

Senate Select Committee on Superannuation
Attention: Ms. Sue Morton
Parliament House Canberra ACT 2600

Dear Ms. Morton,

Attached is my submission on the inquiry into superannuation and standards of living in retirement.

Yours sincerely,

M. Andersson, 25.7.02

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Submission to Senate Select Committee on Superannuation

This submission is made in a private capacity.

Abbreviations and notes: \$K is thousands of dollars, \$M is millions of dollars and figures have been rounded, SG is Superannuation Guarantee of 9%. Government refers to the Australian Government, ATI is adjusted taxable income.

Assumptions: Unless noted, the basic assumption is that the individual is a male born in Australia, who never leaves Australia for any period, never marries or has children, works full time on median male weekly earnings from 18 to 65 (47 years of super contributions), receives no inheritance, accesses age pension and super at 65, lives to 85, has a life expectancy of 20 years at age 65, and dies in his own home with no major health or aged care requirements. Couples are assumed to be as above, living together, and the same age.

CPI is assumed to be a steady 3%. Investment returns both before and after retirement are assumed to be a steady 6% net of taxes, fees and charges. A compound rate of 3% doubles every 25 years and 6% doubles every 13 years.

An annuity with fixed indexation of 3%, a net investment return of 6% for 20 years, nil residual and no reversionary benefits will provide an initial annual payment of about 6.7% of the purchase price. A more conservative net investment return of 3% reduces the initial annual payment to about 5.2%. The purchase price is therefore about 16 to 20 times the initial annual payment. The nominal deduction for return of capital is 4% of the purchase price, is not indexed, and is reduced in real terms by inflation. CPI at 3% is a 75% increase in 20 years or a reduction in value to 57% of the starting figure. The nominal deduction of 4% is therefore about 2.24% after 20 years.

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Recommendations (not complete – refer text of submission)

1. Policy needs to accommodate the diverse family circumstances that can include the single person, couples (one or both retired, similar in age or not), and dependents (parents or children). It should also recognise the variation in work status, particularly for women, and the reality of divorce and remarriage.
2. The cost of health insurance and the reliance on the public health system should be addressed on a whole of life basis as part of health policy.
3. The cost of aged care should be addressed on a whole of life basis in conjunction with health policy.
4. There should be a balance between the pension means test, superannuation assets and tax concessions for superannuation that is periodically reviewed and amended as superannuation assets grow in order to meet policy objectives.
5. Set targets for the age pension and SG components of retirement incomes.
6. Consider new policies to provide universal SG coverage to some specified minimum level at retirement.
7. Treat surchargeable contributions as personal income for tax purposes and the contribution being made out of after tax earnings.
8. Consider treatment of non-surchargeable contributions in the same way as rec. 6.
9. Consider replacement of exit tax with more income tax at time of contribution.
10. Consider wider reforms as discussed at the end of para 4 in this submission
11. Consider restructuring the aged pension in future years to provide a safety net for a minority who have SG below the level in rec. 6, and extra income for others, with a maximum effective marginal tax rate (means test and tax) which never exceeds the top tax bracket (48.5% at present).
12. Consider policies that will integrate and simplify the current tax and means test regime and the need to deal with both Centrelink and the ATO.
13. Develop further incentives to shift discretionary consumption expenditure by or on behalf of teenagers and young adults to both home purchase and retirement savings.
14. Develop new policies to reduce the proportion of people still renting at retirement.

1. Retirement needs

1.1 Adequate income and assets at retirement

Others will have addressed this issue in detail. The individual is concerned with net after tax cashflow including benefits. This may come from income and/or dissavings, ie reduction in assets, and there are substantial variations in both the need and expectations. Expectations are probably tied to needs during working life, but needs are affected by other significant factors including age, family circumstances, health and aged care needs, place of residence and means of transport. Changes to place of residence can require significant net capital expenditure. Concession cards for pensioners and seniors also have some bearing on the cost of living.

