# Chapter 4

# Factors Inhibiting Adequacy

## Introduction

4.1 As reflected in the previous chapter, increasing contributions and widening access to superannuation as a savings vehicle were some of the ways in which evidence to the inquiry suggested that the shortfall between the expectations and reality of incomes in retirement could be addressed. However, much of the evidence to the inquiry suggested that there were a number of factors which reduce the effectiveness of the current contribution arrangements, impact on the adequacy of incomes in retirement, and reduce incentives to save.

4.2 This chapter discusses the impact of:

- front-end taxes;
- fees and charges; and
- rising household debt.

4.3 Discussion of the superannuation taxation arrangements, including the annual and whole of life taxation measures, is included in Part III – Equity.

## The impact of front-end taxes on adequacy

4.4 The introduction of front-end or accumulation phase taxes, including superannuation contributions and earnings taxes from 1988, resulted in reducing the compounding effect of interest on savings and acted as a break on the growth. This situation was extended from 1996 with the introduction of an additional front-end tax, the surcharge tax, on high income earners.

4.5 Despite these developments, in evidence to the inquiry, Treasury indicated that superannuation remains a tax preferred savings vehicle:

> Notwithstanding Australia's approach of taxing superannuation at all three stages (ie contributions, earnings and benefits), research undertaken by Treasury's Retirement and Income Modelling Unit indicates that superannuation is a tax preferred investment over a working lifetime for persons in all marginal tax brackets. … The aggregate size of the tax expenditure associated with superannuation is projected at approximately $10.3 billion in 2002-03.[1]

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1 See footnote in Treasury's submission: *Budget Strategy and Outlook 2002-03,* Budget Paper No. 1, 14 May 2002. For methodology and other related issues see: Appendix B: Superannuation Benefits, *Tax Expenditures Statement 2001.* See *Submission* 78, Treasury, p. 15.

> The taxation of superannuation can affect the adequacy of retirement incomes in a number of ways. In a direct sense, the concessional taxation treatment of superannuation increases the amount of a contribution which is available to be invested (after tax) compared with alternative forms of saving – for example, shares or property acquired out of after tax income. This advantage continues during the accumulation phase of superannuation reflecting the concessional tax rate applying to investment earnings on superannuation account balances. The concessionality of superannuation also has an indirect impact on the adequacy of retirement incomes to the extent that it encourages individuals to undertake retirement savings.[2]

4.6 The Committee notes that a number of submissions to the inquiry recommended the abolition or phasing out of front-end taxes as a means of boosting adequacy. COTA also supported this approach but in doing so, expressed a desire to maintain revenue to fund current age pension payments. COTA submitted that:

> … contributions and earnings taxes reduce superannuation accumulation, and thence pay-outs and retirement incomes. Shifting taxation to the benefits stage would leave more money accumulating in superannuation for longer, and have very positive effects on benefits. This is a desirable outcome, as long as net Commonwealth revenue is not diminished, nor disrupted by the changeover. Revenue is required to maintain the existing Age pension and finance the range of community services currently available to seniors and other members of the community.[3]

4.7 ACOSS expressed its concern that the complexity of the system of taxing superannuation does not provide incentives to save. The Council submitted that:

> From the standpoint of savings incentives, it is the *concessionality* of the tax treatment at each stage, not the *number of times* superannuation savings are taxed, that matters. The present system is highly concessional at each of the three stages. However, transparency is also important. People will only be encouraged to save voluntarily on a large scale if they understand how the tax concessions work. The present system is both complex and opaque.[4]

4.8 AMP submitted that one way of addressing the complexity of the system of taxing superannuation, and to boost retirement savings, would be for the Government to consider a move from front-end to benefit stage taxation. AMP estimated that by implementing a benefit tax, someone on average earnings could add an extra nine per cent to their superannuation over 10 years, or 12 per cent over 20 years.[5]

4.9 In its submission, CPA provided a copy of research that it had commissioned from the National Centre for Social and Economic Modelling (NATSEM). In this

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2 *Submission* 78, Treasury, p. 15.

3 *Submission* 63, COTA, p. 26.

4 *Submission* 65, ACOSS, p. 14.

