BUILDING AUSTRALIANS' RETIREMENT INCOMES
IFSA'S REPSONSE TO THE AUSTRALIA'S FUTURE TAX SYSTEM RETIREMENT INCOME CONSULTATION PAPER

Executive Summary

The Global Financial Crisis has had an enormous impact on financial markets, and therefore on the savings of Australians. The most notable impact has been the dramatic shift in investment returns, swinging from 5 years of almost unprecedented strong investment returns to a once in a generation market downturn. This has all occurred in the context of a highly competitive superannuation industry and gradually increasing consumer awareness of superannuation and the importance of saving for retirement.

The downturn in financial markets has had a serious effect on the confidence that Australians have in financial markets. This includes the superannuation system. Now is not the time to be making radical changes. Radical changes run the serious risk of further reducing consumer confidence in the superannuation system.

Retirement income policy should not, however, be ignored. That would be the wrong approach. The volatility in financial markets underscores that more needs to be done to return retirement income adequacy not only to previous levels but to continue building from there and to help deal effectively with longevity risk. The policy options outlined below would build on and enhance the existing framework.

Action is needed in the following areas:

- Demographic changes will significantly pressure government expenditure over the next few decades. The Australian Government's fiscal position was, at the time of the last Intergenerational Report, projected to deteriorate from just over 1% of GDP to a 'fiscal gap' of around 3½% of GDP by 2046-47. With the recent decline in Australia's terms of trade the current and future fiscal position has deteriorated significantly exacerbating these fiscal challenges.

    - ***Policy Option 1:*** Governments should adopt policies which boost household savings to levels which will deliver an adequate retirement income as an integral part of ensuring sustainable government finances. Refer also to Policy Options 5 and 6 below.

    - The Age Pension will continue to form an important part of Australia's retirement income system. Governments must, however, carefully consider the Intergenerational impacts of Age Pension policy and focus on private provision of retirement incomes with the Age Pension as a safety net (refer Policy Option 4 below).

- The adequacy of retirement incomes remains a concern, particularly for some segments of the population. Analysis of superannuation adequacy needs to move beyond population averages and consider the wide variety of circumstances faced by individuals.

- ***Policy Option 2:*** More sophisticated analysis of superannuation adequacy needs to be facilitated through the publication of "confidentialised" household data on tax and superannuation contributions.

- ***Policy Option 3:*** The superannuation system fails to deliver any tax concessions to compulsory contributions for low-income earners. Superannuation contributions tax paid by low-income earners should be rebated to address this anomaly.

- ***Policy Option 4***: The Government should adopt policies which reduce the long-term cost of the Age Pension through improved targeting.

- ***Policy Option 5:*** The Government should increase the SG rate to 12% when economic circumstances permit. In the absence of an increase in the SG rate, a soft compulsion scheme should be introduced to help boost the superannuation savings of Australians.

- ***Policy Option 6:*** Existing incentives for voluntary saving should be maintained. Other options to boost voluntary savings, such as lowering the superannuation contributions or earnings tax and expanding the Super Co-contribution should be considered when budget conditions permit. In the medium-term, all individuals should be able entitled to an income tax deduction for their personal contributions to superannuation.

- ***Policy Option 7:*** Government policies need to encourage participation, including through maintaining the transition to retirement arrangements rates for older Australians.

- Much attention has been paid to accumulating retirement savings, but there has been far less focus on how these savings are used to fund an individual's retirement. Government involvement in this area should include the following:

    - ***Policy Option 8:*** Streamlining regulation which hampers the development of innovative retirement income stream products that provide an effective option for covering longevity risk in late retirement. In particular, extending the tax exemption on income derived by superannuation assets used to fund an income stream to a portion of assets set aside to fund longevity insurance – such as a deferred income stream which commences at a future age.

    - ***Policy Option 9:*** Developing a longevity index for Australia.

    - ***Policy Option 10:*** The Government should issue long-dated Government bonds, including CPI-linked bonds.

IFSA's Vision for 2040

The Australian community in 2040 will be a very different community to Australia in 2009. The forces changing the Australian community include an ageing population, technological change and globalisation.

The challenges presented by an ageing population have been outlined in the Intergenerational Reports produced by the Australian Government and the Productivity Commission Research Report, *The Economic Implications of an Ageing Australia*.

The Australian community will need to meet the challenges of an ageing population through:

- Sustainable and equitable government finances – current and future generations should not incur an unfair tax burden to finance the retirement of past generations, including Age Pension, health and aged care costs. Taxes should be equitably distributed across income cohorts.

- Greater financial security and an appropriate lifestyle in retirement for Australians achieved through the traditional three pillars as well as strong workforce participation:

    - A strong and viable social safety net covering retirement income, as well as health and aged care costs, targeting those individuals who are not self-sufficient in retirement (Pillar 1).

    - Government policies which mandate a minimum level of savings and set appropriate default arrangements for individuals (Pillar 2) both before and after retirement, thereby reducing the relative importance and long-term cost of Pillar 1 and intergenerational funding pressures.

    - A superannuation system which encourages individuals and families to meet their expectations of an adequate standard of living in retirement through additional voluntary savings (Pillar 3). This requires a stable retirement income system with widespread community support.

    - Strong workforce participation – tax and income support policies should encourage older Australians who have the capacity and desire to continue in the workforce in a range of forms.

- Utilising capital markets to maximise the productivity of capital and allow risk to be diversified. Financial products should be available to:

    - Provide a range of retirement income products that recognise the financial circumstances, exposure to and tolerance for risk of Australians.

    - Facilitate the mitigation of risks, including inflation, market movements and longevity, by retirees willing to incur the cost of insuring against these risks.

