# Retirement Incomes Integration - Superannuation, Social Security & Taxation

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# Synopsis

The issue of provision for retirement incomes in Australia is attracting increasing attention for a range of reasons. These include poor returns on super funds over the last few years, the extreme complexity of superannuation, social security and taxation arrangements, and the increasing size of the lump sums that retirees unfamiliar with the investment world are required to manage. There is also concern that the system fails to adequately and smoothly provide for the transition from lump sum superannuation benefits to incomes in retirement which will keep pace with living standards.

There is a recognition that changes will need to be considered as a result of the Ageing Population. The Intergenerational Report[1] forecasts an increase in government Age and Veterans' Pensions expenditure from **2.9%** to **4.6%** of **GDP** over the next 40 years

Changes are also required to eliminate the many anomalies that have built up over the years and to simplify the systems – in short to properly integrate the outcomes of the operations of the government and private arrangements. Summary details of the current rules are set out in an Appendix to this paper.

It is noted that, within the "3 pillars" structure, there is no set of Government goals or objectives – nor has the Labor Party published one. It is desirable for changes to be planned in the context of such a framework. In addition, to minimise individual concerns and the need for elaborate transitional arrangements, any changes should be announced well in advance of their having any major impact.

**A number of problems have been identified for which possible solutions are put forward. These are summarised in Section 6 and addressed more specifically in the succeeding sections.**

The focus has been on eliminating anomalies and simplifying the system, improving the transition from lump sum to retirement income, and reducing government expenditure in the longer term, while increasing the viability of the private system to meet retirement income needs.

The Paper does not put forward a comprehensive set of possible government goals and objectives. However, in Section 20, the authors indicate that the suggestions are practical and/or capable of further development within the context of likely government goals consistent with community expectations.

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# 1. Introduction

## 1.1. The Australian System

Australia has a retirement incomes structure commonly referred to as a three-pillar system. The pillars are:

- A means-tested unfunded basic Government Age Pension available to all (eligible) persons living beyond an age from which the community considers there should be no obligation to work (currently 65 for males and 62.5 for females rising to 65 by 2014);
- Compulsory contributions to provide for retirement benefits (currently in the form of employer contributions of 9% of salary, the so-called SG (Superannuation Guarantee) contributions, which are made to approved funds; however self employed and non employees are not included); and
- A framework which encourages the accumulation of voluntary contributions for retirement above the compulsory contributions.

The Government pension is made either by the Department of Social Security (Age Pension) or the Department of Veteran Affairs (DVA Pension). References to "Age Pension" without qualification in this Paper include DVA Pensions.

The majority of Australians are now in lump sum accumulation funds. Many purchase an allocated pension or complying pension from the fund on retirement (often maintaining a similar investment portfolio to that which they held in the accumulation phase, pre-retirement). Many others will use the lump sum to purchase a separate retirement vehicle (and they need to transfer their assets to the new vehicle).

Australia's three-pillar system of provision for retirees is supported strongly by the main political parties and has general community acceptance.

It is also understood to be highly regarded by experts in other OECD countries.

**BUT**, if there are no major changes:

- The Intergenerational Report published in 2002 forecasts that the cost of Age and Veteran's Pensions payable by the Government will increase from **2.9%** to **4.6%** of Gross National Product by 2041/42;
- The full Age Pension is considered by some parties to provide no more than **75%** of the costs of a "modest but adequate" standard of living;
- The Assets Test for the Age Pension causes there to be no payment to an individual whose assessed assets are in excess of $302,500, **YET** a retiree with **$1 million of assets** PLUS a multi-million dollar home can arrange their affairs to receive a part Age Pension (and the associated fringe benefits).
- For the average Australian, the means test might operate to provide **minimal** additional net income from the investment of as many as 20 years' additional contributions for superannuation benefits;
- Retirement for most people will be dominated by:

- The need for continual education, advice and discussion on superannuation, social security, taxation and investments; and

- Concern over the ability of investments to provide adequate income throughout their (uncertain) remaining lifetime.

- Despite a working lifetime of compulsory superannuation contributions of 9% of earnings, the IGR estimates that more than **75%** of those reaching age 65 by 2041/42 will rely on receiving as part of their retirement income a full or part Age Pension - and this number could go higher with an increasing proportion of retirees utilising financial planning services;

These points suggest that there are some serious issues which need to be addressed if we want our system to be financially stable and meet the community's sense of fairness to stakeholders.

This requires a focus on interlocking the separate aspects of the system - in short, Integration.

In this regard, it is worth noting that one of the most difficult aspects of stabilising the system is the tension between taxing superannuation, targeting social security benefits to those in need, and encouraging self-sufficiency in retirement.

## 1.2. The Integration Problem

Australia's private superannuation and social security systems have developed separately with little linkage between the two. Changes to both systems are driven by a combination of taxation revenue policy and those short-term community needs identified as important by the government of the day. The interaction between them is complex and often inefficient. Moreover, when changes are made, consideration is given to "grandfathering" existing conditions for those who would be adversely affected.

There are several reasons why the two systems (and taxation policy) need to be integrated. The current system is inequitable and future costs will rise as the population ages unless benefits are properly targeted to those in real need. The issues need to be resolved now, as deferral will make integration more difficult and solutions will be more expensive.

Some of the issues demanding action include:

- Eligibility for the Age Pension is distorted by current rules. For example, means test anomalies lead to some of the relatively poor missing out on the Age Pension while many who are relatively wealthy, can collect it;

- Females rely more heavily than males on social security (since they live longer and are generally less self-sufficient than males in retirement);

- The Age Pension structure does not provide for partial or phased retirement;

- Age Pension costs are rising in real terms (as a percentage of GDP) and will rise sharply when the baby-boomer generation retires;

- Retirees are living longer, and mortality is likely to improve considerably through advances in medical science. This will place a further unknown cost on government revenue;

- Financial planning for retirement is often more about maximising social security benefits and minimising tax, than structuring long-term investment plans;

- There are inter-generational issues. Today's young workers are expected to self-fund more of their own pension, while funding (through their taxes) the Social Security benefits of many of those approaching retirement but unable to work, as well as benefits for current retirees;

- Many superannuation benefits are taken as a lump sum. Conversion to income streams which guarantee to keep pace with living standards on reasonable terms is virtually impossible.

It is difficult to integrate superannuation and social security structures without reviewing the objectives of national Retirement Incomes policy and the needs of those who are not self-sufficient in retirement. This Paper identifies many of the problems, reviews the issues and makes various suggestions for future government policy.

In summary:

- The structure of the Australian Retirement Incomes system is conceptually good, but it is inefficient due to poor implementation;

- Integration is hampered by the lack of clearly defined objectives;

- The structure has become too complex, and there appears to be little political agreement to simplify the system;

- Many anomalies have developed over the years which are difficult to eliminate without a comprehensive overhaul of the system; and

- There are public concerns about the value of superannuation – and clear cases where superannuation is not efficient.

## 1.3. Objectives of Paper

The prime objective of this Paper is to consider sensible changes to the Retirement Incomes model. These changes must be socially and politically acceptable, and may be introduced over a number of years. We examine where Australia will be without change, and then suggest short and long term modifications that will lead to a fairer and more efficient system.

### *1.3.1. Government Involvement in Superannuation*

Any consideration of retirement incomes needs to address the significant Government involvement in superannuation:

- The provision of "safety net" benefits through the provision of the Age Pension and various supplementary benefits;

- The taxation of superannuation contributions, investment income and benefits;

- Security of members' superannuation benefits through its regulatory regime;

- Member protection from undesirable selling practices;

- Member protection from diminution of small benefits;

- The sharing of superannuation benefits in divorce; and

- The range and types of investments permitted for superannuation funds.

### 1.3.2. Government Objectives

Governments are responsible for setting strategies for provision of retirement incomes and for development of long term savings.

All political parties and industry bodies now support the "three pillars" structure described above. Although there is much public criticism of the system, it is usually about the monetary outcomes and detailed aspects, rather than the basic structure.

Australia already has a commitment to a significant private sector involvement with substantial onus on members to manage their own investment strategies through the provision of investment choice.

Politicians, economists and other commentators appear to have a common view that Australians *must save more* and *must become more self-sufficient in retirement.* Therefore, this paper makes the critical assumption that it is achievable for private superannuation to *eventually* replace the Age Pension for *a majority of* Australians. Social Security will then be a genuine safety net for those in need.

It is not clear that this is an objective of Government, nor does there appear to be any sense of urgency amongst politicians to make the required changes to meet it. Sharp rises in the Social Security costs of the aged are not expected in the next decade. Hence, the problem is perceived to be a long-term one and there are no immediate electoral consequences of deferral.

Significant change will also create both winners and losers. Unfortunately, our three-year electoral cycle (and the threat of alienating some voters) almost *encourages* politicians to defer a review of the superannuation system. However, in practice, deferment of decisions will increase the problem and shift them to the next generation.

In the long-term, any proper integration of retirement incomes and social security will rely on the growth of member superannuation account balances, thereby allowing the majority of future retirees to be self-sufficient when they cease work. Integration of assets held outside superannuation is much more difficult to achieve.

### 1.3.3. What is Integration?

The Concise Oxford Dictionary defines "*integrate*" as "*to make into a whole*" or "*to complete by addition of the parts*".

Integration may mean simply recognising that two or more overlapping areas may be brought closer together or that they more smoothly allow for each other's impact. The concept of a "single composite system" has probably not been envisaged in relation to Superannuation, Social Security and Taxation.

We need to ask whether true integration along the lines of the dictionary definition is desirable or even achievable? What level of integration makes sense?

At one level, integration could be the constant changing of rules to impose apparent overall fairness. This is what happens now, though in an ad-hoc and uncoordinated manner.

At another level, integration could be the amalgamation of all income in retirement to provide a single monthly payment (after tax/tax rebates) derived from all (agreed) sources - with a separate advice setting out the breakdown of items contributing to the total.

While this might appear to be superficially utopian, it could have appeal to a significant proportion of the retired population. After all, consolidated reporting of investments was not a service available 10 years ago, but is now being promoted and implemented by a number of market participants. So, why not consolidated income reporting?

This Paper includes consideration of what degree of integration is desirable for a range of issues. This will have regard to other objectives, including greater simplicity which appears to be a universally supported objective for the system.

# 2. Current Arrangements

## 2.1. The Private Sector "Pillars"

### *2.1.1. Superannuation Guarantee Contributions*

Compulsory employer contributions commenced at 3% of earnings in the mid-1980's through a series of industrial awards. The payments were made in lieu of a national 4% wage increase. Industry funds grew out of many of these awards through the combined effort of trade unions and employer associations.

In 1992, the Superannuation Guarantee (SG) legislation was introduced to raise the level of compliance by employers, increase the contribution rate over time, and to expand coverage to the vast majority of employed Australians.

The employer rate of SG contributions reached 9% of earnings from 1 July 2002. There is no current plan to increase the SG above this, though a number of commentators consider that a higher rate is required if members are to receive an adequate retirement income from this source alone. It is noteworthy that the Commonwealth will introduce an accumulation fund for all Federal public servants employed from 1 July 2005. The contribution rate on this fund will be 15.4% of salaries, and the employer will meet the administrative costs of managing the fund.

Compliance with the SG is very high. If an employer does not make the payments within 28 days of the end of the financial quarter, then equivalent non-deductible payments, together with interest and penalties, have to be made to the ATO.

As the compulsory employer contributions have increased, the amounts of superannuation funds and the average account balances of members have grown rapidly. There is a popular view that the SG will gradually replace the Age Pension (and the authors consider this to be desirable for the majority of Australians). However, Treasury's own modelling shows that in forty years time, the majority of Australians will still receive part-Age Pensions, if there are no changes to the current rules.

### *2.1.2. Voluntary Contributions*

There are tax concessions for employers, low-income earners and self-employed individuals who make voluntary additional superannuation contributions. The co-contribution for low-income earners is quite generous; the government will match dollar for dollar up to contributions of $1,000 for those earning less than $27,500 a year (with a reduced level for those earning up to $40,000 a year). We can speculate that a significant part of these contributions will be paid by wealthy relatives of those starting their careers, rather than people who are long-term low-income earners, as the latter have little disposable income available to put into superannuation.

The amount of voluntary contributions is increasing but a high portion of these are *undeducted* contributions made by middle- to high-income people approaching retirement. The main objective of these transfers is to convert non-superannuation funds into superannuation benefits, where the tax on investment income is lower. Thus, in many of these cases, there is no addition to national savings, but simply a change of the tax structure of an existing asset.

### *2.1.3. Restricting benefits*

In order to reduce concessions for high-income earners, benefits have been limited through three key factors:

- The imposition of Reasonable Benefit Limits (RBL's) for tax concession purposes on retirement benefits;
- The imposition of limits (for tax purposes) on contributions; and
- A surcharge of up to 15% on deductible contributions (reducing to 12½% over the next 3 years), which is a tax on the contributions made by employers on behalf of high income earners.

## 2.2. Size of Private Superannuation Market

The Australian private fund sector is growing very strongly. All key indicators, namely assets, members and contributions, have shown strong past growth despite recent volatility of investments. This will continue for many years. As private account balances grow, the dependence of future retirees on social security will be reduced. Accordingly, Government objectives should include encouragement of all members to build their account balances.

The following items have all contributed to this growth:

- The increase in compulsory employer SG contributions;
- High real rates of return throughout the 1990's (largely due to increased amounts held in Australian and international equities);
- A growth in the number of people (baby-boomers) entering the pre-retirement years – and making higher additional contributions; and
- Public sector shift from unfunded defined benefits schemes to funded accumulation benefit arrangements for superannuation funds under management.

APRA produces a number of statistics about the size of the market and many of these are summarised in Appendix D[2]. These have been projected over the next 10 years by Rice Walker Actuaries[3] as follows (in 2003 dollars):

| Market segment | Today 30/06/2003 | | In 10 years 30/06/2013 | |
|---|---|---|---|---|
| | ($M) | (%) | ($M) | (%) |
| Employer funds in Master trusts | 45,000 | (8.4) | 192,816 | (17.5) |
| Personal super (retail) | 96,836 | (18.1) | 256,936 | (23.3) |
| Post retirement (retail) | 45,838 | (8.6) | 98,722 | (9.0) |
| Retirement Savings Accounts | 3,657 | (0.7) | 6,624 | (0.6) |
| Eligible Rollover Funds | 3,721 | (0.7) | 4,044 | (0.4) |
| Unallocated reserves | 9,500 | (1.8) | 0 | (0.0) |
| Corporate funds | 57,539 | (10.8) | 38,301 | (3.5) |
| Industry funds | 56,015 | (10.5) | 144,065 | (13.1) |
| Self-managed funds | 109,086 | (20.4) | 213,605 | (19.4) |
| Public Sector funds | 106,769 | (20.0) | 146,074 | (13.3) |
| **Total Market** | **533,961** | **(100.0)** | **1,101,187** | **(100.0)** |

## 2.3. Age Pension

### 2.3.1. *Eligibility*

The Age Pension is a benefit paid to most retired Australians. It is not a universal pension but is means tested. More than 25% of retirees receive a part Age Pension due to the application of the means tests. Payments are made from general taxation revenue, so it is a Pay As You Go (PAYG) scheme.

Subject to the means tests, Australian males who have attained age 65 and females from age 62.5 are entitled to an Age Pension payable by Centrelink, a government agency, on behalf of the Department of Social Security (DSS). The female retirement age is being gradually increased to age 65. People entitled to benefits from the Department of Veterans Affairs (DVA) receive similar payments but become eligible five years earlier.

The benefit is linked to 26% of Male Total Average Weekly (Ordinary Time) Earnings (MTAWE). The current pension is $452.80 per fortnight for a single person and $378.00 (each) for a married couple. Payments are indexed half-yearly in March and September. Appendix B sets out the current eligibility criteria, including the Income and Assets Tests.

The annual costs of the pension benefits (which are paid from taxation revenue) are:

| Financial Year | DSS $ billion | DVA $ billion | Total $ billion | Pension Costs as % of GDP | Annual Increase of Pension costs |
|---|---|---|---|---|---|
| 1999 | 13,295 | 4,748 | 18,043 | 2.78 | 3.26% |
| 2000 | 14,157 | 4,687 | 18,844 | 2.80 | 4.44% |
| 2001 | 15,599 | 5,284 | 20,883 | 3.04 | 10.82% |
| 2002 | 16,666 | 5,347 | 22,013 | 3.08 | 5.41% |
| 2003 | 17,773 | 5,416 | 23,189 | 3.16 | 5.34% |

*Source: Family and Community Services, Australian Bureau of Statistics*[4]

In 2000-01, there was a large increase in DSS and DVA costs. A pension supplement of 4% of the base pension at 1 July 2000 was paid as compensation for the introduction of GST. Of course, this table simply shows the changes in cash payments, not the underlying long-term liabilities of current pensioners. Michael Rice[5] calculated the present value of pensions to be $172 billion as at June 1997. These current liabilities are now of the order of $250 billion or 34% of GDP.

In addition to pensions, there are a number of other associated costs for retirees. The largest of these is rent assistance, which costs about $300 million a year.

### 2.3.2. *Current Cohort of Retirees*

Appendix C has a more detailed analysis of the status of people who have attained the retirement age. These include tables of pensioner statistics sourced from DSS and DVA data from July 1997 through to July 2003.

#### *Retirees*

From ABS data, we know the total population of pensionable age and the numbers of people in full-time employment. From DSS and DVA data, we know the numbers of people on full and part Age Pensions. There are also some deferred pensioners participating in the Pension Bonus Scheme. The balance must represent those who are *self-funded retirees.*

The status of retirees of pensionable age is summarised as follows:

| Number of People | Status as at June 2003 | | | | | | |
|---|---|---|---|---|---|---|---|
| | Full DSS | Part DSS | Full DVA | Part DVA | Self Funded | Employed* | Population |
| Males >65 | 455,537 | 246,493 | 104,872 | 50,776 | 217,172 | 60,200 | 1,133,271 |
| Females >62.5 | 735,189 | 333,201 | 176,828 | 37,511 | 304,922 | 32,116 | 1,618,958 |
| Total | 1,190,726 | 579,694 | 281,700 | 88,287 | 522,094 | 92,316 | 2,752,229 |

** includes 55,161 people registered on the Pension Bonus Scheme. There are similar numbers of males and females in this scheme.*

*Source: Family and Community Services, Australian Bureau of Statistics*

In addition, there are younger DVA pensioners due to the earlier eligibility age and also some younger DSS pensioners who are married to, or dependent on, Age Pensioners.

The above table also excludes retired Australians who are resident overseas. In June 2003, there were resident overseas: 18,913 males and 16,012 females in receipt of full DSS pensions, and 14,341 males and 12,743 females in receipt of part DSS pensions.

### *Percentages*

The above table re-expressed as percentages shows:

| Percentage of Population of (DSS) Pension Age | Status as at June 2003 | | | | | | |
|---|---|---|---|---|---|---|---|
| | Full DSS | Part DSS | Full DVA | Part DVA | Self Funded | Employed | Total |
| Males | 40.2 | 21.8 | 9.3 | 4.5 | 19.2 | 5.3 | 100.0 |
| Females | 45.4 | 20.6 | 10.9 | 2.3 | 18.8 | 2.0 | 100.0 |
| Total | 43.3 | 21.1 | 10.2 | 3.2 | 19.0 | 3.4 | 100.0 |

Reviewing these statistics and comparable figures for earlier years, leads to the following observations:

- Around 22% of retirees (including those still working) are entirely self-sufficient in retirement. The Age Pension, far from being a safety net for the poor, is an integral part of the income of most retired Australians;
- The percentage of males on full DSS pension is rising, though the females on full pension fell in the last three years. This is a function of the gradual increase in the female pension age;
- The number of fully self-funded pensioners has increased slightly over the last five years;
- The take-up of the Pension Bonus Scheme has been quite small - possibly due to the absence of publicity and the modest level of benefit. There were 55,000[6] participants after the first five years - out of 760,000 eligible. Although this is a relatively small rate (about 7.4%), the numbers have grown each year and the current level is close to 10% of eligible pensioners; and
- Many of those shown as still employed are likely to be self-employed and less likely to retire on Social Security.

### 2.3.3. *Dependency by Age*

We analysed the social security recipients by age, showing that people become more dependent on welfare as they grow older. This happens for two reasons:

- Older people were generally less well-off when they retired years ago than today's cohort of newly retired persons. Therefore, we would expect older people to be more dependent on welfare; and

- The sharp rise in dependency between ages 65 and 80 shows that retirees appear to become less independent as they age. This implies that they spend their assets in the early years of retirement, rather than utilising them over their lifetime.

