Australian Business Economists

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INTRODUCTION

Thank you Stephen.

It's great to be here today to talk about the financial services industry to a group of professional business economists.

Firstly a few words about the Financial Services Council. This is the peak industry body representing Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks, licensed trustee companies and public trustees.

This industry is responsible for investing more than $2.6 trillion on behalf of 11.5 million Australians. The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange and is the third largest pool of managed funds in the world.

The Financial Services Council promotes best practice for the financial services industry by setting mandatory Standards for its members and providing Guidance Notes to assist in operational efficiency.

As a forum of business economists, I expect many of you have a focus on macroeconomics, looking at the ins and outs of economic developments and how they impact the outlook for economic growth, inflation, employment, return and risk outlooks across asset classes and industries, and so on.

We have already heard a lot about the prospects for the Australian and global economy, and I am sure before today is over we will hear many more views.

I want to limit my remarks today to economic policy.

I'm not going to provide advice on whether you should be an active or passive investor, what asset allocation you should have, who is going to give you the cheapest fees or whether you get value for money by focusing on fees.

These are issues for the market to determine.

Consumers will choose what is best for them if the market is set up correctly.

Today I want to focus on what policy makers know best.

That is, how to set the rules of the game for markets to do their job and allocate resources efficiently.

My hope is that I can encourage you to be just as vocal on economic policy as you are about your views on the economy, as you all have a wealth of knowledge and expertise that you can share.

Political leaders often urge our business leaders to contribute to the national debate on policy – and I heartily concur.

Today I wish to focus on superannuation policy and how best to make this market as efficient as possible.

Superannuation in Australia is mandatory. Every working Australian must place 9.5 per cent of our salaries into superannuation – called the Superannuation Guarantee - where it cannot be touched until we cease our working lives – for my children, that's 40 years.

Because of this fact we must strive to ensure that the superannuation system delivers the best possible result – self-funded retirement – for every Australian.

Superannuation is one of the things we Australians do best. The recent Melbourne Mercer Global Pension Index found that of all pension systems in the world, Australia's was number one for adequacy and number three overall, coming in behind Denmark and the Netherlands.

Australia got a B+ - meaning it has a sound structure with many good features, but has some areas for improvement.

Today this discussion will cover:

(1) what David Murray's Financial System Inquiry recommended for superannuation and why it is important to implement these recommendations as soon as practically possible; and

(2) what more needs to be done to ensure the superannuation system in improves retirement outcomes for Australians.

On the way I plan to touch on some of the context around the superannuation system and some issues around taxation.

So let's begin with some context.

CONTEXT

Governments, from time to time, conduct root and branch reviews of the health of the financial system, the most recent being Murray's Financial System Inquiry.

The good news is that the Murray Inquiry concluded that Australia's financial system is in good health.

Overall, in most sectors of the financial services industry, the FSI recommended a steady as she goes approach.

The clean bill of health should give consumers and investors confidence. The Australian financial services industry is stable and well regulated.

However, there were recommendations for reform, particularly in relation to the wealth management industry.

This focus on wealth management, and in particular superannuation, is appropriate.

After property, superannuation is the second most significant asset we all have.

The FSI was the third holistic review of our financial system – following Wallis and Campbell - but the first to examine our compulsory superannuation system in detail since its introduction in 1992.

At the time of the Wallis Inquiry in 1997, compulsory superannuation was in its infancy.

The system only managed around $300 billion and the contribution rate was 6%.

In the 18 years between the Wallis and the Murray Inquiries there was significant growth in the superannuation system, primarily due to the increase in the Superannuation Guarantee rate to 9.5%, as well as strong non-concessional contributions and investment returns.

There is now more than $2 trillion under management in our superannuation system.

Currently, it is the worlds' fourth largest private pension system behind the US, Japan and the UK.

Deloitte has forecast that super funds under management will grow to $9.5 trillion by 2035 - firmly establishing the system as structurally important to Australian household's financial wellbeing.

The future rate of growth of the superannuation system is difficult to predict accurately – as it will be influenced by the aging demographics of the Australian workforce, wages and employment growth, the scheduled increase in the Superannuation Guarantee rate and taxation policy.

All estimates, however, lead to the same conclusion – the superannuation system will be responsible for administering a pool of capital that will likely account for a multiple of Australia's GDP and be larger than the capitalisation of the securities exchange.

As I said, globally, the Australian superannuation system is world leading. We were one of the first to move to a three pillar system of:

- a taxpayer funded means-tested age pension;
- a minimum level of compulsory employer superannuation contributions; and
- voluntary private superannuation and other savings.

