Part 2:
The Superannuation Guarantee

2.1 Benchmarks for retirement income adequacy

ACOSS supports compulsory saving for retirement but believes the present balance between retirement and pre-retirement savings needs is wrong, especially for low income-earners.

Our starting point is the simple proposition that the purpose of long-term saving is to smooth expenditure across the life course. This point seems to have been overlooked in the present debate over the adequacy of the retirement incomes.

In this debate, the wrong questions are being asked to produce the "right" answer: that compulsory superannuation saving should be raised by either 3% or 6% above the present 9% of earnings. This is a one-dimensional discussion about retirement income targets, without reference to the extent to which people should sacrifice current expenditure to achieve them.

The following four questions have not been properly addressed:

(1) What is the minimum level of income required to avoid hardship in retirement?

There is a common assumption that an Age Pension fixed at 25% of average earnings is adequate for this purpose. This is unlikely to be so, especially for private tenants and single retirees who have run down their assets.

The maximum rate of pension is $10,700 per year for single people and $17,800 for couples. The Social Policy Research Centre (SPRC) has developed a set of Low Cost Budget Standards to measure the minimum expenditure level required by various households to avoid hardship. In the case of home-owning retirees, these amount to $12,500 for single people and $17,300 for couples.[38]

(2) Should compulsory saving be sufficient to achieve exactly the same living standard after retirement as that attained through working life, or is it acceptable for retirement living standards to be somewhat lower than those attained over working life?

In other words, should individuals have a choice to target a slightly lower standard of living after retirement (and spend or save more for other purposes)?

Australians have traditionally experienced a reduction in living standards after retirement. Indeed, most retirees still rely predominantly on the Age Pension, currently set at 25% of average earnings. This is insufficient on its own to achieve the standard of living to which most of the next generation of retirees aspire. However, to completely eliminate the gap between pre-retirement and retirement incomes would be over-ambitious.

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[38] DSS (1998) updated to 2002 using the CPI. Note that these are lower than the SPRCs "Modest But Adequate" budgets described below.

This is clearly the case for the "Baby Boomer" generation, who will not receive Superannuation Guarantee contributions over the whole of their working lives. During the long transition period from a system built on the Age Pension towards one that combines the pension and the full Superannuation Guarantee, expectations are rising faster than retirement savings. This is an inevitable transitional problem, though expectations have been raised excessively by some superannuation industry advertising.

Unfortunately, there are no easy "short-cuts" that allow the Baby Boomers to achieve the same retirement income levels as the next generation (those who commence working life after the Superannuation Guarantee is fully implemented). If this is their goal, the Boomers must be prepared to save voluntarily or work longer. To compel them to save more than 9% of earnings to achieve it would be unfair to them. To achieve it through higher tax subsidies would be unfair to the next generation.

The purpose of compulsory saving is to overcome myopia - the failure of most people to plan and save for their long-term futures. This makes sense. However, the current retirement income debate is distorted by the myopia of over-ambitious and arbitrary retirement income targets.

To inject some realism into the debate over retirement income "benchmarks", we should ask how much income people are (or should be) prepared to forego throughout working life to meet their retirement income needs. We should also explain to people that the vast majority of future retirees over the next 40 years will continue to be entitled to at least a part Age Pension.[39]

(3) How should living standards be measured for the purpose of developing benchmarks for the adequacy of retirement incomes?

Clearly, benchmarks based on gross incomes are misleading, since they take no account of taxation, the loss of current income throughout working life due to compulsory saving, nor the steep reductions in the cost of living that normally accompany retirement. For example, most of the present generation of retirees have no dependent children, have paid off their homes, and are no longer employed. Their expenses are much lower after retirement.

(4) What priority should be given to saving for retirement over other long-term savings needs?

The present superannuation system gives absolute priority to saving for retirement. Yet, other lifelong savings needs are becoming more important than was the case in the past. Most couples now need two incomes to achieve a socially acceptable living standard. This means that they increasingly need to save to sustain their incomes during that part of the life course when one partner leaves the paid workforce to care for a child. Home ownership is slipping out of the reach of low and even middle income-earners in our largest cities (and the expense of a first home usually comes at the same time as those associated with young children). A growing number of workers face a future of insecure employment (including bouts of unemployment) unless they upgrade their skills in mid-life.

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[39] Many people of workforce age apparently believe that the Age Pension will not be available to them when they retire, because the "Government won't be able to afford it." This is the regrettable outcome of public debate over the future affordability of the Age Pension in the early 1990s, brought about to justify the decision to introduce the Superannuation Guarantee. While the future affordability of health, and welfare benefits and services is a legitimate issue for Governments to raise, this example demonstrates the need for Governments to argue their case with caution and avoid exaggerating the problems. Alternatives to cutting back on benefits and services (including raising workforce participation, birth rates, and taxation) should also be fully explored and debated.

Significantly, two of these long-term savings needs - child rearing and further education and training to forestall mature-age joblessness, are critical to any rational public policy response to the ageing of the population.[40] Yet an implied assumption of the present retirement income debate is that the only contribution that superannuation policy can make to reducing "age dependency" is to boost compulsory saving for retirement in order to ease Age Pension and public health costs (see box below). This is one-dimensional thinking.

Compulsory retirement saving: a salve for population ageing?

The non-existent "Age Pension funding crisis"

One of the main arguments for the introduction of the Superannuation Guarantee in 1992 was that in the absence of compulsory retirement saving, the future cost of the Age Pension might not be unsustainable.[41] Such were the fears of a pension "crisis" at this time that a growing number of the general public was convinced that the pension would no longer be available for them in their retirement. That view persists to this day, notwithstanding the fact that over the next 40 years, the vast majority of retirees will receive at least a part-pension under current rules.

