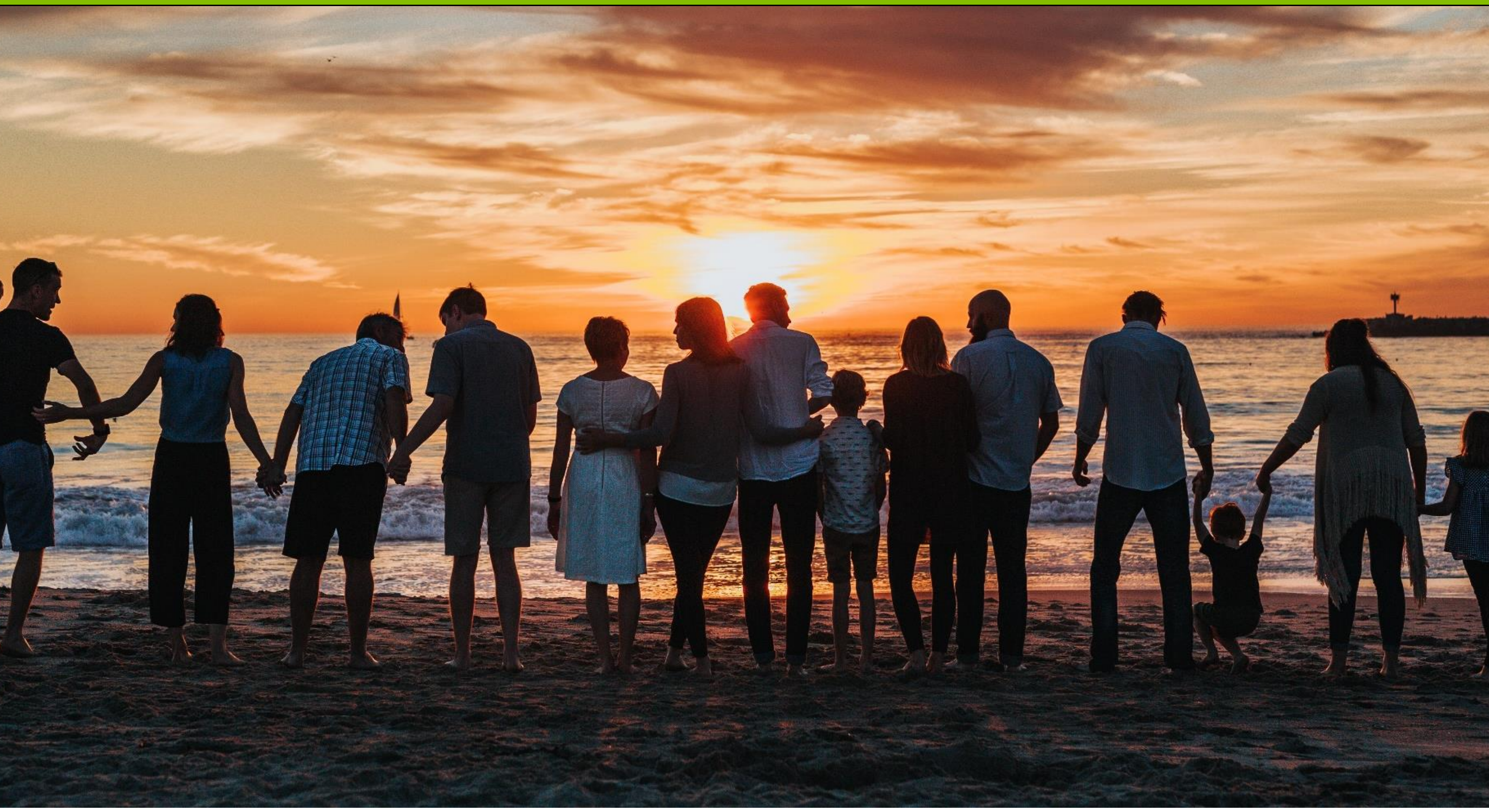
Retirement Incomes Review

FSC Submission

February 2020



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1 About the Financial Services Council

The FSC is a leading peak body which sets mandatory Standards and develops policy for more than 100 member companies in one of Australia's largest industry sectors, financial services.

Our Full Members represent Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks and licensed trustee companies. Our Supporting Members represent the professional services firms such as ICT, consulting, accounting, legal, recruitment, actuarial and research houses.

The financial services industry is responsible for investing $3 trillion on behalf of more than 15.6 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 fourth largest pool of managed funds in the world.

Scope

Given the FSC's membership and expertise, this submission largely focuses on the superannuation system and its interactions with both superannuation members (both in accumulation and retirement phase) and other aspects of the retirement income system.

2 Executive Summary

2.1 Introduction

The FSC welcomes the opportunity to make a submission to the Retirement Incomes Review (**the Review**).

Australia has one of the world's leading retirement income systems. However, despite the strength of the system, we agree that there is still work to be done to ensure all Australians can achieve a dignified and financially secure retirement.