This system has lifted the retirement savings of all Australians, helped to buffer the prospective deterioration in Australia's budget finances as our population ages by reducing reliance on the aged pension, and importantly, has created an ecosystem which has enabled the development of our world leading expertise in funds management – a sector that is growing exponentially.

Just to give you a flavour of this industry - the recent FSC-Perpetual Australian Fund Managers Cross Border Flows Report – which measures the overseas fund flows into Australian fund managers - found that foreign investment into Australia through managed investment trusts has more than doubled in the past five years - from $20.3 billion in 2010 to $43.6 billion.

More than half of these funds coming in to be managed by Australians are being invested offshore– in other words, our skilled fund managers are being sought by global investors to manage not only investments in Australia, but also their global portfolios.

As we transition from a resources-based economy to an exporter of services, our funds management expertise and cross-border trade of financial services will be imperative for growth.

All of this tells us that superannuation is good for Australia, but as the Melbourne Mercer Global Pension Index stated – there is room for improvement.

REFORMS IN PROGRESS TO IMPROVE SUPER

The FSI was an important milestone for the industry because as the system continued to grow, the Government and the general public needed confidence that the growth was good for the country and the financial system.

Superannuation saves the Government, and taxpayers, more than $7 billion every year on age pension expenditure.

It generates almost $11 billion in annual tax revenue for the Federal Budget.

Our system is world leading in its vision to address the challenge of an ageing population.

Along with growing wool and wheat and mining iron ore, it's one of the things we do best.

The superannuation system also enjoys an extraordinary level of public support.

The 2015 FSC-ING Superannuation Sentiment Index found that more than 81 per cent of Australians are in favour of the system and agree that superannuation is essential to providing them with a comfortable retirement.

This is an incredible achievement for a system that has evolved over 23 years from a cottage industry made up of small, occupational based funds.

However, today, superannuation is neither a mature system nor is it calibrated to deliver on its objectives.

The Murray Inquiry made three critical recommendations that are intended to ensure the system continues to mature and deliver on its promise of higher standards of living in retirement and less dependence on the age pension.

Two of these were aimed at ensuring superannuation is as efficient as possible:

1. the governance of superannuation trustees is strengthened by independent directors; and
2. That all superannuation trustees be required to compete to attract and retain members by extending the choice of fund regime.

The third recommendation aims to provide clarity around the objective of superannuation.

A clearly defined objective must be designed to help policy makers develop and implement long term decisions that are in the interest of the system, and to put a stop to piecemeal tinkering and the temptation of grabbing Australian's savings to fix problems with the budget.

It's timely to remind ourselves about the sensible policy basis for these reforms.

Governance and superannuation

The current law governing superannuation has no requirement for independent directors on super trustee boards.

As we all know, in corporate Australia it is well established that independent directors increase diversity on boards, introduce skills and expertise, and play an important role in protecting consumers and shareholders from conflicts of interest.

This is also the standard expected of all other APRA-regulated financial institutions and ASX listed corporate entities.

Legislation is currently before the Senate to require all trustees to appoint independent directors on fund boards.

This is a very moderate reform and it will apply to all super funds – retail, industry, corporate and public sector.

Pension funds and retirement schemes in OECD countries such as the US, the UK and Hong Kong have moved to independent directors or put in place specific legislation to protect consumers from conflicts of interest.

The Australian reforms are supported by a broad range of advocacy groups including:

- Consumer groups, such as Choice and National Seniors;
- Employer groups, such as Australian Chamber of Commerce and Industry, the Business Council of Australia and the Australian Industry Group;
- The small business sector;
- The Australian Institute of Company Directors;
- The Association of Superannuation Funds of Australia; and
- The Australian Prudential Regulatory Authority

A requirement to appoint independent directors was a feature of both the Government's Financial System Inquiry as well as the previous Labor Government's Cooper Review.

A mandatory superannuation system that is forecast to grow to $9.5 trillion over the next twenty years deserves the highest standard of governance.

<u>Competition in superannuation</u>

The FSI also observed that superannuation funds were less efficient than they should be relative to the growth of the system over the last two decades.

It is a well established principle that competition drives better outcomes for consumers through ensuring the more efficient allocation of resources.

This principle also holds true for the superannuation industry, however a large sector of the industry – the default superannuation market which covers around 70 per cent of working Australians – is protected from competition by complex industrial law.

At present, over $9 billion in annual superannuation contributions flow to superannuation funds chosen for listing in modern awards by the industrial tribunal, or through enterprise agreements, solely on the submissions of the relevant trade union or employer organisation.