The reality was, and is, that growth in Age Pension expenditure in Australia will be modest by international standards over the next 40 years. This is due mainly to its low rate, and means testing. This is acknowledged by the OECD and by the *Intergenerational Report* released with this year's federal Budget Papers. That report estimates that over the next 40 years, the cost of Age and Service Pensions will rise by around 1.7% of GDP - which is just 60% of the average increase in OECD countries.[42]

According to Treasury's Retirement and Income Modelling Group, the Superannuation Guarantee is projected to reduce future Age Pension costs by less than 0.5% of GDP in any event.[43] In other words, the Superannuation Guarantee will have only a small impact on a modest problem. Its most important role is to improve future retirement incomes - not to avert an Age Pension affordability crisis. (continued over page)

[40] McDonald & Kippen (1999), McDonald (2001), OECD (1998).
[41] Dawkins (1992).
[42] Costello P (2002), OECD (1996).
[43] Cited in Fitzgerald V (2002), p10.

Compulsory retirement saving and population ageing (continued)

The new "health funding crisis"

The focus of fiscal concern has now shifted to future health and aged care services. The *Intergenerational Report* estimates that these will rise by 5.2% of GDP over the next 40 years. These and similar projections by other researchers have prompted calls for the extension of the Superannuation Guarantee to insure against people's health and care costs in old age.[44]

Given our experience of the "Age Pension crisis" debate of the early 1990s, we should tread warily here. To begin with, a close inspection of the *Intergenerational Report's* projections reveals that only 1.9% of the above 5.2% of GDP increase in health and age care costs is driven by demographic change. The other 3.3% is mainly the result of an assumption that increases in the costs of medical and pharmaceutical benefits since 1983 will persist over the next 40 years. These cost increases, which include the introduction of Medicare in 1984 and the Health Insurance Rebate in 1998, affect the whole population, not just older people. Further, they might not persist over the next 40 years.

Nevertheless, health and aged care costs are likely to rise substantially over the next 40 years, due in part to the ageing of the population. Debate over how this might be financed is therefore welcome.[45]

A system of compulsory health insurance through superannuation is unlikely to be the fairest and most efficient way to address future health care costs. If people are forced to save to meet these costs, it is inevitable that future Governments will take the opportunity to claw back part of *their* costs through user charges. In other words, to a large extent, people would be forced to save to improve the Federal Budget bottom line rather than their own health. This is likely to occur if overall levels of compulsory retirement saving are substantially raised, whether or not the additional saving is earmarked for health purposes.

Requiring individuals to meet a greater share of their own future health services is not necessarily an inequitable policy. However, Australia has a strong tradition of universal publicly-funded health care services (for example, in public hospitals) and benefits (for example, Medicare and the Pharmaceutical Benefits Scheme). So far, these policies and institutions have served us well. Our health care services are sound by OECD standards, universal service provision gives people a greater sense of security that their basic health care needs will be met, and access for low income-earners to basic health care services is relatively good[46]. At the same time, Australian Governments spend much less on health (in proportion to GDP) than in countries such as the United States that rely more heavily on user charges and insurance-based financing of health services.

Moreover, there are other ways to finance future health and aged care provision, including an increase in taxation and/or a tax levy along the lines of the current Medicare Levy.[47] Given Australia's relatively low taxation levels (in proportion to GDP) there is scope to pursue this alternative without undermining economic competitiveness. Our experience with the Medicare Levy suggests that this might also attract public support.

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[44] Fitzgerald V (2002).

[45] ACOSS has not at this stage developed a detailed position on these issues.

[46] The exceptions, such as dental care, prove the rule. For example, dental care is mainly financed by fee for service and voluntary health insurance. Access to these services is poor for low income earners.

[47] Saunders P (1995).

Instead of acknowledging these competing long-term savings needs, advocates of higher compulsory saving for retirement often treat them as "barriers" to an adequate retirement income. Accordingly, if workers leave employment for a number of years to raise children or to improve their education, they emphasise the risk that these workers might fail to achieve an (arbitrary) retirement income target.

Viewed from this perspective, the solution is to increase the level of compulsory retirement saving during the time when they are employed. Again, this is one-dimensional thinking. It overlooks the hardship experienced by many people who leave or lose their jobs, and their need to save in anticipate of these risks. It also ignores the important role of investments in physical or human capital (such as a home or further education) in improving retirement living standards.

2.2 Comparing pre and post-retirement living standards

A good starting point for informed debate over retirement income needs is reliable data comparing future retirement *living standards* (as distinct from gross or disposable incomes) with those attained over working life. We examine below the outcomes of two studies, by the Retirement and Incomes Modelling Group in the Treasury (RIM, 1999), and the National Centre for Social and Economic Modelling (NATSEM, 2002).

Retirement and Income Modelling group study

In a 1999 study, the Retirement and Income Modelling Group (RIM) within the Federal Treasury compared projected retirement and pre-retirement incomes for people on various wage levels who receive Superannuation Guarantee contributions only, throughout working life. Significantly, the measure of living standards used was "potential expenditure" rather than gross income. This took account of taxation, the loss of earnings due to superannuation contributions and the Age Pension, and assumed a full draw-down of savings after retirement.[48] A selection of the results is presented in Table 3 below[49].

It should be noted that these hypothetical examples are not representative of the whole population. Some of them, especially the first two rows of couples, are unrealistic. For example, the "average" income-earning couples in which each partner receives average earnings over working life are actually high-income households.[50]

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[48] We refer to "potential expenditure" as "income" in the following summary of outcomes.

[49] Tinnion & Rothman (1999). The assumptions used in these examples are that working life is either 40 or 35 years commencing in 1997 (apart from the last case in which women leave the paid workforce for a period to care for children); only Superannuation Guarantee contributions are made; and half the retirement benefit is taken as a lump sum with the other half taken as a complying pension. Both the Age Pension and superannuation benefits are taken into account, but not any voluntary saving outside superannuation.

[50] The vast majority of couples of workforce age earn less than twice average earnings because married women generally earn about half their husband's income. Therefore, the first two rows of "middle income" couples in the table are actually high income-earners.