    - Facilitate the use of housing wealth for income support as people age.

- Provide appropriate retirement income policy settings that support an internationally competitive economy.

Government policies, the community's attitude to superannuation and workforce participation by older Australians have all improved significantly over recent years.

Yet more needs to be done if this vision is to be realised.

The remainder of this document analyses the extent to which existing government policies, financial products and consumer behaviours are contributing to the achievement of this vision and outlines reforms which would help make this vision a reality.

Policy settings must be flexible enough to allow Australians to make appropriate choices which cater for the wide variety of economic and personal circumstances that they will face.

Assisting Australians to develop a broader and deeper financial understanding will ensure they are well placed to make informed decisions about their future and what they and government need to do to address their financial needs. In this regard, IFSA considers there to be an important role for government in helping ensure that all Australians grow in competence and confidence when making decisions about long-term savings and retirement provisions through access to information and other advice on superannuation and income streams. It is our hope that the Review's outcomes will be consistent with this objective.

Sustainable Government Finances

Policy objective: Current and future generations should not incur an unfair tax burden to finance the retirement of past generations, including Age Pension, health and aged care costs.

The central message of the Intergenerational Report 2007 is that demographic and other factors continue to pose substantial challenges for economic growth and long-term fiscal sustainability.

Demographic changes will significantly pressure government expenditure over the next few decades. The last Intergenerational Report projected a deterioration of the Australian Government's fiscal position from a surplus of just over 1% of GDP to a 'fiscal gap' of around 3½% of GDP by 2046-47.

With the recent decline in Australia's terms of trade, the current and future fiscal position has deteriorated significantly. This has exacerbated the fiscal challenges facing the Australian Government in providing for retirement incomes.

Substantial increases in longevity to date, and anticipated further increases, heighten this challenge. The Intergenerational Report 2007 shows that a 3.5 year increase in life expectancy at birth for both males and females (to 89.5 for men and 92.3 for women) in 2046-47 would increase government spending by 1.13% of GDP. Longevity risk is also a substantial challenge facing retirees and is discussed in more detail on pg 21.

The demographic funding challenge – to meet the income needs and other needs of an ageing population – requires action on two fronts: improving national income and improving saving.

A large number of Australians will be disappointed with their financial situation and resulting lifestyle when they reach retirement unless they do more than rely on the current levels of compulsory superannuation. Some sections of the community are more exposed than others, including: those who spend time away from paid employment, often women for family support reasons and the increasing numbers of families in small businesses who do not fully participate in the Superannuation Guarantee (SG) system.

While population ageing is a slow process, many of the policy changes necessary to address the changes it creates will take time to have full effect. Action is needed now to address challenges that Australia will face in 30 to 40 years time.

Policy Option 1

Governments adopt policies which boost household savings to levels which will deliver an adequate retirement income as an integral part of ensuring sustainable government finances.

Measuring the Adequacy of Retirement Income

Delivering adequate retirement incomes is central to meeting the challenges of an ageing population.

Adequacy has recently been measured in terms of replacement rates. Replacement rates are typically designed to measure whether the individual can achieve a similar standard of living in retirement as they had pre-retirement after adjusting for a number of factors. Typical adjustment factors include:

- the likelihood that lower taxes will be paid in retirement,
- the individual is no longer expected to be saving a portion of their income to fund retirement, and
- work related expenses will no longer be incurred.

While useful, this approach is being overtaken by more sophisticated analysis. One form of analysis involves attempting to specifically estimate the expenses an individual is likely to incur in retirement. In order to facilitate this, retirement can be broken down into distinct phases with different expenditure requirements:

- Active phase
  - Continuation of lifestyle but more time for leisure, travel and family

- Passive phase
  - Shift to more passive activities, travel is closer to home
  - Increased expenditure on health

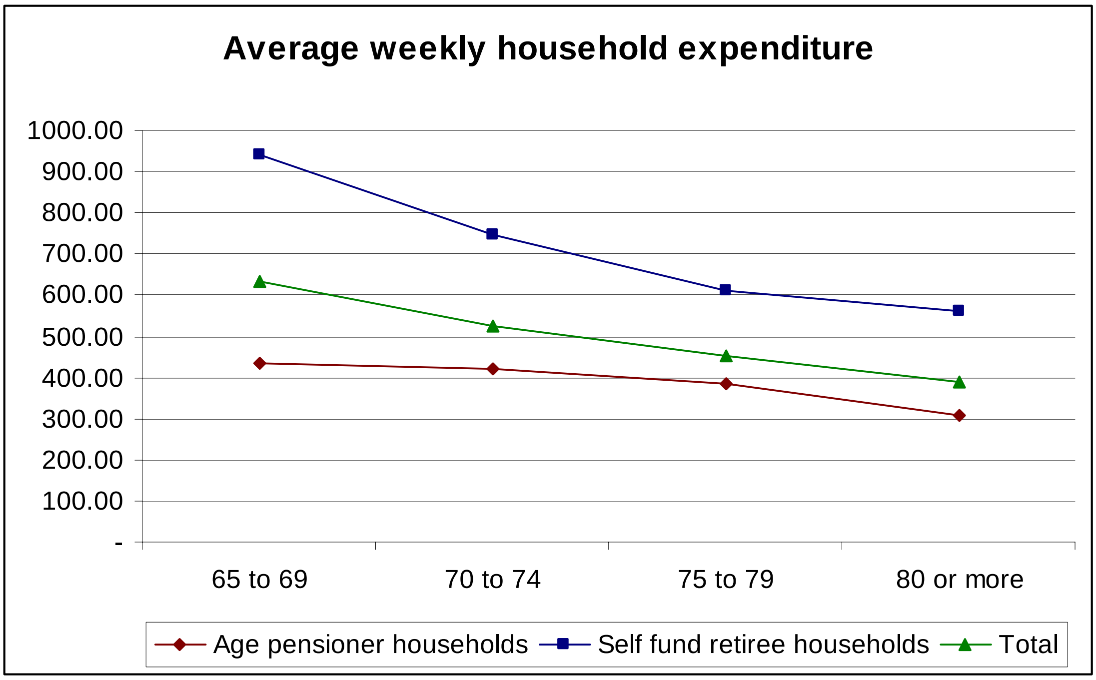
- High dependency phase
  - Restricted mobility means leisure activities are limited
  - Increased expenditure on health and aged care

The three phases of retirement will vary in length across the population, and the line between these different phases is difficult to determine.