### 2.3.4. *Trends over Time*

By examining the characteristics of the male cohort at age 65 in June 1997 and again six years later, at age 71 in June 2003, we can observe the movements of this selected group between the different categories. Using population mortality, we can also compare the size of each group in June 2003 against the number of expected survivors from the original cohort in June 1997.

After allowing for expected deaths, the number of employed males had fallen by 4,696 from June 1997 to June 2003. The number of people without pensions also reduced by 3,753. This is in line with our assumptions that more people leave the workforce as the group ages, and that some of the self-sufficient group begin to claim the pension.

The number of people with DVA benefits increased slightly within the period, as some people transfer from the employed or self-sufficient group to the DVA group.

The transition movements between the full pension and part pension are more complex. The change in the number of people on full pension may be due to the later retirement of those employed at the start of the period or the increased reliance of those previously on part pension. The change in the number of people on part pension is a result of those employed or self-sufficient at the start of the period, becoming eligible or some transitioning between full and part pensions over the six year period.

| Male cohort | June 1997 (age 65) | | June 2003 (age 71) | |
|---|---|---|---|---|
| | Number of People | Percentage of Population | Number of People | Percentage of Population |
| Full DSS Age Pension | 25,357 | 37.2% | 29,800 | 48.9% |
| Part DSS Age Pension | 16,007 | 23.5% | 16,348 | 26.8% |
| DVA Age Pensions | 1,716 | 2.5% | 1,674 | 2.7% |
| Self Funded | 16,218 | 23.8% | 10,337 | 17.0% |
| Employed | 8,875 | 13.0% | 2,742 | 4.5% |
| **Total** | **68,174** | **100.0%** | **60,941** | **100.0%** |

*Source: Family and Community Services, Australian Bureau of Statistics*

A startling statistic is while 37% of 65 year old men were self-sufficient, just six years later less than 22% of the same group did not claim welfare pensions.

# 3. Current Issues

## 3.1. Adequacy

It is not possible to set a national Retirement Incomes policy or to target reasonable benefits in retirement until the government and community have determined an appropriate target income for the average retiree.

The (now defunct) Senate Select Committee on Superannuation released a report in December 2002 which, amongst other things, considered adequacy of retirement incomes. The report contains a detailed review of adequacy and considered the views of the broader superannuation industry. Obviously, there is no correct answer for any particular individual but it is still necessary to develop a target.

The Committee requested details from Treasury, which provides all the figures used by government, of its modelling. It assumes adequacy to be a replacement rate of 60% of gross income for a single male retiring at age 65 after 30 years of work on average earnings. This figure includes income from all sources, including the Age Pension.

This person is atypical for a number of reasons. These include:

- The wide diversity in number of years worked in a career;
- The tendency for the majority of Australians to retire prior to age 65;
- Much higher annuity rates for females together with periods of broken service for child bearing and raising; and
- Skewness of income which means that the majority of people earn less than average weekly earnings at any time.

The Committee noted that there was a high degree of consensus amongst industry experts that the desirable target for a person on average earnings should be a replacement rate of 70-80% of the pre-retirement expenditure. This equates to about 60-65% of gross pre-retirement income.

The Committee also noted that the target would need to be higher for those on lower incomes and a lower percentage for those on high incomes. It also found that the current superannuation arrangements are unlikely to deliver these outcomes and that other strategies would be required to address the anticipated shortfall.

Dunsford and Ho in their paper for the May 2003 IAAust Convention, "The Future for Retirement Incomes"[7] drew upon work carried out by NATSEM on the development of a "Living Standards Index". This approach attempted to accommodate the differing reasonable expectations of those on higher and lower pre-retirement incomes.

Their conclusions included that, on certain assumptions:

(1) A middle income couple (earning 100% and 75% of MTAWE) could maintain their pre-retirement living standards in retirement, with 50% of their pre-retirement earnings. (This was due partly to the significant tax concessions available to pensioners).

(2) The SG contribution rate should be increased to 10% of salary (exclusive of cost of insurance benefits) in order for 40 years' contributions to be reasonably expected to

maintain pre-retirement living standards in retirement, for a range of couples and single males. Single females would require higher contributions.

Other commentators have suggested a higher SG in the range 12% to 18%. The actual number required depends on a number of factors relating to the individual.

## 3.2. Investment and Inflation Risks

One of the major changes that has occurred over the last 20 years in Australia has been the gradual transformation from defined benefits to accumulation funds.

In the private sector, new entrants almost universally have been required to join accumulation funds for the last 5 years. In some cases, existing members of defined benefit schemes have had their accrued benefits frozen, and future contributions paid into an accumulation scheme.

Therefore, most people are now subject to three specific risks which have created a greater degree of uncertainty in terms of retirement incomes. If there is any major criticism of our current system, it is the fact that we have moved away from a pooling of some risks, towards individuals bearing the risks with consequent greater variability and uncertainty.

The three specific risks now borne by Australian workers are:

- The investment performance of member accounts;
- Risks of inflation in that there is no guarantee that benefits will maintain their value in real terms; and
- Risks, particularly longevity, associated with converting a lump sum on retirement into a suitable income stream.

It is noteworthy that many Parliamentarians and judges remain in defined benefit schemes with very generous terms. This issue receives frequent media attention, and the Federal Labor party has indicated that it could review these schemes should it come to power.

It is often claimed that the generous pension arrangements exist as compensation for lower basic remuneration. If this is felt to be the case, consideration should be given to moving the politicians and judges on to a standard 9% SG arrangement and to increasing their salaries by the excess of normal contributions required to meet their current superannuation arrangements over 9% of salaries. This would reduce media attention on the super arrangements and allow their "normal remuneration" structure to be subject to more objective scrutiny.

Even though new Federal public servants will be subject to the above risks from July 2005, this is ameliorated by the high employer contribution rate (15.4% plus the cost of administering the fund).

## 3.3. Longevity Risk

Some people live for many years in retirement; others do not. On average, females live longer than males and smokers have a lower life expectancy than non-smokers. In the future, advances in medicine and other sciences are expected to increase longevity generally.

Community focus should be on the adequacy of incomes in retirement – however long that period of life may be.

The community does not discriminate between those who live for a short period and those who live for a long period in terms of the annual cost of providing the Age Pension. There is no call for the estates of those who die early to receive some form of compensation for the failure of the deceased to collect the balance of an expected number of years of Age Pension payments.

The reverse is the case for private lifetime pension payments where the focus is on the cost of purchase. Females are expected to pay more than males of the same age for the same annual pension. If the life insurance industry carried out underwriting of prospective pensioners, the cost of the pension would vary according to expected longevity.

Thus, for lifetime pensions, the cost of individual longevity is borne by the community in the case of Age Pensions, and borne by those dying early in the case of private pensions.

The concern over possible “loss of capital” in the event of early death is a major reason why private lifetime pensions are not popular. In practice the private market for lifetime annuities is weak for a number of other reasons as well, including: poor returns as a result of the need for conservative investment to provide guarantees (and satisfy prudential capital adequacy requirements), and the expectation that “self-selected” pensioners will generally have greater longevity than the population as a whole. There is also the lack of an efficient “growth” product, apart from those paying pensions out of SMSF (DIY) arrangements.

In these circumstances, the focus of private superannuation has been on lump sums which are regarded as a personal “nest egg” for the owner to spend during their lifetime in such a way as to maximise their entitlement to the Age Pension. Many plan to retain the “capital” to leave to the family or other estate beneficiaries.

Were saving for superannuation to be a wholly voluntary exercise, and were there no tax benefits, then the community’s sense of fairness and acceptance that an individual should benefit from their own efforts, would tend to support this personal nest egg philosophy.

However, superannuation is now compulsory for employees, and there are significant tax benefits for all savings through superannuation. The purpose of these regulatory measures is to facilitate the provision of private retirement incomes and reduce reliance on government/community funded Age Pensions. Since the community is funding the tax advantages, it arguably has a right to influence how the benefits should be used.

With its focus on retirement incomes, it seems reasonable for the community to accept that longevity risk should be supported by the community (rather than borne by each individual) - at least to the extent of the equivalent of the Age Pension not paid by the government, but provided privately.

This can be achieved if part of an individual’s superannuation benefit were required to be used to purchase the equivalent of the part of the Age Pension (or the full amount) not available under the means test.

However, the mortality tables suggest that, for the same pension, the cost should be different for males and females. It should also be different depending on the health of the retiree.

The balance between the parties as to who should bear the cost of longevity is likely to become an increasingly important issue as the current Australian population ages and the pensions payable to the longer-living females increase.

## 3.4. Social Security Anomalies

The Social Security system is broadly based on the needs of beneficiaries. However, there are so many rules, variations and anomalies that it is debateable whether the structure is fair. Many recipients should be financially independent. Removing them from welfare would allow us to increase the benefits of those who live in or close to poverty.

We need to question the very structure of the system.

### *3.4.1. Couples*

The Age Pension structure was developed a century ago around the concept of a married heterosexual couple. In that male-focused era, pensions commenced at the end of a working life, which was set at age 65. Females tended to retire earlier. Today, there is legal equality between men and women and we are now moving towards equivalence of retirement ages.

In the modern world, the traditional lifetime marriage is no longer the norm for the majority. Perhaps one-third of all marriages will end in divorce, and perhaps one-third of all Australians will never marry. Alternative relationships, including same sex couples, are now relatively common.

The Age Pension for a single person is about 20% more than received by a person in a conventional marriage. Theoretically, two people living together share some economies and have lower costs. But many single people share in retirement. Why should nuns living together, or two sisters, or a homosexual couple be treated more generously than a married couple?

*Is it practical to move the social security system entirely to an individual (singles) basis?*

### *3.4.2. Renters & Home Owners*

Social Security recognises the higher cost structures of those people who rent in retirement. Not only does the Assets Test have higher thresholds for renters, there is considerable additional expenditure on rental assistance for Age Pensioners.

These rules were set in more egalitarian times. The value of homes now varies substantially by region. As the family home is exempt from the Assets Test, there is an incentive for pensioners with valuable homes to remain in them. This is reasonable, since many older people are reluctant to move away from familiar territory. However, the absence of death duties means that the community pays the Age Pension and other benefits, and the children then inherit a valuable tax-free estate.

Australia's high rate of home ownership ensures that most retirees live above poverty levels. Encouraging more people to own a home in retirement continues to be a worthwhile objective.

*Can we unlock the value of the family home for income-poor pensioners?*

*Should the Assets Test have a threshold for the family home (say, $600,000 in 2004 dollars)?*

### *3.4.3. Income & Assets Tests*

About 670,000 Australians receive a part-Age Pension. This is nearly 25% of all retirees. The test is applied quarterly, creating a great deal of administration and stress for pensioners.

It would make far more sense to conduct the test once at retirement, but this could not be done efficiently under current rules. Every time the post-retirement product rules or social security rules change, there are winners and losers.

*Could the system be changed to conduct a once only means test at retirement?*

### *3.4.4. Retirement Age / Pension Bonus Scheme*

Most people can retire at any time between 55 and 75. Yet the Age Pension has an inflexible retirement age – though even this is different for men, women and military veterans.

Most Australians retire *before* the official retirement age, often due to redundancy. This makes integration difficult. Until recently, people in this position were forced to use their accumulated superannuation benefits to stay afloat. Now these are quarantined if they receive welfare before Age Pension age.

The pension bonus scheme encourages people to work beyond normal retirement age in return for a large lump sum payment on actual retirement. The lump sum accumulates for up to five years. It has not been very successful with only 55,000 participants after five years of operation, compared with 760,000 eligible.

A major problem with the system is that the lump sum benefit received is worth far less than any Age Pension payments foregone by deferral. Nonetheless, the accrued lump sum payments for those who have deferred, is close to $1 billion. This does not appear as a provision in our National Accounts.

A further problem is that it is not possible for people to work part-time under the current system and take a part Age Pension as they then do not qualify for the Pension Bonus Scheme. In reality, we should encourage people to work either full or part-time, if they choose to do so.

*How can we help people to work part-time and gradually wind-down to retirement?*

### *3.4.5. Defence Force Veterans*

Eligibility for a DVA pension is five years less than for DSS. Historically, the armed forces and civilian groups such as the police and firemen have retired earlier than 65. The main justification was the physical nature of the work and the reward for engaging in war.

Is there any modern justification for a different retirement age?

*Why not equalise the DVA and DSS retirement ages (for future retirees), but give early retirement credits for those who do see active service?*

### 3.4.6. *Blind People*

Blind people are not subject to the Income and Assets tests. Why are they treated differently to other disabled people? Surely, this is a historical anomaly that has become difficult to change without offending the blind? If blind people have other needs, arguably these can be fulfilled through other social welfare benefits.

*Can we remove this privilege for the blind without appearing to be cold-hearted?*

### 3.4.7. *Migrants*

Migrants qualify for an Age Pension after ten years residency. Many migrants bring in their parents under family reunion programmes. If they are elderly, they may be required to fund their own health costs – in fact, they need to show that they have private health insurance. Eventually, they can receive a full Australian Age Pension, often with little or no contribution from their original homeland.

Some migrants return to their country of origin to retire. They may still receive a full or part Age Pension, but Australia does not then provide their health benefits.

*Where older people enter Australia under family reunion programmes, would it be reasonable to ask their family to contribute towards their retirement income benefits?*

### 3.4.8. *Poverty Traps*

The combination of means testing and tax rules frequently leads to high rates of "effective taxation" on marginal incomes for those earning between $20,000 and $30,000 p.a. In some cases the penalty can be more than 100%. Withdrawal of fringe benefits for such people (as well as some on lower incomes) as these "thresholds" are reached, exacerbates the position.

To a significant extent this arises from the desire to "target" government revenue to those most in need. Even so, it is also desirable to encourage personal effort for social as well as welfare saving reasons.

*Why not introduce a fundamental principle that no marginal effective tax rate should exceed 50%?*

## 3.5. Superannuation anomalies

### 3.5.1. *Self-employed Persons*

There is no compulsion for self-employed persons to fund their own retirement benefits as the SG does not apply in these cases.

This issue needs to be addressed as nearly 11% of the workforce, or over 1 million people, are self employed.

### 3.5.2. *Those not in Work-force*

Only moderate benefits can accrue for those not in the work-force. The separation of the nexus between employment and superannuation needs to be broken down further. Splitting of future contributions is a step towards this.

There are also problems for people excluded from the workforce for various reasons at different times. This indicates periods of unemployment, disability and child rearing. No superannuation contributions are made in these periods.

In particular, it could be considered reasonable that people on parental leave, or not working while raising young children, should receive some form of SG contribution during these periods. Of course, there is a major issue about who should bear the cost of such a benefit.

### 3.5.3. Taxes are based on Financial Years

The focus of tax concessions on individual years means that people who begin to accumulate benefits later in life are taxed heavily for doing so. The age-based contribution limits and the contributions surcharge both penalise those who try to catch up when in middle age.

### 3.5.4. Tax Status of Contributions

The tax-deductible status of contributions varies according to the status of the contributor. It would simplify the system if the tax status for contributions made by employers, employees and the self-employed could be harmonised in some way.

### 3.5.5. Lump Sum Benefits

The focus on lump sum superannuation benefits is probably the biggest barrier to any sound integration strategy. It is impossible for any individual to save for a target lump sum given the uncertainties associated with conversion into an income stream. Several of the potential solutions raised later address this issue.

### 3.5.6. Access Prior to Age Pension age

Currently, access to super benefits is available from age 55 (rising to age 60 by 2024). This has encouraged early retirement. Benefits can be dissipated prior to age 65 and then application made for the Age Pension.

*Should access to super be restricted prior to Age Pension age?*

## 3.6. Tax Issues

There are a myriad of taxation rules which impact an individual's superannuation benefit build up and retirement income.

It is difficult to measure the full impact of taxation policy due to the wide number of variables. However, we have set up a simple model to illustrate the relative damage to benefits at retirement, and comment upon the concessions for income in retirement which are intended to offset this damage.

### 3.6.1. Taxation of Contributions

The tax on deductible contributions at 15% reduces the 9% SG to 7.65%. This has the greatest effect on savings made closer to retirement age. Removal of the tax would increase benefits significantly.

Further, many people are also subject to the contributions surcharge, which can take up to an additional 15% (reducing to 12½% over the next 3 years). For people in middle age, this is often a further barrier to accumulating a reasonable benefit.

### 3.6.2. *Tax on Investment Income*

Taxing investment income at 15% has a similar effect as taxing contributions at this rate on the ultimate retirement benefits.

### 3.6.3. *What is a Reasonable Tax Take from Superannuation?*

The government takes $6 billion p.a. in various superannuation taxes. Against this, Treasury estimates the value of tax concessions to be about $12 billion p.a.

However, Government expenditure would be much higher if all people of retirement age were receiving the full rate of the Age Pension.

For example, if all current retirees drew a full pension, the expenditure for Age (and Veterans') Pensions would rise from $23.2 billion to $32 billion p.a. This shows that superannuation (and other accumulated wealth) does lead to significantly reduced government expenditure for retirees.

### 3.6.4. *Impact of Tax*

Let us assume that a young employee earning $30,000 p.a. wants to accumulate enough at retirement to guarantee a lump sum of $100,000 (in today's dollars) and a retirement income stream equivalent to the single rate Age Pension at age 65. Using the key assumptions of a 7.5% gross earning rate, and 4.5% salary increases to age 65, we can calculate the required contribution rate.

| Age At entry | Required contribution as a percentage of salary | | | |
|---|---|---|---|---|
| | Current taxes | No Investment Earnings Tax | No Contributions Tax | No Taxes |
| 20 (male) | 9.2 | 7.7 | 7.8 | 6.6 |
| 30 (male) | 14.3 | 12.5 | 12.1 | 10.6 |
| 20 (female) | 10.3 | 8.6 | 8.7 | 7.3 |
| 30 (female) | 16.0 | 14.0 | 13.6 | 11.9 |

Clearly, the impact of taxes made before the benefit stage is profound.

### 3.6.5. *Tax Advantages*

To offset the impact of taxes on the superannuation benefit build up, there are several legitimate devices used to minimise taxation in retirement. The following example is based on advertisements from major financial institutions.

Take a married couple, Ann who is 63 and Bob who is 66.

They have retired with a lump sum superannuation benefit of $230,000 each to invest. They invest all of their benefit into an allocated pension account, which generates a pension income of $26,400 for each of them in the first year of retirement.

For each individual, the marginal rate of tax paid on the pension income is as follows:

| Taxable income $ | Marginal tax rates % | Marginal tax paid $ |
|---|---|---|
| 0 - 6,000 | Nil | Nil |
| 6,001 - 20,000 | 17% | 2,380 (=17%*14,000) |
| 20,001 - 50,000 | 30% | 1,920 (=30%*6,400) |
| **Total** | | **4,300** |

Each is eligible for the pension rebate, which is 15% of the pension income. This amounts to $3,960.

Each will also obtain the Senior Australians Tax Offset of $340 each. This is based on the full rebate of $1,602, reduced by 12.5 cents for every dollar of taxable income that is above $16,306 but less than $29,122.

The overall tax position for each of the couple is such that the tax payable ($4,300) on the pension income is completely offset by the two rebates ($3,960 + $340).

In effect, the couple can receive a combined retirement income of $52,800 a year tax-free.

The example assumes that they have no other source of income. In subsequent years of retirement, the level of annual pension income will vary as the age of the retiree and the relevant pension multiple changes.

It is worthwhile comparing this couple with a single income family with three children. In this case, the tax paid on similar family income can be as high as $6,645 after allowing for family income benefits. While the retirees' concessions exist ostensibly to offset the tax levied during the Superannuation accumulation phase, there may be a serious inequity in the tax system.

## 3.7. Complexity

The complexity of the (1) Superannuation, (2) Social Security and (3) related Taxation legislation is such that financial planners' primary focus of developing a plan to meet financial needs must often be relegated to 4th position in terms of priorities, when providing advice to retirees and those about to retire.

# 4. Government Goals

## 4.1. Primary Goal

In our view the government's primary goal should be to ensure that community attitudes towards provision for retirees are satisfied. This has led to the following general goals for retirees:

- Ensure provision of basic needs in relation to daily living, health and aged care; and
- Encourage financial independence.