Compulsory superannuation delivers good outcomes for most individuals, but the system is still maturing. We are still yet to see a generation of Australians retire who have received Superannuation Guarantee contributions from the beginning of their working lives.

As the system matures more and more Australians will retire with superannuation as one of their largest assets, and the system must be able to help these individuals manage their savings and retirement incomes.

The four principles selected by the panel as a framework for assessing the system – adequacy, equity, sustainability and cohesion – provide a useful context for examining the outcomes being delivered for members.

These principles are similar to the objectives for a retirement income system identified by the Henry Tax Review – broad and adequate; acceptable (which includes equitable); robust; simple and approachable; and sustainable.[1]

Many issues could be considered under more than one of the panel's principles, with each providing a different lens on these policy concepts and how they impact the system as a whole.

To assist the Panel, we have used the four key principles to provide structure according to the key analysis being provided, and have flagged where there may be interaction with other principles.

There are a range of competing forces to be balanced in charting a course for the superannuation sector. For example, there is constant tension between the desire to implement reforms which would improve retirement outcomes, and providing regulatory stability to improve confidence in the system.

The Panel can helpfully contribute to policymaking by providing an evidence base which helps to frame these decisions.

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[1] See Section 2.1 of Australia's future tax system (2009) Retirement Income System: Report on Strategic Issues.

2.2 Adequacy

The lack of agreement on the objective of the superannuation system is evident in debates about adequacy, particularly in relation to the level of income which is considered “adequate” in retirement and the Superannuation Guarantee (**SG**).

Disagreements around adequate retirement balances often arise from differing views about adequacy benchmarks and the extent to which the goal of the retirement income system is to have personal savings reduce reliance on, and ultimately replace, the Age Pension.

The Age Pension safety net does ensure that, by international standards, Australia provides less adequate retirement incomes for average and higher income earners than for low income earners. This data provides a clear case for boosting retirement savings across the board – including at the lower end.

Arguments that retirement incomes in Australia are already adequate are often based on the use of an inappropriate discount rate in calculations, resulting in retirement outcomes which would be unlikely to meet community expectations. They also fail to consider the significant risks that adequacy may worsen particularly due to declining superannuation returns, increasing longevity, increased costs of ageing, and changing work patterns.

Objective of superannuation

Unless there is an agreed objective of superannuation, framed around providing an adequate level of retirement income to provide a dignified standard of living, it will be difficult to ensure policy settings align with the goals of the system.

Even with an agreed adequacy objective, individuals will still have differing needs and circumstances which means the system needs to be customisable and retain flexibility. There is no “one size fits all” retirement goal.

Legislate a Retirement Incomes Covenant

To support the range of retirement balances and goals that members have, it is essential that a retirement income covenant be enacted to ensure all funds are obligated to support their members into retirement.

In order to properly contextualise its evidence base, the Panel should consider the philosophical starting points and policy objectives of different stakeholders, and how this influences their findings and recommendations.

Adequacy is also an area where there are a number of policy levers available to adjust retirement outcomes. Boosting savings through an increased Superannuation Guarantee is a key path to ensuring individuals have adequate savings, and would financially benefit the community. Other policies such as Age Pension means tests also has a significant impact on retirement outcomes, as does the superannuation preservation age, which should be increasing in parallel with increases in the Age Pension age.

A more efficient default superannuation system

Ending superannuation account erosion, particularly by reforming default superannuation to prevent individuals from being defaulted into poor performing funds and stop the creation of unintended duplicate accounts when individuals move between jobs, is a key policy change that should increase adequacy of retirement savings.

Higher superannuation returns also boost adequacy – and Australian super funds have remarkably strong net returns by international standards. Policies to reduce costs and fees should boost net returns; but international comparisons of fees are quite flawed and should not be used as benchmarks.

Improving retirement income adequacy for all workers

Broadening coverage of the Superannuation Guarantee would improve adequacy – those individuals who are self-employed, working multiple jobs in the gig economy and not meeting the $450 monthly threshold in any of their roles, or on parental leave can have their retirement savings significantly impacted. These coverage issues need addressing, particularly due to the changing nature of work.

For those on very low incomes, there is a trade-off to be considered between the value of saving for retirement or having additional money in their pockets in the present. The Low Income Superannuation Tax Offset (LISTO) attempts to address this issue, while improving equity outcomes, for those on low incomes receiving SG contributions.

Importantly, individual circumstances should be included in assessing particular policies for Superannuation Guarantee coverage.

2.3 Equity

An equitable retirement income system should deliver fair outcomes to all participants, taking into account their circumstances.

Our superannuation tax settings are fair

The superannuation system currently provides similar tax benefits across low, middle and higher income earners, as compared to other OECD countries which provide significantly higher tax benefits to higher income earners.

Measures such as the Transfer Balance Cap increase equity by limiting the accumulation of large superannuation balances. The relatively small number of high balances remaining in the system will exit the system over time.

However, while there are a range of policies in place intended to create an equitable retirement incomes system, there are currently groups who are not served as well as others by these policy settings.