As you would expect, modern award listing is more likely to correlate with the industrial coverage of the sponsoring organisations - not always the performance of the default MySuper product.

An enterprise agreement can be used to prevent someone from leaving that superannuation fund.

The Financial System Inquiry made very sensible recommendations that these arrangements that undermine competition in the superannuation industry should end.

Murray recommended that all consumers be allowed to choose their own superannuation fund and that all MySuper products be allowed to compete for default contributions.

These are important competition reforms that will result in lower fees for consumers and improved net returns.

FSC research has shown that if the mooted reforms encourage and enable some consolidation in the more than 300 funds that exist today, fees could fall.

Our research shows that if the size of the smallest fund is not smaller than $10 billion, average fees could fall by 20 basis points, or 18 per cent, to 90 basis points.

However I also want to point out that while scale is important, there is also room in the market for small, niche funds that do a good job for their members.

Highly performing funds, regardless of whether they are industry, retail or corporate, have nothing to fear from competition.

Policy makers should be wary of arguments that some funds deserve protection from competition.

Protected incumbents always argue they are a special case - they deserve tariffs, subsidies, or anti-competitive barriers to new entrants. Time and time again history has shown that removing such barriers benefit consumers.

Look at our wool industry as an example – when the guaranteed floor price was removed, we were left with a mountain of wool stock, which had to be gradually sold off so as not to disturb global markets – but today with that stockpile gone and our growers competing in the global market, we have a leaner and vastly more efficient wool industry.

Same with textiles - and any number of industry sectors which have had to adjust to a level playing field environment.

In superannuation, the Government has committed to implementing the FSI recommendation for promoting competition – in other words, introducing a level playing field for all funds.

<u>Objective of super</u>

There are other important recommendations from the Murray Inquiry that will further improve the superannuation system for future generations – the first and most emphatic was that the purpose of superannuation must be defined.

The FSI stated: "Seek broad political agreement for, and enshrine in legislation, the objectives of the superannuation system and report publicly on how policy proposals are consistent with achieving these objectives over the long term."

Pleasingly, we may get bipartisan support for this. The Government has committed to this recommendation and the Opposition has demonstrated a clear willingness to participate in the debate.

The FSC, for our part, defines the objective of superannuation is to (1) provide adequate retirement incomes for Australians to improve quality of life in retirement and (2) sustain public finances through reduced outlays as the population ages.

In other words – to ensure that the majority of Australians can achieve an adequate retirement and reduce the call on the public purse.

We firmly advocate that the purpose of super – thus defined – needs to be enshrined in legislation based on bipartisan support, in order to remove it from the annual Budget, and political cycle.

Agreeing on an objective will become an important benchmark against which all future reforms can be measured.

It will also refocus debate on the most important issue confronting superannuation: do the policy settings enable the system to deliver higher standards of retirement for Australians?

If we do not have a purpose for super enshrined in legislation, and policies delivering on that goal, the risk is that consumers and policy makers reach the conclusion that it is not delivering on its promise.

Unfortunately, the pause in the super guarantee rate at 9.5 per cent was a short sighted policy that will push the cost of an ageing population on to future generations and slowdown the ability of superannuation to achieve its objective.

We urge the Government not to target superannuation as a source of revenue to fund other Government policies.

The FSC calls on the Government to use the ongoing tax review to examine how the SG rate and the tax settings for superannuation interact and recalibrate the system to deliver on a settled objective for the system - to deliver adequate retirement incomes for more Australians.

<u>Inappropriateness of the tax expenditure statement</u>

It’s also worth touching briefly on why some commentators are arguing that superannuation should be raided for revenue.

One of the problems the Treasury has had over the last decade has been an inability to produce reliable and meaningful tax expenditure estimates that are able to inform public debate.

Treasury acknowledges that ‘the estimates of reported tax expenditures are not necessarily reliable indicators of the budgetary impact of removing particular tax concessions.’

However, each and every year they produce figures without attempting to improve them.

The three major criticisms of these methodologies are:

- that they are not costings with assumed behaviour changes in which assets inside the system would reduce year on year;

- the assumption that taxpayers would pay full marginal tax rates ignores likely behavioural changes directed towards the use of tax-effective investments (such as negatively geared housing, shares or investments with deferred capital gains); and

- that the long-term saving in Age Pension outlays should be factored into the cost estimate.

The estimates depend on projected investment returns, including the realisation of capital gains and the timing of carry forward losses.

This audience would know that on numerous occasions the parameter assumptions underpinning the Tax Expenditures Statement have been inaccurate.