My estimate of net annual cashflow needs in the context of this submission for around 80% of people is \$13K to \$28K for a single person and \$19K to \$43K for a couple. This assumes there are no other dependents and no requirement for major expenditure on housing or health and aged care and home ownership with no loans. It also assumes one car, if any, per household, and costs of \$7K to \$15K that apply to both the single and couple household, and other costs of \$6K to \$13K per person. This net cashflow could be generated entirely from an annuity indexed to CPI (may not be adequate index). A net purchase price at age 65 of 20 times annual cashflow (assuming a conservative investment return) would be \$260K to \$560K for the single person and \$380K to \$860K for the couple. (These purchase prices would be reduced by around 20% with better investment returns.) The upper limits grossed up for tax (variable) would probably be less than the upper limit of the aged pension income test for both the single and couple, ie \$31K and \$51K. Some people may be able to live solely on the aged pension with no other cashflow for part of their retirement years, but it is barely adequate for 20 years when compared with expenditure levels prior to retirement. The maximum aged pension is \$11K for a single and \$18K for a couple. The asset value or rental value of the family home will be significant in many parts of Australia when compared with these retirement needs.

If people wish to have a balance in their lifestyle over the whole of their life and their expenses are less in retirement, then a target for retirement needs might be 70% of comparable expenditure in their earlier years. Data is available to identify this reduction. Net incomes in earlier years are often reduced by savings beyond SG for retirement, by savings or payments directed to purchase of the family home (including relocation), and to meet the needs of dependent children. In addition, one member of a couple may be on a lower income, working part time, or not at all. Expenditure is also offset through tax

concessions such as tax rebates for super, and various income support payments including family tax benefit and child care benefit.

The median gross income for a male in his forties is probably around \$40K, which is about \$31K net. Families are so diverse and dynamic that a comparable family or couple figure is difficult to suggest. An average over the life of the family is presumably less than double the male figure, and perhaps around \$50K net. Taking 70% of these figures gives median targets in retirement of \$22K for a single and \$35K for a couple.

A gross income of \$50K where the basic tax rate changes from 30% to 42% is about \$38K net. The introduction of the current scales was supposed to put 80% of taxpayers on a marginal rate of 30% or less. The basic super tax of 15% in and 15% out corresponds to this 30% rate. A gross income of \$60K where the basic tax rate changes from 42% to 47% is about \$44K net.

1.2 Aged care and health in retirement

Aged care, and in particular residential aged care, raises special issues. The majority of people never enter a nursing home. The costs are high in relation to retirement income and assets, and also the individuals own home. The contributions, both capital and recurrent, by individuals are also subject to substantial means tests. The probability of an individual at birth eventually entering a nursing home is low by historical standards and while it may be increasing, it may never become the norm. This suggests the need for the risk to be carried by the wider community, which could be in the public and/or private sectors. The issues and policy responses are similar to the ongoing debate on health policy. The major difference is that most people incur some health expenditure during their life, whereas that cannot be said of nursing homes. Aged care and health needs form part of a spectrum. High level care for dementia in nursing homes requires a different policy response to routine health care at the GP. Health care spans the whole of life, and health insurance premiums are not aged based like life insurance. Any move in this direction affects all age groups and would be a major change to health policy.

2. Sources of retirement income and adequacy

Retirement income can come from various sources including age pension, SG, super on top of SG, non-super savings, inheritances, and employment.

Government policy is directed to private savings including SG and extra super. There appears to be no Government policy or targets on the level of retirement incomes, or the component parts, and in particular, for the age pension. With the current trends towards accumulation schemes, the investment risk is being transferred from the Government and employers to the individual.

The age pension and government sector defined benefit schemes are largely unfunded and rely on Consolidated Revenue. The level of funding could be increased, but it is not necessarily a concern with stable demographics, and a once only aging of the demographic profile can probably be accommodated from Consolidated Revenue. If the Government establishes an investment portfolio for funding purposes, it raises macroeconomic issues particularly if the fund is used to support the bond market.

Data would be available on defined benefit schemes in the private sector, and they are probably on the decline.