Increasing adequacy and coverage of the system, as discussed in Section 6.5, is one step to improving equity of outcomes by addressing some of the reasons why some individuals receive lower levels of SG contribution. However, the Panel is correct in noting that there are instances where inequitable superannuation outcomes are driven by non-superannuation issues.

Close the gender superannuation gap

For example, the gender gap in superannuation balances is closing, but slowly, and the impacts of the gap are being felt by women retiring now. Measures such as paying SG on parental leave are not gender specific but will benefit women as they are more likely to take leave for longer. However, the retirement income system cannot solve the primary reason why women generally retire with lower balances – their lower lifetime earnings overall.

Similarly, for the growing cohort who do not enter retirement owning their own home, appropriate support such as rental assistance should be considered as part of the retirement income system, but this should not be a replacement for other housing affordability measures.

When considering equity for particular groups of Australians, the retirement income system can only go so far to correct for inequities originating outside the retirement incomes system.

In the retirement phase, means testing of the Age Pension has an equity impact as it helps target Budget spending toward those who most need it, as well as improving sustainability by reducing overall costs.

However, for some individuals the current settings may mean some retirees are worse off if their superannuation balance increases. This perverse incentive may have material impacts on confidence in the system, and discourage voluntary retirement savings.

In considering equity, it is also appropriate to consider how the system serves those who may require access to funds before their retirement. Life insurance provided through superannuation helps protect individuals who experience illness or injury during their working life, can provide extra support to an individual's family in the event of death, and can provide substantial benefits to the Government Budget.

Early access to superannuation also provides an important safety net where immediate needs outweigh the importance of retirement savings, but should not be considered a panacea to solve problems which exist outside the superannuation system, including housing affordability.

When considering the costs to members and the system of these policies, it is important to balance concerns about account erosion with the improved overall outcomes for consumers.

2.4 Sustainability

The retirement income system needs to work effectively to deliver good retirement outcomes for individuals without relying on excessive Government spending.

Government support for the retirement income system through tax concessions for superannuation savings has a cost to the Budget, which is offset by the reduction in spending on the Age Pension that is made possible by superannuation savings. Australia's retirement income system provides a good balance between these two factors, with spending on the Age Pension forecast to decline as the superannuation system matures, and super tax concessions that cost much less than generally thought.

Australia's low level of pension spending

Compared to OECD nations, Australia has a relatively low level of spending on Government pensions, largely due to strong means testing. However, as noted above, this can result in equity concerns for some cohorts and could be simplified.

It will be important to continually monitor sustainability of the system, and ensure that policy settings maintain a sustainable retirement income system without adversely impacting the retirement outcomes of individual Australians.

Superannuation in the economy

The broader impact of the superannuation system's contribution to national savings should also be considered. These indirect benefits provide additional capital for infrastructure investment and make Australia less vulnerable to shocks in global capital markets.

Confidence in the retirement income system is essential to ongoing sustainability, both to ensure individuals are appropriately engaging with retirement savings and to prevent the risk of political pressure to make policy changes that erode the benefits of the system.

Confidence in the system is also closely tied to cohesion and the ability to effectively navigate and engage with the system, as discussed below.

2.5 Cohesion

Many of the factors which are identified as shortcomings of the retirement income system by various stakeholders directly relate to the complexity that has continued to develop in the system over time. Ongoing, often disjointed reforms and a lack of clear, consistent policy direction have led to a regulatory environment which is difficult for industry experts to understand and virtually impossible for members to meaningfully engage with unassisted.

Complexity leads to confusion and disengagement

This complexity is most obvious as individuals begin to plan for their transition into retirement. This is where the complexity in the superannuation system is compounded by the lack of coordination with interconnecting systems, including social security and aged care.

There is a role for retirement products to assist with some of these post-retirement interactions, such as capital requirements for accessing aged care. There is also a significant role for engagement assisted by technology. The increase in information available to individuals through MyGov about their superannuation affairs, as well as the introduction of online onboarding for new jobs, helps to simplify processes and provide individuals with the information they need to make better decisions about their superannuation.

Often the best way to navigate the complexities of our retirement income system is through financial advice, but affordable advice is becoming out of reach for many Australians.

The Panel should also consider how individual behaviour in relation to superannuation is impacted by more or less cohesion in services. For example, there is a strong anecdotal view that individuals specifically manage their finances to gain access to the Health Care Card. Whether or not this is supported by data, there is benefit to considering whether simplifying means testing and potentially broadening access to some entitlements may improve retirement outcomes.

Other complexities in the system, including a range of technical issues and the barriers to modernising legacy products, should also be addressed to improve retirement outcomes.

This complexity for members impacts their capacity to make decisions at many key stages, and is a key barrier to engagement. At a high level, two policy responses are required to address this:

- In the short term, it is vital to ensure individuals have access to affordable, independent, high quality financial advice to support key superannuation and retirement decisions; and,
- In the longer term, it will be important to work toward a simplified superannuation and retirement system that supports consumer decision-making, increases confidence and promotes engagement.

3 FSC Recommendations

1. The Review should contextualise its examination of the retirement income system by relating its findings back to the purpose of superannuation.