Current expenditure patterns of Australians by age cohort are collected through the Australian Bureau of Statistics Household Expenditure Survey 2003-04, both for the total population and separately for age pensioner households[1] and self funded retiree households[2].

The survey shows a consistent decline in expenditure for both age pensioners and self-funded retirees as individuals age. The chart below shows average spending falling by approximately 30% for individuals aged 80 or more relative to spending for individuals aged 65 to 69. The major contributors to this decline in spending are expenditure on recreation (28%), transport (20%) and food and non-alcoholic beverages (16%). This is consistent with retirees moving from active to the high dependency phase. However, it may be partly caused by the depletion of inadequate private savings due to an immature superannuation system.

[1] Households whose principal source of income is the Age Pension or service pension.
[2] Households whose principal source of income is superannuation and/or investment income and where the household reference person is not in the labour force and over 55 years of age.



Source: Australian Bureau of Statistics, IFSA

In the Australian context, expenditure in the high dependency phase (and to a lesser extent the passive phase) is likely to be capped through Australia's public health system. This highlights the importance of factoring in the provision of goods and services by the government in measuring the welfare of retirees.

Average expenditure on medical care and health expenses exhibits a large amount of variability for self-funded retirees between the ages of 75 and 79, making it difficult to use the Household Expenditure Survey to draw conclusions on how private expenditure on health care changes as people age. These costs may however be a significant contributor to the desire of retirees to either retain access to some capital in retirement and to ensure they have retirement income in addition to the Age Pension over the full course of their retirement.

Due to the likelihood that the elderly will need to make a larger contribution to their health care costs over time, retirement incomes will need to be higher or retirees will need to make separate provision for these costs.

These expenditure patterns emphasise the difficulty of measuring the adequacy of retirement incomes. Absolute approaches – such as measuring adequacy in terms of a given saving rate over an individual's employment or a level of income in real dollars during retirement – mask important issues. The appropriate rate of saving will vary across households and vary over the life-cycle of particular households. Incomes in retirement need to be flexible to allow for variations in expenditure, such as health care costs.

Public debate on adequacy is currently constrained by a lack of available data. In order to administer the Super Co-contribution and the caps on superannuation contributions, the Australian Taxation Office collects data from superannuation providers on all contributions to superannuation in Australia. This data should be made publicly available by household on a "confidentialised" basis to enable improved independent analysis of superannuation adequacy and the extent to which current retirement savings are effectively used to address inflation, investment and longevity risk.

Policy Option 2   The Australian Government should publish “confidentialised” household data on tax and superannuation contributions to inform the public debate on superannuation adequacy.

Equitable Government Finances

Policy objective: Taxes should be equitably distributed across income cohorts.

Australia's superannuation system is designed to provide incentives for individuals to save for their retirement. These incentives reflect the fact that superannuation is 'locked-away' for long periods of time. An equitable superannuation system should ensure these concessions are available to taxpayers across income cohorts.

The Super Co-contribution scheme helps ensure that incentive for voluntary contributions is available to some extent to low-income earners. However, this is only available to those who are able to contribute to superannuation from their after-tax income. Many low income earners do not however receive tax concessions for the vast majority of their superannuation contributions which are made by their employers.

A tax on contributions and investment earnings for superannuation was introduced in 1988 at a rate of 15%. The incidence of this tax is on both labour income (contributions) and capital (earnings). The tax treatment of superannuation contributions can be assessed relative to the tax treatment had the contributions been paid directly to the employee.

As at August 1988, average male, full-time, ordinary time earnings (AWOTE) were approximately $26,000. The tax rates for the 1988-89 year are set out in the Table 1 below. In addition, no low income tax offset was available in 1988-89.

Superannuation contributions, including compulsory SG contributions, were therefore taxed at a concessional rate for individuals earning more than 20% of AWOTE, i.e. taxed at 15% rather than the individual's marginal tax rate.

Table 1 – Tax Rates for 1988-89

Taxable income	*Tax on this income*
$1–$5,100	Nil
$5,101–$12,600	24 cents for each $1 over $5,100
$12,601–$19,500	$1,800 + 29 cents for each $1 over $12,600
$19,501–$35,000	$3,801 + 40 cents for each $1 over $19,500
$35,001 and over	$10,001 + 49 cents for each $1 over $35,000

AWOTE is currently approximately $62,500. The tax rates for the 2008-09 year are set out in the table 2 below. In addition, a low income tax offset of up to $1,200 is available - delivering an effective tax free threshold of $14,000 for eligible taxpayers.

Superannuation contributions, including compulsory SG contributions, are currently taxed at the equivalent of the individual's marginal tax rates (less the Medicare levy) until individuals earn approximately 55% of AWOTE.