Table 3

Retirement income as a proportion of pre-retirement income

Household type	Low income (half average earnings)*	Middle income (average earnings)*	High income (twice average earnings)*
Single person			
With 40 years' Superannuation Guarantee contributions	126%	94%	73%
With 35 years' Superannuation Guarantee contributions	111%	78%	56%
Couple			
Both with 40 years' Superannuation Guarantee contributions	110%	78%#	64%
Both with 35 years' Superannuation Guarantee contributions	88%	65%#	49%
Husband with 40 years' contributions, wife with 36 years[51]	116%	86%	65%

Source: Tinnion & Rothman (1999).

* This amount each in the case of couples, except for the last row (where the wife receives half average earnings).
# These couples are actually high income-households since they earn twice average earnings between them.
Note: average full-time ordinary-time earnings in February 2002 were $43,000.

Broadly speaking, the outcomes of the study were as follows:

- For *low income-earners*, the 9% Superannuation Guarantee overshot the mark.[52] Most low income-earners achieved *higher* incomes after retirement than those previously attained. Their income replacement rates[53] after retirement were around 110-120%.
- *High income-earners* attained much lower incomes after retirement than they previously enjoyed. Their income replacement rates were around 50-70%. However, their *absolute* incomes in retirement were significantly higher than the other groups and adequate from a community standpoint.[54] Further, they are well placed to top up their compulsory saving with voluntary saving (which was not modelled by RIM).
- Those on *average earnings* achieved replacement rates of around 80%-90%, which on the face of it seems adequate if we accept that people with compulsory savings only will still experience a modest reduction in their living standard after retirement.[55]

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[51] In this case, the wife receives half average earnings and is employed part-time for 4 years.

[52] Fitzgerald (1994).

[53] That is, average annual income after retirement divided by average annual income through working life.

[54] For example, the high-income couples receive 2.75 times the Age Pension, or around $50,000 per year.

[55] The couples on average earnings with 35 years' of contributions do not attain these replacement rates, but note our comment above that these are not actually "average" income couples.

NATSEM study

The above analysis, and all previous studies, are limited by the fact that people's expenditure requirements before and after retirement are not taken into account. Clearly, a retired couple with no dependants who own their home outright can achieve the same living standard on a much lower income, as a couple with two children paying off their mortgage.

An important study published this year by NATSEM for CPA Australia and Tower Financial Services, attempts to fill this gap.

The NATSEM study uses a set of *Budget Standards* developed by the Social Policy Research Centre to compare the basic expenditure needs of different types of households. These Budget Standards are based on expert assessments of the expenditure required to achieve a "Modest but Adequate" standard of living: that is, to live in modest comfort with few luxuries, according to contemporary Australian standards. They take account of a wide range of expenses including the costs of children, housing costs, food, leisure, and so on. The budgets vary in accordance with household size and other needs.

By way of example, the Modest but Adequate Budget Standards in 2001 for home-owners with no dependants were $13,260 per year for singles, and $19,500 per year for couples.[56]

The use of these Budget Standards enables NATSEM to compare:

- retirement living standards with the "Modest but Adequate" benchmarks;[57]
- retirement living standards with their average living standard over working life.

Table 4 below shows a selection of the study's "base case" results. [58] Again, it should be noted that these hypothetical examples are not representative of the whole population, though they are much more realistic than those used in the RIM study.

The low, middle and high incomes in the table refer to the average incomes attained over working life by a person with high school education only, a trade certificate or diploma, and a degree, respectively. Therefore, these groups are not equal in number. In particular, the high-income group would be much smaller in number than each of the other two groups. Further, not all income groups are represented.

The family types refer to family status during working life. That is, the single males and single females never marry and the couples with no children never have children. Therefore, these groups are not equally divided. In particular, the number of couples who have two children at some stage during working life is likely to be larger than the other groups. The number of couples who have no

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[56] Note that these figures, taken from the NATSEM study, are slightly less than the SPRCs Modest but Adequate budget standards, since they exclude certain non-discretionary housing costs (which are taken into account separately by NATSEM).

[57] The Modest but Adequate Budget Standards have also been used by ASFA as a benchmark for retirement income adequacy. See ASFA (1998).

[58] This is based on the following assumptions: that the full 9% Superannuation Guarantee is contributed over a working life of 40 years (less than this for female partners in families with children); and half the benefit is taken as a lump sum and half as a complying pension. The Age Pension is taken into account in addition to superannuation benefits, but not any voluntary saving outside superannuation. Earnings rise throughout working life (except for those of mothers) in accordance with "average" earnings for individuals with different skill levels - that is, high school education only (low income), trade certificates or diplomas (middle income), and degrees (high income).

children throughout working life is likely to be relatively small. Therefore, adding the results for each of these groups together will not give an accurate picture of "average" retirement living standards across the population.

Table 4:

Retirement living standards: Compared with Modest but Adequate Budget Standards and pre-retirement living standards

Household type	Low income	Middle income	High income
Single male	($32,000 per year)[59]	($37,200 per year)	($53,600 per year)
Retirement living standard as a % of Budget Standard	163%	172%	187%
Retirement living standard as a % of pre-retirement standard	116%	108%	84%
Single female	($26,900 per year)	($32,100 per year)	($45,300 per year)
Retirement living standard as a % of Budget Standard	138%	146%	161%
Retirement living standard as a % of pre-retirement standard	116%	104%	84%
Couple (no children)	($55,100 per year)	($65,700 per year)	($96,100 per year)
Retirement living standard as a % of Budget Standard	170%	176%	193%
Retirement living standard as a % of pre-retirement standard	96%	85%	65%
Couple (2 children)[60]	($50,000 per year)	($61,300 per year)	($92,500 per year)
Retirement living standard as a % of Budget Standard	162%	171%	188%
Retirement living standard as a % of pre-retirement standard	118%	104%	79%

Source: NATSEM (2002)

[59] Average annual income over working life for each household type, in year 2000-01 dollars. Thanks to NATSEM for this additional information, which is not published in their report.

[60] Assuming the mother withdraws from the paid labour force for 4 years after birth of first child, and for 2 years before retirement, in low and middle-income families. In all 3 examples they are employed part-time for a period after their children are born.

These results can be summarised as follows.