2. When the Review examines incomes over the whole retirement period, the Review should use wages growth as the desired growth rate for retirement incomes, not CPI (inflation), because using wages is consistent with community preferences for the Age Pension to grow by wages, and using CPI would generate incongruous and anomalous results.

3. The Review should examine the potential impact of lower superannuation returns on retirement incomes and the Budget.

4. The Review should examine the potential impact of increased longevity and increased costs of ageing on retirement incomes and the Budget.

5. The Review should investigate the reasons for decisions to retire, and delay retirement, particularly making use of data held by Government agencies.

6. The Review should consider the costs and benefits of increasing the superannuation preservation age to 62 years.

7. The Review should examine the costs and benefits of removing the $450 threshold for SG contributions, including assessing the number of employees affected, their demographics, the impact on retirement incomes, and the long-run impact on the Budget.

8. The Review should examine the costs and benefits of providing SG contributions on the Commonwealth's Parental Leave Pay scheme.

9. The Review should update and assess the progress in reducing the extent of SG underpayment given the implementation of relevant Government policies. This research should cover the impact of underpayment on the gender superannuation gap and on disadvantaged groups.

10. The Review should assess the extent of multiple job holding in the Australian economy (both those holding multiple concurrent jobs, and those frequently changing jobs), assess how the current retirement income system caters for these Australians, and the potential for changes to the system to improve how the retirement income system caters for them.

11. The Review should conduct further study into the impact of potential future work patterns on retirement incomes, including the costs and benefits of extending some form of contribution to the self-employed.

12. The Review should assess the main opportunities for policy change to reduce costs for super funds, and hence reduce fees, without impacting member outcomes.

13. To the extent the Review conducts international comparisons of fees and returns, the Review's focus should be on net returns, and the Review should acknowledge the numerous problems with international comparisons of fees.
14. To the extent the Review examines the relationship between fees and returns, this analysis should exclude legacy products and advice commissions.
15. The Review should assess the modelling by the Productivity Commission of the Budget impact of life insurance inside superannuation, and if possible extend this modelling to include death cover and the benefits of life insurance products to individuals.
16. The Review should examine the impact of recent and potential policy changes on the retirement savings for women.
17. The Review should consider the costs and benefits of permitting easier rollover of superannuation balances between members of a couple, and allowing couples to have one joint superannuation account. This would consider the impact of these policies on gender equity, retirement income adequacy, complexity and fiscal sustainability of the system, and how separation of couples would be addressed.
18. The Review should examine how the Australian superannuation system has increased national savings and has as a result provided benefits, direct or indirect, to the Government Budget, supporting the objective of sustainability.
19. The Review should measure the tax expenditure for superannuation against an expenditure benchmark, factoring in behavioural changes and the offset against the Age Pension. If the benchmark includes any part of an income tax benchmark, then this benchmark should be adjusted for inflation.
20. To the extent the Review considers the distributional impact of superannuation tax expenditures, it should analyse these as a proportion of income earned or as a proportion of contributions.
21. The Review should examine the costs and benefits of merging the pension income and asset tests into one means test.
22. The Review should examine the impact of the exemption of the family home from the pension means tests on retirement incomes, including the impact on adequacy and equity.
23. The Review should examine the best way to measure the complexity and regulatory burden of the retirement income system for consumers, financial planners and super funds, and how this burden has changed over time.
24. The Review should examine the costs and benefits of introducing framework changes to the retirement income system to reduce the burden of existing regulations and limit the potential for future increases in this burden.

25. The Review should examine the red tape caused by the Transfer Balance Cap, particularly the individualised cap that will be introduced shortly, and whether there are ways to achieve the same policy outcome with a reduced red tape burden.

26. The Review should examine the red tape barriers to the use of personal deductible superannuation contributions and whether there are ways to achieve the same policy outcome with a reduced red tape burden.

27. The Review should consider the importance of financial advice when making decisions regarding superannuation, in particular when transitioning to retirement.

28. The Review should examine approaches to make retirement advice more affordable and accessible.

29. The Review should provide updated estimates on the number of legacy products in the retirement income system (including the number of customers affected), the costs of legacy products to the system, and analyse the costs and benefits of a comprehensive modernisation regime for legacy products in the system.

4 Purpose of the retirement income system

4.1 Defining the objective of super

In October 2015, as part of its response to the Financial System Inquiry (**FSI**), the Government announced[2] that it intended to legislate the objective of superannuation – that the objective of the superannuation system is to provide income in retirement to substitute or supplement the Age Pension.

Unfortunately, the legislation introduced to Parliament in 2016 lapsed at the 2019 election.

The FSC continues to be strongly supportive of a legislated purpose of superannuation, and has proposed an alternative formulation orientated towards the outcome the system is designed to achieve – consumers' aspiration to save for adequate retirement incomes:

> *To deliver dignity and independence for all Australians in retirement by providing replacement income that is adequate to provide a comfortable standard of living.*

As debates over the future of the superannuation system continue, it is more important than ever to take a long-term focus, and refrain from reactive policy driven by short-term interests and influences.