Table 2 – Tax Rates for 2008-09

Taxable income	*Tax on this income*
$0 – $6,000	Nil
$6,001 – $34,000	15c for each $1 over $6,000
$34,001 – $80,000	$4,200 plus 30c for each $1 over $34,000
$80,001 – $180,000	$18,000 plus 40c for each $1 over $80,000
$180,001 and over	$58,000 plus 45c for each $1 over $180,000

Based on the 2008-09 tax rates, Treasury's *Architecture of the Tax and Transfer System* paper estimates that around 1.2 million individuals do not receive a personal income tax benefit from the tax rate applied to their concessional superannuation contributions. In addition, a further 1.2 million individuals only have a concession equivalent to 1.5 percentage points (i.e. the Medicare levy). This is a serious flaw in Australia's taxation arrangements.

Individuals will be on low marginal tax rates for a wide variety of reasons. They may have just started out in the workforce – in which case higher tax rates on superannuation than they pay on their regular income creates a negative first impression of superannuation. They may be returning to the workforce from parenting or caring duties – in which case they are likely to have recently experienced a period of limited superannuation support. IFSA considers that government support of retirement savings for individuals on low marginal tax rates is appropriate.

Policy Option 3

The Government should rebate the superannuation contributions tax paid by low income earners. The Australian Tax Office could pay an amount equivalent to 15% of the concessional contributions made on behalf of an individual to their superannuation fund using the same administrative system as the highly successful Super Co-contribution scheme.

This payment would be made once the individual's income tax return had been assessed and would be available to all individual's with a marginal income tax rate below 15%.

A Strong and Viable Social Safety Net (Pillar 1)

Policy objective: A strong and viable social safety net covering retirement income, as well as health and aged care costs, targeting those individuals who are not self-sufficient in retirement.

The Age Pension, combined with the system of associated health and other benefits, is a critical component of living standards for most retirees, and will continue to be so in the future if no actions are taken to improve saving.

The *Intergenerational Report 2007* projects that approximately 40% of retirees will continue to receive the full Age Pension in 2038 (compared to approximately 60% currently). This is despite the maturing of the SG system. The report projects an increase in Age Pension expenditure to 4.4% of GDP in 2046-47 from 2.5% in 2006-07.

The Australian Government is currently reviewing the Age Pension arrangements. The appropriate arrangements depend on whether the Age Pension is designed to alleviate poverty or supplement retirement incomes. Assuming a mix of both objectives is desirable, setting the rate of the Age Pension requires the Government to balance the intra-generational equity – an equitable distribution of income across the population at a given point in time – with the inter-generational equity issues identified in the *Intergenerational Report 2007*.

It is also vital to minimise any negative impacts on workforce participation and private savings that the Age Pension and associated arrangements have. For example, high taper rates for the Age Pension income test discourage workforce participation by older Australians and high taper rates for the assets test penalise additional savings. These need to be carefully designed so that they do not distort the decision to save or work. The current arrangements also create an incentive for individuals to access at least $1 of Age Pension in order to qualify for associated benefits.

There are widespread views in the community, particularly amongst younger workers, that the Age Pension 'won't be around when I retire'.

IFSA has a longstanding view that the proportion of self-provision in retirement needs to increase, not the least to ensure the long-term sustainability of government finances.

As part of its consideration of the retirement income system, either through the Australia's Future Tax System review or separately, the Government should adopt policies which reduce the long-term cost of the Age Pension through improved targeting.

Policy Option 4   The Government should adopt policies which reduce the long-term cost of the Age Pension through improved targeting.

Compulsory Superannuation (Pillar 2)

Policy objective: Government policies mandate a minimum level of savings and set appropriate default arrangements for individuals (Pillar 2) both before and after retirement, thereby enabling the relative importance of Pillar 1 to reduce.

A key rationale for the SG is that people may not voluntarily save enough for their retirement.

Research from the Reserve Bank of Australia[3] indicates that compulsory superannuation contributions are not offset by reductions in other forms of saving. An extra dollar in compulsory superannuation accounts is estimated to add between 70 and 90 cents to household wealth. The increase in household wealth is highest for lower income households.

An increase in the rate of SG would therefore help address the pressures of an ageing population by boosting household savings and improving the adequacy of retirement incomes for Australians.

The *Australia's Future Tax System Retirement Income Consultation Paper* (the AFTS Retirement Income Consultation Paper) estimates that if the SG rate was increased at 1% every two years, the cost to revenue in 2014-15 (the year it would reach 12%) would be $1.9 billion per year.

While the AFTS Retirement Income Consultation Paper estimates the effect of increasing compulsory saving on replacement rates, it does not break this analysis down to analyse the extent to which these extra savings are reducing future Age Pension expenditure by the Australian Government. Reductions in future Age Pension expenditure are a key benefit of boosting compulsory savings given the significant intergenerational funding pressures that the Australian Government faces.

Table 1.2 of the AFTS Retirement Income Consultation Paper demonstrates the extent to which the Age Pension will continue to support the retirement incomes of Australians. Even under a fully mature SG system the Age Pension will provide 50% of the retirement income of Australians on a median income (0.75 Average Weekly Ordinary Time Earnings (AWOTE)), falling to 15% for high income earners (2.5 times AWOTE).

In the context of the intergenerational funding pressures facing the Australian Government, Australia's retirement income system needs to be rebalanced away from public provision towards higher private provision.

There are also likely to be benefits to the Australian economy in having a larger pool of domestic savings to draw on. The importance of this is demonstrated by the significantly decreased availability of credit since the onset of the global financial crisis.

IFSA considers that a universal increase in the SG rate is the simplest, most efficient approach to increasing the private provision of retirement income.

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[3] Connoly, E., The Effect of the Australian SG on Household Saving Behaviour, Reserve Bank of Australia Research Discussion Paper 2007-08.