Compared with the *Modest but Adequate Budget standards*:

- All groups achieved at least this standard, and this still applied if working life was reduced from 40 to 35 years[61] (though not if it was reduced further to 30 years)
  - In fact, all groups achieved at least one-and-a-half times this standard except single females (who were presumably handicapped by relatively low wage levels), those where the main breadwinner worked for less than 40 years, and those with relatively low superannuation fund earnings rates.

Compared with *their pre-retirement living standards*:

- The *low-income* groups attained a *higher* living standard in retirement (110-120% of pre-retirement standards), except couples without children whose living standards fell marginally (because their pre-retirement living standard was relatively high due to the absence of children).
  - Where the low-income groups worked for 35 years instead of 40, they attained a retirement living standard of 70-80% of their pre-retirement standard (lower for couples without children).
- The *high-income* groups attained a *lower* living standard in retirement (around 80% of pre-retirement standards, less for couples without children).
  - Where the *high-income* groups worked for 35 years instead of 40, they attained a retirement living standard of 50-60% of their pre-retirement standard (lower for couples without children).
- The *middle-income* groups attained a *higher* living standard in retirement (around 100-110% of pre-retirement standards), except couples without children whose relative living standards were once again lower.
  - Where the *middle-income* groups worked for 35 years instead of 40, they attained a retirement living standard of around 70% of their pre-retirement standard (lower for couples without children).

One caveat on the above findings is the fact that the Modest but Adequate Budget Standard does not take account of the higher health and aged care costs faced by many retired people. When NATSEM attempts to take these costs into account, the retirement living standards of all groups fall slightly (hence the ratio of retirement to pre-retirement living standards also falls slightly). On the other hand, they also note that the costs of children are only taken into account up to age 16. Taking the costs of supporting older children into account would marginally reduce the pre-retirement living standards of couples with children, and therefore marginally increase the ratio of retirement to pre-retirement living standards in those examples.

[61] The outcomes for shorter periods of working life are not shown in this table. Outcomes for these and other scenarios are detailed in an Appendix to the NASTEM study.

Overall, this study suggests that for both low and middle income-earners, the Superannuation Guarantee *overshoots* the mark. The exception is the minority group of couples who never have children. The reason they fail to attain their previous living standard after retirement is that their pre-retirement living standard is higher due to the absence of children. Presumably this group, along with high income-earners, has a greater than average capacity to save voluntarily for retirement.

High income-earners generally attain a *lower* living standard post-retirement than that to which they were accustomed during working life. However, as noted above their retirement living standards are well clear of the Modest but Adequate benchmarks, and they are in the best position to save voluntarily for retirement.[62]

Retirement living standards are significantly lower where individuals are employed for less than 40 years. However, 40 years is a reasonable benchmark for future projections for males, and for females without children.[63] Over the past decade, workforce participation rates among mature age people (50-65 years) have stabilised, while those of mothers have continued to rise. As the population ages and the health of mature-age people improves, the workforce participation rates of these two groups can be expected to rise steadily.[64] Moreover, public policy is now discouraging early retirement, as evidenced by the gradual increase in the superannuation preservation age to age 60 (though this should be accelerated).

In this context, we acknowledge the fact that employment is becoming less secure for many people, especially low-skilled workers. However, as argued above the policy implications for superannuation are not clear-cut. In our assessment, these trends call for greater support for long-term saving for contingencies *other than retirement*, including unemployment and further education and training. Low paid workers in insecure jobs face a high risk of poverty during their working lives. They should not be required to sacrifice more of their future wage increases to boost their retirement incomes.

2.3 An assessment of the Superannuation Guarantee

The NATSEM research is a major advance on previous studies of retirement income adequacy. A study along these lines should have been conducted in the early 1990s *before* the Superannuation Guarantee was introduced, to inform public debate over the appropriate level of compulsory retirement saving.

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[62] Where they save an extra 3% as employee contributions, the high-income groups apart from couples without children attain 100% of their previous living standard.

[63] Note that the "base case" scenarios in the NATSEM study take account of the temporary withdrawal of mothers from the paid workforce to care for children, which means that 40 years of paid employment is still not a typical pattern for married women and sole parents.

[64] One important reason for this is that, all things being equal, a labour shortage will emerge.

More research is needed to establish the adequacy of retirement incomes attained through the 9% Superannuation Guarantee and Age Pension. A model of pre and post retirement *living standards* (as distinct from incomes) that covers the majority of the population is needed, to overcome the limitations of the small sets of hypothetical case studies used in the NATSEM study and others. Trends in voluntary long-term saving should also be taken into account, both within and outside superannuation.

More importantly, research is needed to identify and quantify other long-term savings needs, especially "life-cycle" savings needs such as child rearing, home ownership, and further education and training.

However, there is sufficient information available for us to make the following provisional assessment of the Superannuation Guarantee, and indicate broad directions for reform:

- A compulsory retirement savings system is necessary to ensure that future generations achieve an adequate income in retirement. This should be its main objective. Easing future Age Pension and other fiscal costs should be a secondary consideration.

- The 9% Superannuation Guarantee saving requirement is close to the mark (though slightly too high for middle income-earners) but overshoots the mark in respect of low income-earners.[65]

- Although the Superannuation Guarantee fails to achieve comparable levels of income replacement for high income-earners, this is not an appropriate role for a compulsory savings regime. The Superannuation Guarantee nevertheless provides high income-earners with a decent absolute living standard in retirement, and they are in a strong position to save voluntarily to improve income replacement levels after retirement.

- It would be impractical to set different Superannuation Guarantee contribution rates for different groups in the population. The foregoing points suggest that the compulsory retirement savings requirement should be somewhat less than 9% of earnings.

- There is a strong case for broadening the scope of compulsory saving, and taxation support for saving, to long-term savings needs other than retirement. These long-term savings needs include home purchase[66], income maintenance while a parent withdraws from the paid workforce to care for a child, further education and training, and for low wage-earners the purchase of necessary assets such as cars and refrigerators (to help them avoid excessive debt levels).

- Any such *long-term savings system* should be flexible enough to take account of the wide variations in long-term savings needs and the inability of Governments to accurately predict trends in future savings needs. If long-term savings for different purposes are quarantined into separate accounts, the system would be costly to administer and insufficient savings would accumulate within each account.