A clear, legislated objective for superannuation should help to achieve this, and should be central to all research and policymaking in the superannuation sector.

Research recommendation 1: the Review should contextualise its examination of the retirement income system by relating its findings back to the purpose of superannuation.

4.2 A clear focus on retirement incomes

At June 2019, there was $847 billion of superannuation balances in the retirement phase,[3] and around 700 people are reaching retirement age each day.[4] There are various forecasts for the future of the Australian superannuation system, all showing strong growth in the system, faster than the rate of GDP growth:

- Rice Warner: $4.8 trillion by 2034 (about 170% of GDP), reaching just over 180% of GDP in 2048.[5]
- Deloitte: $10.2 trillion by 2038, or about 225% of GDP.[6]

[2] Page 12 of https://treasury.gov.au/publication/government-response-to-the-financial-system-inquiry
[3] Rice Warner Superannuation Market Projections Report 2019, Table 8.
[4] Based on the number people aged 65 at June 2019 (254,825) divided by 366, rounded to nearest 10.
[5] Rice Warner Superannuation Market Projections Report 2019
[6] Deloitte Actuaries & Consultants, *Dynamics of the Australian Superannuation System: The next 20 years to 2038*, November 2019 https://ioandc.com/wp-content/uploads/2019/12/6-Deloitte-paper-Dynamics-of-Super-the-next-20-years.pdf

- Treasury: about 180% of GDP in 2035 and about 225% of GDP in 2050.[7]

As a comparison, the superannuation system is currently about 145% of GDP.[8]

Currently account based pensions (**ABPs**) are the predominant product available in retirement. While an ABP may be appropriate for some retirees, retirement incomes policy should be focused on creating a market for a broader range of retirement income products.

Delivering income in retirement is a different paradigm to accumulating savings. Factors that should be addressed in any retirement income strategy include the importance of looking at retirement income over and above account balances at the point of retirement, management of longevity, market and inflation risks and understanding member needs and wants during retirement.

4.2.1 A retirement incomes covenant

The Government's proposed retirement income covenant (**The Covenant**) is an important reform that will require funds to develop a retirement income strategy for members and provide guidance to help members understand and make choices about the retirement income products offered by the fund.[9]

The Covenant would, for the first time, provide an obligation for superannuation funds to consider the retirement needs of their members as they formulate, review regularly and give effect to a retirement income strategy to assist members to meet their retirement income objectives.

It is an important element in providing strong governance of Trustees in the retirement system and ensuring that they appropriately consider the retirement needs of members, including longevity and other risks that become heightened in retirement.

The Government has proposed that the Covenant be implemented by amendments to the SIS Act and associated regulations. The Government proposed that trustees would need to consider a number of factors for members, with the strategy optimising the retirement outcome for members (given trade-offs between the factors).

A Covenant will work alongside the Design and Distribution Obligations regime and Member Outcomes Assessments to ensure that product providers are delivering suitable retirement income products that help Australians meet their retirement needs.

[7] https://research.treasury.gov.au/sites/research.treasury.gov.au/files/2019-11/The-superannuation-system-in-aggregate.pdf
[8] Table 4 of Rice Warner Superannuation Market Projections Report 2019.
[9] The Treasury, *Retirement Income Covenant Position Paper*, May 2018 principles 1 & 2

5 Improving retirement outcomes

5.1 Getting default super right

5.1.1 The default system embeds suboptimal outcomes

The Final Report of the Productivity Commission's review of superannuation in 2018[10] (the **Productivity Commission Final Report**) found "The primary source of balance erosion lies in multiple accounts" (page 295). Productivity Commission modelling suggests an individual with two accounts for their whole working life will be 6 per cent worse off at retirement (or $51,000 worse off) compared to an individual with only one account (page 532).

Government policies are helping to address existing duplicate accounts in the system, particularly the processes recently introduced as part of Protecting Your Super to facilitate the transfer of inactive superannuation accounts to active accounts through the ATO.

However, these processes do not address the *creation* of additional, new multiple accounts, which occurs primarily due to the existing superannuation default model.

The existing default model can mean a new employee is automatically provided with a new super account if they take no action. Employees who can exercise choice can avoid the creation of new accounts simply by specifying SG contributions should go to their existing account. However, many employees fail to take this action and a new account is automatically, and unnecessarily, created.

In some cases, employees are prevented from exercising choice, and the creation of a new account is mandatory. The workplace agreement is *forcing* the employee to create a new account whether or not they want one.[11]

The default arrangements not only create unwanted duplicate superannuation accounts, they also mean superannuation consumers can be defaulted into underperforming products. The Productivity Commission reviewed the performance of default super products (MySuper linked with predecessor products) over the 11 years to 2018 and found 17 products underperformed their tailored benchmark by more than 0.25 percentage points. These underperforming products had 1.6 million members and $57 billion in assets. Underperforming products were from all segments – industry, retail and public sector (see Final Report, page 531).[12]

The Productivity Commission concluded "One of the main drivers of subpar outcomes is the way default funds are tied to employers and the workplace relations system, with employer

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[10] Productivity Commission (2018) *Superannuation: Assessing Efficiency and Competitiveness*, Report no. 91.
[11] This issue will be addressed if the Treasury Laws Amendment (Your Superannuation, Your Choice) Bill 2019, currently before Parliament, is passed.
[12] Note the FSC has previously raised concerns that the MySuper performance data across 11 years may incorrectly match products over time. See an FSC supplementary submission to the Productivity Commission's inquiry into super: https://www.pc.gov.au/__data/assets/pdf_file/0004/232861/subdr218-superannuation-assessment.pdf

choice constrained by lists of funds in modern awards and enterprise bargaining agreements." (Final Report, page 24).