If a target is set for the aged pension and SG components of retirement income, then tax concessions may not be required in future for what are largely mandated savings. If these two components provide a reasonable retirement income for say 80% of people, do we want to encourage additional saving, and are tax concessions required to ensure this voluntary additional saving. Income tax is currently replaced by tax on super and subsequent rollovers because the receipt of income is deferred. Deferred income and the corresponding assets are usually ignored in relation to income support payments and tax concessions (eg family tax benefits and certain tax rebates). In this context, targets are essential to formulation of policy. The age pension and SG together are likely to eventually provide an adequate income for most people, but the SG benefit will probably add to the age pension rather than replace it. If the Government wishes to reduce reliance on the age pension, it will need an outcome with an increase in mandated super, or other retirement income. If this is achieved, the full age pension will become a safety net for a minority of retirees. Such an outcome will require changes to current policy.

The eventual benefits from super depend on contributions, taxes, fees and charges, and investment returns. The full aged pension is effectively a defined benefit. The eventual SG benefit is subject to considerable uncertainties both before and after retirement. By definition, the individual will carry some investment risk affecting average returns and the volatility and timing of returns. Any attempt to avoid this eg by using a flat annual dollar contribution begs the question why not stay with the aged pension, funded or unfunded. It also raises potential transition and administrative issues.

An average return of 3% after inflation, taxes, fees and charges, equates to a doubling of each contribution after 24 years. A single male working full time for 40 years retiring on a salary of \$50K is likely to have around 6 times final salary \$300K at age 65. A corresponding figure for a traditional couple who have had children, no divorce and a broken work pattern for the female, is probably around \$500K. Both figures are at the lower end of needs discussed above if there is no other cashflow. In both cases, receipt of this benefit can be structured to allow for receipt of a significant part age pension. (Age pension entitlements typically vary over the long timescales involved.) The combination of SG and aged pension for the above cases will be adequate. SG benefits are very sensitive to investment return and fees and charges, especially trailing commissions. This is ameliorated by the combined affects of the age pension means test and tax.

Substantial reductions in potential SG benefits may occur for people with shorter periods of full time work, notably women, but also some other groups. These include people who are self-employed or overseas, or who choose to work part time, for significant parts of their working life. Women may be out of the workforce or working part time while they raise children, but they may also choose these options because the husband earns sufficient income to give them that choice. In some cases, income support benefits (such as family tax benefit and youth allowance) directed to families support that choice.

These groups currently rely on the age pension, spouse entitlements, and specific policies aimed at the self employed and small business owner/operators. An alternative is to pursue after tax universal SG coverage for women and possibly some other groups could be achieved through SG contributions by the Government or husbands or employers on their behalf. Government benefits or tax expenditures directed to wives or families could be split between split between immediate payments and retirement payments. Examples are the family tax benefit and the dependent spouse rebate. The current and proposed tax rebates for low income workers and spouse contributions apply to wives on low incomes, but they are voluntary and means tested, which is different to the mandated SG.

Some proposals shift wealth in the community but do not necessarily increase the overall wealth. There may be some scope for a small shift in expenditure from before retirement to after retirement. The dynamics of such change are not obvious. Retirement incomes can also be increased through a reduction in inefficient processes and an increase in overall income and wealth in the community.

Potential policy changes include a reduction in the administration costs of the super surcharge, an improvement in the productivity of financial advisers and asset consultants, and reforms that affect individual choice on work and investment decisions.

Consideration should be given to complete decoupling of work status from super and retirement income at age 65 in conjunction with other recommendations in this submission. This would allow flexibility over 65 for people who may have accumulated sufficient savings but may wish to work and want some freedom of choice.

Most retirement saving is skewed to later years and may remain so. This reduces the power of compounded returns to the individual and also in the broader economic sense. It also increases the risks from volatility in investment returns. Saving for retirement competes with the immediate need to buy a home and meet the additional expenditures of raising children. However some discretionary consumption expenditure by or on behalf of teenagers and young adults could be shifted to both home purchase and retirement savings. Some current proposals address this issue, but more could be done. Similar action is required to reduce the proportion of people still renting at retirement.

3. Tax and government funding.

The pension RBL (\$1124K) is well above the likely SG outcomes and allows for a significant amount of voluntary super. The current and proposed arrangements may allow a high income earner to accumulate super up to the pension RBL for himself and a non-working wife. They may finish with annual fund earnings of \$50K to \$100K each, with a concessional tax rate of 15% (in addition to normal income and tax). This would seem very generous to some in the community. This is a strong incentive to save, but is it a priority for scarce tax dollars. What proportion of these savings would occur without the incentive and if there is no access to the age pension (for a couple with \$2M), why would the Government encourage additional savings at these levels?