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[65] In respect of middle income-earners, this assessment is based on a presumption that a reasonable retirement income target for the *compulsory* savings system would result in a modest reduction in living standards after retirement. Those who wish to maintain *exactly the same* living standards after retirement as those enjoyed during working life (or more) could save voluntarily.
Low income-earners are disadvantaged by the present superannuation system in three ways: they are forced to set aside an excessive proportion of their limited earnings for retirement, they receive little taxation support for this, and a large part of the resulting increase in their retirement income is clawed back under the Age Pension income test.

[66] Real estate Institute of Australia (1996).

- Ideally any system of *compulsory saving* for needs other than retirement should be integrated with the retirement savings system, to give individuals the option to either draw down part of their superannuation savings for purposes other than retirement, or to devote all of their compulsory saving to their retirement.

- An integrated system of *taxation support* for long-term savings would ensure that the overall level of public support for long-term saving is equitably distributed. Otherwise, high income-earners could "double dip" on tax support for saving for retirement and other long-term savings systems. The cost to revenue could be prohibitive.[67]

- If an integrated system of compulsory long-term saving were established along these lines, there would be case for raising the Superannuation Guarantee level above 9%, provided the proportion of earnings required to be set aside for retirement purposes does not exceed 9%. As argued above, it should be slightly lower than 9% - especially for low income-earners.

- On the other hand, those savings that *are* earmarked for retirement purposes should be more strictly preserved for that purpose, by accelerating the proposed increase in the preservation age to 60 years and prohibiting large lump sum retirement benefits. This is necessary to discourage early retirement, and to improve the efficiency of the retirement savings system in maximising retirement incomes. These measures, though long sought by the superannuation industry, are likely to be resisted by many people approaching retirement age. Allowing people to withdraw a part of their compulsory savings for purposes other than retirement (within in a carefully structured long-term savings system) could ease resistance to these necessary reforms.

2.4 An integrated Lifelong Savings System

ACOSS proposes that the present superannuation system be broadened to embrace a wider range of long-term savings needs. This integrated *Lifelong Savings System* would have two components:

- compulsory long-term saving;

- taxation support for compulsory saving, and a modest level of additional voluntary saving (along the lines described in Part 1 of this submission).

The proposed system would have following key features. It should be noted that the amounts used below (the Superannuation Guarantee level, and the ceilings on pre-retirement and post-retirement lump sum benefits) are illustrative only:

1. Compulsory savings would be held in approved Lifelong Savings Accounts operated by a range of superannuation and financial institutions.

2. Voluntary savings could be added to these accounts.

[67] When tax concessions for retirement saving and other long-term saving purposes sit side by side, high income-earners are the most likely group to take advantage of both. Only an integrated system can effectively cap the overall level of tax benefits available to high income-earners.

3. Two-thirds of compulsory savings would be preserved until age 60 for retirement purposes (with earlier access under special circumstances), with lump sum benefits either limited to around $100,000 or taxed at a penal rate above that level.[68]

4. The remaining one-third would be available for use *for any purpose* after five years of saving. This would, however, be subject to a limit on the frequency of withdrawals and an overall ceiling on pre-retirement benefits of around $50,000[69] throughout working life.

   Fund members, not Governments, should decide the purpose for which pre-retirement withdrawals will be used. This would ensure that the system is responsive to individual needs. It would also avoid the need for Government to prescribe an appropriate list of "approved" long-term savings objectives and to enforce this (impossible tasks in any event). The proposed ceilings on the frequency and overall level of withdrawals would limit the scope for withdrawals for "frivolous" purposes.

5. To enhance retirement savings, the above ceiling on lump sum retirement benefits could be reduced, dollar for dollar, by any withdrawals from the account before retirement. For example, if $25,000 were withdrawn for a home deposit, the ceiling on lump sum retirement benefits would be reduced from $100,000 to $75,000.

6. Subject to the introduction of the above life-long savings system, the overall level of compulsory saving could be progressively raised to around 12% of earnings. This would mean that a *minimum* of 8% of earnings (two-thirds of 12%) is devoted to saving for retirement. However, *ACOSS would not support an increase in the level of compulsory Superannuation Guarantee contributions devoted exclusively to retirement saving purposes.*

   The suggested $50,000 flat lifetime ceiling on pre-retirement benefits means that the proportion of earnings earmarked compulsorily for retirement would effectively be *lower* for low income-earners than for high income-earners.[70] This is consistent with evidence that the present compulsory retirement saving requirement overshoots the mark for this group.

7. The Long-term Savings Rebate outlined above would apply to compulsory and voluntary contributions to approved Long-term Savings Accounts, without discrimination as to the purpose for which these funds are saved.

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[68] This is around the current tax-free threshold for lump sum benefits. It would be indexed to movements in average earnings.

[69] This is half the limit for lump sum retirement benefits in point 3 above. This would also be indexed to movements in average earnings.

[70] In the case of low income-earners, it could be 8% throughout working life. This slightly lower level of compulsory saving for retirement is unlikely to have a dramatic impact on their retirement incomes, due to the large "claw-back effect" of the Age Pension income test. See, for example, the estimated effect of early access to superannuation for housing purposes as modelled by RIM in Treasury (1997).
In the case of middle income-earners, it would be unlikely to fall below 9%, due to the interaction between the flat $50,000 limit on pre-retirement withdrawals and a compulsory saving requirement of 12% of earnings. The same applies to high income-earners. It should be noted that their Superannuation Guarantee saving requirement is effectively capped at around $9,000 per year under the existing system. A similar cap should probably apply if their compulsory saving requirement increases to 12% of earnings. Otherwise they could be forced to save much more than they need for an adequate retirement income.

If the Superannuation Guarantee compulsory saving requirement is raised to 12% of earnings, the annual cap on the Long-term Savings Rebate would also increase, eventually reaching 15% of average weekly ordinary-time earnings. This would ensure that all compulsory savings by or on behalf of a worker on an average wage or less would be concessionally taxed, together with a modest tax incentive for voluntary saving (equal to 3% of earnings for an average wage-earner).