These have led in turn to the three-pillar structure for the provision of retirement incomes.

## 4.2. Long Term Goals

In considering long term goals, it is necessary to examine how community attitudes may change in the future. While some reasonable forecasts can be made, inevitably actual changes will occur which are not anticipated. In these circumstances, it is desirable to have a structure which facilitates future changes relatively easily.

The term "*community attitudes*" is vague, and the government of the day may interpret them in different ways - possibly depending on its political persuasion.

A possible approach to these issues is to recognise that there is a "mix" of government and private involvement in each element in the structure, to identify each element and the current mix, and provide for this to be varied in the future on an efficient and fair basis.

The existence of the means test demands some degree of integration between Superannuation and Social Security arrangements. It would appear that one long term goal is the achievement of a genuinely integrated structure - arguably including taxation. This could be seen as a desirable end in itself. Certainly, it would probably be a prerequisite to achieving a simpler system.

Possible future changes in community attitudes which may influence the development of other long term goals are:

### *4.2.1. Treat all People as Individuals*

At present, there is a strong focus on "couples", based on the historical experience that the majority of retirees will be "married once only" couples.

Today, retirees will be in a wide range of relationships. Those living in the same home may be in temporary de-facto relationships, homosexual relationships, or other non-traditional relationships. Some of these are treated as couples for social security benefits (i.e. each receiving less than half the single pension benefit); others are not. Changes in relationships post-retirement also appear to be increasing.

The financial treatment of these situations is now considered by many to be anomalous.

Recently, legislation was passed to provide for superannuation benefits to be included as part of the assets and income to be shared between the parties following divorce.

The possible development of greater freedom for individuals and complexities resulting from differing relationships could lead to community attitudes which demand a total focus on each person as an individual in relation to social security benefits.

Superannuation and taxation rules which treat payments of death benefits to a (traditional) spouse differently from others could also be reviewed under this approach to avoid the current anomalies.

### *4.2.2. Include Value of Home Equity in Means Test*

The historical experience, that most retirees will live in their own home, mortgage free, is no longer a reasonable model. Many will still have a mortgage outstanding; many others will be renting.

The latter may well come about simply as a result of the rise in house prices relative to earnings. This has generated its own issue of the value of home equity for those who are owner occupiers and the current exemption of the value of the family home from the means test.

The community see this as a "fairness" issue. While there does not appear to be an expectation that retirees should be forced to sell their properties to realise their equity, it seems reasonable that the financial services industry should be able to assist retirees to obtain some income from their equity, and that this income (real or "deemed') should be assessed in the same way as other private income.

### *4.2.3. Encourage Later Retirement*

The forecast increase in costs of Age Pensions to be borne by a smaller proportion of workers in the population, needs to be seen in the context of future retirees generally being better off than those currently retiring - as a result of much larger private superannuation benefits.

It is probable that the community will consider this position unfair or unsustainable or both.

It seems likely that increasing longevity will result, in the future, in community expectations that most people should work until a later age than 65.

Long term goals to generate such a change on a reasonable basis would be to remove encouragements to retire early and increase encouragements to work at older ages. This could be on a part-time flexible basis or full time.

Again, implementation of such changes would probably need to be phased in over a period, in tandem with removing the current anomalies.

### *4.2.4. Require Retirement Assets to be used over Lifetime before Access to Age Pension*

The structure of the current Income Test accepts that it is only the income derived from assets that should be considered as generating the need for a reduction of the Age Pension. The capital can be retained for the children to inherit.

This effectively requires the community to support the preservation of retirees' assets for those fortunate to inherit them.

In the context of the increasing cost of Age Pensions (and other services for retirees), it may be considered that access to the Age Pension should be available only after retirees' assets have been committed to be used over their lifetimes.

## 4.3. Other Long Term Goals

Other long term goals could include making improvements to the system to achieve the following general outcomes:

- Simplicity (of superannuation, social security and tax rules);
- Robustness;
- Fairness (including better targeting of benefits and avoidance of poverty traps);
- Affordability;
- Security;
- Stability; and
- Flexibility (in meeting the needs of people in differing circumstances).

## 4.4. Achievement of Long Term Goals

Achievement of long term goals will often mean changes which will have an immediate impact on the current benefits and expectations of at least some individuals. Inevitably, there will be a strong focus on those who would be "disadvantaged", from the financial services industry, politicians and the media.

This scenario has led to many changes being made on a piecemeal basis and with "grand-fathering" of some aspects of existing arrangements. In turn, this has resulted in even greater complexity. It has also often led to increased costs to the government - almost becoming recognised as a price to pay for the necessary political support for any changes.

The current situation demands a major overhaul of integration and other arrangements. Moreover, reining in future government costs is likely to be one of the major priorities.

The achievement of major changes on a simplified basis will require:

- A long term focus;
- Measures which will reduce future expectations for some;
- Minimal use of grandfathering measures; and
- Ability to adjust the system, consistent with the above goals, easily in the future.

Inevitably, the general community requirement for "fairness" will conflict with the aim of simplicity. This conflict may be minimised if there is a sufficient notice period (and possibly phase in period) for the necessary changes to smooth transitional arrangements.

## 4.5. Recognise Social Security Benefits in National Accounts

### *4.5.1. Social Obligation*

All Social Security benefits are paid from taxation revenue. As the population ages, the dependency ratio of pensioners to workers will increase. This will lead to higher average taxation rates needed to fund pensioners' income.

Age Pension liabilities are contingent upon retirees remaining eligible to receive them. However, once on pension, those drawing a full Age Pension at retirement usually continue to do so throughout retirement. Unless they receive a windfall or they sell an asset-exempt home, their financial circumstances are not going to change. Many of those on part Age Pensions will become more dependent as they grow older.

Further, the Government has effectively guaranteed to maintain the single rate of Age Pension at 26% MTAWE (post GST) so there is a clear obligation for future tax-payers to meet these costs. For all practical purposes, the future pension benefits of those people who have already retired are liabilities that we should recognise[8].

### *4.5.2. National Accounts*

There are several reasons for putting the value of these liabilities on the National Balance Sheet:

- Transparency

Governments will be in a better position to plan. Decisions as to whether to increase benefits or change eligibility conditions can then be made with a clearer understanding of the long-term impact.

- Accrual Accounting

The government now has a general policy of accounting on an accrual rather than cash basis. It makes sense for long-term obligations such as Social Security benefits in retirement to be treated in this manner.

- Pre-funding

Pre-funding of benefits is cheaper if a real rate of return is made on investments. If the liabilities appear on the National Balance Sheet, it is more likely that the government will take steps to pre-fund its commitment.

The Australian Federal Government will eliminate most of its long-term debt over the next few years. It has been able to do this by using the proceeds from privatisations such as Commonwealth Bank and Telstra and from running a long series of budget surpluses. It now has an opportunity to pre-fund its pension commitments using future budget surpluses or the proceeds of future privatisations.

Many people approaching retirement are already receiving Social Security benefits and it can be argued that the community also has a long-term liability in respect of their future benefit payments. It would be possible to extend the idea of pre-funding pension liabilities by making provision for future cohorts of pensioners. However, it is unlikely that any government would make such a provision – at least until the benefits of current pensioners were funded.

# 5. Making Changes to the System

## 5.1. Introduction

Suggested solutions to current anomalies or complexities in Superannuation and Social Security legislation and processes are set out and discussed in the next section. Suggestions are also made in respect of related tax issues.

## 5.2. Transitional Arrangements/Grandfathering

It is generally considered that, when major changes are made to the Superannuation rules, some form of grandfathering of existing conditions for current members should apply. Partly this is due to political reality – when winners and losers from any change are created, the losers are the more vocal and this can be reflected as negativity to the Government in the polls. Further, there is little doubt that disruption of financial plans of those in retirement and these nearing retirement would be considered unfair by the broader community.

To some extent this approach may be considered to apply also to the Social Security system. In practice, there has been no dramatic legislative change which has negatively affected anyone for many years.

Governments of both major parties have tended to cultivate the "grey vote". The focus on moving towards the use of Superannuation to buy pensions has been encouraged through the "carrot" approach - i.e. tax and social security concessions and education, rather than the "stick" approach of making mandatory changes.

What tightening there has been, has focused on pursuing illegal rorts rather than fixing legal ones.

The possible solutions in this section include suggested approaches for grandfathering and other gradual change where this seems appropriate.

## 5.3. Targets

The Intergenerational Report forecasts that, with no changes to current rules, the cost of Age Pensions (including those payable under Veteran Affairs legislation) will increase from **2.9%** GDP to **4.6%** GDP over the next 40 years.

This is despite the fact that the Superannuation Guarantee (SG) scheme will have reached maturity for those then retiring.

The main reasons for this increase are:

- An increase in the proportion of pensioners to the total population;
- Increasing longevity of pensioners;
- General generosity of the means tests in assessing complying pensions; and
- Increase in early retirement and consequent use of superannuation benefits prior to Age Pension age.

It is worth noting also that there are potential pressures for increasing the cost still further:

- Increasing the basic pension to the "modest but adequate" living standard determined by ACOSS[1] and others - i.e. from 26% to about 34% of MTAWE;

- Increasing rent allowances from their present, clearly inadequate level - maximum $44 per week;

- Adopting the concept of individual assessment for all, rather than "couples" which apply to a reducing number of shared home relationships on an increasingly discriminatory basis;

- Shifting future benefits to a spouse through contribution splitting (thereby keeping the primary income earner below tax thresholds);

- Increasing the range and availability of fringe benefits;

- Adopting a growth complying pension (as suggested by the Senate Select Committee on Superannuation), which would increase the number of individuals taking advantage of the complying pension Assets Test exemption and generous Income Test treatment; and

- Further, a fixed term (life expectancy) complying growth pension would ultimately result in approximately half these pensioners living beyond their life expectancy and falling back on to a larger or full Age Pension.

In response to such pressure it seems probable that governments will focus on measures to:

- Improve targeting of benefits to those in real need;

- Eliminate anomalies; and

- Encourage working later in life.

Arguably this approach is also justified when it is recognised that the likely substantial increase in expenditure on the Pharmaceutical Benefits Scheme will largely benefit pensioners.

Accordingly, this is the general approach that has been adopted in this paper in relation to putting forward suggestions.

In practice, all aspects of the system, as well as the suggestions for improvement, can be adjusted by degrees in dollar terms to achieve desired government targets.

## 5.4. Elimination of "Poverty Traps"

The targeting of government expenditure to those in most need creates possible "poverty traps". Many individuals have little incentive to increase personal earnings due to loss of benefits and additional tax.

This position applies in a range of Social Security benefit situations. It is noticed in the case of Age Pensions where the Income Test reduces benefits by 40% of marginal earnings, tax and Medicare levy can take up to another 44% of the balance (including reduction in Senior Australians Tax Offset) i.e. up to 66% in total.

If the pensioner has assets in excess of $150,000, it is possible for the Assets Test to effectively impose a total penalty of over 100% of additional income generated by any increase in those

[1] Australian Council of Social Service

assets. In addition, loss of any part Age Pension leads to the loss of the Commonwealth Health Card and the associated fringe benefits.

It is considered that the elimination of “poverty traps” is desirable from a community point of view for a range of reasons:

- Encouragement of personal effort and earnings has economic benefits;
- The existence of “poverty traps” results in welfare dependency and public cynicism; and
- The potential for significant loss of benefits encourages non disclosure of earnings.

However, the actual proposals for elimination of “poverty traps” and their methods of implementation are crucial to the achievement of positive outcomes. Indeed, initially, expenditure may need to be increased, so that a clear plan and monitoring of outcomes will be essential.

One of the proposals in this paper is a structure for the integration of Tax and Social Security benefits. It is appreciated that this is a wider subject than solutions to retiree issues. However, it is put forward briefly in Section 16 (Problem J), as a basis for possible further development.

# 6. Summary of Identified Problems and Possible Solutions

A summary of the identified problems and possible solutions is as follows:

| Problem | Possible Solution(s) |
|---|---|
| **Superannuation Issues** | |
| **A.** Industry Retirement Income Products do not (currently) match Needs of Retirees | |
| (1) The Life Insurance industry does not make available annuities which provide income guaranteed to keep pace with living standards. | ***The Government Issues Bonds which provide income which is Guaranteed to Increase in line with Increases in Average Weekly Earnings or the Age Pension.*** |
| (2) The Life Insurance industry does not provide lifetime annuities on attractive terms due to the need to allow for the "self selection" of annuitants and the uncertain rate of improvement in longevity generally. | ***Part of a Retiree's Superannuation Assets are Compulsorily required to be used to Purchase a Lifetime Annuity.*** |
| **B.** The government is not adequately insulated against the consequences of retirees' investments failing to provide expected levels of income throughout retirement | ***(1) Require Purchase of Equivalent of Part or Full Age Pension with Compulsory (SG) Superannuation Benefit at Retirement.***<br>***(2) Offer All Retirees Opportunity to buy from the Government the Balance of Age Pension (or Full Amount) they were denied under the Means Test.***<br>***(3) Pre-Fund Age Pension.*** |
| **C.** Early Retirees can spend their Superannuation benefits and then claim the Age Pension. | ***Make Access to Super prior to Age Pension Age Conditional upon Buying the Full Age Pension.*** |
| **Social Security Issues** | |
| **D.** The Equity of Retirees in their own Homes is not assessed under the Means Test. | ***Assess Owner Occupier Home.***<br>***(1) Assess (Excess) Rental Value - All Homes***<br>***(2) Assess (Excess) Rental Value - Higher value Homes only***<br>***(3) Assess (Excess) Potential Home Equity Release Income***<br>***(4) Introduce "Claw Back" on Death*** |
| **E.** Complying Pensions are assessed for Social Security purposes on a basis which excludes the "capital content" element of the pension, resulting in many richer people being able to claim the Age Pension. | ***Assess Complying Pensions in Full as Income, for means testing purposes.*** |

| | Problem | Possible Solution(s) |
|---|---|---|
| **F.** | The Assets Test assesses marginal assets on a basis which often results in reduction in total Income. It is also inconsistent with the Income Test. | ***(1) Means Test Assess Incomes Only, Deeming Income from Specific Assets as required.***<br>***(2) Deem all Assets as capable of providing Means Test Assessable Income at a Current Lifetime Annuity Rate.*** |
| **G.** | There are insufficient financial incentives for those eligible for the Age Pension to work beyond Age Pension age. | ***Ignore Earnings from Personal Exertion under Income Test Assessment.*** |
| **H.** | Married couples as individuals receive less Age Pension than Singles or those in other types of relationship living in the same house. | ***Move Age Pension Assessment from Couples to Individuals.*** |
| **I.** | Frequent Means Tests are often harrowing for pensioners and involve significant time and effort on their part as well as the Government. | ***(1) Pay Age Pension to All People from Advanced Age***<br>***(2) Means Test "Once Only"*** |
| | **Taxation Issues** | |
| **J.** | Double Taxation of Means Tested Benefits | ***Hold maximum tax threshold at 50% of income*** |
| **K.** | There are insufficient incentives for individuals to make voluntary contributions to superannuation funds. | ***Allow Tax Relief for All Types of Voluntary Super Contributions (subject to limits)*** |
| **L.** | The superannuation surcharge is a highly inefficient form of taxation | ***Cap superannuation taxes in real terms***<br>***Eliminate Surcharge in Favour of Increase in Top Marginal Tax Rate***<br>***Shift tax liability to companies rather than superannuation funds.*** |

While each "solution" may have its merits, it is possible that changes are more readily achieved if all or some of the solutions are implemented as a package. This particularly applies where the solutions may have complementary financial outcomes for most people – i.e where "positives" and "negatives" broadly offset each other.

The following sections set out the possible solutions and their arguments in more detail and note possible disadvantages.

Other suggestions to assist in the process of improving integration are:

- Set a Target Benefit of the Maximum Tax Free Lump Sum (Currently $117k) plus Full Age Pension; and
- Fund Unfunded Liabilities

# 7. Problem A – Poor Retirement Income Products

## 7.1. Industry Products do not (currently) match Needs of Retirees

Retirement needs require primarily a steady income increasing in line with living standards. Although pensioners become less active as they age (and therefore consume less), they tend to spend more on health related items and services.

Guaranteed annuities in the market are poor value for money as a result of the need for conservative investment and longevity protection against self selection.

They also do not keep pace with living standards, with income commonly linked to CPI increases (and capped), rather than to average wage increases.

Future tax payers will ultimately need to provide for those whose investments fail to meet retirement income expectations.

Arguably there are two problems, with possible solutions as follows:

## 7.2. Problem A (1)

**The Life Insurance industry does not make available annuities which provide income guaranteed to keep pace with living standards.**

### *7.2.1. Possible Solution*

**The Government issues Bonds which provide Income which is guaranteed to increase in line with Increases in Average Weekly Earnings or the Age Pension.**

Ideally, the bonds are in the form of medium to long term, term certain annuities with no residual value.

**Disadvantages**

The channelling of retirement funds into Government bonds may direct some private money away from industry and property development.

In practice, it is the fixed interest part of many portfolios which will be exchanged for “living standards” bonds.

The Government will, however, need to reconsider its current practice of aiming for budget surpluses to retire debt. One approach may be to use the proceeds from issuing “living standards” bonds, to invest in trust funds established for funding part of its own unfunded superannuation and pension liabilities.

## 7.3. Problem A (2)

**The Life Insurance industry does not provide lifetime annuities on attractive terms due to the need to allow for the "self selection" of annuitants and the uncertain rate of improvement in longevity generally.**

### *7.3.1. Possible Solution*

**Part of a Retiree's Superannuation Assets are Compulsorily required to be used to Purchase a Lifetime Annuity.**

One form of compulsion could be to require those reaching Age Pension age to purchase the equivalent of the balance of the Age Pension (or the full Age Pension) to which they are not entitled under the means test.

This approach will enable life offices to issue annuities to such retirees allowing for population longevity rather than self selected annuitant longevity.

The combination of utilising population longevity with "living index" annuity bonds should enable the estimated cost of the Age Pension at age 65 under an annuity bought by a life company to reduce from the current $250,000 to around $200,000 for a male. (A superannuation fund taking on this liability using best estimate assumptions may well need to allocate only $150,000)

The adoption of this suggestion would thus have two advantages:

- Enable the retiree to receive an income in retirement consistent with expenditure for basic needs on good terms; and
- Limit significantly the Government's future responsibility to provide for the retiree. Certainly there would be no need to carry out means tests thereafter.

**Disadvantages**

The compulsory purchase of pensions will limit the flexibility of retirees as to their use of their assets in retirement.

This proposal would not be popular.

The channelling of retirement funds into Government bonds will divert some private money away from industry and property development.

# 8. Problem B – Insulation of Government from Retirees' Investment Performance

**The government is not adequately insulated against the consequences of retirees' investments failing to provide expected levels of income throughout retirement.**

This can occur as a result of, for example:

- Poor investment management;
- Poor investment performance; and
- Excessive expenditure during the early years after retirement.

It would be possible for the Government to force people to take benefits as a guaranteed pension. A lump sum threshold would be permitted to ensure there is some flexibility. Of course, once the equivalent of the Age Pension has been locked in, retirees would be able to invest the balance of their lump sum at their own discretion.

## 8.1. Possible Solution (1)

**Require Purchase of Equivalent of Part or Full Age Pension with Compulsory (SG) Superannuation Benefit at Retirement.**

This has two immediate benefits:

- It assists the current awkward transition from Superannuation lump sums to lifetime retirement incomes; and

- It builds on an expectation amongst many in the community that the benefits arising from the Compulsory Superannuation (SG) Scheme are intended ultimately to replace the Age Pension for today's youngsters.

It also has the long term effect of reducing the number of people reliant on a full or part Age Pension, and the cost to government of Age Pensions generally.

Politically, this suggestion could only be implemented in respect of compulsory contributions paid in the future (or alternatively for people currently below say, age 45).

The relatively slow build up of compulsory superannuation contributions means also that the financial effects on those currently nearing retirement would be minimal.

The "equivalent" pension to the Age Pension should include a guarantee that it will keep pace with future rises in the Age Pension. Based upon recent history, this is likely to be in excess of CPI increases (since the Age Pension is linked to male wages).

To assist the private annuity market to provide such guarantees, the government will need to issue "Age Pension linked" bonds of various terms for investment matching purposes. Ideally, these could be in the form of long term, no residual value, annuities (as suggested in 7.2.1).