5 *Submission* 64, AMP, p. 4.

report, NATSEM indicated that a straight abolition of the 15 per cent tax on employer superannuation contributions, and also of the superannuation surcharge, would have a similar effect on retirement living standards to an additional 3 per cent employee contribution to superannuation.[6]

4.10 In its submission to the inquiry, the IAA modelled the impact of front-end taxes on a target level of end benefits of 60 per cent of gross income before retirement. The results are presented in **Table 4.1.**

**Table 4.1: Examples of a 20 year old male on a current salary of $30,000 retiring at age 65 or age 70**[7]

| | **Retire @ 65** | **Retire @ 70** |
|---|---|---|
| With current taxes | 19.3% | 15.5% |
| No contributions tax | 16.4% | 13.2% |
| No investment tax | 16.9% | 13.4% |
| No cont/investment taxes | 14.4% | 11.4% |

Note: The projections show that the contribution rates required for a male on a current salary of $30,000 to achieve the target retirement benefit.
Source: *Submission* 74, IAA, p. 10.

4.11 According to the IAA, **Table 4.1** demonstrates that if a male retires at age 65, the elimination of contribution and investment taxes on superannuation would reduce the required contribution to provide the target retirement benefit from 19.3 per cent to 14.4 per cent of salary. Retiring later gives more years to contribute and leaves less time in retirement to receive the benefit. As a result, the required contribution rate reduces significantly for males retiring at age 70 rather than age 65.[8]

4.12 The IAA suggested that one means of reducing the impact of taxes on adequacy worthy of consideration would be the capping of taxes as a percentage of Gross Domestic Product (GDP). The IAA indicated in its submission that although this would be difficult to implement, a cap would maintain existing revenue in real terms while limiting future increases.[9]

4.13 In response to a question from the Committee on the effect of front-end taxes on adequacy, Dr Hazel Bateman, of the Centre for Pensions and Superannuation at the University of NSW, provided the following information:

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6 *Submission* 43, CPA, p. 6.

7 *Submission* 74, IAA, p. 10. The IAA notes that ‘For the purposes of illustration, we have assumed a target retirement benefit that is sufficient to provide (in present day value) a lump sum of $100,000 plus a pension equal to the Age Pension. The examples assume that, based on an investment earning rate of 6 per cent p.a. and inflation of 4 per cent p.a., the equivalent lump sum present value of the Age Pension for males is $140,000 at age 65 and $114,000 at age 70.’

8 *Submission* 74, IAA, p. 10.

9 *Submission* 74, IAA, p. 12.

> …under the current superannuation tax regime (of a 15% contributions tax and a net earnings tax of 8%) with administration charges and insurance premiums of 2% of assets per annum, a gross contribution rate of 17.7% is required to generate the same retirement income as a 9% net contribution rate. Including lump sum taxes, the gross contribution rate increases to 19.9%.[10]

## The impact of fees and charges on adequacy

4.14 In November 2002 the Committee reported on the provisions of the Superannuation Legislation Amendment (Choice of Superannuation Funds) Bill 2002. A large body of evidence was provided to the Committee during that inquiry on the impact of fees and charges on account balances. Most of the evidence to that inquiry suggested that fees and charges have an adverse impact on fund balances and retirement incomes, and that entry and exit fees prohibited portability and consolidation of accounts. Suggestions to address these issues included a cap on fees and charges or prohibiting entry and exit fees.

4.15 In its report on Choice of Superannuation Funds, the Committee commented on the impact of fees and charges, noting that Treasury uses an assumed fee of 1 or 1.2 per cent in its modelling of projected retirement incomes, a figure which is significantly lower than many retail funds offer. In its report, the Committee indicated the fees charged by funds should reflect the underlying cost of the service, but that a cap on fees and charges would not be without its practical problems. The Committee also noted that in its consultation paper on portability, the Government leaves open the option of regulating exit fees.

4.16 Further, in its report on Choice of Superannuation Funds, the Committee emphasised the importance of a standardised disclosure regime, which has been consumer comprehension tested, to allow valid comparisons to be made between funds. The Committee also considered that the disclosure regime should allow employees to compare funds based on the projected end benefit, rather than the overall cost of the fees and charges.[11]

4.17 The impact of fees and charges on the adequacy of retirement incomes was also a major issue raised during this inquiry into the adequacy of superannuation, where similar evidence was provided.