5.1.2 A better default superannuation system for Australians

To address the issues with the superannuation default system, both the Productivity Commission[13] and Royal Commission into Financial Services[14] have recommended the introduction of a 'default once' mechanism for default superannuation. This mechanism allows an individual to choose a product at the time they enter the workforce, or be placed in a default product if they fail to exercise choice, and carry that product with them between employers unless they actively choose otherwise.

Untying default superannuation from the employment relationship through a 'default once' system would prevent the account proliferation that is an inherent part of the current industrial relations system.

A mechanism with a strong safety net, such as choice from a list of high quality default (MySuper) products would ensure that members who do not make an active choice will not be worse off. This should involve an improved member outcomes test for MySuper authorisation which would ensure that the quality of all default products in the market would increase over time.[15]

We note that a 'default once' system would also need to address the retirement income needs of members. Retirement income is an important component of fund choice that members will need to consider in a 'default once' system.

5.1.3 Alternative default models

Several alternative models have been proposed for default superannuation.

'Best in show'

The Productivity Commission's 'default once' model is broadly similar to that proposed by the FSC, however it involves the creation of a 'best in show' list of 10 products that would be the default superannuation products.

The FSC expressed our concerns about the top 10 'best in show' proposal in detail in a submission to the Productivity Commission.[16] In summary, there are potential harmful market impacts from unnecessarily concentrating default superannuation contributions into a small number of funds. Even if the bulk of existing members outside the top 10 do not roll their savings into a top 10 fund, a relatively static list of 10 'best in show' products could see

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[13] Productivity Commission Final Report, recommendation 1.
[14] Financial Services Royal Commission Final Report, recommendation 3.5
[15] See Productivity Commission Final Report, pages 586–7.
[16] See: https://www.pc.gov.au/__data/assets/pdf_file/0003/230529/subdr199-superannuation-assessment.pdf and https://www.pc.gov.au/__data/assets/pdf_file/0013/230530/subdr199-superannuation-assessment-attachment.pdf

a small number of super funds controlling an ever-growing portion of the superannuation market over time.

This level of scale has significant potential consequences for the superannuation system and the broader market. Of particular concern is the fact that, given sufficient scale, the investment decisions of one fund could materially impact underlying assets.

The super funds selected for the top 10 will find it more difficult to make material changes in asset allocations as trading volumes increase, and the risk of oversaturation of Australian markets could be large. Concentration of default superannuation savings in a few funds would also unnecessarily concentrate risks from the performance of those funds, and additionally would concentrate the ownership of many companies, discouraging competition in much of the economy. The economy could be seriously harmed.

Given this, there are significant problems with a ‘best in show’ model if it has a shortlist of only 10 products. A substantially longer ‘best in show’ list would address many of these concerns; nevertheless the preferred model remains the model outlined in Section 5.1.2 above.

Auto-rollover

An alternative model to address account proliferation is ‘auto rollover’. This model would mean anyone who changes employment would have their existing superannuation balance automatically transferred from their current fund to the default product for their new employer.

This model generates unnecessary costs, including from setting up and closing accounts, transferring balances, and buy/sell spreads. The Productivity Commission conservatively estimated such a model could lead to about 500,000 additional rollovers per annum, costing at least $45 million.[17] The FSC has previously estimated the number of rollovers could increase by up to 720% and the dollar value of rollovers could increase by up to 128% ($179 billion).[18] The increased turnover would mean increased liquidity requirements, reducing the ability for funds to invest in unlisted assets that often provide good returns.

This model also provides poor member outcomes for many, for the following reasons:[19]

- it works particularly poorly for those with multiple jobs, or who regularly transfer between temporary jobs – and the proportion of employees in these situations is growing (see section 6.7.1 below).
- superannuation members may lose specific arrangements they have set up with their fund, including investment and insurance arrangements. This could have a highly detrimental impact on some members.

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[17] Productivity Commission Final Report, page 303.
[18] See: https://www.pc.gov.au/__data/assets/pdf_file/0003/230529/subdr199-superannuation-assessment.pdf
[19] Productivity Commission Final Report, pages 303–4.

- it encourages disengagement, as members are less likely to be able to locate their superannuation easily and are unlikely to develop relationships with funds they see as temporary.
- The performance outcomes are a lottery – while a member might be moved into a better performing product, conversely they could be moved into a worse performing product – as noted in Section 5.1.1 above, some products in the current default segment perform poorly.