**Disadvantages**

- The compulsory purchase of pensions will limit the flexibility of retirees as to their use of their assets in retirement;

- This would not be popular (though the lump sum threshold could be held at (say) $100,000, non-indexed, to smooth the transition; and
- The channelling of retirement funds into Government bonds will divert some private money away from industry and property development.

## 8.2. Possible Solution (2)

**Offer All Retirees the Opportunity to buy from the Government the Balance of Age Pension (or Full Amount) they were denied under the Means Test.**

The previous suggestion could be taken further. The Government could offer the retiree the opportunity to buy from the Government with any of their private means the balance of the Age Pension (or the full amount) that they are not entitled to as a result of means testing.

Under this structure, all retirees should then receive a total income at least equal to the Age Pension from the Government – whether qualifying in full or part for the Age Pension or not at all, with the balance of the cost or the whole being provided from personal sources.

The offer could be made available at any time after Age Pension age, albeit the cost would change through increased age and movements in investment market returns.

If the balance (or the full amount) was purchased from the Government, the whole retired population could therefore receive amounts totalling the Age Pension from the Government. This could have significant administrative advantages.

Alternatively, the partial or full Age Pension could be purchased from the private sector. This would require the Government to issue sufficient debt linked to movements in MTAWE, so that private companies can match assets against their liability to index the purchased "Age Pension".

Initially at least, the scheme could be voluntary, with the Government offering generous terms for purchase. Ultimately, such a purchase could be made a condition for future retirees to be credited with a part Age Pension.

Once compulsory, the "true" cost would fall from that applying to "self selected" pensioners to that applying to "aggregate population" pensioners.

In practice this could be made the basis of the "generous terms" suggested above for the initial period when the scheme is voluntary.

**Disadvantages**

The compulsory purchase of pensions will limit the flexibility of retirees as to their use of their assets in retirement. This would not be popular.

- The channelling of retirement funds into Government bonds will divert some private money away from industry and property development; and
- The scheme could be seen as a form of "double dipping by the Government". The individual pays taxes which are to pay for their pension, and the individual pays again to purchase a full or part pension.

It would need to be made clear that the purchase of the Age Pension under this scheme was an investment of the individual, subject to the Means Test. As such it is equivalent to any other investment.

## 8.3. Possible Solution (3)

**Pre Fund Age Pension**

As a further extension to suggestions (1) and (2) above, the government could introduce a "Pre Funding of the Age Pension" scheme.

The general principle would be that contributions would purchase a part of the Age Pension - either from the government or from a life office.

A range of options could be considered, e.g.

- 50% of the 9% SG contributions - with an income cap; and
- A fixed $ contribution out of the 9% SG payment each quarter.

The contributions could then be treated as purchasing:

(i) A proportion of the (deferred) Age Pension, or

(ii) A deferred pension of a $ amount, indexed in line with MTAWE.

The adoption of (i) above in conjunction with a contribution related to income, would provide a form of progressive taxation. This may be considered a suitable offset to other suggested solutions to problems in this paper which have the reverse effect.

It could also be mandated that each superannuation fund be obliged to provide a "Part Age Pension" investment option, for employee choice in respect of the balance of any SG contribution.

Funds raised by the Government under these suggestions could be reinvested in the market, through fund managers - to avoid any concern that Government action with regard to Age Pension provision was undermining investment markets, or distorting them.

Alternatively, as discussed above, the Age Pension could be purchased in the private sector, if suitable AWOTE linked assets are available for matching purposes. Compliance criteria would be needed for private providers, and a collective insurance scheme would be a good protection for pensioners.

**Disadvantages**

- Whichever option was considered, the scheme would be complex and involve significant administration;
- The Scheme could be seen as undermining the private superannuation market in terms of its flexibility to meet individual needs, and range of investment options; and
- Any scheme introduced would be expected to change in the future, thereby potentially creating a whole new set of transitional complexities.

# 9. Problem C – Double-Dipping

**Early Retirees can spend their Superannuation benefits and then claim the Age Pension**

## 9.1. Possible Solution

**Make access to Superannuation benefits prior to Age Pension age conditional upon buying the Full Age Pension.**

The principles are simple and logical:

- The community agrees to an Age Pension age beyond which there is no obligation to work;

- The government pays a means tested Age Pension from that age, and an unemployment benefit or disability benefit to those unable to work prior to that age;

  The government provides part compulsion and part incentive for the accruing of superannuation benefits to assist in limiting their liability for Age Pensions;

- Access to Superannuation benefits should therefore be made available only at Age Pension age;

- Those who are unable to work prior to Age Pension age may apply for unemployment or disability benefits – under current means testing rules. Accrued Superannuation benefits are currently, and should continue to be, excluded from such means testing.;

  The focus of the above suggested approach is the avoidance of "double dipping": i.e. dissipation of superannuation benefits prior to Age Pension age and then claiming the full Age Pension; and

- An exception to the "no access" rule could therefore be made if the full Age Pension was purchased in advance, i.e. on a deferred/discounted basis.

The purchased (deferred) pension would be a private asset and included in Assessed Income in post Age Pension age means tests.

**Disadvantages**

- Adversely affects expectations of current generation of workers; and

- Ignores the current important part that access to Superannuation plays in assisting the adjustment of 55 to 64 year olds made redundant and having difficulty in finding new employment.

The second disadvantage above is a real issue and outside the scope of this Paper. Even so, it is considered to be one which can be addressed separately and more directly than providing a "double dipping" option for able bodied individuals whom the community would expect to continue working.

# 10. Problem D – Accessing Home Equity

## 10.1. The Equity of Retirees in their own Homes is not assessed under the Means Test.

The relative positions of owner occupiers and renters represent possibly the most glaring anomaly in the Social Security system. Rent allowances contrast unfavourably with the rental value of the reasonable but modest accommodation enjoyed by many owner occupier pensioners, even in country areas with low cost rental accommodation.

In Sydney and Melbourne the differences are substantial.

If a level playing field was desired, the Age Pension should be increased to cover the cost of basic rental accommodation.

Home owners could then be deemed to be "enjoying" their accommodation rent free i.e. an equivalent benefit equal to the rental value of the property. This would be made subject to the means test, after allowing for any associated costs, eg an existing mortgage.

Such an approach would be difficult to implement in view of the huge differences in the cost of basic rental accommodation in different parts of the country.

At the same time, in considering action to eliminate this anomaly, any government must recognise the social and community value of owner occupation and be careful not to disturb this.

Whatever process is chosen, reasonable notice should be given - i.e. at least 12 months - to allow individuals to plan appropriately.

### *10.1.1. Possible Solution (1)*

**Assess (Excess) Rental Value – All Homes**

The basic pension assumes home ownership. Accordingly, the focus could be on the excess of rental value enjoyed by pensioners over an agreed reasonable average/norm.

For example:

Current average home rental value, say, $200 per week (after costs)

Example Pensioner home rental value $500 per week

*Hence include (500-200) = $300 as additional notional income in means test assessment.*

*Accordingly, reduce Age Pension by 40% x 300 = $120 per week*

**Disadvantages**

Clearly, to adjust the Age Pension in this way could force many home owners to sell their houses and move to another area simply because they would suffer a loss of income which they need for basic living. This could possibly destroy their sense of community through loss of familiar surroundings.

Such a proposal is likely also to be politically unacceptable.

Local rental indices could be used to set the standard in each geographic area. The average allowance for a pensioner could be the index rent for a 2 bedroom townhouse. The rental value of the owner's residence, less the 'pensioner index rent for the area' could then be included in the means test.

While this approach is possible, it seems likely to be complex administratively. The owner's "deemed rent" and "benchmark index" rents for each area would need to be continuously updated. Pensions would possibly need to be adjusted for the changes, giving rise to complaints and possible media coverage.

### *10.1.2. Possible Solution (2)*

**Assess (Excess) Rental Value – Higher Value Homes only**

Another softer action could be to take a long term view. Focus only on high value homes - say with rental value over $600 per week. Income Test adjustment could be in respect of only the excess of rental value over this figure.

If the $600 per week is not indexed, then the test would become increasingly tighter for each group of future retirees.

Ultimately the national average rental value would reach $600 per week, when this base value can be indexed thereafter.

Once assessed in this way, there should be no further assessment for the pensioner.

**Disadvantages**

While only penalising the better off, the scheme could still be seen as one which forces people to sell up and move from areas they have lived all their lives. This could arise readily in the inner suburbs of Sydney and Melbourne.

Administration is difficult in cases where extended families share a residence.

### *10.1.3. Possible Solution (3)*

**Assess (Excess) Potential Home Equity Release Income**

A possible alternative approach is to focus on what additional income the pensioner could generate from a Home Equity Release Scheme (HERS).

The "deemed" income could be determined by assuming that the owner occupier could effect a Home Equity Income Plan version of HERS, or Reverse Mortgage. Under this plan, the retiree would borrow an amount each month. The borrowings and interest would be rolled up, to be repayable on the death of the retiree, or prior sale of the home.
Assuming reasonable terms, the owner occupier retiree should be able to receive home equity release payments providing an annual income of 1% of the owner's equity, expected to be payable throughout life from Age Pension age. (As borrowings, this income would not be taxable, and, under current rules, not assessable under the means test).

A suitable benchmark home equity value could be chosen. The deemed annual income for means test assessment purposes would be 1% of the actual home equity over the benchmark.

For example:

| | | |
|---|---|---|
| Benchmark Home Equity | | $ 600,000 |
| Actual Home Equity | | $1,000,000 |
| Expected Annual Borrowing (1%) | | $ 10,000 p.a. |
| Deemed Income for Means Test is 1% of (1,000,000 - 600,000) | | |
| | = | $ 4,000 p.a. |
| *Reduce Age Pension by 40% of $4,000* | | *$ 1,600 p.a.* |

This approach has a much smaller impact than the "assess the rental value" approach. In particular, it does not force home owners to consider selling their homes. It focuses directly on the likely additional income that could be generated from the equity in the home.

To minimise disruption, implementation could be staged:

- Applies in 12 months time to new Age Pensioners;
- Applies in 2 years time to retirees currently under age 70;
- Applies in 3 years time to retirees currently aged 70 – 80; and
- Never applies to retirees currently over age 80.

It is appreciated that Home Equity Release Schemes are not popular in this country, and that the type of product suggested is not widely sold (and, where it is, the terms may not be the same as those suggested). However, the schemes could become more popular if the government were to announce that it was considering assessing home equity in this way. Floating the general idea would certainly generate industry and community interest.

**Disadvantages**

***General concern within the community over reducing benefits for pensioners.***

For this reason it would be necessary to set the benchmark at a level which would result in penalising only those who are clearly better off.

In this context a balance must be determined between reducing the pensions of those who, but for the large increase in home values, would be in the same financial position as "average" pensioners historically, and the fact that such increase in home equity can generate income which would previously not have been available.

***Income available from the market may be less than that "deemed" by Government***

This situation must be avoided and hence would require close consultation between the government and mortgage providers. It is likely that banks would be less generous to owners who already had mortgages, than to those who did not. 1% of equity as an annual income may readily be available where an $800,000 home was unencumbered. However, 1% of $800,000 may not be available in the case of a $1,000,000 home with an existing $200,000 mortgage.

***Behavioural Response: Don't bother to pay mortgage off by retirement***

This must be anticipated (and a possible range of subtle variations in mortgage versus equity value targets).

For this reason, it is suggested that the initial focus should be on denying modest benefits to those whose current situation is most anomalous. If only relatively small penalties were involved, there would be less incentive for negative behavioural response which itself puts the pensioner in a less satisfactory position.

### *10.1.4. Introduce "Claw Back" on Death*

Under this arrangement, the government would continue with allowing generous anomalies since the "over-payments" would be clawed back on death. (Such "over payments" would need to have an objective basis for their determination). This is a more benign way of applying a means test.

For example, the amounts of Age Pension reduction arising from the adoption of one of the suggested solutions above could be accrued with interest until death, rather than imposed during life. The Department of Health and Ageing would need to take a lien on the property to restrict further mortgaging or possible disposal without repayment of the Government debt

Of course, those wealthier pensioners who want to avoid the new "death duties" could do so by not claiming the Age Pension.

**Disadvantages**

Government charges on deceased estates are politically unacceptable as the community is generally not in favour of them.

# 11. Problem E – Generous Assessment of Complying Pensions

**Complying Pensions are assessed for Social Security purposes on a basis which excludes the "capital content" element, resulting in many richer people being able to claim the Age Pension.**

An example is: male retiree with $1,000,000 of Super benefits in Self Managed (DIY) fund at age 65. (Approximations used in following calculations)

| | | |
|---|---|---|
| Complying pension income payable throughout life certified by consulting actuary as supportable by the fund's investments: | | $70,000 |
| Capital Content element ("Deductible Amount) = $1,000,000/16.21[2] | | $61,690 |
| Income Element Assessable | | $8,310 |
| Value of Pension - DFACS[3] basis | = $900,000 | |
| "Deprived Assets" | $1,000,000 - $900,000=$100,000 | |
| less "gifting allowance" | $10,000 | |
| = Assets included in Assets Test | $90,000 | |
| "Deemed Income" from above Assets at (say) 4% | | $3,600 |
| Total Assessable Income for Income Test purposes | | $11,910 |

Age Pension entitlement

| | |
|---|---|
| Age Pension | $11,773 |
| less 40% (11,910 - 3,120 (threshold)) | = $(3,516) |
| ***Part Age Pension Entitlement*** | ***$8,257*** |

### *11.1.1. Possible Solution*

**Assess Complying Pensions in Full as Income for Means Testing**

By its nature a Complying Pension is intended to exhaust all capital over the pensioner's lifetime. That is the justification for excluding it from the Assets Test. Whether or not a part of the pension has been bought by a superannuation lump sum payment does not alter this position. The fact is that the pensioner is enjoying the full benefit as income. It is equivalent to the income from a non commutable public service pension which is assessed in full.

Therefore, the full amount of all Complying Pensions could be justifiably included in the Income Test Assessment.

[2] Life Expectancy = 16.21 years
[3] Department of Family and Community Services

"Life Expectancy" pensions are arguably an anachronism. Pension payments will be higher than those for "Lifetime" pensions and around 50% of pensioners can be expected to outlive their "life expectancy".

Assessing such pensions in full would be expected to result in fewer such pensions being issued.

Alternatively, failure to assess them in full could be seen as providing those living beyond their life expectancy and collecting the Age Pension with a form of "double dipping".

**Disadvantages**

Such action would adversely affect many retirees of more modest means as well as the "better off".

Complying Pensions are locked in; they cannot be changed. Arguably, if they had always been assessed in full as income, some retirees would have selected Allocated Pensions with their greater flexibility - even if that meant they would not be entitled to the Age Pension.

In practice, many retirees would have needed to choose a Complying Pension anyway in order to take advantage of the higher Pension RBL. Many such retirees would not have expected to be eligible for the Age Pension.

To take account of existing retirees' different situations, some form of grandfathering of (or transitioning from) existing means test assessments may be necessary.

Even so, it would be expected that the richer existing retirees and all new retirees could be made subject to new rules to eliminate this anomaly.

# 12. Problem F – The Social Security Assets Test

**The Assets Test assesses marginal assets on a basis which often results in reduction in total after tax income. It is also inconsistent with the Income Test.**

Example A - Male Retiree age 65

| | Super Lump Sum $149,500 Rolled over into Allocated Pension | Super Lump Sum $302,500 Rolled over into Allocated Pension |
|---|---|---|
| Allocated Pension Income | $9,522 | $19,267 |
| Age Pension | $11,773 | $0 |
| Gross Income | $21,295 | $19,267 |

The Allocated Pension income assumed above is the minimum permitted. Of course, a greater income could be taken. However, even taking the minimum, reasonably expected investment performance will not provide an income increasing with inflation beyond around age 85.

The problem with the Assets Test (when applied to Allocated Pensions) is that the marginal reduction in the Age Pension is commensurate with marginal assets earning 7.7% p.a. income. Not only is this level high in the current economic environment, but even at this level the Assets Test imposes a 100% penalty on the "benefit" of holding additional assets.

It is an enormous discouragement to saving if the savings achieved are subject to such treatment. In practice, the investment would be treated better as a Complying Pension, but they have other problems! (Refer to Section 11).

## 12.1. Possible Solution (1)

**Means Test Assess Incomes Only, "Deeming Income" from Specific Assets as required.**

Arguably, the means test should only focus on incomes.

The focus of Age Pension benefits is on ensuring that retirees have an adequate income. By penalising Allocated Pensions for some retirees, the rules irrationally influence the type of investments which they hold.

**Disadvantages**

While logical, and eliminating some means testing activity, this proposal leads to the need to focus on the different levels of income arising from different types of asset, with "deeming rates" for specific assets as necessary. While "deeming income" for many types of asset is already part of the system, the proposal may introduce another form of complexity.

The proposal, by itself, would probably lead to an increase in the cost of Age Pensions.

## 12.2. Possible Solution (2)

An alternative, simpler, approach to dealing with this issue would be to **"Deem all Assets as capable of providing (Means Test) Assessable Income at a Current Lifetime Annuity Rate".**

The current Complying Pension rate could be the current market rate for lifetime annuities which keep pace with living standards.

The focus here is on ensuring that those seeking the Age Pension are effectively utilising their own assets over their lifetime, before taking Government (community) money. This suggestion addresses the issue of current taxpayers supporting pensioners in such a way as to enable them to pass their assets on to their children (refer section 4.2.4).

This approach could work quite satisfactorily, and arguably is fair even if not immediately popular, if introduced in conjunction with the "buy Age Pension" suggestion. (See Section 8)

The Income Test could be carried out as follows:

| | |
|---|---|
| Assessed Income | $23,120 |
| Threshold Income | $3,120 |
| Excess | $20,000 |
| Age Pension "denied" | $(8,000) |

Pensioner then uses some of his/her assets to purchase the "Age Pension denied".

The "Age Pension denied" would be indexed in line with the Age Pension and included in Assessed Income in future means tests.

**Disadvantages**

This proposal would be seen to have a negative impact on many pensioners. This impact could comprise the pressure to sell assets which had low current income but were expected to produce strong capital growth. In addition, pensioners could appear to be "forced" to sell assets which had family connections or where there was a family shared ownership, or assets which were likely to realise less than their perceived current value.

Arguably though, this position exists for many pensioners under the current Assets Test.

It is probable that some sort of grandfathering of existing arrangements would need to be considered for the infirm elderly, or at least a reasonable period of notice given for existing pensioners to review their investments.

# 13. Problem G – Working after Age Pension age

**There are insufficient financial incentives for those eligible for the Age Pension to work beyond Age Pension age.**

### *13.1.1. Current Financial Disincentives*

Currently there are significant financial disincentives for potential Age Pensioners to earn assessable income from working beyond Age Pension age.

The reduction in the Age Pension from such earnings is 40% and marginal tax and medicare levy, including reduction in the Senior Australians Tax Offset, could take up to another 44% of the balance, i.e. effectively 66% in total!

### *13.1.2. Pension Bonus Scheme Unattractive*

The Pension Bonus Scheme was introduced 6 years ago as a measure to encourage working beyond Age Pension age.

For deferring claiming for 1 year, the bonus is just $1,107. While this is arguably better than nothing, against the Age Pension forgone of $11,773, it seems unlikely to be a sufficient trigger to encourage those not anticipating to work, to find a job.

Even after 5 years, when the bonus reaches its maximum of $27,666, this is equivalent to only around 40% of the pension foregone. While the bonus is tax free, many recipients would have expected to pay little or no tax on the pension income anyway.

In addition to the unsatisfactory financial incentives, the scheme is complex administratively - the client must register (and prove eligibility), defer claiming for at least 1 year and work at least 960 hours per year, i.e. around 20 hours per week. They need to do this until age 70 to enjoy the maximum benefit.

### *13.1.3. Possible Solution*

**Ignore Earnings from Personal Exertion under Means Test Assessment**

Of course, it would seem unlikely that the Government would want to provide bonuses to those who would have worked anyway. But no scheme can really differentiate between those who would, and those who would not, have worked without the incentive.

The simplest approach would be to increase the Age Pension age – i.e. the "stick" rather than the "carrot". However, politically it is probably necessary to generate a "culture" of working longer (older) before taking such action.

A "working older" culture would be assisted by simply ignoring earnings from personal exertion under the means test.

Most of those who are able to earn significant amounts after Age Pension age, will be those who have been sufficiently successful in their previous working life not to be eligible for the Age Pension anyway. It is possible that many others are currently simply not declaring their earnings.