Tax on input and exit could in principal be considered as a replacement for income tax in the year of input. Tax on earnings could also be considered as an average and concessional income tax that administratively cannot be linked to the individuals personal circumstances, without significant change and cost. However, it may be appropriate to increase it in conjunction with broader tax and benefit reforms. The future of personal income tax rates over 30% has some bearing on the tax on input and exit.

The surcharge appears to be a poor substitute for personal income tax. There are excessive administration costs and complexity for the individual leading to additional personal costs. The surcharge rate also applies to all contributions leading to higher effective marginal rates than the notional rate. The current ATI used to determine the surcharge rate includes contributions to super, implying that they were seen to be part of the income for that year. The maximum surcharge rate of 15% is also related to the difference between the average 30% rate for income tax and the top rate of 47%. The ATI phase-in range was initially \$70K to \$85K, but is now approximately \$90K to \$110K. Consider an individual with ATI of \$90K that includes \$12.95K of surchargeable contributions. If they receive additional income (eg bank interest) of \$1295, they will incur a 1% surcharge of \$129.50 or 10% of the additional income. This is in addition to the marginal tax rate which may be 48.5%.

If the high rates of personal income tax are to continue, then the surcharge should be collected from the individual, preferably as part of their personal income tax return. There will be some administration, compliance and transition issues, but if practical and cost effective, then what is the argument against the obvious? Any consideration of costs should consider all costs, not just those of the ATO. A possible approach is to treat all the surchargeable contributions as after (personal income) tax contributions. This can be reconciled annually between the employer(s), employee and the ATO. The super fund receives an undeducted contribution and is not affected by the transactions between the other parties. The employer can withhold tax and provide the information in the annual payment summary. The individual can then file a personal tax return, which incorporates all payments if there are multiple employers. Any further adjustment is between the individual and the ATO. Abolishing the surcharge altogether removes revenue with no offset and provides an additional concession to people who are mostly high income

earners. Replacement with a tax on exit is another change and may not address any issues of equity. A possible exit change would be the reduction in RBLs.

The same changes could be considered for the 15% contribution tax for SG or all contributions. The individual and the ATO should be able to identify the SG component. The employer(s) has to pay super to the fund to meet SG requirements (a flat 9% of gross income) and additional super in accordance with the conditions of employment. Tax would be withheld at rates advised by the ATO and information provided to employees in the same way as with other payments. It would appear that the ATO could verify compliance with SG from the information provided, unless the information is falsified. The employer is making the payment to the fund and certifying that on the payment summary. There are some administrative similarities here with after tax payments made by Government defined benefit schemes.

The same changes could also be considered for the 15% exit tax. (This ignores the concession for the first \$112K.) It has been suggested that all tax is collected at or through retirement. This raises broad macroeconomic issues and issues of equity. This would be a major change that may be too difficult to transition. Similarly, is there an argument for abolishing the exit tax and replacing it with income tax as suggested with the surcharge?

Is it reasonable to reduce progressivity of overall tax (and benefits) by deferring income from peak earning years to retirement? Would the question be relevant if income tax and some of the means test for benefits were not as progressive for middle and upper incomes?

Wider reforms on a similar basis could be extended to FBT, reportable fringe benefits (different time of year for reporting?) and the broad issue of effective marginal rates and complexity with respect to various benefit payments, tax rebates and the Medicare levy. A whole of government approach is long overdue. The effective marginal tax rate in the broad picture is generally a minimum of 31.5% and frequently in excess of 48.5%, without necessarily being on the top income tax rate. This includes families with children and at least one parent in full time work and a family taxable income of \$25K to \$60K. These are the people who will have SG and the age pension and be subject to effective marginal rates greater than 31.5% in retirement.

Baby boomers can generally access super before 65 with more concessions. They may also have dependent children and there may be a significant age difference between husband and wife.

