Senator the Hon Mathias Cormann  
Minister For Finance and Acting Assistant Treasurer  
Parliament House  
CANBERRA, ACT, 2600

Dear Minister

SOME PROPOSALS FOR REDESIGN OF AUSTRALIAN SUPERANNUATION POLICY

In this submission, we make suggestions for further improvements to Australia’s superannuation policy. We would be very pleased to discuss these suggestions with you if you think that would be helpful.

By way of background, our comments are based mostly on discussions at a seminar organised by the Academy of the Social Sciences in Australia (ASSA) that became known as the Castles Roundtable (named after Ian Castles AO, former Secretary of Finance and Australian Statistician who was an expert on the interconnection between the tax and social transfer systems). The participants were a mixture of senior public servants, researchers in the relevant fields, representatives from NGOs and former agency heads like us. It was held in October 2011, after the Tax Summit of the previous Government. The focus of the Roundtable was on the personal tax and social transfers sections of the Henry Review (several members of the Review team participated in the Roundtable). There was a dedicated session on Age Pensions and Superannuation.

Whilst ASSA has agreed we should make this submission, and it is based on ASSA activities, it includes some personal views that have not been cleared with others in the Academy.  
Andrew Podger was secretary of several Commonwealth Departments and Public Service Commissioner in a long public service career in which he was closely involved in social policy including on retirement incomes. In 2006-07 he chaired a review of military superannuation for the then Government. He is currently Professor of Public Policy in the College of Arts and Social Sciences at ANU. Dennis Trewin was the Australian Statistician. He was a Trustee and Board member of ARIA (the Commonwealth employees’ superannuation fund) for 4 years. Both of us are Fellows of the Academy.

Our strong preference would be to phase out the current tax regime which taxes contributions and exempts benefits and replace it with the more orthodox approach of exempting contributions and taxing benefits. This would not only be fairer but more sustainable financially and more consistent with the objective of superannuation to help people spread their lifetime earnings. Pending such a major change, we recommend measures that would have a broadly similar impact and also ensure superannuation savings are used for genuine retirement purposes.
Our specific recommendations are:

1. Discontinue the proposed increase in the contribution of the superannuation guarantee to 12% to allow lower income workers in particular greater flexibility in how to use their income.
2. Remove the caps on annual contributions to enable better provision for retirement especially for those who are disadvantaged by the current arrangements such as women whose career is interrupted by caring responsibilities. A less preferred alternative is to have a cap on lifetime contributions.
3. Increase the age at which superannuation can be accessed while leaving a five year period before age pension age during which people would be allowed to begin their transition to retirement.
4. Limit the amount that can be taken out in the form of lump sums on retirement (or alternatively introduce taxation arrangements which strongly discourage the taking out of lump sums).
5. Mandate the proportion of the retirement benefit to be taken out as an account based income stream or, preferably, a lifetime annuity.
6. Develop the market for lifetime annuities.

These changes should lead to an increase in the superannuation funds available for investment. Furthermore, it should also reduce the pressure on the age pension.

Objectives and Basic Design of the Superannuation System

We believe the central objectives of the retirement incomes system are two-fold:

1. To protect the elderly against poverty by assuring they have access to a reasonable minimum income (essentially delivered by our ‘foundation pillar’, the age pension).
2. To facilitate the spreading of lifetime earnings so that people, in retirement, can maintain their desired living standards (delivered in our system by two pillars – the mandatory defined contribution (through the superannuation guarantee) and the voluntary contribution (also usually a defined contribution and fully funded).

This ‘three pillar’ approach has received wide acclaim internationally including by the OECD and the World Bank because of its much firmer funding base than the social insurance systems used in most of Europe and North America, but it still has weaknesses particularly in not providing secure income maintenance throughout people’s retirement years. We do not yet have widespread community understanding of the income after retirement needed to maintain living standards (the income replacement rate), or the level of accumulated contributions needed to achieve this (taking the age pension into account), or even the availability of suitable pension products.
Taxation policy is particularly important to the two superannuation pillars (under objective 2), as both involve individuals effectively setting aside some of their current income to defer consumption to their retirement years, and expect the government to facilitate this fairly. The Castles Roundtable participants had a clear in principle preference for taxing superannuation benefits rather than contributions (and earnings) for several reasons. Such an arrangement would be more consistent with international practice, provide a clearer incentive to set money aside for retirement beyond the guarantee while allowing the tax system to have a progressive impact on lifetime earnings and consumption. In the long run, it would better address the financial challenge of our ageing population, making people pay taxes when they receive and spend their benefits rather than taxing younger people earlier. Such an approach was excluded from the terms of reference of the Henry Review.