Accordingly, the cost to Government revenue of such a change may not be high – and may well be considered worthwhile in the context of developing the "right" culture in the community. This

would however, need to be tested. Such a change could be introduced in conjunction with changes to the current concessional tax structure of retirees.

In practice, current "ageism" amongst employers is probably the greatest bar to encouraging older age working.

Another "discouragement" is the current "cult" of *early* retirement, encouraged by early access to superannuation benefits – currently age 55, rising to age 60. This is still 5 long years prior to the current (male) Age Pension age.

The government is in a position to influence change here in all respects:

- Set an example by introducing an "older worker" culture in its own departments and businesses;
- Moving the age for access to Superannuation to the Age Pension age, or adopt the suggestion in Section 9; and
- As suggested above, ignoring earnings from personal exertion for means test purposes.

The latter would have a side benefit if the concept of a "once only" means test was pursued (see Sections 4.1.2 and 15.2); all such tests could be carried out at Age Pension age.

**Disadvantages**

The proposal could be seen as over generous to individuals who don't need support.

For this reason, it may be necessary to place a cap on the non-assessable earnings.

A further alternative would be to have a reduced assessment for earnings from personal exertion - say 50%. However this adds complexity.

# 14. Problem H – Married versus Single

**Married couples as individuals receive less Age Pension than singles or those in other types of relationship living in the same home.**

In this regard, it is worth reflecting that Superannuation accrual is likely to move slowly to individuals rather than simply "employees", now that future contributions can be split between spouses.

### *14.1.1. Possible Solution*

**Move Age Pension Assessment from Couples to Individuals**

Arguably, it is anomalous to treat a married or de facto couple differently from two other people living together.

The issue may have been of minor importance when the majority of such people living together were couples.

Today however, there is a much wider range of relationships and living arrangements. Moreover such relationships and living arrangements change more frequently. Arguably this trend is continuing.

The logical approach is to treat all people as individuals for Age Pension purposes.

It is recognised that to adopt this approach immediately would create a significant cost to government revenue. However, in anticipation that such an outcome is to be reasonably expected in the future, the government could move slowly towards equality.

For example currently 50% of a couple's Age Pension is equal to 83.5% of an individual's pension.

This 83.5% could be increased by 1½% each year over the next 11 years, or alternatively say, ¾% per annum over the next 22 years, to reach 100%.

**Disadvantages**

There would be a significant increase in Government costs. However, the move may arguably be inevitable to meet changing community attitudes to developments in social patterns.

# 15. Problem I – Frequency of Means Testing

**Frequent Means Tests are often harrowing for pensioners and involve significant time and effort on their part as well as that of the Government.**

## 15.1. Possible Solution (1)

**Pay Age Pension to All People from Advanced Age**

For many pensioners, as they become older, their ability to comprehend means test issues reduces. This particularly occurs when changes are made to benefits and procedures.

In many cases they will transfer to aged care accommodation.

The quarterly assessment process can become more and more difficult.

One suggestion is that from an advanced age, say 85, the full Age Pension is paid to all on a universal basis. A side benefit of this would be the transfer of the longevity risk from individuals back to the Government. This would assist retirees to match their investments to their more certain income needs. This may even lead to a small reduction in expenditure on Age Pensions between the ages of 65 and 85.

This is estimated to cost under $1 billion each year (an increase of 4% over the current total age Pension costs) based on the current cohort of pensioners - but the cost would rise sharply as the baby-boomers age.

Implementation of any policy of this nature would need to include review of the minimum access age in line with increasing longevity.

Of course, this option is not an issue if the suggestion in Section 8 of the purchase of part / all of the Age Pension is adopted.

**Disadvantages**

The additional cost to the Government would outweigh the administrative savings.

## 15.2. Possible Solution (2)

**Means Test "Once Only"**

This suggestion was first analysed by Professor David Knox. Ideally, for administrative convenience and for the convenience of the prospective Age Pensioner, the means test is carried out just once – i.e. at Age Pension age or actual retirement, whichever is later. (If the suggestion in Section 13.1.3 to make earnings from personal exertion exempt from the means test is adopted, the means test could then be carried out at Age Pension age for everyone.)

Adoption of the "Incomes Test only" and "Buy Age Pension reduction" suggestions in sections 12.1 and 8.2 respectively, would facilitate the possibility of a "Once Only" test.

In these circumstances, the retiree will have a guaranteed income for life at least equal to the Age Pension.

Arguably the government has then fulfilled its responsibility to such retirees. The possibility of a retiree becoming "poorer" in the future, say as a result of dissipation of assets, or of such assets producing lesser income, could be considered to be the retiree's own responsibility.

Exceptions might be made:

- Where the assets in the future start to produce less than the Age Pension, or
- In the case of the loss of an owner occupier's home – for whatever reason. This could generate the need to provide a rent allowance.

This process leaves out self funded retirees who, at Age Pension age, aren't eligible for an Age Pension, or for some other reason do not apply at that time – but apply later.

Arguably though, the same approach could be adopted at the later date. Income Test assessment would then be carried out, and some assets used to purchase any means tested reduction in the Age Pension.

Alternatively, to overcome change in circumstances and/or reassessment issues, the principle could be extended to all those reaching Age Pension age. Even those who would not be eligible for the Age Pension could be obliged to use some of their assets to buy the whole of the Age Pension at Age Pension age.

The preservation of superannuation assets until Age Pension age would assist in avoiding 'double dipping'. This could be considered a better approach for self funded retirees, as this would assist in restricting possible deliberate dissipation of assets prior to Age Pension age, in favour of generating a full or part Age Pension post Age Pension age.

It would be necessary to consider what rules should apply to those whose financial position "improves" such that, under current Social Security rules, their Age Pension would be cut.

A "once only" means test would possibly generate a behavioural response for people to "minimise" their financial position at Age Pension age, or at least *declare* only a minimum position.

Administrative checking procedures may therefore need to be made more vigilant for any "once only" test.

If this can be carried out to reasonable satisfaction, the government could take the view that future improvement in a retiree's position is likely to be minimal. Certainly the number of retirees that enjoy significant consistent improvement should be quite small.

Accordingly, "no further means test for retirees" could be a justifiable approach on administration savings grounds – particularly if there was no adjustment for the "losers" (other than in exceptional circumstances).

Of course, if aged care becomes means tested then the government will have the opportunity to review a retiree's position again when that need arises.

**Disadvantages**

People could manipulate their ownership of non-superannuation assets at a point in time. It is more difficult to cheat for an extended period as a spot audit might uncover any fraud.

# 16. Problem J – Double "Taxation" of Means-tested Benefits

## 16.1. Introduction

At the present time, the operation of the Income Test reduces the Age Pension by 40% of marginal private income. In addition, in many cases the marginal rate of tax is 31.5%. For some, the operation of the reducing Senior Australians Tax Offset as income increases, acts as a further 12.5% marginal tax. Thus, the total marginal tax of 44%, applied to the 60% balance of marginal income, increases the total marginal effective rate of tax to 66%!

The focus of the government's approach is to use its revenue to provide Social Security benefits which target those in greatest need. At the same time, it is considered desirable to maintain incentives for those who are able to reduce their dependency on the State. Unfortunately in this desire to keep the number of recipients of partial benefits to a minimum, "poverty traps" have been created which reduce the incentives.

This punitive structure is not confined to retirement incomes but acts elsewhere in the tax and social security systems.

In fact, taking account of all those on Social Security and family benefits, those on low incomes with tax offsets, and those whose incomes exceed $52,000 p.a. it is probable that a very significant proportion of Australians are in a position whereby their marginal effective tax rate is approaching or greater than 50%.

It is noted also that:

(i) Rates of tax deduction for dependants and children arguably are inadequate, and means testing of benefits add further complexity.

(ii) The 15% superannuation surcharge is horrendously difficult to administer and catches many whose normal incomes are well below the (current) $94,691 threshold. Arguably it is intended to represent simply an increase in the top marginal rate of tax.

There is a possible approach to minimising the conflict between "targeting" and avoiding high marginal effective tax rates, whilst simultaneously simplifying the income tax system and its inter-relationship with Social Security benefits. The suggestions below also incorporate possible solutions to more realistic allowances for dependants and elimination of the superannuation surcharge.

## 16.2. Maximum Aggregate Marginal Effective Rate of Tax

A maximum aggregate marginal effective rate of tax on <u>all income and benefits of 50%</u> is suggested.

## 16.3. Tax Scales - Seniors

To avoid "double taxation" of marginal income, one approach is to make the maximum income free of tax to be the minimum level at which there is no entitlement to the single Age Pension.

This minimum income is $26,666**.** At this level, the Age Pension of $11,773 is reduced by the suggested 50% of ($26,666 less the means test threshold of $3,120) i.e. a deduction of the same amount: $11,773. Thus the Senior whose private income was $26,666 would receive no Age Pension and pay no tax.

This tax threshold of $26,666 compares with the current level of $6,000.

Under the current arrangements, the Senior with private income of $26,666 would receive a part Age Pension of $11,773 - 40% x ($26,666 - $3,120) = $2,355. Tax and Medicare levy on the total income of ($26,666 + $2,355) = $29,021, would be equal to $4,148, leaving a net income of $24,873.

In order to minimise the impact on the government's Revenue base it is necessary to apply a marginal rate of tax of 50% to all income for Seniors in excess of $26,666. While this appears to be a dramatic step it is worth noting that, currently, the total marginal effective rate for many Seniors is close to, or in excess of 50%.

Inevitably the change to the structure would lead to positive and negative outcomes depending on income. The schedule below provides a range of scenarios and assumes that the current tax offsets would not apply under the alternative scale.

| **Private Assessable Annual Income** | **Current Arrangements** | | | | **Alternative Arrangements** | | | | **Increase (Decrease) in Net Income $** |
|---|---|---|---|---|---|---|---|---|---|
| | Age Pension $ | Total Income $ | Tax $ | Net Income $ | Age Pension $ | Total Income $ | Tax $ | Net Income $ | |
| 0 | 11,773 | 11,773 | Nil | 11,773 | 11,773 | 11,773 | Nil | 11,773 | **Nil** |
| 5,000 | 11,021 | 16,021 | Nil | 16,021 | 10,833 | 15,833 | Nil | 15,833 | **(188)** |
| 10,000 | 9,021 | 19,021 | Nil | 19,021 | 8,333 | 18,333 | Nil | 18,333 | **(688)** |
| 15,000 | 7,021 | 22,021 | (1,068) | 20,953 | 5,833 | 20,833 | Nil | 20,833 | **(120)** |
| 20,000 | 5,021 | 25,021 | (2,388) | 22,633 | 3,333 | 23,333 | Nil | 23,333 | **700** |
| 26,666 | 2,355 | 29,021 | (4,148) | 24,873 | Nil | 26,666 | Nil | 26,666 | **1,793** |
| 30,000 | 1,021 | 31,021 | (5,028) | 25,993 | Nil | 30,000 | (1,667) | 28,333 | **2,340** |
| 35,000 | Nil | 35,000 | (6,780) | 28,220 | Nil | 35,000 | (4,167) | 30,833 | **2,613** |
| 40,000 | Nil | 40,000 | (8,772) | 31,228 | Nil | 40,000 | (6,667) | 33,333 | **2,105** |

The alternative arrangements produce a pattern of net incomes which appears reasonable. However the pattern of changes from the current arrangements (as a result of the current distortions) would make them difficult to implement politically, except perhaps over time.

In practice the above comparisons do not properly take account of variations in the type of private income.

In the case of Complying Pensions purchased with taxed lump sum Superannuation benefits, higher Age Pensions would be available, leading to higher net incomes under the current arrangements - in some cases in excess of those under the alternative arrangements.

## 16.4. Tax Scales - Non Seniors

To fit with the current less generous tax treatment for those who are not Seniors, the tax threshold needs to be lower – say $20,000 - in conjunction with the same 50% tax rate on all income above this.

Again, it is argued that the total marginal effective tax rate for many people - both lower and higher income earners - is already up to this level.

And again there are positive and negative outcomes, as illustrated below:

| Assessable Annual Income ($) | Tax under Alternative Structure ($) | Current Taxation inc Medical Levy ($) | Current Taxation less Alternative ($) |
|---|---|---|---|
| 20,000 | Nil | 2,445 | 2,445 |
| 25,000 | 2,500 | 3,948 | 1,448 |
| 30,000 | 5,000 | 5,622 | 622 |
| 35,000 | 7,500 | 7,197 | (303) |
| 40,000 | 10,000 | 8,772 | (1,228) |
| 45,000 | 12,500 | 10,349 | (2,151) |
| 50,000 | 15,000 | 11,922 | (3,078) |
| 55,000 | 17,500 | 13,857 | (3,643) |
| 60,000 | 20,000 | 16,032 | (3,968) |
| 65,000 | 22,500 | 18,332 | (4,168) |
| 70,000 | 25,000 | 20,757 | (4,243) |
| 75,000 | 27,500 | 23,182 | (4,318) |
| 80,000 | 30,000 | 25,607 | (4,393) |
| 160,000 | 70,000 | 64,407<br>+ 2,160 *Surcharge | |
| | | 66,657 | (3,433) |

* Assuming employer contribution of 9% of total annual income.

## 16.5. Dependants

At lower income levels, many people will be on Social Security benefits. Hence this tax take shown for those people will be reduced by the benefits received so that the move to the alternative arrangements will not be as expensive as appears from the table.

In conjunction with the above scales, higher dependant and child benefits would apply and, apply to all taxpayers - say $8,000 for a dependant and $5,000 each child non taxable cash, in lieu of the current complex mix of means tested benefits and tax concessions.

## 16.6. Comments

The operation of the arrangements would be significantly simpler than those current. In addition to the elimination of the tax offsets and superannuation surcharge, the dependants' and child benefits proposals would arguably represent better social justice - and possibly assist in improving fertility rates.

The alternative arrangements put forward above are intended to illustrate the possible effects of an approach to eliminating "poverty traps" and complexities in the system. The parameters selected are for illustrative purposes only.

It is accepted that more development would be required, and any moves made gradually. In this regard, ultimately the income tax thresholds should perhaps be made the same for both Seniors and Non Seniors in the community.

# 17. Problem K – Insufficient Voluntary Contributions

**There are insufficient incentives for individuals to make Voluntary Contributions to Superannuation Funds**

## 17.1. Possible Solution

**Allow Tax Relief for All Types of Voluntary Super Contributions (subject to Limits)**

To encourage stronger interest in self provision for retirement, tax relief on voluntary contributions should be allowed. Limits would apply along existing lines for Superannuation contributions generally.

In practice some self employed people and employees, able to persuade employers to allow salary sacrifice arrangements, effectively have this benefit. Allowing tax relief directly would permit everyone to have the same opportunity.

Cost to government revenue should be marginal when calculated on a long term basis, since the ultimate benefits received would be taxable at marginal rates (less 15% pension/annuity tax rebate).

**Disadvantages**

There would be an immediate cost to current Government Revenue. Such action would therefore need to be considered in conjunction with taxation policy generally.

# 18. Problem L – Superannuation Surcharge

Many commentators have commented about the Surcharge. It is a tax that has high administration, the cost of which is usually borne by all members of a fund, not just the high income earners. It is a tax based on all personal taxable income – not just income from personal exertion. Therefore, it traps many people who have temporary high income from redundancy packages or other one-off windfalls. The tax also falls disproportionately on those who are saving later in life (catching up).

Nonetheless, the tax now raises about $800 million p.a. and it could not be removed without a substitution elsewhere in the tax system. If a replacement tax was more efficient to collect, the required amount would be lower.

## 18.1. Possible Solution (1)

**Cap superannuation taxes in real terms**

IAAust, in a submission[9] to the Senate Select Committee on Superannuation and Financial Services, noted that superannuation taxes were increasing in real terms. This is a function of the tax being tied to investment income on a growing pool of assets and contributions, which grow in line with national wages.

IAAust suggested that superannuation taxes could be capped as a percentage of GDP so that there was no overall loss of Revenue. However, this would allow a gradual reduction in tax rates. A further suggestion was made that the reduction in rates would be applied to up-front taxes (contributions and surcharge) in the first instance and then to investment income when possible. This would assist in the gradual shift of taxation towards tax on end-benefits.

## 18.2. Possible Solution (2)

**Eliminate Surcharge in favour of Increase in Top Marginal Tax Rate**

The surcharge was intended to be 15% (reducing to 12.5% over the next 3 years) of Superannuation contributions for tax payers whose normal incomes were significantly in excess of those where the top marginal rate starts.

In practice, it catches a lot of people with one-off payments, including some with otherwise relatively low incomes. In addition, of course, it is horrendous to administer.

The Senate is unlikely to agree to simply abandoning it, as this could appear to be giving an unnecessary benefit to higher income earners.

Arguably, the surcharge, as originally intended, represented an increase in the marginal rate of tax for higher earners.

Accordingly, a simpler approach to implementation of this intention could be as follows:

Assuming the weighted average "normal" earnings of people hit with the surcharge is $125,000 p.a.: -

| | | |
|---|---|---|
| Assume 9% Superannuation contributions | = | $11,250 |
| Surcharge is 12.5% | = | $ 1,406 |

The top marginal rate applies from $62,500 p.a. Thus an additional $1,406 tax for the $125,000 earner represents a 1,406/62,500 = 2.25% increase in the top marginal rate of tax, to 49.25% (+ Medicare levy).

It seems likely that a proposal along these lines to the Senate as a quid pro quo, could persuade it to accept elimination of the surcharge.

**Disadvantages**

Impact on individuals will vary. Those in the $62,500 to $100,000 category will pay a little more tax. This objection would be ameliorated if tax and/or other benefits for dependants and children were increased at the same time (refer Section 16 Problem J).

## 18.3. Possible Solution (3)

**Adjust deductibility at Company rather than Superannuation Fund level**

One of the problems of the superannuation surcharge is that it complicates the administration of all superannuation funds. Even funds with a small number of high income earners have to extend their administration operations to cope with the surcharge.

An alternative administrative structure would be to adjust the tax deductibility of superannuation contributions *for companies.* Therefore, when a company prepares its annual tax return, it would claim a full (30%) tax deduction for contributions for those people below the surchargeable threshold. It would receive a tax deduction at the rate of 15-30% for those people above the threshold.

The advantage of this proposal is that the revenue from the surcharge would be protected but the administration would fall back on the Company seeking the tax deduction.

There are a few adjustments that would need to be made. For example, the adjustment would need to be made in the personal tax return of those people who are self-employed, and the surcharge would no longer apply to income from sources other than personal exertion. Given that people who receive windfall benefits such as redundancy payments are arguably subject to inequity in paying a surcharge on these amounts, it is probably an advantage that they be removed from this system.

While this proposal maintains the surcharge structure and all its attendant problems of unfairness, it does at least shift the administration burden from a super fund back to a company. For defined benefit schemes the surcharge liability would usually fall back on the company in any case. Under accumulation schemes, many higher paid employees have salary packages. Arguably these can accommodate the additional tax liability. This proposal would also lead to higher superannuation savings as the net investment in the fund would be higher.

**Disadvantage**

**Tax for many companies would rise in respect of their more highly paid employees. However, if a company wishes, it may be able to "claw back" the additional tax from future pay increases or from adjusting total salary packages.**

# 19. Other Suggestions

Other suggestions to assist in the process of improving integration are:

## 19.1. Set a Target Benefit of the Maximum Tax Free Lump Sum ($117k) plus Full Age Pension

The current average lump sum Superannuation benefit for retirees at age 65 is approximately $65,000 to $70,000. For many people, the lump sum is used to pay off the mortgage and/or have an overseas trip.

The current maximum tax free lump sum from taxed super benefits is $117,576. This is indexed yearly in line with average weekly earnings.

Assuming a current average full time earnings (of both men and women) of $40,000 per annum, some 30 years' 9% Super Guarantee contributions would be required to generate this lump sum (in 2004 dollars).

Investment of this lump sum in an allocated pension to generate income at a low level will not cause any reduction in Age Pension entitlement.

Therefore it seems reasonable to consider, that for many people for the next 20 years or so, minimum target retirement benefits could be (in 2004 dollars):

$117,576 Lump sum; and

$11,773 p.a. Age Pension (single person)

# 20. Implementation of Solutions

## 20.1. Split Population into cohorts

Implementation of any major change creates problems which range from grandfathering conditions (to reduce the impact of any financial detriment), to complex administration. Many logical changes are not made due to the immediate impact on the current cohort of voters.