As noted in the AFTS Retirement Income Consultation Paper the impact of an increase in the SG rate will depend on the economic circumstances at the time of any increase in the SG.

IFSA accepts that the economic circumstances have to be appropriate in order for the Government to increase the SG. Given the current focus on stimulating aggregate demand, it may not be appropriate to increase the SG in the near term. This should not prevent the government announcing increases to the SG rate which commence in the future.

IFSA notes that both the current and previous Government have ruled out increasing the SG rate. As a result, IFSA is also recommending that the Government adopt a soft compulsion approach to boosting superannuation contributions as a more politically palatable, but second best, alternative.

Soft compulsion

A soft compulsion approach would provide for individuals to contribute 1% of their gross income from employment to superannuation on a pre-tax basis from a certain date. This would then be phased up over time to 3% of their gross income from employment. Individuals will be able to opt-out of these contributions.

<u>Impact on employees</u>

All existing employees would be automatically enrolled at the start date, for example 1 July in a given year. Existing employees would need to be clearly notified of the commencement of soft compulsion. However, having been notified, employees should automatically have additional contributions deducted if they do not opt-out. Any other approach would not be default superannuation.

New employees would be provided with the option to opt-out when they commence employment, that is, the employee would be able to instruct their employer to pay this money directly to their bank account when they commence employment

All individuals would subsequently be able to opt-out – or opt-in – on a set date each year.

<u>Impact on employers</u>[4]

The cost to employers would be minimised by limiting the frequency with which employees can opt-out, ensuring that the tax treatment of the contributions is the same as SG and other employer contributions (out of the employee's pre-tax income) and leveraging existing processes – such as combining the opt-out with the standard choice form employers already present their new employees.

For many employers implementation would require updating payroll software (either software purchased from suppliers such as MYOB and Micropay or dedicated internal software for large firms). This software is regularly updated to take account of changes in legislation and in tax rates.

There are approximately 1 million small businesses in Australia, many of whom employ one, or a few, employees. According to industry estimates, perhaps as many as 400,000 micro businesses use software such as a spreadsheet to manage payroll

[4] This section is based on unpublished analysis by Nicholas Gruen, Lateral Economics.

(rather than dedicated payroll software). While these businesses receive less technical assistance than firms who rely on dedicated software to calculate payroll figures, the small number of employees involved also means that the amount of manual work to manage the additional contributions would also be very small.

Impact on government

The cost to revenue of this option would be lower than the $1.9 billion per year cost of a 3% increase in the SG given some individuals would opt-out, therefore paying tax at their marginal tax rates rather than the concessional rate for superannuation contributions.

An opt-out scheme would however increase the cost of the policy option identified above to rebate the superannuation contributions tax paid by low income earners.

Expected outcomes

Recent research by the Parliamentary Library (Nielsen 2008) identifies that a soft compulsion scheme is already in operation in the Tasmanian public service. This scheme provides some evidence on the likely effect of a national soft compulsion scheme in Australia.

Since May 1999 all newly employed Tasmanian public servants automatically contribute 5% of their after-tax salary to the Tasmanian Accumulation Plan. Existing employees in May 1999 were automatically enrolled in this arrangement. Under the arrangements adopted in the Tasmanian Accumulation Plan, all participants may:

- opt out of, or choose to participate in, this arrangement at any time
- vary the percentage of salary contributed at any time (as long as it is a multiple of 1%), or
- elect to contribute a fixed dollar amount from their after-tax salary.

Initially, most existing employees in May 1999 opted out of this arrangement.[5] This may be due to the large initial contribution of 5%. Nevertheless, since its introduction 33% of new full-time and 27% of new part-time workers have not opted out of this scheme. About 90% of those who participate contribute 5% of their after-tax salary.[6]

Introducing a soft compulsion scheme with contributions starting at 1% of income should ensure a higher take-up rate amongst existing employees.

***Policy Option* 5**

The Government should increase the SG rate to 12% when economic circumstances permit.

In the absence of an increase in the SG rate, the Government should require individuals to contribute 1% of their gross income from employment to superannuation on an opt-out, pre-tax basis from a certain date. The contribution rate would be phased up over time until it reached 3%. Individuals will be able to opt-out of these contributions.

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[5] S. Gills - Retirement Benefit Fund Tasmania, Presentation at ASFA Conference Super 007, November 2007, 'Taking the soft option', *Herald Sun*, 19 November 2007.

[6] Op cit

Voluntary Savings (Pillar 3)

Policy objective: A superannuation system which encourages individuals and families to meet their expectations of an adequate standard of living in retirement through additional voluntary savings (Pillar 3).

The Age Pension and the compulsory super system cannot provide adequate living standards in retirement for all individuals. This is due to the wide ranges of circumstances individuals will experience, such as different employment histories.

Incentives for voluntary savings are therefore vital, particularly for those people not well catered for by the SG system, such as the self-employed and those who spend time away from paid employment, often women for family support reasons.

In Australia's retirement income system, a key incentive for voluntary saving is the difference between an individual's marginal tax rate and the rate of tax on contributions and earnings in superannuation.

The attractiveness of the superannuation tax concessions is measured relative to personal marginal tax rates, which have been decreasing over time. However, the taxes on superannuation benefit payments have recently been removed. The highest incentives are received by those on the top marginal tax rate and those with the highest levels of retirement savings.

The majority of Australians face a marginal income tax rate of 31.5%. Given the long-term nature of superannuation savings, a tax rate of 15% on superannuation contributions and earnings represents a good incentive for an individual to save for their retirement.

Adverse changes to the superannuation arrangements come with a significant risk of harming public confidence in the superannuation system, particularly during periods where consumer confidence in superannuation may have already deteriorated due to poor investment returns.

