Institute of Actuaries of Australia

20 June, 2003

The Secretary
Senate Economics References Committee
Room SG.64
Parliament House
CANBERRA ACT 2600

Dear Sir,

Inquiry into the Structure and Distributive Effects of the Australian Taxation System

Objectives

This submission by the Institute of Actuaries of Australia (IAAust) proposes a comprehensive review of the taxation treatment of superannuation, in order to determine:

- the preferred long-term taxation treatment and planned transition path, so that future changes to the taxation treatment can be made in an orderly versus ad-hoc process;
- the appropriate benchmark for measuring the taxation concessions, against which any changes in taxation treatment can be measured; and
- the preferred integration model for superannuation and social security.

Reasons for reviewing taxation of superannuation

IAAust believes it would be beneficial to review the taxation of superannuation as part of this review because:

- *[Adequacy]*. The levels of retirement income expected to be delivered under the current system are, for many people, below the general expectation of what is considered to be adequate. The Senate Select Committee on Superannuation in its December 2002 report supported the widespread view that the 9% Superannuation Guarantee (SG) contribution would provide a retirement income well below that generally considered to be adequate (where this is defined as a pre-retirement

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income "replacement rate" of 70-80% after tax). Treasury's modelling (in its submission to that Committee's inquiry) suggested that, for a retiree earning AWE, the SG will deliver a post-retirement income of less than half the target replacement rate. It is assumed that this shortfall in retirement incomes will continue to be met from the publicly funded age pension system. However, for those who earn more than AWE, who commenced their career before the SG came into effect in 1992, or had significant periods out of the workforce, the combined age pension and superannuation entitlements will be below the target adequacy level.

- *[Budgetary Cost].* Without a greater level of voluntary savings and/or reduced taxes, retirees will continue to rely heavily on the publicly funded age pension system to meet the shortfall. The projections in the Intergenerational Report (IGR) released by the Government with last year's Budget papers indicate that the current high level of dependency is expected to continue over the next 40 years. The IGR shows other cost items, particularly the PBS, as having greater projected expenditure growth. However, the IGR still shows age pension costs as increasing by more than 50% over the next 40 years (from 2.9% to 4.6% of GDP). This will place a strain on the Government's ability to fund age pension costs. Simplifying the tax system for superannuation, and thereby encouraging a higher level of voluntary contribution, will ameliorate this problem.

Issues that need addressing

Summarised here are issues that IAAust believes need addressing in relation to the taxation of superannuation and related considerations.

The current taxation treatment is:

- <u>Complex:</u>

  With three different contribution taxes, two rebates, different tax deduction systems for employers and self-employed and up to 25 different end benefit component tax rates, it is not surprising that the current system results in both a lack of understanding and trust as well as widespread promotion of financial planning strategies to take maximum advantage from the taxation concessions, for example by manipulating existing grand-fathering rules.

- <u>Poorly targeted:</u>

  The flat rate lump sum benefit tax rates result in poorly targeted taxation concessions which favour a) those people on higher rather then lower incomes and b) lump sums over pensions.

- Expected to deliver highly variable outcomes over the next few decades:

  The majority of the current superannuation tax take is received from contributors, as a result of the up-front taxes on contributions and investment earnings. As the population ages and the proportion of retirees increases relative to contributors, the majority of superannuation tax revenue will come from tax on benefit payments, and the total will exceed the current total superannuation tax revenue. This is an issue that would benefit from modelling to assess the impact of these changes, thus allowing a more thorough and realistic evaluation of the revenue impact of superannuation policy.

▪ To date, changes in taxation have often been made on an ad-hoc basis driven by budgetary constraints, combined with a complexity overlay brought about by a need to grandfather existing treatments in many cases. Agreement on a preferred long-term taxation model would enable a transition path, cognisant of budgetary constraints, to be planned. Future taxation changes would only be made if consistent with this long-term model rather then on an ad-hoc basis.

▪ Under the current system, taxation revenues from superannuation will continue to rise in real terms, as the system matures and the flow of benefits out of superannuation, and the taxes on that, increases. Given this outlook it would be possible to increase the incentives for workers to contribute to superannuation, and/or simplify the system, while still allowing tax revenue from this source to increase in line with GDP. In this regard, it may be appropriate to consider capping superannuation taxes as a percentage of GDP so that existing taxation revenue is maintained but not increased.

▪ The benchmark currently used by Treasury measures the impact of the taxation concessions as the concessions provided to current contributors less the taxes received from current retirees. This methodology results in an over-statement of the taxation concessions when measured over the long term, because:

  - The benchmark does not measure the tax concessions less the tax paid over the lives of fund members. Whilst the flow of contributions into superannuation exceeds the flow of benefits out, as is the case at present, this method will continue to overstate the taxation concessions for current members. Put simply, the benchmark uses a cash rather than accruals approach, which in the case of a long-term proposition like superannuation, with taxes on final payouts, distorts the measurements to generate a misleading picture.

  - The benchmark does not take into account the expected savings in direct age pension costs arising from superannuation savings.

  - The benchmark also assumes that monies contributed to superannuation would otherwise be taxed as income and invested in a fully taxed savings vehicle e.g. cash at bank, rather then a collective savings vehicle where deductions such as franking credits reduce the effective tax rate.

The over-statement of the current taxation concessions prevents a meaningful and informed public debate on whether the current taxation treatment is appropriate. A more appropriate accruals-based benchmark, that took account of tax effects over the full life cycle from contribution to benefit payment, would enable proposed changes to the taxation treatment to be accurately costed. We note that the Senate Select Committee on Superannuation, in its December 2002 report, advocated a review of this benchmark.

The linkage between the superannuation and social security systems is complex, inefficient and not well integrated. Existing anomalies allow many relatively well-off retirees to access age pension support to the disadvantage of those less well off.

- An ageing population will necessitate an integrated model in order to contain the pressures on the publicly funded age pension system.
- The fixed dollar limits on tax-deductible contributions by an employer to a defined benefit superannuation fund effectively prevent the rapid securing of entitlements of members of the many such funds that currently have asset levels well below benefit liabilities. IAAust has made a separate submission to government in relation to this issue.

Conclusion

A thorough review of the superannuation system, leading to strategic tax and regulatory reforms, could deliver a system that will:

- facilitate the growth of SG contributions to generate higher retirement benefits;
- through greater simplicity and transparency of the system, attract greater voluntary contributions from workers; and
- allow financial planning advice to workers and retirees to focus more on investment strategies to generate wealth and control risk, instead of on negotiating an over-complex tax and regulatory environment. This should lead to better informed investors who end up with larger retirement incomes from their superannuation contributions.

These outcomes would all tend to improve the adequacy of future retirees' retirement incomes, as well as ameliorating the budget impact of the ageing of Australia's population.

Of course any such review would be a major exercise, requiring involvement of a wide range of special interest groups. It would also require a careful evaluation of the expected fiscal impact of any proposals. However, these are not reasons not to consider a review, given the significant problems of the existing system. Indeed, the time needed for consulting with and obtaining buy-in from special interest groups, and evaluating fiscal impact, together with the potential need to phase in any new arrangements over an extended period, is a reason to start sooner rather than later.

The Role of the Actuarial Profession

The IAAust members have the knowledge and expertise to make a substantial contribution to this debate and IAAust's expert taskforces are prepared to contribute to a review. The IAAust has prepared numerous submissions to date on this and related topics, including submissions to the Senate Superannuation Committee (June and September 2002) and the House of Representatives Committee on Ageing (March 2003). Copies of all IAAust submissions can be obtained from the IAAust website (www.actuaries.asn.au).

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Yours sincerely,

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