

SENATE SELECT COMMITTEE ON SUPERANNUATION

SUPERANNUATION AND STANDARDS OF LIVING IN RETIREMENT

SUBMISSION BY HAZEL BATEMAN AND JOHN PIGGOTT\*

CENTRE FOR PENSIONS AND SUPERANNUATION, UNIVERSITY OF NEW SOUTH WALES

**Introduction**

Throughout the developed world, the call for smaller government has meant that services which have traditionally been provided by government, are now being provided by the private sector, sometimes under compulsion from government. As mandating replaces provision, new policy challenges arise – these have their basis in a new emphasis on the interactions between public and private institutions.

Nowhere has the substitution of mandating for provision been more evident, or more controversial, than in retirement provision. The high profile associated with social security and retirement policy reform has its origins in global population aging. This adds urgency to the reform debate, and a renewed appreciation of financial risk on the part of households, which had been dormant since the introduction of mass social security in the first half of the last century.

Australia has developed an earnings related compulsory retirement incomes policy, the Superannuation Guarantee, which is mandated, rather than publicly provided. It is one of the world leaders in the reform of social security away from public provision and towards mandation. Further, it is enjoying the advantages of a lower projected budget blowout

---

\* Hazel Bateman is Senior Lecturer in Economics, and Deputy Director of the Centre for Pensions and Superannuation (CPS), University of New South Wales. John Piggott is Professor of Economics and the Centre's Director.

associated with demographic transition, but at the same time, it is having to face the challenges inherent in pioneering a new paradigm in an important policy arena.

In the broadest terms, this Committee is asking the question: How much is enough for adequate retirement financing? This is perhaps the most fundamental question in a private and fully funded retirement plan. As mandating replaces provision, accumulation-based retirement plans are becoming more important. The contribution rate required to produce an adequate retirement income is a central continuing issue (as is the meaning of adequacy).

It is important to appreciate that the answer to this question is not just a matter of arithmetic, linking some target replacement rate with a complicated compound interest problem. Rather, we confront a lifelong problem in financial security. Individual preferences, the intrinsic uncertainty of the prices of the financial assets in which accumulations of wealth for retirement are held, the market structures and governance of the institutions in which private lifecycle saving and investment take place, government policies such as taxation and the age pension, and the macroeconomic environment, all have an influence on how much is enough.

Our view is that while the Superannuation Guarantee is a good paradigm for retirement income provision, successive governments in this country have failed to appreciate the implications of particular policy features for retirement accumulations and funded retirement benefits. These are having a critical impact on the performance of the Superannuation Guarantee, and on its capacity to deliver adequate retirement support to future generations of Australians. In the area of retirement policy, both god and the devil lie in the detail.

We believe that **the most critical shortcomings lie in the areas of superannuation taxation, the regulations surrounding the specification of the contribution rate and the choice of fund, fund manager or investment strategy, and the design of benefit payouts.** In this submission, we focus on the first two of these areas. (A supplementary submission will discuss benefit payouts.) We suggest that **policy features associated with each of these compound with one another to seriously inhibit the potential of the Superannuation Guarantee to deliver adequate retirement incomes.** In addition, we touch briefly on the

means of providing channels of tax-preferred but preserved saving and investment for those not in the labour force.

We take sole responsibility for the proposals put forward here, but would like to acknowledge the research from which they derive, which has been undertaken by a broader group. References appear at the conclusion of the document.

## Taxation

**Australia probably has the world's most complex and inefficient system of pension taxation. Major reform of superannuation taxation is long overdue.** The present approach to reform, of making parametric changes from time to time without wide consultation, is likely to have contributed to community distrust of the benefits of the Superannuation Guarantee and superannuation as a reliable source of retirement income, and has contributed greatly to the complexity of the current regime.

The starting point for our proposal is the observation **that the two main lifecycle saving and investment vehicles for most Australians are their home and their superannuation. They should receive similar tax treatment.** Taxation of home ownership can be thought of as a tax on expenditure. You pay for the owner-occupied home out of net-of-tax income, and never pay taxes again. There are no taxes on the imputed income from owner-occupation, and no capital gains taxes.<sup>1</sup> We argue here for a tax on retirement saving that is roughly equivalent in its effects to the taxation of owner-occupier housing. In this way, the tax-induced inter-asset distortion between financial assets and the owner-occupied home can be reduced, and a more efficient allocation of capital resources is likely to result. In addition, individual retirement asset portfolios are likely to be more diversified, with somewhat less emphasis given to the owner-occupied home which, whatever its other virtues, is illiquid and very undiversified.