For individuals on low marginal tax rates, the Super Co-contribution matches post-tax savings at a rate of $1.50 for each $1 saved. While this is a very strong incentive, many low income families will not have available discretionary income to take advantage of it.

Access to salary sacrifice

Salary sacrifice arrangements, whereby employees voluntarily receive additional superannuation contributions in lieu of salary, are currently available to Australian employees at the discretion of their employer. Not all employees are able to access salary sacrifice in Australia.

There are two approaches to extend access to salary sacrifice.

Firstly, the Government could compel businesses to offer salary sacrifice to their employees. This could occur independently or in conjunction with the introduction of a soft compulsion scheme in Australia. While this may impose additional compliance cost on some employers, it has the potential to deliver economic benefits by increasing national saving.

Alternatively, the Government could allow all individuals, not just the self-employed, to claim tax deductions for personal superannuation contributions. This approach provides an additional incentive to contribute to superannuation, although a large part of the benefit would flow to those already doing so. Salary sacrifice arrangements have to be entered into in advance of receiving salary or wages, which may artificially restrict the amount that some individuals contribute to superannuation. This approach would also remove the complexity and uncertainty currently generated by the requirement that an individual must receive less than 10% of their income from employment in order to be eligible to deduct their superannuation contributions. This approach would come at cost to government revenue, but only to the extent that it facilitated higher superannuation contributions.

Self-employed

The self-employed make up 19% of the Australian workforce, broken down into owner managers of unincorporated enterprises (12%) and owner managers of incorporated enterprises (7%).[7]

The self-employed have traditionally been treated differently in the superannuation system, although this has changed in recent times. As part of the Better Super reforms, incentives such as full deductibility for superannuation contributions and access to the Super Co-contribution scheme were extended to the self-employed.

The superannuation system has focused on providing additional incentives for the self-employed to make large contributions to superannuation on retirement. This allows self-employed individuals additional flexibility to invest in their businesses, generating economic growth and employment.

IFSA believes that the Government should conduct further analysis on actual and expected retirement patterns for the self-employed. This should include analysing outcomes for current retirees who were previously self-employed, as well as the assets accumulated by individuals who are currently self-employed.

Policy Option 6

Existing incentives for voluntary saving should be maintained.

A number of policy options exist to boost incentives for voluntary savings for all Australians, such as lowering the tax rate on superannuation contributions and earnings, expanding the highly successful Super Co-contribution scheme and extending deductibility for personal superannuation contributions.

Other policy options, such as increasing the SG or introducing soft compulsion and rebating superannuation contributions tax for low income earners, should be prioritised at this time.

In the medium-term, all individuals should be entitled to an income tax deduction for their personal contributions to superannuation.

[7] Australian Bureau of Statistics, *Employment Arrangements, Retirement and Superannuation, Australia*, Catalogue No. 6361, April to July 2007.

Strong Workforce Participation

Policy objective: Tax and income support policies should encourage older Australians, who have the capacity and desire, to continue in the workforce in a range of forms.

Workforce participation is essential to support Australia's future living standards and national income.

Increasing workforce participation will have a positive effect on GDP and will increase national output and income. According to the Productivity Commission *Potential Benefits of the National Reform Agenda*, "if workforce participation could be increased by around 8% (or 4.9 percentage points) by 2030, GDP could increase by around 6% after a period of adjustment."

Transition to retirement

Transition to retirement strategies allow individuals to access their superannuation in an income stream, after reaching preservation age but before retiring. This increases workforce participation by allowing individuals to reduce their working hours but not completely retire, with their income from working supplemented by drawing on their superannuation balance.

Transition to retirement also provides a tax benefit. An individual over the age of 60 can draw down on their superannuation as a tax free income stream, and direct their earnings into superannuation through salary sacrifice. This ensures the individual faces an effective tax rate of 15% on their labour income, but only up to the cap on concessional superannuation contributions.

The only difference between this arrangement and standard salary sacrifice is that an individual using transition to retirement may be in a position to salary sacrifice more of their income as they can draw down their superannuation balance. Individuals are, however, limited to drawing down 10% of the superannuation balance per year.

As noted above, there are already limits on the scope of transition to retirement strategies. IFSA recommends that transition to retirement policies continue in their current form in order to continue to encourage workforce participation by older Australians.

Superannuation contribution rules

The superannuation system also assists workforce participation by allowing contributions to accumulation funds to continue until age 75, with a 'work test' criteria after age 65.[8] This allows older Australians who have remained in the workforce to continue contributing to superannuation.

IFSA supports the ability of older Australians who are still working to continue contributing to superannuation. IFSA supports the simplification of the superannuation contribution rules, including requiring SG to be paid to age 75 (currently 70) and aligning the age limit on spouse contributions with the age limit on personal contributions.

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[8] To meet the work test, you must be gainfully employed for at least 40 hours in a period of 30 consecutive days during the financial year in which you want to make the contribution.

Age Pension arrangements

The 66.5%[9] of retired persons depending on Government pensions and allowances are likely to be disincentivised from working by the potential loss of income and additional benefits, such as pharmaceutical benefits, through means testing.

The superannuation, tax, and welfare systems need to be more effectively integrated to encourage participation and discourage behaviour aimed at structuring finances to access a part age pension so as to receive the associated benefits.

There are a range of policies that could be considered to improve the incentives for individuals who would otherwise be accessing the Age Pension to continue working.

The Pension Bonus Scheme is already in place to reward Australians who defer accessing the Age Pension. While the concept behind the Pension Bonus Scheme is good, IFSA considers that it is too complex in its current form and that the limits on the benefits which can be accrued are too strict. Hence it fails in its aim to encourage longer workforce participation.