8. The tax treatment of fund earnings and benefits would be consistent with the proposals outlined in Part 1 of this submission, except that benefits withdrawn prior to retirement within the $50,000 lifetime "cap" in point 4 above would be tax free.

The proposed Lifelong Savings System would help meet people's needs to save for purposes other than retirement without undermining retirement savings overall. It would give people - especially low income-earners - greater flexibility in the use of their savings within sensible limits. It would help create a savings culture in place of a debt culture.

If this system is implemented, careful attention should be paid to transitional arrangements. Phased implementation is desirable to avoid any sudden reduction in superannuation savings at the time when fund members are given the option to use them for non-retirement purposes.

Once it is phased in, the above package should *raise* overall levels of private saving *and* retirement saving. Reductions in savings due to the use of superannuation for non-retirement purposes should be offset, in overall terms, by the increase in Superannuation Guarantee contributions, the higher preservation age, and tighter lump sum benefit rules. Retirement savings for low income-earners may be reduced, but this is appropriate given that the Superannuation Guarantee overshoots the mark in their case.[71]

Its cost to public revenue should be modest since the proposed Long-term Savings Rebate would be capped and savings would be made in wasteful tax concessions for high income-earners. The suggested increase in compulsory Superannuation Guarantee contributions would probably account for the bulk of any increased cost to public revenue arising from these proposals over the medium term.[72] This feature of the proposed lifelong savings system is common to a number of proposals from other organisations for reform of superannuation. However, in the proposed system, superannuation tax concessions would be more efficiently targeted to improve long-term saving.

Further, the lifelong savings system would be much less costly than the introduction of a separate system of tax concessions for long-term saving for non-retirement purposes, along the lines of that in the United Kingdom.

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[71] On the other hand, the more generous tax treatment of their contributions proposed in Part 1 of this submission might offset all or part of any reduction in their retirement benefits.

[72] This would be due to the increased cost of superannuation tax concessions, at least until benefit payments exceed contributions due to the retirement of the Baby Boomers.

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Attachment A

Should superannuation be taxed on an income or expenditure basis?

Some commentators argue that superannuation should only be taxed at the benefits end, and that contributions and fund earnings should be tax-free.[73]

One argument for this change is that Australia is "the only country that taxes superannuation three times".[74] While it is true that most OECD countries do not tax contributions or fund earnings, it is also the case that superannuation in most countries has evolved differently to that in Australia. In most other OECD countries, superannuation historically took the form of publicly-run social insurance schemes in which benefits were defined as a percentage of previous earnings (usually with a minimum publicly sponsored "floor"). It is not surprising that the tax treatment of these schemes focussed on end benefits.

Arguments that we should follow the trend in overseas countries are not convincing, nor is the argument that superannuation is taxed "too many times". Earnings invested in bank deposits are taxed twice (as earnings and as bank interest) yet this is consistent with income tax principles. From the standpoint of the level of end benefits and the equity and integrity of the tax system, it is the *amount* of tax paid and how the tax take is distributed across the population that matter, not the *number of times* it is taxed. From this standpoint, it is clear that the current flat 15% taxes applying to employer contributions and fund earnings are very generous towards high income-earners and not generous at all to those on low incomes.

Taxation principles

A more useful approach to resolving this debate is to apply basic tax principles to the taxation of superannuation. From this standpoint, there are two alternative approaches available:

- The *income tax model*, in which personal earnings and fund earnings are taxed according to the progressive income tax scale. This is akin to the current tax treatment of bank deposits as described above.

- The *expenditure or consumption tax model*, in which employee earnings invested by their employers in superannuation are tax free, personal contributions are deductible, fund earnings are tax free, and end benefits are taxed using the standard progressive income tax scale.

In theory it makes little difference *over a person's lifetime* which of these approaches is adopted, since we spend all of our income, apart from inheritances. The difference is purely a matter of timing. In practice, the timing of taxation is very important. The expenditure tax model gives high income-earners substantial *tax deferral* advantages over other tax-payers[75]. It further benefits these and other tax-payers by levying tax at a time when their incomes are lower (after retirement).[76]

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[73] Knox (1996), Fitzgerald (1995), ASFA (1998).

[74] ASFA (1998).

[75] Since they have a greater capacity to save.

[76] Goode (1975) and Bascand J (1989) provide a fuller theoretical discussion of the nature of "pure" income and consumption tax treatment, respectively.

Consequently, it would raise substantially less revenue in current dollars than income tax treatment.

On these grounds, an expenditure tax system that is equitable across people's lifetimes and collects the same amount of revenue in current dollars should have the following features:

- marginal tax rates on end benefits should be higher than the standard rates, to take account of the fact that tax is being levied at a time when incomes are generally much lower;
- an inheritance tax should be levied (so that the benefits of tax-free savings are not unfairly passed on to the next generation).[77]

Claimed advantages of expenditure tax treatment

Advocates of expenditure tax treatment for superannuation argue that is has the following three advantages over income tax treatment:

(1) The tax-free treatment of contribution and fund earnings would boost private saving.

Despite substantial research and academic debate over the effects of different tax treatments on long-term saving, this remains an area of controversy.[78] In theory, a reduction in taxes on contributions and fund earnings could either boost saving (due to a tax incentive effect) or reduce it (because people can reach pre-determined savings targets with smaller contributions, if tax is reduced). The empirical evidence points to some incentive effects from tax concessions for saving, but these appear to be small. Moreover, tax concessions for specific savings vehicles such as superannuation displace other private savings, as people shift their savings into tax preferred vehicles.[79] At the same time, tax concessions reduce *public* saving levels, so their effect on *national saving* levels is unclear.

For many years until the 1980s, the tax treatment of superannuation in Australia approximated the expenditure tax model. Employer contributions were not taxed, generous deductions applied to personal contributions, and fund earnings were not taxed. Yet the majority of wage earners invested little or nothing in superannuation. This is in sharp contrast to the increase in contribution levels and coverage that accompanied the introduction of the Superannuation Guarantee.

