a person achieves a retirement capital account close even to the lump sum RBL, a pension can be drawn to an extent that will provide a comfortable life style for the vast majority. In addition, the personal tax rebates applicable to pension incomes as opposed to non pension generated income, adds to the attractiveness of the pension alternative.

However, where the situation exists of the potential loss of family entitlement to the capital sum of the retirement benefit remaining at the date of death of the retiree, and then the retirees' spouse/partner, there will be a reluctance to take the pension option.

This is particularly important for any co-contribution element existing in the capital sum remaining at death. As a minimum, a method should be found to protect this portion of the balance, but the aim should be to protect the entire remaining capital sum.

3. Combination

Perhaps a partial solution can be found in a system whereby the superannuation guarantee levy contributions and the related earnings are kept separate from the co-contributions and those related earnings.

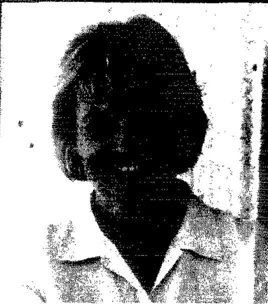
The retiree could then have an ability to take the co-contribution balance as a lump sum (and it should be tax free) with the guarantee levy contributions being used to provide the pension element on retirement.

E. REGIONAL and RURAL

The most significant issues affecting retirement incomes in regional and rural areas, is that, as a general rule, earnings are lower in these areas. Thus the ability to provide a satisfactory level of retirement capital is reduced two fold,

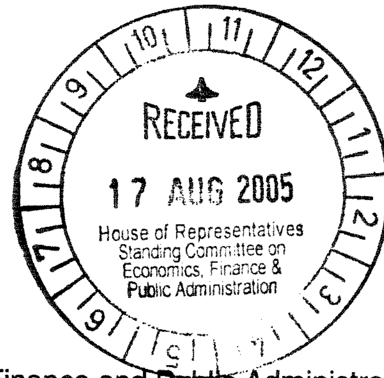
- firstly, the Guarantee Levy contribution is lower, and,
- secondly, the ability of the person to make co-contributions is less.

Access to the required education process and independent advice may be difficult in rural areas. However, with improved communications and the ability of many people to access information through the internet this may not be a serious problem. As mentioned earlier one area that could be reviewed is information available on the internet provided by the government in much the same way as the extensive information is provided by the Tax Office.



SUSSAN LEY MP
Federal Member for Farrer

Attachment A



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Reference: SL/V

16 August 2005

Committee Secretary
Standing Committee on Economics, Finance and Public Administration
House of Representatives
Parliament House
CANBERRA ACT 2600

Dear Secretary

I write to support the attached submission to the Inquiry on *Improving Superannuation Savings – People under age 40*; by a constituent from Albury, Mr Howard Hinde.

I believe this to be an accurate submission highlighting the issues regarding superannuation, especially for people in rural and regional areas; and I recommend the Committee consider the Albury area for a future visit.

Yours Sincerely

The Hon Sussan Ley MP
Parliamentary Secretary (Children & Youth Affairs)
Member for Farrer

Encs