4.18 The Committee cites below a graph provided by Sunsuper on the effect of fees on the balance of a fund over 40 years, based on an initial balance of $100,000:

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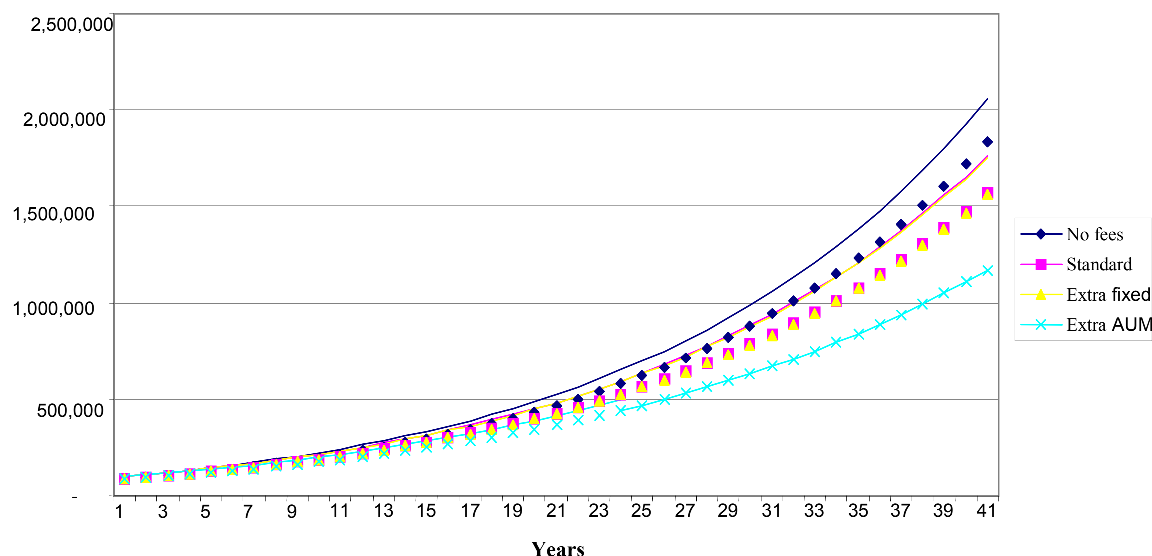
10 *Submission* No.104, UNSW, p. 1.

11 Senate Select Committee on Superannuation, *Provisions of the Superannuation Legislation Amendment (Choice of Superannuation Funds) Bill 2002*, November 2002, pp. 63, 81-82.

**Chart 4.2: Effect of Fees – Accumulation over 40 Years**




Source: *Submission* 128, Sunsuper, p. 3.

Assumptions:
Interest of 6 per cent after tax before fees
Inflation of 3 per cent per annum
15 per cent tax on contributions
Initial annual contribution of $5,000
Standard fees - $1 per week and 0.5 per cent per annum asset fee
Extra fixed is extra $1 per week. Extra fee for assets under management is 1 per cent per annum.

4.19 Sunsuper indicated that the graph shows that over a 40 year period, based on an initial balance of $100,000 and the assumptions listed above, an extra management fee of one per cent per annum would reduce the fund balance in its 40th year from $1,759,000 to $1,314,000, a difference of $445,000.[12]

4.20 Cbus indicated in its written submission that there is an argument that since superannuation contributions are compulsory that the fees that are charged by providers of superannuation funds should be subject to regulation.[13]

4.21 The Committee notes proposals by the ALP to prohibit certain types of fees and cap others.[14]

## The impact of rising household debt on adequacy

4.22 A number of submissions made the connection between rising household debt and the availability of superannuation to repay that debt. For example, Ms

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12 *Submission* 128, Sunsuper, p. 3.

13 *Submission* 42, Cbus, p. 10.

14 Senate Select Committee on Superannuation, *Provisions of the Superannuation Legislation Amendment (Choice of Superannuation Funds) Bill 2002*, November 2002, p. 91.

Wolthuizen from the Australian Consumers' Association made the following remarks at the Canberra roundtable discussion on 8 October 2002:

> The debt burden is something we are seeing and certainly having reported to us, particularly where consumers are using their home equity to fund their lifestyle either through accessing a line of revolving credit attached to their mortgage or using their home as security for other credit to fund things such as school fees, health costs or lifestyle costs and thereby gradually increasing their debt burden. This is really a mentality that puts off the day of reckoning. Our theory is that that day of reckoning is retirement—that is, when the impact on the end benefit that people will receive from their superannuation if a large or substantial proportion of it is used to pay off debts incurred over the course of their working life is determined.[15]

4.23 However, Mr Gallagher from the Treasury considered that the level of household debt had more of a relationship with housing equity than superannuation balances:

> I think the relationship between financial deregulation, award superannuation and the SG is largely coincidental. It would be incorrect to blame the rise in household borrowing on the superannuation guarantee. If you look at the national balance sheets—which I think are the best way to look at this issue, and I also have in mind remodelling—the superannuation guarantee assets are about $75 billion. The rise in borrowing by households has been $365 billion—that is, there is a very large order of magnitude difference between what we have seen in terms of superannuation guarantee savings and the rise in household borrowings. Therefore, I think it is useful to look at the issue of financial deregulation. There are a number of factors that you think might have influenced the rise in borrowing in households. Perhaps one is that … loan devaluation ratios have changed, the need for deposits has changed and, very importantly, people have been able to borrow against their own housing equity in taking a loan. If you look at the national balance sheets, the line of housing equity and the line of rising household borrowing, they have a very similar gradient. I think it would be useful in this issue to look at the access to lending in terms of a person's own housing equity. I will leave it at that.[16]