IFSA understands that the Harmer Review will recommend improvements to the Pension Bonus Scheme. IFSA encourages the Government to adopt any recommendations which improve the role of the Pension Bonus Scheme in encouraging Australians to defer accessing the Age Pension.

Policy Option 7
Government policies need to encourage participation, including through maintaining the transition to retirement arrangements rates for older Australians.

[9] ABS Employment Arrangements, Retirement and Superannuation, Australia 6361.0 April to July 2007 6361.0 page 49

Utilising Capital Markets – Diversifying Risk

Policy objective: To encourage retirees to use their retirement savings optimally to provide income across their retirement.

Australians who have accumulated savings for their retirement must invest wisely if those savings are to maintain their desired standard of living throughout their retirement.

For many low to middle income earners, the Age Pension will form a large part of their retirement income. The Age Pension is a means tested safety net. It is payable in retirement over a person's lifetime, increases over time through indexation and increases as other income and assets fall. The Age Pension therefore mitigates the risks faced by a large number of retirees, acting as a natural hedge against longevity investment and inflation risk. This does however result in the government bearing the cost of insuring retirees against these risks.

Retirees with sufficient assets will seek to maximize an income over their lifetime, whilst managing other secondary concerns, such as estate planning and flexibility of access to underlying assets. Any of the following risks can impact on the ability of a retiree's funds to produce a sustainable lifetime income:

- Living longer than expected (longevity risk)
- Poor investment or market performance (market risk)
- Higher than expected cost of living (inflation risk)
- Inappropriate spending patterns or asset allocation (behavioural risk)
- Inadequate provision for long-term care / health costs

Conversion of superannuation savings into an income stream is voluntary in the Australian private retirement income system. Incentives to enter into income streams were previously provided by exempting earnings on assets supporting a superannuation income stream from tax.

Products such as lifetime and life expectancy income streams available to insure retirees against longevity, market and inflation risk to varying extents.

Nevertheless, an overwhelming majority of income streams in Australia are account based, with retirees either relying on the Age Pension and bearing the residual risk or bearing the risk themselves.

Retirees want to maximise their income and minimise the risks identified above. At the moment, the two common approaches to these dual aims in market-linked pensions are:

(1) Maintaining early retirement income and accepting the risk of running out of private pension income (most common for new retirees), or

(2) Attempting to protect against running out of money in market-linked pensions by living frugally.

These approaches raise the following issues:

(1) To what extent do retirees fully understand the risks they are taking?

(2) What is the scope to develop additional retirement income stream products to assist retirees in managing these risks?

In the face of the wide ranging nature of risks faced by retirees, it is important that retirees have access to high quality financial advice and access to a wide range of retirement income stream products to help manage what recent events have demonstrated are some quite obvious and very significant risks.

IFSA supports a competitive marketplace for retirement income stream products. As such, there should not be unnecessary regulatory impediments to offering products under the life insurance, tax, superannuation and social security legislation that address the risks faced by retirees. IFSA supports simple, consistent rules across all superannuation income stream products, including uniform standards to the extent practicable.

An important priority is giving policy consideration to options that allow individuals to set aside an amount of savings (particularly superannuation savings) to purchase longevity insurance or a deferred lifetime income stream that will commence at a future age.

The income tax legislation presently contains a tax exemption for the investment income of superannuation funds and life insurance companies where that income is used to fund the provision of immediate annuities and current pensions.

The tax exemption does not extend to amounts specifically set aside to fund income streams at a later age. This acts as a disincentive to those who wish to address their longevity risk by purchasing a deferred income stream which could be used to provide income in late retirement.

The tax exemption on income derived by superannuation assets used to fund an income stream should be extended to a portion of assets set aside to fund longevity insurance - such as a deferred income stream which makes payment at a later age.

There are a range of other issues that should be addressed to help facilitate the development and proper use of retirement income stream products, these include:

- Guidance from regulators regarding product status – life insurance contracts versus investment contracts which do not offer the same guarantees.
- Consistent treatment of capital requirements between providers of similar products.
- Modification of capital standards to recognise developments in risk management and transparency.
- The limited supply of long term investment products to enable providers to match the long-tail nature of their liabilities (refer Policy Option 10).

Policy Option 8

The Government should commit to removing regulatory restrictions which hamper the development of appropriate retirement income stream products that provide an effective option for covering longevity risk in late retirement. In particular, extending the tax exemption on income derived by superannuation assets used to fund an income stream to a portion of assets set aside to fund longevity insurance – such as a deferred income stream which makes payment at a later age.

IFSA will identify further regulatory impediments to offering appropriate retirement income stream products.

Longevity Risk

Probability of survival: current age 65					
				A couple	
		Male	Female	Both alive	At least one alive
Life expectancy		**19.5**	**22.9**	**15.7**	**25.7**
Probability of survival until age:	**65**	100%	100%	100%	100%
	80	68%	80%	54%	90%
	85	49%	65%	32%	78%
	90	29%	44%	13%	56%
	95	13%	23%	3%	30%
	100	5%	9%	<1%	12%

Source: A multi-billion dollar battle ... that you must win.
Superannuation industry - Analysis report
Deloitte Actuaries & Consultants

Estimates of superannuation adequacy are typically based on a person reaching their life expectancy. Many retirees will outlive their life expectancy as it is a population average. For example, according to estimates by Deloitte Actuaries and Consultants in the graphic above, there is a 30% probability that one member of a couple aged currently aged 65 will live to 95.

Retirees may wish to insure themselves against the risk of depleting their savings should they outlive their life expectancy. Indeed, individuals may behave myopically by choosing not to insure their longevity risk. In addition, we need to recognise that current life expectancy figures are not a good guide to future life expectancy because:

- Mortality improvement will increase life expectancy over time,
- Most people who have capital available will have longer life expectancy than the average, and
- By definition, about half of retirees will outlive even the adjusted mortality tables.