We consider that changes could be made more readily if those with a perceived negative impact were made to younger people first. This group has the longest lead time and it is probably currently unconcerned about changes at retirement. Transitional changes can then be made for other cohorts.

Examples of how these changes could be introduced are:

**Existing retirees**

- Incentives for part-time work (carers, baby-sitters,) etc;
- Unlock value of family home; and
- Develop suitable retirement products.

**Older workers (50 – 65 years of age)**

- All benefits (above a threshold) to be taken as a pension;
- Calculate Age Pension eligibility at time of retirement;
- Encourage deferral of retirement date; and
- Tax break for own (voluntary) contributions.

**Consolidators (35 – 50 years of age)**

- Discourage early retirement;
- Rewards for deferral of retirement;
- Eliminate poverty traps; and
- Tax break for own (voluntary) contributions.

**Youngsters (< 35 years of age)**

- Age Pension to become a genuine safety net;
- SG contributions during unpaid child-bearing and rearing;
- Rewards for deferral of retirement; and
- Tax break for own (voluntary) contributions.

This general approach can be used in promoting some of the suggested solutions in the Implementation Plan below.

## 20.2. Implementation Plan

The suggested "solutions" to problems in this paper are intended to eliminate major anomalies, reduce complexity, improve stability of outcomes, and to assist in the general integration of Superannuation and Social Security in terms of meeting retirement income needs, with national budgetary constraints.

After the necessary further development and refinement some of the suggestions could be introduced immediately. All could be flagged as solutions intended to be introduced after a period of notice and/or over a suitable transitional period.

The effect on Government revenue will vary and modelling would be necessary to determine actual outcomes. However, the general direction of the effect can be noted. The summary below focuses only on those possible solutions which appear to us to be reasonably practical and/or otherwise capable of development.

| Possible Solution | Impact on Government Budget | Possible Implementation |
|---|---|---|
| ***The Government Issues Bonds which provide income which is guaranteed to Increase in line with Increases in average weekly earnings or the Age Pension*** | Positive in longer term | Immediately |
| ***Part of a Retiree's Superannuation Assets are Compulsorily required to be used to Purchase a Lifetime Annuity*** | Positive in longer term | New age pensioners only - one year's notice |
| ***Require Purchase of Equivalent of Part or Full Age Pension with Compulsory (SG) Superannuation Benefit at Retirement*** | Positive in longer term | New age pensioners only - one year's notice |
| ***Offer All Retirees Opportunity to buy from the Government the Balance of Age Pension (or Full Amount) they were denied under the Means Test.*** | Positive | All age pensioners - immediately, after discussion with industry re terms |
| ***Pre-Fund Age Pension*** | Positive | Immediately |
| ***Assess (Excess) Potential Home Equity Release Income*** | Positive | New age pensioners - one year's notice<br>existing age pensioners - transition over 3 years |
| ***Assess Complying Pensions in Full as Income for means testing purposes*** | Positive | New complying pensioners - immediately; existing complying - pensioners - consider at a later date |

| Possible Solution | Impact on Government Budget | Possible Implementation |
| --- | --- | --- |
| ***Deem all Assets as capable of providing Means Test Assessable Income at a Current Lifetime Annuity Rate*** | Positive | New age pensioners only - one year's notice |
| ***Ignore Earnings from Personal Exertion under Means Test Assessment*** | Negative in early years | Immediately |
| ***Move Age Pension Assessment from Couples to Individuals*** | Negative | Gradually over 11 years |
| ***Means Test "Once Only"*** | Neutral | 5 year plan |
| ***Make Access to Super prior to Age Pension Age Conditional upon Buying the Full Age Pension*** | Positive | Applicable only to those currently under 55 - one year's notice |
| ***Allow Tax Relief for All Types of Voluntary Super Contributions (subject to limits)*** | Negative in early years | Immediately |
| ***Eliminate Surcharge in Favour of Increase in Top Marginal Tax Rate*** | Neutral | One year's notice |

Implementation of all the solutions above should assist the Government in having a positive impact on the budget - at least in the longer term - except:

- **Ignore Earnings from Personal Exertion under Means Test Assessment.**

  This should generate only a small extra cost in the early years. To the extent that more people are encouraged to work, the additional taxation revenue will partially offset the higher Age Pension cost. Ultimately, the development of a "later retirement" culture should enable the government to increase the Age Pension age, which will assist the Budget further by reducing outgo on Age Pensions.

- **Move Age Pension Assessment from "Couples" to "Individuals"**

  While this would be a cost to the Government, it could be spread over a long period. Arguably the move is ultimately inevitable in line with likely community expectations.

- **Means Test "Once Only"**

  If this is introduced in conjunction with measures to require individuals to purchase the whole or part of the Age Pension with available assets, including on early retirement, the cost should be neutral. Achieving this, would also require careful attention to behavioural responses to the introduction of the measure. Even if there is a small increase from those making "special arrangements" with their assets that they might otherwise not do to gain some advantage, the

usual trend for (part) Age Pension costs to increase with age should have ceased.

- **Allow Tax Relief on all Types of Voluntary Contributions**

  The negative impact on government revenue in the early years will be more than offset in later years as the payments arising from the contributions are taxed, and the economy generally benefits from the greater volume of saving in the community.

- **Eliminate Surcharge in favour of increase in Top Marginal Tax Rate**

  This can be made cost neutral by the government setting the revised marginal tax rate(s) appropriately. The superannuation industry will save administrative costs which will flow through to larger funds under management, better benefits and higher tax revenue.

Although we have not done any major modelling, we would like to think that implementation of all the "possible solutions" above would result in an acceptable level of future Government expenditure. This could then enable the Government to re-consider the adequacy of the basic pension (as well as reviewing the myriad of other anomalies and complexities not covered in this paper) - in the context of a newly established set of Government objectives and goals.

In section 1.3.4, we indicated that an objective of the paper was to include consideration of what degree of integration (in the dictionary sense of "making into a whole") was desirable.

In practice we have not done this. This is partially because of the realisation that tax issues need to be addressed to a greater extent than could be covered in the paper.

However, it is worth noting that the various suggestions involving better retirement income products, the possibility of buying part or full Age Pensions from the Government, and simpler means testing have the potential to move the system towards true Integration.

# A. Superannuation Rules & Taxes

## A.1. Contributions

### *A.1.1. Maximum Contribution Limits*

There are no limits to contributions payable to a superannuation fund by or on behalf of any individual. However there are limits for tax deductible contributions.

### *A.1.2. Employer Contributions*

The allowable tax deduction for contributions made by an employer to a superannuation fund for the benefit of an employee is limited according to the age of an employee. The age based deduction limits for employer superannuation contributions are as follows:

| Age | 2003/04 Deductible Contribution Limit |
|---|---|
| Under 35 | $13,233 |
| 35 to 49 | $36,754 |
| 50 and Over | $91,149 |

### *A.1.3. Self Employed Persons*

Deductions are first subject to the same limits as set out above for contributions for employees. In addition, the annual deduction is limited to $5,000 plus 75% of the balance, so a contribution of more than the age-based limit is required to qualify for the maximum deduction.

| Age | Deductible Contribution Limit | Contribution for Maximum Deduction |
|---|---|---|
| Under 35 | $13,233 | $15,997 |
| 35 to 49 | $36,754 | $47,338 |
| 50 and Over | 91,149 | $119,865 |

Note that assessable and exempt income from eligible employment must be less than 10% of total assessable income for a person to be eligible for "self-employed" status.

### *A.1.4. Spouse Contributions*

Tax rebate of 18% on contributions of up to $3,000 made on behalf of a spouse earning less than $10,800. The maximum rebate is $540. The rebate begins to phase out when the spouse's assessable income exceeds $10,800 (with no rebate entitlement at or above $13,800).

### *A.1.5. Superannuation Guarantee*

The minimum employer contribution rate as specified in the Superannuation Guarantee (Administration) Act on 1 July 2003 is 9% of ordinary time earnings.

There is a maximum salary for Superannuation Guarantee (SG) purposes for each superannuation guarantee period (i.e. quarter). In the 2004 financial year, this is $30,560 (up from $29,220 in 2003). Therefore, the SG applies to the first $122,240 of annual earnings.

#### A.1.6. Government Co-Contribution

From 1 July 2003, the government has undertaken to make a "co-contribution" where an individual earns less than $40,000 in a tax year, and makes a personal contribution to a superannuation fund.

The government co-contribution is a $1 for each $1 personal contribution up to a maximum. The maximum is $1,000 for those who earn up to $27,500. Between $27,500 and $40,000 the maximum reduces by $1 for each $8 of higher earnings.

There is no legislative requirement for these limits to be indexed.

### A.2. Benefits

#### A.2.1. Preservation Age

*Preserved* Superannuation benefits cannot be withdrawn in cash until the attainment of the *Preservation Age*. Some benefits are non-preserved under grandfathered rules. The age is being gradually increased from 55 to 60 as follows:

| Date of Birth | Preservation Age |
|---|---|
| Prior to 1 July 1960 | 55 |
| 1 July 1960 to 30 June 1961 | 56 |
| 1 July 1961 to 30 June 1962 | 57 |
| 1 July 1962 to 30 June 1963 | 58 |
| 1 July 1963 to 30 June 1964 | 59 |
| From 1 July 1964 | 60 |

#### A.2.2. Reasonable Benefit Limits

Reasonable benefit limits (RBL) are the maximum amount of employment benefits from retirement or upon termination of employment that an employee can receive at concessional tax rates. The RBL's are cumulative for all benefits received over the person's lifetime.

| Reasonable Benefit Limit | 2002 / 2003 RBL | 2003 / 2004 RBL |
|---|---|---|
| Lump Sum | $562,195 | $588,056 |
| Pension | $1,124,384 | $1,176,106 |

"The higher Pension RBL applies if at least a specified proportion of total benefits (generally 50%) is taken in approved pension form".

### *A.2.3. Death & Disability Benefits*

Superannuation funds are allowed to pay benefits on death and disability. These benefits can include an insured component. The insurance premiums are a deductible expense for the fund. However, the superannuation contributions surcharge (see section A.3) still applies to contributions made to meet the cost of insurance premiums.

**Death**

The vast majority of death benefits are paid as a lump sum.

Benefits paid or distributed to dependants are tax-free up to the pension RBL, and the excessive component is charged at the highest personal marginal tax rate of 48.5% (including Medicare levy).

Benefits paid or distributed to non-dependants are taxed as an ETP up to the pension RBL, and then taxed at 47%.

**Total & Permanent Disability**

The lump sum benefit is divided into the disability portion and the normal portion, based on the ratio of the remaining eligible service period to the total eligible service period. The normal portion is taxed as a normal ETP. The disability portion is tax-free and may be rolled over into another superannuation fund or approved deposit fund as a separate ETP component, to ensure that this portion remains tax-free when the benefit is paid.

**Disability Income**

Many funds provide regular income benefits protecting loss of salary during periods of disablement. Sickness and accident insurance premiums may be claimed as a tax deduction for individuals. Section 279 of the *Income Tax Assessment Act 1936 (ITAA)* allows a complying superannuation fund to claim a deduction for the cost of providing death and disability cover for members of a complying superannuation fund. However, a deduction is not allowable under the ITAA for premiums for income payments during periods of temporary disability longer than two years, to the extent that those premiums relate to benefits for the period beyond two years. This encourages the sponsor employer to provide disability income insurance with benefit periods of no more than 2 years for members within the fund. Often, members pay the premiums by deductions from their account. If an employer wishes to pay long term disability income insurance, this is usually undertaken outside the superannuation fund. The full premium is then deductible and the benefits are all assessable in the hands of the individual. The premiums are more tax-effective as the surcharge does not apply. However, employers cannot claim the premiums as part of their SG commitment.

### *A.2.4. Tax Rates on Benefits*

| Type of Payment | Assessable Portion | Maximum Tax Rate |
|---|---|---|
| **Eligible Termination Payment (ETP) Retirement or Resignation (Employer/Superannuation Fund)** | | |
| ▪ Pre 1/07/1983 component | 5% | Marginal |
| ▪ Post 30/6/1983 component | | |
| ▪ Pre 55 years: Taxed Element | 100% | 21.5% |
| Untaxed Element | 100% | 31.5% |
| ▪ 55 years plus: Taxed Element - $0 → $117,576 | Nil | n/a |
| Balance | 100% | 16.5% |
| Untaxed Element - $0 → $117,576 | 100% | 16.5% |
| Balance | 100% | 31.5% |
| ▪ Undeducted contributions | Nil | n/a |
| ▪ Post June 1994 invalidity component | Nil | n/a |
| ▪ CGT exempt component | Nil | n/a |
| ▪ Excessive component | 100% | 48.5% |
| **Redundancy & Approved Early Retirement** | **Assessable Portion** | **Maximum Tax Rate** |
| ▪ For 2003/4, first $5,882 plus $2,941 for each completed year of service | Nil | N/a |
| ▪ Balance: taxed as an ETP | As above | As above |
| **Concessional Component** | **Assessable Portion** | **Maximum Tax Rate** |
| ▪ Arising from redundancy, approved early retirement or invalidity prior to July 1994 | 5% | Marginal |

| Death & Disability Benefits | Assessable Portion | Maximum Tax Rate |
|---|---|---|
| ▪ Death | | |
| Within pension RBL: | | |
| Payment to dependant | Nil | n/a |
| Payment to non-dependant | | |
| ▪ Pre 1/07/1983 component | 5% | Marginal |
| ▪ Post 1/07/1983 component: Taxed Element | 100% | 16.5% |
| Untaxed Element | 100% | 31.5% |
| Above RBL Pension - Excessive Component | 100% | 48.5% |
| ▪ TPD | | |
| Normal Portion | | |
| ▪ Pre 1/07/1983 component | 5% | Marginal |
| ▪ Post 30/6/1983 | | |
| Pre 55 years: Taxed Element | 100% | 21.5% |
| Untaxed Element | 100% | 31.5% |
| 55 years plus: Taxed Element - $0 → $117,576 | 100% | 0% |
| Balance | 100% | 16.5% |
| Untaxed Element - $0 → $117,576 | 100% | 16.5% |
| Balance | 100% | 31.5% |
| ▪ Disability portion | Nil | n/a |
| ▪ Disability Income | 100% | Marginal |

### *A.2.5. Eligible Termination Payment (ETP)*

Eligible termination payments (ETPs) paid by an employer after 20 August 1996 and taken as cash can attract the termination payments surcharge if the recipient's adjusted taxable income exceeds the surcharge threshold for the financial year.

If the termination is equal to or greater than the maximum surcharge threshold, the surchargeable portion of these 'golden handshakes' is calculated as the number of post 20 August 1996 days divided by the total number of service days. If the termination payment is below the maximum surcharge threshold, the amount of the termination payment divided by the years of service will be used to calculate the adjusted taxable income.

### *A.2.6. ETP Annuity Rebate*

Persons may be entitled to claim an ETP annuity rebate if they are:

- Over 55 years of age and receiving either a superannuation pension paid from a taxed complying superannuation fund, or an annuity purchased by the roll-over of one or more ETPs; or
- Receiving a death or disability pension at any age that relates to:
  - A superannuation pension paid from a taxed complying superannuation fund, or
  - A qualifying annuity purchased wholly by the roll-over of ETP monies.

The rebate is calculated as 15% of the rebateable proportion times the amount of annuity or pension eligible for a rebate less the undeducted purchase price.

### *A.2.7. Bona Fide Redundancy & Early Retirement Payments*

A bona fide redundancy payment or approved early retirement scheme payment is exempt from tax to the extent of the "tax free amount". For 2003/04, the tax-free amount is so much of the payment as does not exceed $5,882, *plus* $2,941 multiplied by complete years of service.

## A.3. Superannuation Surcharge

The superannuation surcharge is levied on the *surchargeable* contributions of high-income earners. A high-income earner is defined by the "adjusted taxable income" for the financial year. Broadly this is taxable income plus fringe benefits plus surchargeable contributions.

For accumulation funds it applies to employer contributions, deductible member contributions, the post-20 August 1996 portion of an employer ETP rolled-over or taken in cash, and allocated surplus amounts on or after 1 July 1997.
For defined benefit funds, it applies to the member's *notional surchargeable contribution* factor times annual superannuation salary. An actuarial certificate is required each year to determine these factors.

The minimum and maximum superannuation surcharge thresholds for 2003/04 are $94,691 and $114,981, respectively. These thresholds are based on "adjusted taxable income" as defined earlier and deductible contributions. The surcharge broadly phases in between the minimum and maximum as follows:

| Adjusted Taxable Income | Surcharge Tax Rate |
|---|---|
| Up to $94,691 | Nil |
| $96,044 | 1% |
| $97,396 | 2% |
| $98,749 | 3% |
| $100,102 | 4% |
| $101,454 | 5% |
| $102,807 | 6% |
| $104,160 | 7% |
| $105,512 | 8% |
| $106,865 | 9% |
| $108,218 | 10% |
| $109,570 | 11% |
| $110,923 | 12% |
| $112,276 | 13% |
| $113,628 | 14% |
| Above $114,981 | 15% |

## A.4. Taxes on Superannuation Funds

### *A.4.1. Fund Income*

Superannuation funds are taxed at the rate of 15% on their assessable income. This is defined as investment income plus employer contributions plus deductible member contributions. There are a number of allowable expenses including administration fees and insurance premiums.

Funds held in respect of post-retirement liabilities are exempt from tax on earnings. Where a fund holds assets in respect of pre and post retirement liabilities, it must separate the assets. The post-retirement assets are *segregated assets.*

Income tax for funds is paid quarterly under the PAYG instalment system (certain small funds may pay annually). PAYG instalments of income tax are payable within 21 days of the end of each quarter.

PAYG instalments replaced several tax collection systems, including the company and fund instalments system and the provisional tax system.

### *A.4.2. Capital Gains Tax (CGT)*

**On assets held for at least 12 months (non-trading stock)**

Assets purchased *prior* to 11:45am 21/09/1999

- Choice of frozen indexed cost base method (indexation frozen at September 1999) or nominal gain is taxed subject to 1/3 discount for super funds.

For assets purchased *after* 11:45am 21/09/1999 the nominal gain is taxed subject to 1/3 discount.

The basic CGT rate is 10% for superannuation and related funds.

**On assets held for less than 12 months**

If the asset was owned for less than 12 months, then indexation does not apply; and for CGT events happening after 11:45am EST on 21/09/99, the 50% discount option is not available, nor is CGT averaging available.

### *A.4.4. Imputation Credits*

Imputation credits are attached to dividends to avoid double taxation. Superannuation funds can use these to reduce their effective rate of tax below 15%.

### *A.5.5. Tax Rates*

The tax rate for a complying fund, approved deposit fund or a pooled superannuation trust is 15% (special income 47%). For non-complying funds the tax rate is 47%.

## A.5. Taxable Income of Retirees

### *A.5.1. Senior Australians Tax Offset*

In the May 2001 Budget, the tax-free threshold was increased for individuals who have attained pension age. The mechanism used was the low-income aged pensions rebate.

The maximum offset for single people is $2,230 applying to taxable incomes up to $20,000. The rebate cuts out at $37,840 annual taxable income.

Foe each member of a couple the maximum offset it $1,602 applying to taxable income up to $16,306. The rebate cuts out at $29,122 (each).

The tax offset for senior Australians reduces at the rate of 12.5 cents for each dollar over the thresholds.

### *A.5.2. Pensioner Tax Offset*

The pensioner tax offset ensures that no tax is payable for pensioners whose assessable income consists of the full pension from the Centrelink or the Department of Veterans' Affairs and, in some cases, a small amount of non-pension income. To claim this tax offset, you must be ineligible for the Senior Australians Tax Offset.