4. The aged pension, means tests, and income tax for retirees

There are income tests and asset tests, and the latter is more severe. This submission will focus on the income test alone and assume that the individual structures his assets in

manner that the asset test does not apply. This would commonly occur through the use of a complying asset test exempt income stream, which can be purchased with superannuation funds at retirement, or may be provided under a defined benefit scheme. Income under the income test is not necessarily the same as income for tax purposes, another complexity that is always changing.

A single aged pension is \$11K, which reduces to nil with a taper rate of 40%, as other income increases from \$3K to \$31K. The combined age pension for a couple is \$18K, which reduces to nil with a taper rate of 40%, as other income increases from \$5K to \$51K. Allowance has to be made for income tax and drawdown of capital or its equivalent in an annuity, to arrive at net available cashflow. A lump sum of around \$100K for a single or \$160K for a couple will generate total cashflow including a full age pension of around \$15K and \$25K respectively averaged over retirement. These amounts are at the lower end of the needs identified above, and the lump sums should be generated by SG for most people.

The tax offset for seniors has a taper rate of 12.5% and this increases the effective tax rate. The combined effective marginal taper of tax, offset and pension can be calculated as follows. With the gross simplification that income for tax purposes is the same as income for pension purposes, and ignoring drawdown of capital, \$1.00 of extra private income is reduced by \$0.40 loss of pension. The net \$0.60 is then reduced by as much as 44% tax rate (31.5% marginal rate and 12.5% offset taper) to \$0.336. This is equivalent to a tax rate of 66.4%. This also ignores any taper (20%?) in the Medibank levy.

Consideration could be given to restructuring the age pension as SG balances grow, particularly if there is a move to universal SG coverage to a specified minimum level at retirement.

The age pension could be seen as two parts. One part is a safety net for the minority of people who have less than adequate SG coverage. The other part provides additional income for a significant proportion of retirees, who cannot live on SG alone. The balance will change over time as SG grows. The effective marginal tax rate (means test and tax) should be reasonably uniform. If it is too large, there may be disincentives to savings and risk behaviour before and after retirement, and in some cases to have paid work in retirement years. On the other hand, high rates reduce the impact on cashflow due to volatility of investment returns and maintain cashflow if private income diminishes with age. Taper rates and income free area are problematic, particularly for the safety net component. There is a need to simplify and integrate the current tax and means test regime and the need to deal with both Centrelink and the ATO. This needs to allow for administration costs, compliance and capabilities of all parties. There is clearly an advantage in having simple arrangements for older people, unless their affairs are handled by third parties.

5. Investment returns and risks

Investment returns are vary volatile and sharemarket cycles are as long as 30 years. The US sharemarket had strong returns from around 1982 to 2000, notwithstanding corrections in 1987 and 1997/8. But it roughly roughly doubled from 1997 to 2000 and then nearly halved by late July 2002 (in nominal terms). The World sharemarket returns were similar for the period from 1997. The Japanese Nikkei dominated the sharemarket in 1989 in the way the US market did in 2000. Its level in July 2002 is around one quarter of the 1989 level (in nominal terms). Returns from the late 60s to the early 80s for both the US and Australian sharemarkets were quite different. The return for US or Australian shares from the trough in late 1987 to the peak in 2000 is substantially more than the return from the peak in Sept/Oct 1987 to July 2002.

Property markets are equally volatile, witness the peak in asset values in 1989 and the subsequent writedowns. In some cases, funds absorbed these over a long period of time, and accounting practices in this regard could be viewed with some concern.

Bonds had good returns for most of the 90s due to a steady fall in interest rates. This cannot be sustained, witness recent low interest rates in Japan.

The expectations of Government and individuals may be different and is based on mixed advice. Average historical returns and expectations both for individual asset classes and for mixtures such as balanced funds need to be measured between two similar points in the market cycle. At the same time, actual returns will be affected by the entry and exit points, and sometimes timing will be much more significant than the industry suggests. Several actuaries have assumed long term real returns between 3% and 4%, in some cases for funds with a high proportion of growth investments, and some funds with a high proportion of growth investments have targets of 5% for real returns. On the other hand, I quote Phillippa Smith of ASFA on the 7:30 Report on ABCTV on Monday 23 July 2002 "...in terms of setting retirement incomes expectations, I would say that it is better to be more conservative and expect real returns on average of about six, seven per cent...". The context in terms of timescale and type of investment was not clear. Advice from the industry in the late 90s with reference to the previous 10 to 20 years tended to be consistently pointing to expectations of an average long term real return of 5% to 8% for growth funds.