(2) The higher taxation of end benefits would relieve fiscal pressure on future Governments as the population ages.

The *Intergenerational Report* in this year's Federal Budget Papers suggests that, all things being equal, Federal Government expenses will increase by 5% of GDP by the year 2040. However, only 2% of this increase is due to population ageing (the remainder is due to more generous public support for health care services and pharmaceuticals for the population generally). Moreover, this assumes that there is no increase in the workforce participation rate in response to the anticipated labour "shortage". The Report notes evidence from the OECD that Australia is relatively well placed to weather the fiscal cost of an ageing population.

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[77] An alternative approach would be to strictly quarantine superannuation savings so that they can only be used for retirement (preferably in the form of an actuarially-determined pension with no draw-downs apart from regular fortnightly payments). On the death of the retiree, unused benefits could revert to a surviving spouse (but there would be no transfers of superannuation assets to children). However, the payment of such a pension would create space for high income-earners to devote a greater share of their non-superannuation investments to bequests.

[78] American Economic Association (1997). Engen, Gale & Sholtz (1994), Freebairn (1999).

[79] Gravelle J (1991), Smith R (1990), Gallagher P (1996).

It should be noted that the current system taxes superannuation benefits, although this tax treatment (like that of contributions and fund earnings) is highly concessional.

There is a strong case for the prohibition or penal taxation of large lump sums, to stem "leakage" of retirement savings under the present system. An accelerated increase in the preservation age to 60 years is also necessary to discourage early retirement. Both these measures would help reduce the future budgetary cost associated with the ageing of the population.

However, any attempt to substantially increase benefits taxes across the board faces huge political obstacles.

An example illustrates this point. In 1983, at a time when (as described above) contributions and fund earnings were substantially free of taxation, the previous Government sought to increase the highly concessional tax rates that applied to superannuation lump sums (at that time, only 5% of a lump sum retirement benefit was brought to tax). This triggered an air pilot's strike and an electoral backlash among mature age people in the 1984 Federal Election.

Even after these changes were made, the tax treatment of the post-1983 component of lump sum benefits is highly concessional. A tax free threshold of $106,000 applies, and amounts above this are taxed at either 16.5% or 31.5%, unless the very generous Reasonable Benefit Limit ($529,000) is breached.

Any attempt to apply the ideal expenditure tax treatment outlined above (with a high marginal tax rate schedule to compensate for the tax deferral benefits if contributions and fund earnings are untaxed) would founder politically. The coming generation of retirees will wield considerable political influence and they are not likely to stick to a pact with any present-day Government that removes taxes on contributions and fund earnings in returns for high taxes on benefits.

(3) Expenditure tax treatment "smooths" the effects of variations in income across a person's working life on end benefits (for example, some people might have low incomes for most of their working life, then boost their savings later on when their incomes are much higher).

From a lifelong perspective, this argument makes sense. Under income tax treatment, the same end benefit could be taxed very differently according to the timing of contributions. However, such inequities are not likely to be substantial. With the exception of periods out of the workforce for study and child rearing purposes, most people who have above-average incomes for their age group now are likely to have above-average incomes over their working life. For example, a person earning $80,000 at age 50 is unlikely to have had a *lower-than-average* income across his or her working life as a whole. Unfortunately there is little or no longitudinal survey data available in Australia to test this proposition.

Nevertheless, this disadvantage of income tax treatment of long-term savings from an equity standpoint is probably more than offset by the fact that expenditure tax treatment offers high income-earners substantial tax deferral benefits that are not available on the same scale to people on lower incomes. From an equity standpoint, the *timing* of taxation is very important.

Practical difficulties

Expenditure tax treatment of superannuation is theoretically attractive. However, in practice:

- It is not at all clear that this would boost the overall level of voluntary saving.
- Equitable expenditure tax treatment would require politically unsustainable levels of tax on end benefits, together with a tax on inheritance.

Pure income or expenditure tax treatment for superannuation is probably unattainable in Australia. However, both equity and economic efficiency could be improved if the present system was reformed so that it more closely approximates one of these models.

Any major shift towards expenditure tax treatment that does not tax end benefits appropriately (as described above) would seriously jeopardise equity in return for uncertain efficiency gains.

Perhaps the most critical practical difficulty is that the removal of taxes on contributions and fund earnings would deprive present day Governments of substantial tax revenues - an amount of $4.3 billion in 2001-02.[80] This is more than the present Federal Government contribution to the financing of the higher education sector.

Advantages of income tax treatment

On the other hand, a shift towards income tax treatment would have the following benefits:

- more equitable tax treatment in each year and (probably) over the life cycle;
- a strengthening of the integrity of the personal income tax system against salary sacrifice arrangements;

It is also possible to support and encourage long-term saving by taxing savings concessionally within an income tax framework. We now turn to this last point.

Encouraging long-term saving within an income tax framework

Concessional tax treatment for superannuation savings is unlikely to have a substantial impact on overall private saving levels, once the effects of shifting of savings into superannuation from other vehicles is taken into account. However, it is likely to have some impact on the margin. That impact will be maximised if the concessions are transparent and well-targeted.

Moreover, there is a strong case (as we argue in the body of this submission) for compensating wage earners for the loss of disposable income over the short and medium term arising from compulsory saving under the Superannuation Guarantee. It is widely acknowledged that low income-earners (those with the least capacity to save and the lowest superannuation saving rates prior to the Guarantee) were the worst affected by this measure.

Well-targeted tax concessions to support compulsory saving and encourage voluntary saving are feasible within an income tax framework.

Targeting is important. Policies that compel or encourage low and middle income-earners to save are more likely to boost the overall level of private saving than incentives directed towards high income earners.[81] The reason for this is that high income-earners are much more likely to save in the absence of encouragement from Government than low or middle income-earners. Therefore, concessional tax treatment for the savings of high income-earners involves large deadweight costs for Governments. That is, the foregone tax revenue has little net impact on the saving behaviour of this group, except to shift savings towards tax-preferred vehicles such as superannuation.