Rates for single pensioners are:

| Taxable Income | Tax offset |
|---|---|
| Less than $16,653 | Maximum $1,811 |
| $16,653 - $31,141 | Maximum tax offset reduced by 12.5 cents for every dollar of taxable income over $16,653 |
| More than $31,141 | Nil |

Rates for coupled pensioners are:

| Taxable Income | Tax offset |
|---|---|
| Less than $13,789 | Maximum $1,324 |
| $13,789 - $24,381 | Maximum tax offset reduced by 12.5 cents for every dollar of taxable income over $13,789 |
| More than $24,381 | Nil |

### *A.5.3. Medicare Levy*

The Medicare Levy is calculated at 1.5% of taxable income. For those eligible for relief, no levy is payable up to their lower income threshold, while those with taxable incomes between thresholds, 20% of the difference between income and the lower threshold is payable.

| Category | 2003 Income tax threshold | 2003 Cut-out threshold |
|---|---|---|
| Senior Australians Tax Offset | $20,000 | $21,622 |
| Pensioner Tax Offset | $17,164 | $18,556 |

In addition to the Medicare Levy, those on high incomes ($50,000 for singles, $100,000 for families plus $1,500 for each dependent child) who are not covered by private patient hospital cover are liable to pay the Medicare Levy Surcharge. The Medicare Levy Surcharge is calculated at 1% of taxable income.

# B. Social Security Pension Criteria

## B.1. Eligible Age

| Current Pension Ages | | |
|---|---|---|
| | **DSS** | **DVA** |
| Male | 65 | 60 |
| Female | 62.5 | 57.5 |

The age for females is being increased gradually to equal the male pension age. Equivalence will be reached in 2014. The eligibility before then is as follows:

| FEMALE PENSION ELIGIBILITY | | |
|---|---|---|
| Women born between | Pension Age | |
| | DSS | DVA |
| 1 July 1935 and 31 Dec. 1936 | 60 ½ | 55 ½ |
| 1 Jan. 1937 and 30 June 1938 | 61 | 56 |
| 1 July 1938 and 31 Dec. 1939 | 61 ½ | 56 ½ |
| 1 Jan. 1940 and 30 June 1941 | 62 | 57 |
| 1 July 1941 and 31 Dec. 1942 | 62 ½ | 57 ½ |
| 1 Jan. 1943 and 30 June 1944 | 63 | 58 |
| 1 July 1944 and 31 Dec. 1945 | 63 ½ | 58 ½ |
| 1 Jan. 1946 and 30 June 1947 | 64 | 59 |
| 1 July 1947 and 31 Dec. 1948 | 64 ½ | 59 ½ |
| 1 Jan. 1949 and later | 65 | 60 |

Note: Shaded area shows the birth dates of women at the current pensionable age.

## B.2. Residential Qualifications

The benefits are only payable to people who have been Australian residents for at least ten years (including at least one consecutive period of five years) and who are in Australia on the day the claim is lodged.

Other people may be eligible as a result of:

- Residence in certain countries with which Australia has a reciprocal agreement counting towards Australian residence; OR
- A qualifying residence exemption (arriving into Australia as refugee or under special humanitarian program); OR
- Being a female widowed in Australia, when both she and her late partner were Australian residents and:
  - Who has 104 weeks residence immediately prior to claim; or
  - Who was in receipt of Widow B Pension, Widow Allowance, Mature Age Allowance or Partner Allowance immediately before turning Age Pension age.

## B.3. Basic Rates & Method of payment

Benefit criteria depends on marital status, income and assets. The benefits as at September 2003 are shown below, together with amounts payable in previous years:

**Pension rate per fortnight**

| | Sept 99 | Sept 00 | Sept 01 | Sept 02 | Sept 03 |
|---|---|---|---|---|---|
| **Single** | $366.50 | $394.10 | $410.50 | $429.40 | $452.80 |
| **Couple** | $305.90 | $328.90 | $342.60 | $358.40 | $378.00 |

- Age pension payments are taxable income;
- Can be paid overseas in certain circumstances;
- For couples (married or de facto heterosexual couple), each partner receives the above rate;
- Single pension rate is payable to both members of a couple if couple is separated because of illness;
- Half-married rate is payable to one of a couple if partner not receiving pension, benefit or allowance; and
- Additional $5.80 per fortnight Pharmaceutical Allowance for most pensioners, single or couple (combined), or $2.90 per fortnight if only one of a couple is a pensioner.

## B.4. Rent assistance

Pensioners who rent also receive significant government support. The benefits as at September 2003 are based on the following criteria:

| Family Situation | Maximum payment per fortnight | No payment if fortnightly rent is less than | Maximum payment if fortnightly rent is more than |
|---|---|---|---|
| Single, no children | $94.40 | $83.80 | $209.67 |
| Single, 1 or 2 children | $110.88 | $110.46 | $258.30 |
| Single, 3 or more children | $125.30 | $110.46 | $277.53 |
| Couple, no children | $89.20 | $136.60 | $255.53 |
| Couple, 1 or 2 children | $110.88 | $163.52 | $311.36 |
| Couple, 3 or more children | $125.30 | $163.52 | $330.59 |

Note: Children refers to dependent children.

## B.5. Means Tests

Eligibility is tested based on assets as well as income. The harsher of the two tests applies.

### B.5.1. *Income Tests*

| Income Test for pensions – per fortnight | | |
|---|---|---|
| **Family Situation** | **For full pension** | **For part pension** |
| Single, no children | Up to $120 | Less than $1,266.50 |
| Couple (combined), no children | Up to $212 | Less than $2,116.50 |
| Additional children | Add $24.60 per child | Add $24.60 per child |

- For full pension, income over these amounts reduces the rate of pension payable by 40 cents in the dollar (single), 20 cents in the dollar each (couple).
- For part pension, these figures may be higher if Rent Assistance is also paid.
- For part pension, Pharmaceutical Allowance is included.

Note that there is no income test for age pensioners who are permanently blind.

### B.5.2. *Assets Test*

| Assets test for home-owners | | |
|---|---|---|
| **Family Situation** | **For full pension / allowance** | **For part pension** |
| Single | Up to $149,500 | Less than $302,500 |
| Partnered (combined) | Up to $212,500 | Less than $466,500 |
| **Assets test for non-home-owners** | | |
| **Family Situation** | **For full pension/allowance** | **For part pension** |
| Single | Up to $257,500 | Less than $410,500 |
| Partnered (combined) | Up to $320,500 | Less than $574,500 |

- For part pensions, limits will increase if Rent Assistance is paid;
- For full pension, assets over these amounts reduce pension by three dollars per fortnight for every $1000 above the limit (single and couple combined);
- For part pension, Pharmaceutical Allowance is included; and
- No assets test for age pensioners who are permanently blind.

### B.5.3. *Extra allowable amount for Retirement Village Residents*

The Extra Allowable Amount is the difference between the non-home-owner and the home-owner asset test limits, currently $108,000. If the Entry Contribution is equal to or less than this amount, the pensioner is assessed as a non-home-owner. The Entry Contribution will count as an asset and the pensioner may qualify for Rent Assistance.

## B.6. Pension Bonus Scheme

**Basic conditions of eligibility**

- Allows *eligible* people who work and defer claiming Age Pension to earn a tax-free lump sum bonus.

- Must register before a bonus can be accrued. Earliest registration is the date the person meets age and residency criteria for Age Pension.
- Must defer a minimum of 12 months from date of registration.
- Cannot accrue bonus after age 75.
- Must complete at least 960 hours of gainful work each year.
- Not paid if person has received income support (except Carer Allowance) since meeting age and residence criteria for Age Pension.
- Bonus is paid when first claiming and receiving Age Pension.
- Amount of bonus paid is based on how long pension has been deferred from date of registration, rate of pension and if partnered.
- Maximum of five bonus years.

**Basic Rates and method of payment**

| Lump Sum Bonus | | |
|---|---|---|
| **Bonus Years** | **Single** | **Partnered (Each)** |
| **1** | $1,107 | $924 |
| **2** | $4,427 | $3,695 |
| **3** | $9,960 | $8,315 |
| **4** | $17,706 | $14,781 |
| **5** | $27,666 | $23,096 |

## B.7. Commonwealth Seniors Health Card

The Commonwealth Seniors Health Card gives older Australians access to concessions on prescription medicines through the Pharmaceutical Benefits Scheme. A Telephone Allowance is also available to assist with the costs of telephone line or mobile phone connection and is paid to: pensioners; certain older long-term allowees; and eligible Commonwealth Seniors Health Card holders.

**Who is eligible?**

To get the card and the telephone allowance persons must:

- Qualify for the Age Pension; or
- Be an Australian resident and in Australia for a period of, or periods totalling 104 weeks; and
- Have reached pension age; and
- Have annual income less than the following amounts (as of 1 April 2003);
  - $50,000 (single);
  - $80,000 (couple combined); and

- If a person has dependant children, an additional $639.60 should be added for each dependent child.

**Concessions on prescription medicines**

Generally, those holding the Commonwealth Seniors Health Card pay only $3.80 for each Pharmaceutical Benefits Scheme (PBS) medicine.

More will be paid if the medicine is not listed on the PBS or is only partially covered.

When $197.60 is spent on PBS prescription medicines in a calendar year, that person is entitled to free PBS medicines for the rest of the calendar year.

**Telephone Allowance**

The telephone allowance is a non-taxable payment of $19.20 paid every three months. The payment is not subject to an income or assets test.

## B.8. Deeming Rates as at 1 July 2003

Under the pension and allowance Income Tests, income from all financial investments is assessed under one simple set of rules, known as deeming. Deeming assumes that financial investments (see list below) are earning a certain rate of income, regardless of the actual earnings rate.

This rule was introduced to simplify the calculation of the Income Test (which is done quarterly). The deeming rates are determined by the Minister for Family and Community Services from time to time.

The deeming provisions are made as follows:

- The value of a person's financial investments are added together;
- The first $35,600 of these assets for a single person ($59,400 combined for couples where at least one member of the couple is getting a pension) is deemed to earn income at a lower deeming rate (as at 1 July 2003, this is 2.5 per cent);
- The amount over $35,600 for a single person ($59,400 combined for couples where at least one member of the couple is getting a pension) is deemed to earn income at a higher deeming rate (as at 1 July 2003, this is 4.0%); and
- The actual income earned is not counted.

**Financial Investments include:**

- Bank, building society and credit union accounts;
- Cash;
- Term deposits;
- Friendly society bonds;
- Managed investments;
- Assets in superannuation and rollover funds held by anyone of Age Pension age;

- Listed shares and securities;
- Short term asset tested income streams;
- Loans and debentures;
- Shares in unlisted public companies; and
- Gold and other bullion.

**Financial investments do not include:**

- A person's home or its contents;
- Entry contribution to a retirement village;
- Cars, boats and caravans;
- Antiques, stamp or coin collections;
- Assets in superannuation and rollover funds held by anyone under Age Pension age;
- Standard life insurance policies;
- Holiday homes, farms or other real estate;
- Income streams other than asset tested income streams (short term).

Note: Asset tested short-term income streams are not financial investments, but are treated in the same way as financial investments.

### *B.8.1. Treatment of Income Streams*

**Allocated Pensions**

Allocated Pensions are akin to a managed investment. They operate as a unit trust and can have a range of investment options and different fund managers. There are minimum and maximum withdrawals each year based on the account balances and an age-related pension factor from a table issued by the government actuary.

Money held in an allocated pension does not comply for the purposes of the pension RBL and is subject to both the Income and Assets Tests.

For the Assets Test, the value of the pension is taken to be the account balance at time of assessment. For products without an account balance, the asset is valued as:

Purchase Price – {[(purchase price – residual capital value) ÷ term] × term elapsed}

Assessable income of pensions with at least a five year term for the Income Test is calculated as:

Gross annual income – [purchase price - residual capital value) ÷ term]

**Lifetime annuities**

In Australia, life companies issue all lifetime annuities. The concept of an annuity is that the life insurer provides a guaranteed stream of income to the annuitant in exchange for a lump sum payment at outset. The company invests the capital payment, usually in a fixed interest investment of a term similar to the annuitant's expectation of life at purchase.

As times have changed, annuity products have become very sophisticated and applicants are now offered a variety of options at entry. This is one product where the life company is exposed to the risk that the policy-holder will live too long. However, these products are extremely interest-sensitive and it is equally as important to set the right interest rate as it is to anticipate future mortality correctly.

The Australian public has never purchased lifetime annuities in large volumes. The reasons for this include:

- Retirees seemed to be uncomfortable with the concept of placing their lump sum with a single financial institution for the balance of their life! Many retirees appeared to be confused by the thought of "losing their capital" on a lifetime annuity.
- Until the introduction of the RBL system in 1992, retirees could take up to 7 times their final salary as a lump sum (with very favourable tax treatment of the benefit). Hence, there was little incentive to purchase an annuity for most people.
- There has been a very small annuity market and, for many years, there was little published material on comparative prices.
- Annuity income was counted in assessing eligibility for the Age Pension (whereas lump sums could be more easily dissipated or hidden).
- Annuity rates offered by life offices are unattractive reflecting the capital requirements of the Statutory valuation basis.

**Complying Lifetime Pensions /Annuities**

Provided a lifetime annuity satisfies certain conditions, it can be accepted as a Complying Pension/Annuity for both Pension RBL and Age Pension purposes.

Under Social Security rules, the purchase price of a Complying Pension or Annuity is exempt from the Assets Test. Additionally, assessable income from these pensions is equal to:

Gross annual income – (purchase price ÷ term)

As a greater number of people have retired with benefits exceeding the lump sum RBL, they have used complying annuities in order to qualify for the pension RBL. This led to an increase in sales but they are still low relative to other forms of retirement savings business. One reason for this has been the current low annuity rates, which reflect the low yields on the matching fixed interest assets backing the products.

**Term certain annuities**

These products operate in a similar manner to bank term deposits. They are for a fixed term, provide a set rate of interest and can return some or all capital on maturity. Until recently, most sales were for short-term periods. However, a change in Social Security rules from September 1998 has seen a shift to longer-term products.

They became popular for a number of reasons:

- Retirees gravitated towards short-term investments as interest rates fell from the highs of the late 80s and early 90's;
- The full return of capital was perceived to be an advantage; and
- Familiarity with bank term deposits meant that it was easy to shift funds from these into term certain annuities which pay no tax on earnings.

**Complying Life Expectancy Annuities**

Subject to certain conditions, “life expectancy annuities” are accepted as Complying Pensions/Annuities for the purposes of exemption from the Assets Test.

Life expectancy annuities comprise “no residential value” term certain annuities where the term is equal to the expectation of life (according to Australian population mortality tables), and include those where the term is between 15 years and the life expectancy.

Such Complying Annuities have become quite popular as a means for ensuring eligibility for at least a part Age Pension.

# C. Pensioners on Social Security

## C.1. Retirees

We obtained statistics of pensioners from DSS and DVA as at July 2003. From ABS data, we know the total population of pensionable age and the numbers of people in full-time employment. There are also some deferred pensioners participating in the Pension Bonus Scheme. The balance represents those who are self-funded retirees.

The status of retirees of pensionable age is summarised as follows:

| Number of People | Status as at June 2003 | | | | | | |
|---|---|---|---|---|---|---|---|
| | Full DSS | Part DSS | Full DVA | Part DVA | Self Funded | Employed* | Population |
| Males >65 | 455,537 | 246,493 | 104,872 | 50,776 | 217,172 | 60,200 | 1,133,271 |
| Females >62.5 | 735,189 | 333,201 | 176,828 | 37,511 | 304,922 | 32,116 | 1,618,958 |
| Total | 1,190,726 | 579,694 | 281,700 | 88,287 | 522,094 | 92,316 | 2,752,229 |

** includes 55,161 people registered on the Pension Bonus Scheme (app. 27,307 male and 27,854 female).*

| Number of People | Status as at June 1997 | | | | | |
|---|---|---|---|---|---|---|
| | Full DSS | Part DSS | Full & Part DVA | Self Funded | Employed* | Population |
| Males >65 | 373,181 | 204,717 | 207,976 | 141,189 | 52,900 | 979,963 |
| Females >60.5 | 739,585 | 319,122 | 225,042 | 267,582 | 36,972 | 1,588,303 |
| Total | 1,112,766 | 523,839 | 433,018 | 408,771 | 89,872 | 2,568,266 |

** includes 16,045 people registered on the Pension Bonus Scheme (7,943 male and 8,102 female).*

In addition, there are younger DVA pensioners due to the earlier eligibility age and also some younger DSS pensioners who are married to, or dependent on, Age Pensioners.

## C.2. Percentages

The above table re-expressed as percentages shows:

| Percentage of Population of (DSS) Pension Age | Status as at June 2003 | | | | | | |
|---|---|---|---|---|---|---|---|
| | Full DSS | Part DSS | Full DVA | Part DVA | Self Funded | Employed | Total |
| Males | 40.2 | 21.8 | 9.3 | 4.5 | 19.2 | 5.3 | 100.0 |
| Females | 45.4 | 20.6 | 10.9 | 2.3 | 18.8 | 2.0 | 100.0 |
| Total | 43.3 | 21.1 | 10.2 | 3.2 | 19.0 | 3.4 | 100.0 |

| Percentage of Population of (DSS) Pension Age | Status as at June 1997 | | | | | |
|---|---|---|---|---|---|---|
| | Full DSS | Part DSS | Full & Part DVA | Self Funded | Employed | Total |
| Males | 38.1 | 20.9 | 21.2 | 14.4 | 5.4 | 100.0 |
| Females | 46.6 | 20.1 | 14.2 | 16.8 | 2.3 | 100.0 |
| Total | 43.3 | 20.4 | 16.9 | 15.9 | 3.5 | 100.0 |

Past government policies have clearly failed, since only 20% of retirees are entirely self-sufficient in retirement. The Age Pension, far from being a safety net for the poor, is an integral part of the income of most retired Australians.

## C.3. Change Over Time

Reviewing these statistics and comparable figures for earlier years, leads to the following observations:

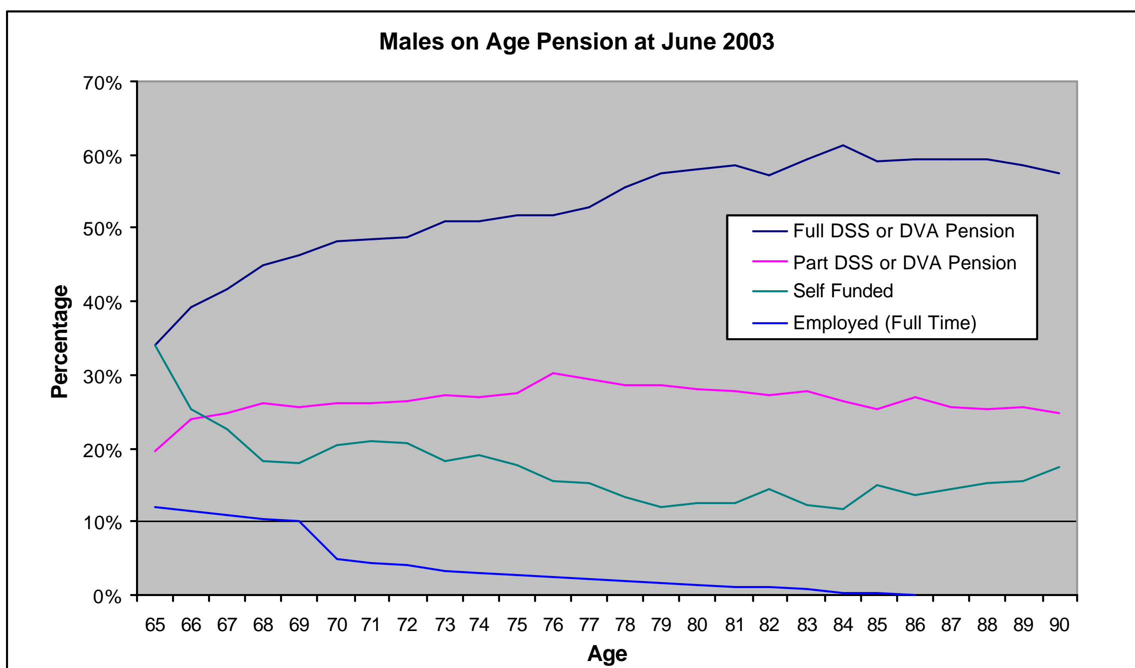
- The number of males on full DSS pension is rising, as expected, though the females on full pension remained constant in the last three years. This is a function of the increase in the female pension age.
- The number of fully self-funded pensioners has increased.
- The take-up of the Pension Bonus Scheme has been quite small (app. 7.4% of those eligible, or 55,000 in first five years).
- Many of those shown as still employed are likely to be self-employed and less likely to retire on welfare.

## C.4. Dependency by Age

We examined the proportion of people on pension at each age. This confirms that people become more dependent as they age.

The male graph below shows only 35% of those reaching retirement age receive a full pension immediately. This rises to nearly 50% by age 70 by which time the majority of men have retired. The percentage then grows throughout the seventies to 60% and generally remains at this level.