We recognise that there would be significant transition issues associated with any move to tax benefits rather than contributions, but note there are precedents for some form of grandfathering such as the different treatment of capital gains on investments acquired prior to September 1985. Modern IT capacity could make grandfathering easier than in the past. An alternative approach would be to identify taxes already paid on contributions and investment earnings and to allow some offset to a new tax on benefits in recognition of these, but we suspect such an approach would be very complicated.

If these transition issues, having been carefully explored, are considered not to be manageable, then it is important to adjust the current approach of taxing contributions and exempting benefits to more closely replicate the overall incidence of the tax system on superannuation savings that the preferred approach would have. This is what we understand the Henry Report’s recommendations were intended to achieve, through a progressive regime of taxes on contributions. Some moves have been made in this direction but they could be taken further.

**Relevant Henry Committee Recommendations**

- The tax on superannuation contributions in the fund should be abolished, increasing saving from currently taxed contributions by 17.5 per cent
- Instead, employer superannuation contributions in the fund should be included in employee taxable income. Subject to annual limits, all contributions would attract a tax offset payable to contributors
- All incomes and gains of superannuation funds should be taxed at a rate of 7.5 per cent, further increasing savings

Our specific comments on superannuation policy are explained below as they relate to the Accumulation Phase, Transition to Retirement Phase and the Retirement Phase.
Accumulation Phase

The retirement income system should be designed with a focus on the needs of the great bulk of Australians. At the lower end of the income scale, superannuation may not be a priority for the good reasons that they have other immediate needs and the age pension provides both protection against poverty and reasonable income maintenance. We do not suggest, however, that there should be any exclusions by design or opting out provisions as the universality of our superannuation system is one of its real strengths. There is nonetheless a question about the appropriate balance between the level of contribution to be mandated and that which is voluntary (with incentives).

We do not agree with the current policy to increase the employer’s compulsory contribution from 9% (now 9.25%) to 12%, and strongly oppose the Association of Superannuation Funds of Australia (ASFA) White Paper proposal to increase it further to 15%. Our view was widely supported amongst those at the Castles roundtable. While the additional amount would ostensibly be paid by employers, the impact on their profitability would almost certainly (and properly) lead them to seek offsets to their costs by lower salary increases (indeed, the original guarantee was negotiated between government, business and the unions as a trade-off for wage increases). In effect, it would force savings by employees some of whom might have more urgent needs at the time. While we certainly agree that, on average, most people need to set aside 12-15% or more of their incomes towards their retirement needs if they are to be able to maintain living standards, compelling all of them to do so throughout their working lives notwithstanding any other needs, would be too restrictive. A better approach would be to put more effort into encouraging higher personal contributions on a voluntary basis (or higher employer contributions negotiated by the relevant employees), facilitating higher voluntary contributions when circumstances allow (including the years after children have left home and the years immediately before retirement when discretionary income is often higher). There was no firm view at the Roundtable on what is the most appropriate level of the guarantee, and there was no criticism of the current 9% (particularly with some government assistance towards the contributions for very low income earners), but there was wide concern about the impact of increasing it much beyond the current level.

Holding the superannuation guarantee to around 9% adds to the case to remove the cap on voluntary contributions. This would allow persons to contribute at that part of the life cycle when they are best able to do so. Some, including ASFA, have suggested removal of the annual cap, but then imposing some cap on lifetime contributions. This may be better than the current arrangements, but our preference is that there should be no cap and instead, as discussed below, more effort should be directed to ensuring accumulated contributions are indeed used for retirement purposes. Arbitrary limits on lifetime superannuation contributions would run the risk of re-introducing complex arrangements such as those when RBLs were in place; in any case, the cap would have to be very high (eg if people on incomes up to, say, twice average earnings were allowed to use the system to maintain half that income in their retirement, the limit would need to be over $1 million).
We do believe that the level of subsidy for those with earnings at the high end is currently greater than necessary and could be reduced, but we would not support taxing the higher income earners to the extent that they are discouraged from spreading lifetime earnings as has been suggested by some commentators. Put another way, we believe it is inappropriate to think the benchmark for proper taxing of superannuation is the regime that applies to normal bank accounts (taxing incomes before the money is banked and taxing the interest earned, both at the person's marginal tax rate), but some increase in the tax paid by those on high incomes (say, over $180,000 pa) would be consistent with our preferred regime of taxing benefits rather than contributions.

**Transition to Retirement Phase**

We agree with proposals for a phased increase in the age at which super can be accessed but note that there is a case for access to some benefits before age pension age to facilitate transition to retirement. We suggest raising the preservation age to 62, maintaining a five year difference with the age pension age. The truth is, not everyone can work full-time to age 65 or 67, and society gains from the numbers of people (particularly women) who reduce their paid work at older ages to care for elderly parents or grandchildren and do other charitable work.