National default fund

Some commentators argue the issues with the Australian superannuation default system (noted in Section 5.1.1 above) would be addressed by establishing a National Default Fund (**NDF**), which would be a government sponsored monopoly fund for all default super contributions.

The NDF proposal is often taken to mean the Future Fund taking on the role as the NDF. The Productivity Commission considered the NDF proposal, noting the arguments that the NDF would have economies of scale, would simplify the default picture for employees, and would avoid the problems with account proliferation (Final Report, pages 571−2).

However, the Commission recommended against the NDF proposal as it did not provide competition for the default market, faced various conflicts of interest, and created the risk that the NDF would have an implicit government guarantee against poor returns, meaning the NDF takes an excessively conservative investment strategy. The Commission also implied that the benefits of the NDF would be matched by the Commission's 'best in show' model (Final Report, page 572). We note competition issues could be addressed by requiring the NDF to outsource key functions, and the implicit government guarantee is debatable as any boost to member balances inside the NDF might be largely negated by reduced Age Pension payments (see Section 6.5.3 below).

5.2 Engagement

Improved engagement will assist with improving retirement incomes, as engaged members are more likely to make choices relating to their superannuation that will improve their retirement outcomes. Improved engagement will also increase competitive pressure on funds to provide products that meet the needs of members.

5.2.1 Barriers to engagement

There are a range of reasons why individuals do not engage with superannuation. Many of these are linked to the default superannuation system, which encourages disengagement and account proliferation.

Policy initiatives which could improve engagement include:

- Ending the creation of unintended duplicate default accounts through a "default once" mechanism that allows individuals to take one fund from job to job, as recommended by the Royal Commission and Productivity Commission (see Section 5.1.2 above).
- Allowing all workers to exercise choice of fund (see Section 5.1.2 above).

- Reducing the complexity of the retirement incomes system (see Section 9.2 below) and the frequency of regulatory change (see Section 6.9.1 below).
- Ensuring financial advice is affordable and accessible (see Section 9.3 below).
- Governments, regulators and industry promoting the overall benefits of the system, which is one of the best in the world,[20] notwithstanding the areas for potential improvement.
- Implementing a retirement income covenant which will enhance the requirements on funds to engage with members on retirement needs (see Section 4.2.1 above).

There are a number of other superannuation policies in place or being implemented, such as displaying superannuation details on myGov accounts, which will continue to assist in increasing superannuation engagement.

6 Adequacy

6.1 Retirement adequacy standard

The FSC supports a superannuation system that aims to provide retirees with adequate retirement incomes.

There are a range of ways to measure adequacy, and the lack of an agreed adequacy benchmark or standard is a key factor in ongoing debates about retirement income system settings.

A replacement rate of 70 per cent has been adopted by the OECD (discussed below), and has been adopted or accepted by various commentators and analysts including those that question an increase in the SG rate.[21] The replacement rate is retirement income as a proportion of working age income. A higher replacement rate shows retirees are receiving income that is closer to the income they received when they were employed.

Replacement rates have also been used to determine retirement income adequacy by the Henry Tax Review and previous recommendations of the Senate Select Committee inquiry into superannuation and living standards in retirement.

However, a replacement rate approach is not appropriate for all individuals. For example, for low income earners this 70 per cent replacement rate may be inadequate by community standards, and a higher replacement rate is likely to be warranted. A replacement rate of 70 per cent means a retiree who earned 50 per cent of average incomes would have retirement income of 35 per cent of average incomes which may not meet community standards.

[20] Australia has the third best retirement income system out of the 37 countries included in the Melbourne-Mercer index for 2019, see https://www.mercer.com.au/our-thinking/mmgpi.html
[21] See for example Daley, Coates, Wiltshire, Emslie, Nolan & Chen (2018) *Money in retirement: More than enough.*

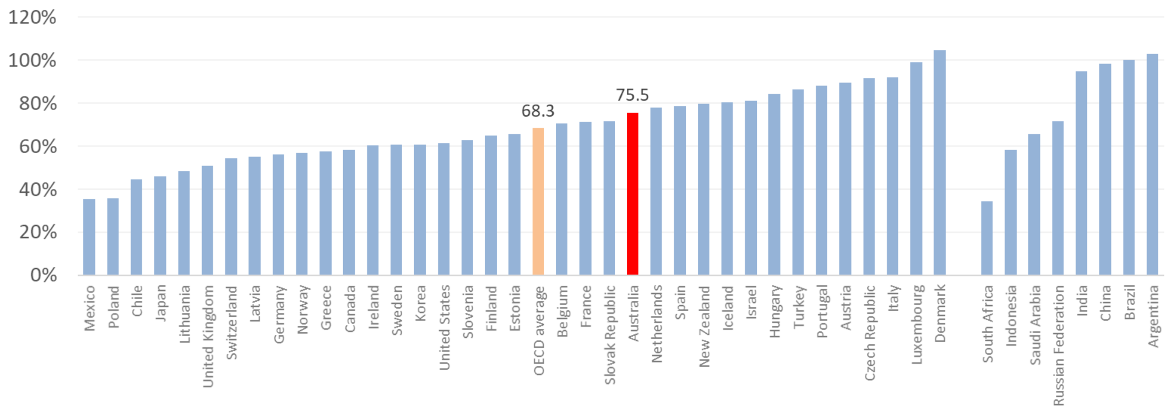
For simplicity, the OECD's 70 per cent figure is used below to contextualise the FSC's analysis.