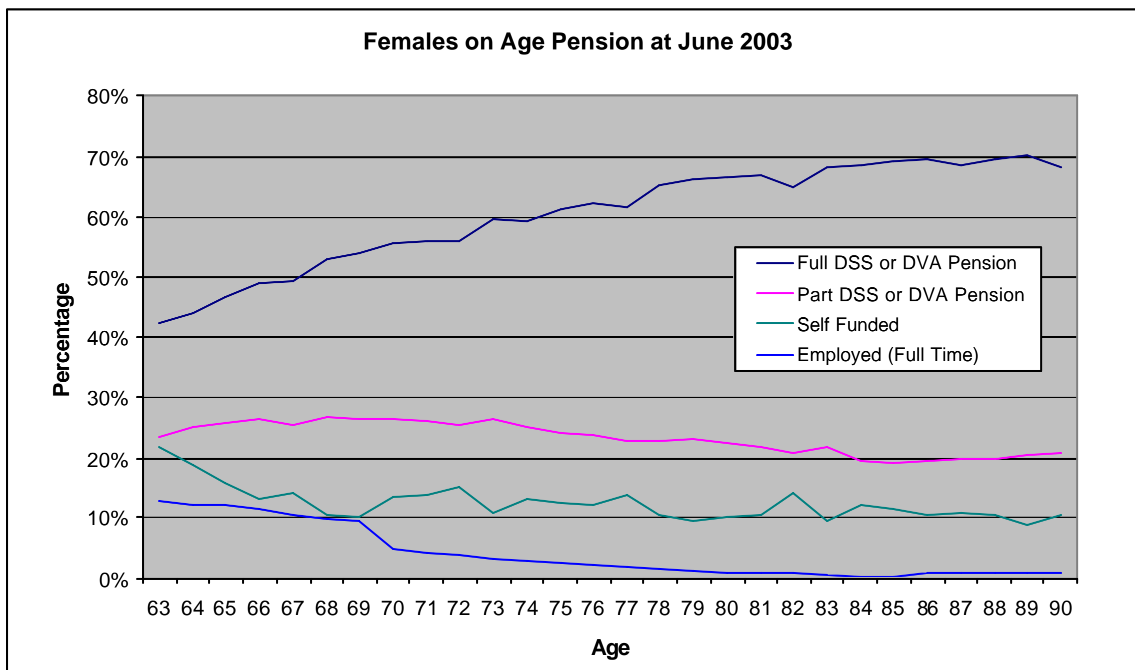
Those who are totally self-sufficient are about 45% of the population at age 65. However, as more people retire, this number declines to about 25% at age 70. From age 75 onwards it fluctuates between 12% and 20%.



The female graph shows the generally higher dependency on social security of younger female retirees. Over 40% of females receive a full pension by age 63 and this rises gradually to 60% by the early 70's.

Only 34% of women of initial retirement age are not in receipt of a pension, compared to 46% of men of the same age.

Through most of retirement the female rate of full pension dependency varies from 5% to 10% greater than that of similarly aged males.




## C.5. Impact of recent policy initiatives

The two major policy changes affecting numbers on welfare in retirement have been the increase in the female retirement age and the introduction of the Pension Bonus Scheme.

Female numbers on the Age Pension would have increased by more than 126,000 but for the change to the eligible pension age. If this age had remained at 60 (and 55 for DVA recipients), the expected numbers at June 2003 would have been:

| Number of Females | Full Pension | Part Pension | Total |
|---|---|---|---|
| Actual | 924,852 | 381,629 | 1,306,481 |
| Expected | 1,007,389 | 425,187 | 1,432,576 |
| Difference | 82,537 | 43,558 | 126,095 |

This has saved the government about $1,345 million p.a. in pension payments. Therefore, the actual underlying growth in pension costs is far higher than shown in the published National Accounts and we will see sharp rises in the next few years as these 126,000 females become eligible.

Under the Pension Bonus Scheme, people who are eligible for a pension may continue to work a minimum of 960 gainful hours p.a. They can then defer receipt of their pension for up to 5 years and they will receive a bonus of up to $27,666 (based on single pension amount at June 2003).

The value of pension payments foregone considerably exceeds the bonus payment. A single person would lose nearly $59,000 in pension benefits over the five-year period.
Some 55,000 people joined this scheme in its first five years. This has saved the government up to $570 million p.a.

Even when these initiatives are taken into account, it can be seen that underlying pension costs are already rising quite steeply.

# D. Today's Superannuation Market Place

## D.1. Current Size

The retirement market can be measured in a number of ways. All key indicators, namely assets, members and contributions, have shown strong past growth. This will continue for many years due to the impact of the compulsory (SG) contributions regime. As private account balances grow, this should reduce the dependence of future retirees on social security. Accordingly, it is a worthwhile government objective to encourage all members to build their account balances.

There has been consistently strong growth in superannuation assets over the last fifteen years, although recently growth has been more volatile due to international stock market fluctuations.

The following items have all contributed to this growth:

- The increase in compulsory employer superannuation contributions;
- High real rates of return throughout the 1990's (largely due to increased amounts held in Australian and international equities);
- A growth in the number of people (baby-boomers) entering the pre-retirement years – and making higher contributions; and
- Public sector shift from unfunded defined benefits to funded accumulation benefits.

### *D.1.1. Asset Allocation*

Australian equities and unit trusts now dominate superannuation assets, with 44.6% of total superannuation assets at June 2003, while there is a further 17.7% in assets invested overseas.

The breakdown of total assets by type of investment at June 2003 was:

| Investments | Assets ($billion) | Percentage of Total Assets |
|---|---|---|
| Cash and Deposits | 43.7 | 8.2% |
| Loans and Placements | 20.0 | 3.8% |
| Interest-bearing Securities | 88.1 | 16.5% |
| Equities and Units in Trusts | 238.0 | 44.6% |
| Direct Property | 31.2 | 5.9% |
| Other Assets | 18.3 | 3.4% |
| **Total Assets in Australia** | **439.4** | **82.3%** |
| Assets Overseas | 94.5 | 17.7% |
| **Total Assets** | **533.9** | **100.0%** |

*Source: APRA*

### *D.1.2. Members*

The Australian population is about 20 million, with 9.6 million employed persons. There were 25.085 million superannuation accounts at June 2003, resulting in an average of about 2.6 superannuation accounts per employed person. Consolidation of member accounts would reduce fees and encourage members to take a greater interest in their benefits.

| | Superannuation Members by Fund Type (000's) | | | | | Total |
|---|---|---|---|---|---|---|
| | Corporate | Industry | Public Sector | Retail | Small Funds | (000'S) |
| June 1999 | 1,386 | 5,899 | 2,836 | 9,280 | 319 | 19,720 |
| June 2000 | 1,350 | 6,506 | 2,756 | 10,532 | 388 | 21,532 |
| June 2001 | 1,361 | 6,891 | 2,836 | 11,252 | 408 | 22,749 |
| June 2002 | 1,078 | 7,177 | 2,937 | 12,164 | 442 | 23,797 |
| June 2003 | 1,104 | 7,549 | 2,962 | 12,975 | 495 | 25,085 |

*Source: APRA*

## D.2. Types of fund

The number of superannuation and APRA approved deposit funds increased by 36% over the last four years. The main reason was the substantial growth in small (self-managed) funds which went from 193,396 to 267,066. The number of all other types of fund fell in that period.

The number of retail funds fell by 25% from June 1999 to June 2003. This reflects rationalisation amongst financial institutions as well as growth of master trust products, which aggregate personal superannuation, corporate funds and allocated pensions within the same vehicle. Many approved deposit funds were also absorbed into other superannuation products.

There was also a notable decline (48%) in the number of corporate funds during this period. Most small corporate funds have been wound-up and members and asset have transferred into master trusts and industry funds.

| Fund Type | Total Number of Funds | | | | |
|---|---|---|---|---|---|
| | June 1999 | June 2000 | June 2001 | June 2002 | June 2003 |
| Corporate | 3,597 | 3,400 | 3,235 | 2,495 | 1,874 |
| Industry | 146 | 144 | 139 | 122 | 112 |
| Public Sector | 95 | 94 | 94 | 89 | 73 |
| Retail | 307 | 292 | 274 | 254 | 231 |
| Small Funds | 193,396 | 210,366 | 221,544 | 238,841 | 267,066 |
| **Total** | **197,541** | **214,296** | **225,286** | **241,801** | **269,356** |

*Source: APRA*

There has been a rapid shift to accumulation funds due to increasingly onerous responsibilities imposed by regulators on employers under defined benefit schemes. Almost all the small funds are accumulation arrangements.

| Date | Assets by Fund Type ($ billion) | | | | |
|---|---|---|---|---|---|
| | Accumulation | Small Funds | Defined Benefit | Hybrid | Total |
| June 1999 | 157,071 | 60.904 | 21,628 | 126,658 | 366,260 |
| June 2000 | 185,177 | 70,552 | 20,328 | 145,821 | 421,878 |
| June 2001 | 214,537 | 78,196 | 21,711 | 152,618 | 467,063 |
| June 2002 | 230,219 | 92,229 | 16,225 | 138,683 | 477,356 |
| June 2003 | 233,484 | 109,086 | 15,856 | 151,281 | 509,707 |

*Source: APRA*

This total excludes the balance of Statutory Funds so the numbers are slightly less than those shown in Table D.1.1.

## D.3. Contributions

In recent years, there has been steady growth in employer contributions, largely due to the increases in the SG rate. Much of the growth in member contributions is due to transfers of non-super investments into funds as undeducted contributions (mainly by pre-retirees) into retail funds.

| Year Ended | Total Superannuation Contributions ($ million) | | |
|---|---|---|---|
| | **Member** | **Employer** | **Total** |
| June 1999 | 17,759 | 31,299 | * 49,056 |
| June 2000 | 20,413 | 25,861 | 46,274 |
| June 2001 | 22,747 | 27,476 | 50,223 |
| June 2002 | 23,289 | 28,756 | 52,045 |
| June 2003 | 18,969 | 35,202 | 54,171 |

*Source: APRA Superannuation Trends June Quarter 2003*

* During the June 1999 quarter, three public sector funds received $8.4 billion in exceptional employer contributions.

For the year ended June 2003, the contributions made to each type of superannuation fund were as follows:

| Fund Type | Contributions ($ million) | | | |
|---|---|---|---|---|
| | **Member** | **Employer** | **Total** | **%** |
| Corporate | 591 | 5,066 | 5,657 | 10.4 |
| Industry | 505 | 8,217 | 8,722 | 16.1 |
| Public Sector | 2,684 | 7,714 | 10,399 | 19.2 |
| Retail | 9,118 | 9,276 | 18,394 | 34.0 |
| Small Funds | 6,072 | 4,928 | * 11,000 | 20.3 |
| **Total** | **18,970** | **35,202** | **54,172** | **100** |

*Source: APRA Superannuation Trends June Quarter 2003*

* The majority of this amount is from transfers into relatively new funds.

There is also a clear indication that members of industry funds rely heavily on employer contributions, as these represent 94.2% of the total contributions made.

### *D.3.1. Unfunded Liabilities*

The total unfunded liability of the Federal and State governments was $129.6 billion as at 30 June 2003. In the past, public servants had generous unfunded defined benefit arrangements. However, over the last decade, the majority of State and Federal arrangements have changed to fully-funded accumulation funds. These apply to new employees after the date of conversion.

The unfunded liabilities for members who are still on the old benefit structure are now recorded as a liability on the balance sheet of State governments. This amount is broken down as follows:

| Government | 30 June 2003 ($ billion) | Liability per capita |
|---|---|---|
| Commonwealth | 89.0 | 4,476.5 |
| New South Wales | 13.2 | 1,974.1 |
| Victoria | 13.6 | 2,765.7 |
| Western Australia | 5.5 | 2,817.2 |
| South Australia | 4.5 | 2,946.2 |
| Tasmania | 1.4 | 2,934.4 |
| Northern Territory | 1.4 | 7,056.5 |
| ACT | 1.0 | 3,096.9 |
| Queensland | NIL | NIL |
| **AUSTRALIA** | **129.6** | **6,518.6** |

## D.4. Market Segmentation

The Australian superannuation market can be divided into wholesale and retail markets. Personal superannuation products and small funds are the major players in the retail superannuation market, whilst public sector funds and corporate funds dominate the wholesale superannuation market.

| Market segment | FUM 30 June 2003 | |
|---|---|---|
| | ($M) | (%) |
| **Employer Funds** | | |
| Corporate Funds | 57,539 | (10.8) |
| Industry Funds | 56,015 | (10.5) |
| Public Sector Funds | 106,769 | (20) |
| **a) Total Employer Funds** | **220,324** | **(41.3)** |
| **Retail Funds** | | |
| Master Trusts | 45,000 | (8.4) |
| Personal Superannuation | 96,836 | (18.1) |
| Post Retirement Products | 45,838 | (8.6) |
| Retirement Savings Accounts | 3,657 | (0.7) |
| Eligible Rollover Funds | 3,721 | (0.7) |
| Unallocated Reserves | 9,500 | (1.8) |
| **b) Total Retail Funds** | **204,552** | **(38.3)** |
| **c) Self-managed Funds** | **109,086** | **(20.4)** |
| **Total Superannuation Market** | **533,962** | **(100.0)** |

*Source: Rice Walker Market Projections Report*

## D.5. Projected Growth

Rice Walker projects the growth of markets for the next ten years. These projections are updated every six months. Key assumptions used are a 7.5% p.a. gross earning rate, 4.5% p.a. salary increases and CPI growth of 3% p.a.

### D.5.1. Retail

The growth in master trusts is expected to continue over the next 10 years, from total assets of $45,000 million to $192,816 million (in 2003 dollar terms). This is partly due to stand-alone corporate funds transferring to fully outsourced arrangements.

Personal superannuation products are expected to grow to $256,936 by 30 June 2013, maintaining its dominant position in this market.

The amount of unallocated reserves is in respect of reserves held in life office statutory funds. These amounts are expected to reduce to zero by 2013 as the legacy products for which they are held gradually decline.

| Market segment | Today 30 June 2003 | | In 5 years 30 June 2008 | | In 10 years 30 June 2013 | |
|---|---|---|---|---|---|---|
| | ($M) | (%) | ($M) | (%) | ($M) | (%) |
| Master Trusts | 45,000 | (22.0) | 120,063 | (33.5) | 192,816 | (34.5) |
| Personal Superannuation | 96,836 | (47.3) | 157,736 | (44.0) | 256,936 | (46.0) |
| Post Retirement Products | 45,838 | (22.4) | 67,742 | (18.9) | 98,722 | (17.7) |
| Retirement Savings Accounts | 3,657 | (1.8) | 4,922 | (1.4) | 6,624 | (1.2) |
| Eligible Rollover Funds | 3,721 | (1.8) | 3,825 | (1.1) | 4,044 | (0.7) |
| Unallocated Reserves | 9,500 | (4.6) | 4,500 | (1.3) | 0 | (0.0) |
| **Total Retail Funds** | **204,552** | **(100.0)** | **358,789** | **(100.0)** | **559,142** | **(100.0)** |

*Source: Rice Walker Market Projections Report*

### D.5.2. Wholesale

The decline of corporate funds is expected to reduce their market share in the wholesale superannuation market by 10.4%.

Industry funds are expected to increase their share of the wholesale market by 9.6% over the next ten years. This is partly due to market share from stand-alone corporate funds transferring to fully outsourced arrangements, where industry funds compete with master trusts. Self-managed funds are also expected to increase their market share, by 6.3%, becoming the dominant segment in this market.

| Market segment | Today 30 June 2003 | | In 5 years 30 June 2008 | | In 10 years 30 June 2013 | |
|---|---|---|---|---|---|---|
| | ($M) | (%) | ($M) | (%) | ($M) | (%) |
| Corporate Funds | 57,539 | (17.5) | 35,370 | (8.6) | 38,301 | (7.1) |
| Industry Funds | 56,015 | (17.0) | 101,322 | (24.5) | 144,065 | (26.6) |
| Public Sector Funds | 106,769 | (32.4) | 119,699 | (29.0) | 146,074 | (26.9) |
| Self-managed Funds | 109,086 | (33.1) | 156,628 | (37.9) | 213,605 | (39.4) |
| **Total Wholesale Market** | **329,409** | **(100.0)** | **413,019** | **(100.0)** | **542,045** | **(100.0)** |

*Source: Rice Walker Market Projections Report*

## D.6. Retirement Products

Funds held in post retirement products have had mixed growth in recent years. The largest segment, allocated pensions, has grown by more than 14% p.a. over the last 4 years, while lifetime and term certain annuities have had more modest growth of 5.5% p.a.

In addition to these retail funds, there are several corporate and public sector funds that pay pensions.

### *D.6.1. Incentives for Private Pensions*

Australia has a unique structure in that people are not forced on retirement to purchase pensions with their accumulated superannuation balance. This discontinuity on retirement is one of the major causes of poor integration with social security benefits.

There are some incentives for retirees to convert their superannuation (and other investments) into a retirement stream. The main ones are:

- Lump sum amounts above the lump sum RBL are taxed at marginal rates of personal tax;
- Converting half or more of a benefit into a complying pension doubles the amount for which tax concessions are made;
- The investment income of retirement income assets is not taxed (unlike pre-retirement assets which are taxed at 15%);
- Payment of undeducted contributions into superannuation at the time of retirement converts assets into tax-free investments;
- Allocated pensions can be set up to leave benefits on death to dependants; and
- Suitable manipulation of assets and income can allow relatively wealthy people to access a full or part Age pension.

The funds under management held for private pensions have grown strongly in recent years, so the government incentives to convert benefits into pension form are working. What is less clear is whether this is reducing the Age Pension liabilities.

### *D.6.2. Market size of post retirement products*

**Projections of the Post Retirement Market**

| Year to June 30 | Funds under management ($ million) |
|---|---|
| 2004 | 45,838 |
| 2005 | 45,992 |
| 2006 | 46,284 |
| 2007 | 46,987 |
| 2008 | 48,182 |

*Source: Rice Walker Market Projections Report*

# E. Glossary of Terms

*CGT exempt component* – An ETP will have this component if a member rolled-over proceeds of certain business assets to use in retirement and they were disposed of after 1 July 1997. This component is the amount that was eligible for a capital gains tax exemption.

*Concessional component* – Invalidity, redundancy or approved early retirement payment made before 1 July 1994.

*ETP* – Eligible Termination Payments are lump sum payments defined to include superannuation benefits and certain employer payments made as a result of the termination of a taxpayer's employment. ETPs consist of a number of components, each of which is subject to different taxation rules.

*Notional surchargeable contributions factor* – This factor is the present value of employer provided benefits accruing in the year. It is calculated by an eligible actuary using assumptions in accordance with either a) Superannuation Contributions Ruling SCR 97/1 or (b) another method approved in writing by the Commissioner.

*Pre-July 1983 component* – An ETP will have this component if the member's/employee's eligible service period started before 1 July 1983.

*Preserved Benefits* – In general preserved benefits must be retained in a superannuation fund until the member has satisfied a condition of release as specified in the Superannuation Industry (Supervision) Act 1993.

*Post-June 1983 component* – Most ETPs will have this component as the member's/employee's eligible service will include a period after 30 June 1983.

*Post-June 1994 component* – This is a component of an ETP that is paid to an employee because of a permanent disability. It is not taxed.

*RBL* – A Reasonable Benefit Limit is the maximum amount of retirement and employment termination payments that an individual can receive over his or her lifetime at reduced tax rates.

*SMSF* –Self Managed Super Funds are small funds regulated by the ATO. They can have no more than 4 members, all of whom must be trustees.

*Surchargeable contributions* – The calculation of a member's surchargeable contribution differs for accumulation and defined benefit funds. For accumulation funds, the member's *surchargeable contributions* are the sum of a number of payments including employer contributions, personal contributions and certain components of a rolled over *ETP*. For members of a defined benefit fund the *surchargeable contributions* are the amounts that make up the actuarial value of the benefits (net of expenses) that accrued to the member over the financial year. The calculation of this amount involves using a *notional surchargeable contributions factor.*

*Superannuation Surcharge* – Surcharge is levied on surchargeable contributions received by superannuation funds after 20 August 1996. It is payable if the adjusted taxable income of the member is greater than the surcharge threshold for that year.

*Undeducted contributions* – An ETP component which consists generally of 'personal' contributions made by the member after 30 June 2003.

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