## *Committee view – factors inhibiting adequacy*

4.24 The Committee notes that there are a number of factors which reduce the effectiveness of the current contribution arrangements, impact on the adequacy of incomes in retirement, and reduce incentives to save. They include front-end taxes, fees and charges, including death and disability insurance premiums, and rising household debt.

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15 *Committee Hansard*, 8 October 2002, p. 683.

16 *Committee Hansard*, 8 October 2002, p. 682.

*Impact of front-end taxes*

4.25 Evidence cited by the Committee suggests that the impact of front-end superannuation taxes can have the same effect as a three per cent increase in contributions. Nonetheless the Committee also notes that the reduction or removal of front-end taxes would have a very significant effect on revenue.

4.26 During the inquiry the Committee sought suggestions from witnesses on how to make up any possible revenue shortfall if front-end taxes were to be reduced or removed, but did not receive any compelling suggestions on how this could be achieved. Although, as will be discussed in Part III – Equity, suggestions were made to cushion the Budget by phasing in any front-end tax reductions, or by introducing a withholding tax. As will also be discussed in Part III – Equity, the Committee would prefer a gradual move away from all front-end superannuation taxes so that, in the long term, tax would only be applied to the end benefit and has recommended that the contributions tax be gradually phased out.

4.27 The Committee notes that capping taxes at a proportion of GDP was suggested by the IAA as a means of maintaining current levels of revenue. However the Committee considers that the implementation of such a cap, and the consequences for end benefit tax, would negate any benefit.

4.28 The Committee believes that there is a basic mis-match of revenue flow and budgetary need inherent in the current arrangements. That is taxes are brought forward and spent well ahead of the retirement of people who will have future health and social security calls on the budget. This matter is also addressed in the Part III - Equity section of this report.

*Impact of fees and charges*

4.29 The Committee notes the important impact of fees and charges on the level of retirement incomes. In some cases a one per cent difference in fees and charges, all other considerations remaining the same, can produce a 25 per cent reduction in retirement income over 40 years.

4.30 The Committee notes that the nine per cent Superannuation Guarantee (SG) is somewhat illusory, because leakages from the employers' SG contributions, such as contributions tax, death and disability insurance premiums, fees and charges, lower the employers' investment on behalf of employees, so that the fund member does not actually receive the full nine per cent because of these leakages.

4.31 However, as an alternative to increasing the level of SG contributions, the Committee notes that one possible option could be the introduction of a compulsory national death and disability insurance scheme, under which all employers would contribute a flat amount for minimum levels of cover for all employees. The Committee notes that obtaining appropriate insurance cover at a reasonable cost is becoming harder, and that such a scheme could assist those on low incomes, and allow more money to be invested for generating retirement incomes.

4.32 The Committee considers that every effort should be made to make the impact of fees and charges, however described, as transparent as possible to the fund member. In particular, the Committee considers that fees and charges should be disclosed in such a way that the member can be aware of the impact on those fees and charges on the end benefit, rather than the overall cost of the fees and charges.

4.33 The Committee notes the announcement by the Parliamentary Secretary to the Treasurer, Senator the Hon Ian Campbell, that the Government has commenced discussions with the regulators and industry to design a disclosure system which would provide more information about fees and charges.[17]

4.34 The Committee considers it unfortunate that the regulations for product disclosure statements were inadequate in their failure to provide meaningful fee disclosure for consumers. With the regulations subsequently disallowed, there is now a further gap in the financial services regulatory framework which needs to be addressed. The Committee urges the Government to form the next disclosure regime on the basis of broad consultation and consumer testing.

*Impact of rising household debt*

4.35 The Committee is also concerned about the effect of the rise in household debt on the ability of people to save for retirement. The Committee considers that this relationship should be closely monitored, and if the level of debt becomes a problem for retirement income policy, remedial action should be considered. Remedial action could take the form of limiting access to lump sums, or expressed another way, promoting access to income streams relative to lump sums.

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17 Announcement by Senator the Hon Ian Campbell at the ASFA Annual Conference, Brisbane, 15 November, 2002. Reported in *Australian Financial Review,* Saturday 16 November, 2002, p. 8.