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[80] Federal Budget Paper No 1 (2002-03).

[81] Fitzgerald & Harper (1992).

Transparency is also important. Most tax-payers are not aware of the fact that the flat 15% contributions tax delivers $5 billion worth of tax subsidies to tax-payers who sacrifice salary for superannuation (both compulsorily and voluntarily). A more transparent tax subsidy *at the contributions end* should yield a higher increase in voluntary saving per-dollar of revenue foregone.

Concessional income tax treatment is the fairest and most efficient way to support and encourage superannuation saving. A simple, transparent tax rebate for contributions that is targeted towards low and middle income-earners is the most appropriate vehicle to achieve these objectives.

Attachment B: Present taxation treatment of superannuation[82]

1. Contributions

Employer contributions

Employer and tax deductible personal contributions are included in a complying superannuation fund's income and taxed at a nominal rate of 15%.

Contributions to complying superannuation funds are fully tax deductible to employers up to the age based deduction limits, for 1999-2000 set out below:

Table 4: Deduction Limits

Age of employee	Deduction limit
Under 35	$11,912
35 to 49	$33,087
50 and over	$82,054

Rebate on personal contributions by a low income-earner

An employee who receives any form of employer superannuation support (but is not a 'self employed person') is entitled to a tax rebate of up to $100 for personal contributions made to a complying superannuation fund, provided the employee's assessable (ie, gross) income is less than $31,000. The tax rebate is 10% of the lesser of: $1,000 reduced by 25 cents for each dollar of the taxpayer's assessable income over $27,000 or the amount of the contribution actually made. These amounts are not indexed.

Rebate on contributions for a low income spouse

A contributing spouse is entitled to receive an 18% rebate for contributions up to $3,000 a year to a superannuation fund or RSA of a spouse with assessable income below $10,800 a year. The rebate phases out on a dollar for dollar basis, so it is no longer available where the low-income spouse's assessable income is over $13,800 a year. These amounts are not indexed.

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[82] Source: Rothman G, *Assessing the tax advantages of superannuation*. Treasury Retirement Income Modelling Task Force, 1999 - updated to 2002.

Contributions by self employed people

'Self-employed persons' (whose income from an employer is less than 10% of their total income) get a full tax deduction on the first $3,000 of contributions plus 75% of the remaining contribution up to the age based deduction limits.

Surcharge

All employer, certain 'golden handshakes' and tax deductible personal superannuation contributions made by or for high income earners are subject to a surcharge of up to 15%. The surcharge is currently phased in over the income levels of $85,242 to $103,507 effectively increasing by 1% for each additional $1,118 of income from $85,242.

2. Fund earnings

The earnings of complying superannuation funds are taxed at a nominal rate of 15% (non-complying funds are taxed at a rate of 47%).

3. Benefits

Reasonable Benefit Limits

The amount of concessionally taxed superannuation benefits a person is allowed to receive over his or her lifetime is limited by Reasonable Benefit Limits (RBL). The table below shows the lump sum and pension RBLs. The pension RBL is available provided at least 50% of the total benefits received by a person are taken in the form of a pension or annuity that satisfies the pension and annuity standards.

Table 5: Reasonable Benefit Limits

Amount	
Lump sum RBL	$529,373
Pension RBL	$1,058,742

Eligible Termination Payments

Eligible Termination Payments (ETP) are lump sums usually paid on retirement or resignation from a job and include 'golden handshakes', payments from superannuation funds, Approved Deposit Funds and Retirement Savings Accounts. ETPs are taxed differently from other income. They are broken down into several components (although not all ETPs have every component). Each is taxed in a different manner and subject to various rebates.

Taxation Treatment of Eligible Termination Payments

ETP COMPONENT	Maximum Tax Rate (including 1.5% Medicare levy)
Post June 1983 component – refers to superannuation benefits accrued with respect to employment or fund membership after 30 June 1983. This component is the amount of the ETP reduced by the total amount of all the other ETP components. These benefits are taxed according to whether the fund earnings were taxable and the age of the benefit recipient, as follows.	
<u>Person less than age 55</u>:	
• **Taxed element**: a post-June 1983 component is a taxed element if the payer is subject to 15% tax on investment earnings of the fund (ie. Most superannuation funds).	21.5%
• **Untaxed element**: a post-June 1983 component is an untaxed element if the payer is not subject to 15% tax on investment earnings (eg. some government superannuation funds and golden handshakes for employees).	31.5%
<u>Person 55 years or over</u>:	
• **Taxed element:**	
– from $0 to $105,843	0%
– balance	16.5%
• **Untaxed element:**	
– from $0 to $105,843	16.5%
– balance	31.5%
Pre July 1983 component - the amount of an ETP that relates to superannuation benefits accrued with respect to employment before 1 July 1983.	5% of amount is taxed at marginal tax rates
Undeducted contributions – member contributions (since 1 July 1983) not subject to a tax deduction (not included for RBL purposes - see below).	Exempt
Capital Gains Tax (CGT) exempt component – an exemption from CGT (on a total maximum capital gain of $500,000) can be claimed on the sale of a small business where the proceeds are used for retirement.	Exempt
Concessional component - until 1 July 1994, this included any approved early retirement scheme payment, bona fide redundancy payment or invalidity payment. From 1 July 1994, ETPs no longer have a concessional component, except where an ETP with a concessional component was rolled over (transferred to) a complying superannuation fund before 1 July 1994, and subsequently paid out by the fund.	5% of amount is taxed at marginal tax rates
Post June 1994 invalidity payments - the recipient's disability must be verified.	Exempt
Non-qualifying component – that part of an ETP that represents investment income accruing between the time of purchasing an annuity (other than by a rollover) and the time of payment.	Full amount taxed at marginal tax rates
Excessive component – the amount of an ETP in excess of a person's RBL.	48.5%

Pension and annuity rebate

Where a person receives an ETP annuity or pension from a taxed superannuation fund and the person is 55 or more years of age, the person is entitled to a tax rebate, at 15%, on the assessable part of the annuity or pension payment that is not in excess of the person's RBL.