In fact, since the 2007-08 Budget Treasury has **consistently** overestimated the concessional earnings tax expenditure.

What is even more alarming is what various stakeholders then do with these figures, and the conclusions they then draw.

There are numerous examples, but since I am with a group of economists it might be worth highlighting a fallacy of composition error.

Treasury constantly notes that the TES cannot be additive in nature.

However, various external parties add their contribution tax expenditure estimate and earning tax expenditure estimate together, and then develop proposals to change superannuation taxation - based on illusory savings.

What's worse is they develop proposals without the clear objective of super in mind.

Treasury only produces TES estimates for a limited time frame, whereas with super we are talking about intergenerational policy.

The concept of having a fit-for-purpose TES should not be beyond us.

The Treasury has invested heavily in providing a number of innovations to various aspects of their estimates for the budget, but there has been an underinvestment in improving the Tax Expenditures Statement.

To demonstrate this point, the Treasury has begun producing structural budget balance estimates providing forecasts, confidence intervals for macro-economic projections, revenue and expenditure estimates, but there have been scant innovations to the Tax Expenditures Statement.

The TES should be improved if we are to have a properly informed public debate.

In the interim, stakeholders who bank revenue from the savings derived from the TES should not be spending it as any such revenue is not likely to be forthcoming.

Taxation of superannuation

The FSC agrees that the tax treatment of superannuation should be on the table as part of a national discussion on our tax system.

Any changes, however, must ensure that fewer retirees are dependent on the part or full pension than is currently the case.

The Assistant Treasurer has correctly pointed out there are already strict controls on the size of concessional contributions that can be made into the superannuation system.

The challenge for policy makers and the industry is to undertake an objective, evidence based assessment of how the tax treatment of the system and the superannuation guarantee rate can collectively deliver higher replacement rates for all Australians, and in particular those Australians who can afford to reduce their future reliance on the age pension.

Deloitte Access recently made a contribution to the debate, modelling a version of the Henry Review proposal for taxing superannuation at marginal rates less a 15 per cent rebate.

While this model is worthy of debate, we must remember that the $6 billion in revenue the Deloitte proposal generated is $6 billion less retirement income for Australians – and not only for wealthier Australians.

Taken together with the pause in the superannuation guarantee rate at 9.5 per cent, a modest rebate of 15 per cent would take even more employed Australians further away from an adequate retirement.

The primary reason is that Deloitte did not model Henry's model for superannuation taxation.

They modelled a version of contribution tax proposals and did not include Henry's recommendation to halve earnings tax.

A 15 per cent rebate would send too many middle income earners backwards.

A 15 per cent rebate would result in a contributions tax rate of 22 per cent for each dollar an employee earns over $80 000 – a significant tax increase relative to the current rate of 15 per cent.

And I do not think anyone would call an employee earning $80 000 wealthy – it is only slightly higher than Average Weekly Ordinary Time Earnings.

Even those earning between $37 000 and $80 000 per annum will be paying a contributions tax rate of 17.5 per cent – a tax increase relative to the status quo.

I would suggest that it is incumbent on the Tax Green Paper to examine options for superannuation tax reform that recalibrate the tax and contribution rates to ensure that the majority of Australians have higher income replacement rates in retirement.

The question we should be asking is which model would deliver adequate retirement incomes for a larger portion of the working public who would otherwise be reliant on the age pension.

This is a debate the FSC welcomes, but we must ensure that the outcome results in higher living standards for Australian retirees.

I suggest that without a firm understanding of the purpose and objective of superannuation, any reform in this area would be putting the cart before the horse.

Many of you who work in monetary policy circles would be familiar with the work of Jan Tinbergen in relation to policy targets and policy instruments.

Targets are those variables the policy maker wishes to influence, whereas instruments are the variables that the policy maker can control directly.

Having an objective of superannuation is a fundamental and necessary condition for policy makers to be able to then use their instruments to meet their targets.

Conclusion

The superannuation system has had three pillars for many years. What we need to do now is make sure these pillars continue on solid foundation.

In the short term this requires making sure we progress reforms to strengthen governance and improve competition in superannuation, both of which will improve the efficiency of the system.

We also need to:

- Agree a purpose for superannuation –to achieve adequate retirement incomes for all Australians and to reduce the cost to the Government of an ageing population.;
- Make sure tax expenditure estimates are reliable and meaningful so we can accurately assess how close or far away we are from our purpose;

- Make the necessary changes to policy settings both taxation and expenditure, including superannuation settings, to ensure we stay on track towards meeting our objectives.

We have a good system – but there is room for improvement to take us to the next level of great.

Thank you.