It can easily be shown that, in a formal sense, in a proportional taxation system, contributions taxes and benefits taxes at the same rate are equivalent.<sup>2</sup> It follows that to meet

---

<sup>1</sup> In value terms, it is also exempt from means testing in the age pension.

<sup>2</sup> "Equivalence" implies that the present value of revenues and tax costs are the same, and that an individual who has formulated a lifecycle plan of working, saving, and retirement, and who operates in a certain world,

the above objective, **superannuation taxation should be redesigned so that a tax, equal to the individual personal marginal income tax rate, is levied on either contributions or benefits, but not both, and not fund earnings.**

In spite of this formal equivalence, there are some practical reasons why benefits taxation is to be preferred to contributions taxation. (Benefits taxation is the predominant structure across the OECD.) Among these are:

- Benefits taxation allows the application of the progressive income tax rate schedule to take account of variability in investment performance and the form of benefit withdrawal. This can be seen as more equitable than a contributions tax.
- With defined contributions superannuation, progressive benefit taxation would appear to entail more investment risk sharing by government than contribution taxation, beyond that implied by the age pension. Insurance against investment risk is difficult to procure in a defined contributions context, and the social benefits associated with the risk sharing could be significant.
- Where contributions are made by employers, they are clearly a cost of earning income, and deductible to the employer. If employee contributions are taxed, there is an incentive for employer contributions to replace employee contributions, in order to minimize tax. Employee contribution tax symmetry would simplify the regime.
- Given the anticipated tax liability associated with demographic transition, benefits taxation has the advantage that the tax revenues will be realized at a time when public sector liabilities for the aged are high.

---

will make the same decisions in the two regimes. Bateman, Kingston and Piggott (2001), Chapter 6, offers a simple demonstration of the equivalence result, and a useful discussion of the taxation of retirement incomes, on which the present discussion partly relies. See also Bateman and Piggott (1999) and Doyle, Kingston and Piggott (1999).

Some of the current revenue shortfall could be met by charging a withholding tax on contributions at a rate of 20%, with the remainder of the tax to be paid (or credited) on benefits when they are paid out.

A final advantage of this structural reform is that the taxation of superannuation would be integrated with the personal income tax. This is simplifying in its own right, and also makes “special” taxation of superannuation more difficult for future governments to contemplate. In our view, a major reason for the complexity of the current tax arrangements is that superannuation taxation was decoupled from personal income taxes at the outset.

**These considerations lead us to advocate a tax on the benefits of superannuation saving only, collected under the personal income tax, with deductibility for contributions and the non-taxation of fund earnings. A withholding tax on contributions would help to meet the current revenue shortfall.** Implementing the benefits tax approach in Australia would allow superannuation taxation arrangements to be significantly simplified with the removal of the contributions tax, the tax on superannuation fund income, the superannuation surcharge, lump sum taxes, reasonable benefit limits and the annuity rebate.

Even with a withholding tax, some revenue shortfall will result from this reform. But in this context, we see no reason why every tax reform must be revenue neutral from its year of implementation. The economic and administrative efficiency improvements which would result from this reform would in our view more than offset the disadvantage of revenue shortfall.

### **The Net Contribution Rate and Leakages**

There has recently been a good deal of controversy about the level of administrative fees and charges associated with the superannuation (where administrative charges include all administration and investment fees and charges). This controversy is ongoing, and we do not wish to debate particular estimates of administration charges

here. We believe that whatever the arguments about specific figures, there is general agreement on four propositions:

- Administrative charges which appear low when expressed as a percentage of assets can have major impacts on life cycle accumulations;
- The level of administrative charges is influenced by the complexity of the regulatory and compliance environment within which superannuation accumulations and payouts operate;
- Competitive pressures to keep such costs contained are most effective when the stakeholders directly affected are involved directly in the transaction; and
- The crucial issue is the net of administrative charges returns, rather than administrative charges *per se*.

Table 1 illustrates the importance of the level of administrative charges on retirement payout, and also shows the importance of the interaction between taxation and administrative charges. The table reports the proportions by which accumulations at retirement are reduced as a result of the combined effects of taxation, insurance premiums (which industry sources indicate can be as high as 0.8% in retail funds), and administrative charges, expressed as a percentage of assets. The corresponding effective contribution rates are reported in parentheses.