Government policy will be based on some on modelling which will include some expectations on long term real investment returns as an average with some sensitivity analysis. Governments already provide a range of advice to consumers on other issues, (eg buying a home), and consideration should be given to advice or regulation in this area.

Questions have been raised about overseas investments in relation to Australian employment and also the weight of money driving up stockmarkets. The weight of money and also governance issues are increasing concerns. The large government,

corporate and industry super funds should be taking an increasing role in governance issues.

The volatility of exchange rates is large, and there are variations in hedging arrangements. Individuals may not be well informed on this issue, may not have investment choice on currency hedging, and the reporting by funds and trustees may be limited. Reporting of returns by asset class is sometimes limited as well. A large proportion of the expenditure by retirees beyond the initial years would be skewed to services and have a large Australian content. There is no inherent need to have exposure to foreign currencies to hedge against expenditure tied to those currencies. It is more a matter of maximising returns. Over the last 15 years, there has been an overall decline of the \$A. This provides currency returns on an unhedged basis, but will it continue, and what are the other economic implications for Australia if it does?

The implications are that average returns need to be viewed over the long term, and that there may be sustained periods up to 15 years of above average returns followed by the reverse. Many individuals and particularly baby boomers will build most of their savings over a 15 year period. People also have broken work, may make one off investments from inheritances and termination payments, and make one off drawdowns for large one off expenses in retirement.

Entry and exit strategies impact individuals. They don't necessarily buy or sell other investments with complete disregard of the market.

6. Other issues

There are several related issues not discussed in this submission. These include investment choice, choice of fund, reserve accounts in funds.

Most retail funds have unit prices which can often be obtained in real time over the phone from automated systems.

A particular complexity is the calculation of entry and exit prices or interest where an amount is only invested for part of the year, ie a sum is contributed or withdrawn (includes rollover), or investment choice is exercised. This occurs within some industry and corporate funds and possibly some government funds. Some reforms in this area could be considered.

There can be considerable differences in communication between members and the trustees of funds in the industry, corporate and government sector. Retail funds are excluded here. Sometimes there is less than full disclosure of pertinent information. Sometimes the trustees feel that too many members cannot understand the information that could be provided. This may have been addressed recently by a Productivity

Commission inquiry on the reporting by super funds. Some reforms in this area could be considered.

There is a wider issue of the literacy of individuals and education, including both adults, teenagers and children.

7. Fees and charges

Fees to financial planners and advisors that flow to individuals directly or indirectly are often large. They may not be transparent where the recipient is an employee of a large institution or has a close association with an institution. The commission structure that is prevalent is somewhat similar to the commissions of the 70s when life insurance was sold on a tax driven basis. A comparison can be made with trading in shares through a full service stockbroker with ongoing advice and through an automated discount broking service. There is competition in this area, but is there enough, and is the whole approach justified. Much of the advice is directed at explaining the complexity of the framework. Much of it explains the investment choices. The specific plans often follow patterns. The complexity could be reduced and broad education provided by other means.

There are probably a small number of asset consultants who advise trustees (and the latter are insured). The role and independence of asset consultants is perhaps open to the same concerns as currently exist with accountants who are both auditors and consultants. Of course at an individual fund member assumes the asset allocation role when they exercise choice of investment or choice of fund, or invest outside super.

8. Defined benefit funds

Most of the recommendations can probably be accommodated by defined benefit funds, particularly with respect to the surcharge where notional contributions have already been assessed. Many of these funds are closing in the government sector, with options being provided to existing members to transfer out of them. Are these funds declining in the private sector, and does the government have a policy on the future of these funds?

9. Sources of data

Centrelink and the ATO should have sufficient data between them to provide data by age of the individual and trends from one year to the next if arrangements are made for the future or suitable archives are available. They should also have some data for couples.

End of submission