If longevity risk - the probability of dying at each age in the future - is reliably known, the risk of a retiree outliving their life expectancy can be pooled at a lower cost to individuals.

Pooling addresses idiosyncratic longevity risk, that is, the risk of a given individual outliving their life expectancy. However, systematic longevity risk, that is, the risk of the population outliving their life expectancy, does not go away if individuals insure. That risk is typically transferred to product providers.

A key problem is that expected future life expectancy is currently changing and it is difficult to accurately quantify how it will change in the future. Private markets need to estimate future life expectancy in order to correctly price assets that allow retirees to insure against longevity risk.

Providers of longevity risk products need to maintain capital reserves and take on longevity risk in order to offer these products. The price of these insurance products would fall significantly if they were purchased by a wider cohort of the population. In a market where few retirees specifically insure against longevity risk there is a problem of adverse selection because the group who insure typically have longer life expectancies than the population.

A secondary market for longevity risk would provide efficiencies which would also have a beneficial effect in reducing the price of these products.

Alternatively, retirement income stream products may be developed which assign idiosyncratic longevity risk to the product provider, and allow all or part of the systematic longevity risk to be assigned to individuals.

The OECD is considering the above issue and what role government could play.[10] The OECD concluded that:

- Pension funds and insurance companies need financial instruments in order to better hedge their liability risks (inflation, longevity, interest rates) and expand their role as providers of pensions and annuities.
- Governments can help with long-tail risks, in particular longevity risk at very old ages, and with aggregate longevity risk. There is a role for governments in encouraging the market for longevity hedging products by, for example, producing an official longevity index.
- Governments should also consider issuing more long-term and inflation-indexed bonds, as was recently done by the Danish Central Bank, which issued a 30-year bond that was largely bought by domestic pension funds and insurance companies.
- An increased supply of government bonds of very long maturities would not only facilitate asset-liability management by pension funds and insurers but would also help develop the market for other long-term securities such as infrastructure bonds.

The OECD considered the issue of governments issuing of longevity bonds and noted that governments in OECD countries already bear significant longevity risk. The Australian Government faces significant intergenerational funding pressures and one of the objectives of policy should be to reduce these.

IFSA believes the Government's role is to provide a means tested safety net in the form of the Age Pension and not to take additional longevity risk for private pension providers.

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[10] OECD Seminar on the Payout Phase of Pensions, Annuities and Financial Markets: 12 November 2008, Paris, France and in particular OECD (2008), *Governments and the Market for Longevity-Indexed Bonds*.

The development of a secondary market for longevity risk

In order for private markets to price longevity risk, both buyers and sellers of longevity risk are required. The most obvious hedgers, i.e. sellers of longevity risk, are providers of longevity risk products. The buyers of longevity risk are more difficult to identify but reasons for buying longevity risk include:

- Risk premium: Investors who take on longevity risk will earn a risk premium in return. [11]
- Diversification: Longevity is uncorrelated with other asset classes. Therefore it is a very attractive asset class in the context of Modern Portfolio Theory, adding return with very low incremental risk. [12]
- Asymmetric information: Market participants may believe they have superior mortality modelling skills and believe they can outperform other market participants; for example insurance companies or hedge funds specialised in insurance linked securities.[13]
- Sharing risk: Some business activities benefit from increased longevity, such as issuers of standard life insurance policies, drug firms, businesses providing services for the elderly and investors in retirement real estate. These businesses may wish to share this risk.

Credit Suisse and JP Morgan have both launched longevity indices to establish a platform around which longevity derivatives can be structured.[14] A longevity index is a standardised measure of the expected average lifetime for a group of individuals, and can include both historical and projected values.

The current indices are based on international life expectancy experiences and are relevant to Australia to the extent that they help create an international capital market for longevity risk. In addition, Australian life expectancy may be closely correlated with life expectancy in other developed countries.

Australia is expected to become one of the largest markets in the world for pension products as the SG system matures. A longevity index based on Australia's experience would facilitate the development of income stream products for Australian retirees. It should also provide an appropriate basis for financial advisors to provide objective information to their clients in addressing the adequacy and appropriateness of their retirement income arrangements.

Policy Option 9

The Australian Bureau of Statistics and the Australian Institute of Health and Welfare, as official statistical agencies, should develop and publish an independent and robust longevity index for Australia, in consultation with the private sector and the actuarial profession.

[11] Fred Kabbaj and Guy Coughlan, "Managing Longevity Risk Through Capital Markets", *De Actuaris*, September 2007.
[12] Op. Cit.
[13] Op. cit.
[14] Op. cit.

Issuing long-dated government bonds, including CPI-linked bonds

Widely available, creditworthy, long-dated bonds – especially those that are linked to inflation outcomes – have been identified as important to support the provision of retirement income stream products. Providers of retirement income stream products may face interest rate risks over the life of retirees, which in some cases may exceed 40 years. Existing bonds are generally too short to effectively hedge against such risks.[15]

There is a natural role for the Australian Government to play in the issuance of long-dated bonds. With the Australian Government increasingly focused on boosting infrastructure investment, there is likely to be an increased need for government borrowing. Given the long-term nature of infrastructure investments, governments may wish to match the term of the borrowing with the expected life of the asset.

Policy Option 10

The Government issue long-dated bonds, including CPI-linked bonds.

[15] This paragraph draws on the analysis contained in Creighton, Jin, Piggott and Valdez (2005), *Longevity Insurance: A Missing Market*, presented to the Singapore Economic Review Conference, August 2005.