Starting with a 9% contribution, and no tax, administrative, or insurance charges, current annuity rates would deliver a male on average earnings, retiring at age 65, an annual income of \$41176 as a level payment, or a replacement rate at retirement of 69.1%.<sup>3</sup> While the benchmark for adequacy is not rigorously defined, this will be seen by many to be enough, but not too much. But at an effective contribution rate of 4.1%, implied by fund income taxation, a 1.5% administrative charge, and a 0.5% insurance premium, the retirement income reduces to \$18758, or a replacement rate of 31.5%.

**That is, the compounding effects of superannuation taxation, administrative**

---

<sup>3</sup> Based on current single life annuity quotes, with a 10 year guarantee.

charges, and insurance premiums lead to an income stream which is likely to be seen by many as not enough to provide adequate retirement provision.

**Table 1: Percentage reduction in retirement accumulation (and effective contribution rates)\***

	Administrative charges and insurance, % assets, pa				
	0%	0.5%	1.0%	2.0%	3.0%
<b>Taxation</b>					
<i>AWE employee</i>					
No taxes	0 (9.0)	12 (7.9)	22 (7.0)	39 (5.5)	51 (4.4)
Contributions and fund income taxes	29 (6.4)	36 (5.7)	43 (5.1)	54 (4.1)	63 (3.3)
Including lump sum taxes	36 (5.7)	43 (5.1)	49 (4.6)	58 (3.8)	64 (3.2)
<i>2.5 x AWE employee</i>					
Contributions, fund income taxes and surcharge	41 (5.3)	48 (4.7)	53 (4.2)	62 (3.4)	70 (2.7)

Assumptions: Single male contributing continuously for 40 years, 5% real rate of return, 1% real wages growth, no inflation, contributions taxed at 15% and fund earnings subject to an effective tax rate of 8%.

\*Adapted from Bateman (2002)

These considerations reinforce the case, stated above, for superannuation tax reform. But they also demand an examination of whether competitive market forces might be more effectively deployed to reduce administrative charges.

It is striking that under current arrangements, the management of superannuation monies often effectively lies in the hands of the employer, who chooses the superannuation fund and by implication the governance and management structure (and the associated charge structure). The employee, who is paying these charges through reduced deposits into his superannuation accumulation account, is not a primary party to

this transaction. That is, the intended beneficiary of the Superannuation Guarantee, the worker, often does not have effective negotiating rights in this transaction.

We believe that this anomaly leads in some cases to higher charges than would arise if the employee was a direct party to the negotiation. However, it is not straightforward to overcome this problem. One possibility is to re-specify the Superannuation Guarantee contribution rate so that it defines the amount deposited in the worker's account. Employers would then be better motivated to seek lower administrative charges. But this is not the whole solution, since they may also tend to seek low quality and less expensive financial service providers, who may offer only low cost low expected return investment options.

Nevertheless, there are advantages to this kind of re-specification. At the very least, it would be transparent to employees exactly what the Superannuation Guarantee is guaranteeing.

As we noted earlier in the submission, the impacts of taxation and administrative charges compound. Complex tax treatment not only makes capricious changes to the taxation of superannuation more likely, but also leads to a higher administrative burden, and therefore higher administrative charges.

Finally, we would like to reiterate the position that we took at the outset. We believe the Superannuation Guarantee to be a sound paradigm for retirement provision. It can be reformed to deliver adequate retirement provision to future generations of Australian retirees, without placing onerous fiscal burdens on future generations of Australian workers. But reform is definitely needed. In the absence of considered change, the Superannuation Guarantee will perform considerably below its potential.

July 10 2002.



## References

Hazel Bateman, "Retirement Income Strategy in Australia", *Economic Analysis and Policy*, 32, 1, March 2002, 49-70.

Hazel Bateman, Suzanne Doyle and John Piggott. "Private Mandatory Retirement Provision: Design and Implementation Challenges", in Toshihiro Ihuri and Toshiaki Tachibanaki (eds), *Social Security Reform in Advanced Countries*, Routledge, London, forthcoming.

Hazel Bateman, Geoffrey Kingston, and John Piggott. *Forced Saving: Mandating Private Retirement Incomes*, Cambridge University Press, 2001.

Hazel Bateman and John Piggott. "The Costs of the Superannuation Surcharge", *Information Paper No 66*, Committee for Economic Development of Australia (CEDA), October 1999.

Suzanne Doyle, Geoffrey Kingston, and John Piggott, "Taxing Super", *Australian Economic Review*, 32, 3, September 1999, 207-218.