More important than a large increase in the preservation age is to limit how much can be taken in early lump sums not directed to genuine retirement income purposes. We discuss the issue of lump sums more generally in the next section where we suggest a significant proportion of accumulated benefits at preservation age be directed towards an account based income stream or lifetime annuity from age pension age. This in itself would reduce the funds available in the transition stage, but we are also attracted to an additional restriction. We believe there should be some limit on total early payments, whether through income streams or lump sums especially the latter eg one quarter of accumulated benefits at age 62.

The tax regime to apply to any lump sum payments would depend on the policy on taxing benefits generally. If all benefits were taxed as we have advocated, an equivalent scale like the one introduced in 1983 would need to be considered for lump sums, or something tougher to discourage lump sum payments. If benefits are not taxed, some penalty tax on lump sums, or lump sums over some threshold, could be considered but our inclination is for a firmer requirement for lifetime annuities while allowing some flexibility in drawing down the remaining accumulated benefits as the retiree assesses his or her needs and preferred lifestyle.

**Retirement Phase**

We believe Australia’s retirement system still has some way to go to mature as a widely understood, reliable and adequate system of income maintenance in retirement. Allowing individuals to run down their retirement savings by taking out a significant part in the form of lump sums is perhaps the most obvious example of this lack of maturity. Among other things it places unnecessary pressure on the age pension as a safety net and the default insurance for many against the risk of longevity, adding to future budget pressures. Indeed some financial advisers actively encourage their clients to take out lump sums and spend them so they are eligible for the age pension. The system
needs to be focused on delivering acceptable income throughout people’s retirement years, with some flexibility to consume more during the early, active years of retirement. Whilst taxing lump sum withdrawals could be a step in the right direction we prefer an approach where a certain percentage of the lump sum would be mandated to be converted to an account based income stream or a lifetime annuity. An intervention of this nature is standard practice in many other countries and would go a long way towards changing the public mindset from simply total accumulated contributions to the level of contributions required for income security throughout retirement years.

We agree with proposals that would encourage the take up of lifetime annuities but, as stated above, we would go further and suggest that a percentage of the lump sum should be converted to a lifetime or deferred lifetime annuity. The take-up of lifetime annuities in Australia has in fact been steadily reducing and is possibly the lowest in the OECD. More analysis is needed on the amount that should be mandated but it should be significant rather than a token amount, aimed to encourage an ongoing income replacement rate of at least 60% by the time our system has matured. This mandated percentage needs to allow sufficient flexibility to manage the transition to retirement and allow superannuants to spend more in the early years of retirement if desired, but it should not allow people to use the age pension as their main form of longevity insurance when their tax-supported superannuation savings ought to be used for that purpose.

The current tax and regulatory impediments to the provision of lifetime annuities, including deferred annuities, also need to be addressed by the Government. The Henry Report noted the problem for the market in managing longevity risk and identified various options for the Government to facilitate the capacity for providers to address this risk. These include issuing longevity bonds which might in time help the market to offer reasonably priced lifetime annuities. Our concern is that the market may take a considerable time to respond. If this was the case, another option identified was that the Government should offer indexed annuities for sale itself. These might be limited in value, say to the amount of the pension or the pension means test free area pending the development of a wider market, the funds from the sale being held in a suitable government investment fund like the Future Fund. Given the Government gives away such annuities now in the form of age pensions, the risk involved in selling lifetime annuities would be minimal, and would be more than offset by the reduction in the reliance on age pensions as longevity insurance. The Castles roundtable supported this sort of approach to address this important weakness in the Australian superannuation system and, if necessary, to kick start the market. However, the industry may be able to identify other options for developing the market and we would encourage consultation with them.

There is clear failure in this particular aspect of superannuation policy. On the supply side, as mentioned above, there are impediments to greater market provision of lifetime annuities. On the demand side, there are insufficient incentives to take up annuities. Both the supply and demand side need to be addressed. Australia is the only OECD country with a mandatory accumulation structure without an agreed de-accumulation structure. Longevity risk is not being managed well in a population that is ageing. There is a strong need for policy reform and research in this area.
Concluding Comments

We do not have the resources to cost our proposals but this obviously needs to be done and we are happy to assist with this work. Such analysis should be over the longer term so that any transition costs can be amortised. Our strong impression is that there would be significant savings to the government from the shift towards lifetime annuities and away from lump sums by reducing the demand for age pensions and, in the longer term, additional revenues from taxing benefits rather than contributions. However, the latter would also have a significant impact on the timing of the revenues (including an initial reduction in revenues) that would need to be assessed.

Our recommendations are not, however, aimed only at further improvements to the financing of Australia’s retirement income system, but to greatly improve its effectiveness in meeting the two fundamental objectives mentioned earlier.

We would be happy to discuss this further with you or your staff.

Andrew Podger AO, FASSA  
Professor of Public Policy, ANU
Dennis Trewin, AO, FASSA  
Policy and Advocacy Committee, Academy of Social Sciences in Australia  
Date: 14 April 2014