6.2 International comparisons of retirement income adequacy

Based on a 70 per cent replacement rate standard, Australia provides adequate retirement incomes for low income earners by comparison with other developed countries, while Australia's provision for middle income earners and those earning a bit above the average is much less adequate.

This is shown in the OECD data on the replacement rate for retirees. Figure 1 below shows the OECD's projected retirement income replacement rates in OECD countries for low income earners, or those earning 50 per cent of average incomes. The figures are for a representative individual who starts work in 2018 at age 22 and works to retirement age, and covers both mandatory private and public pensions.

Figure 1 – net replacement rates for low income earners in OECD

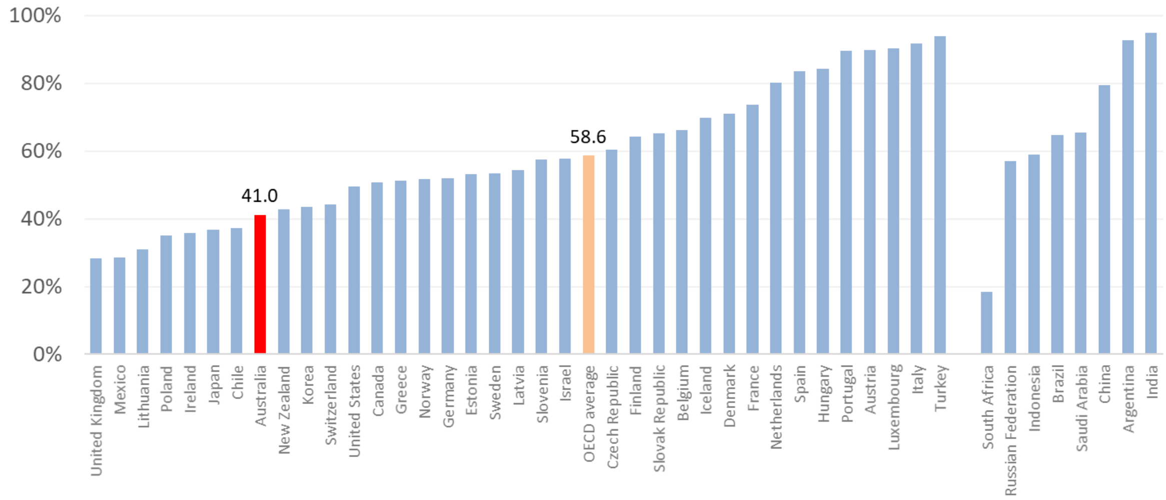


Source: OECD Pensions at a Glance 2019, Figure 5.5.

Figure 1 shows Australia provides retirement incomes for low income earners that are 76 per cent of working age incomes, somewhat above the OECD average for this group of 68 per cent. This is the income at the start of retirement, when many low income earners would have some superannuation – but the income would decline over time as superannuation balances run out. In addition, it is arguable that retirement income that is 76 per cent of 50 per cent of average incomes (ie about 37.5 per cent of average) may not be adequate in its own right.

Australia's replacement rate at average incomes is significantly lower. The projected retirement income for an Australian average income earner starting work in 2018 is 41 per cent of work income, well below the OECD average of 59 per cent for this group, see Figure 2 below. This is also well below the target replacement rate of 70 per cent.

Figure 2 – net replacement rates for average income earners in OECD



Source: OECD Pensions at a Glance 2019, Figure 5.4.

The replacement rate for workers on incomes at 150 per cent of average is 43.8 per cent, also substantially below the OECD average for this group of 54.7 per cent.[22] Again, this is also well below the target replacement rate of 70 per cent. While this income is above the average, it is not particularly rich as it represents an income of about $129,000 per year before tax.[23]

The much lower replacement rate in Australia for average income earners, and people earning somewhat above the average, is for various reasons including:

- the Australian Age Pension is much more targeted than in other developed countries, allowing our Government to spend significantly less than other developed countries on pensions (see Section 8.3 below);
- compulsory contributions for retirement are lower in Australia than in other developed countries (see Figure 4 below); and
- the tax concessions for private retirement savings are smaller at average income levels than in other countries (see Section 7.2.1 below).

The targeting of the Age Pension is particularly shown by Australia being only one of two OECD countries (along with Chile) that initially provides no Government age pension to individuals with average pre-retirement income. This is shown in Figure 3 below with Australia circled in red. Across the OECD, almost all other countries provide Government pensions to this group at the time of retirement, with the average pension being 39.6 per cent of pre-retirement income; the Australian Government pension is zero for this group at time of retirement (in Australia, this group of retirees may receive a pension later in retirement if their assets run down).

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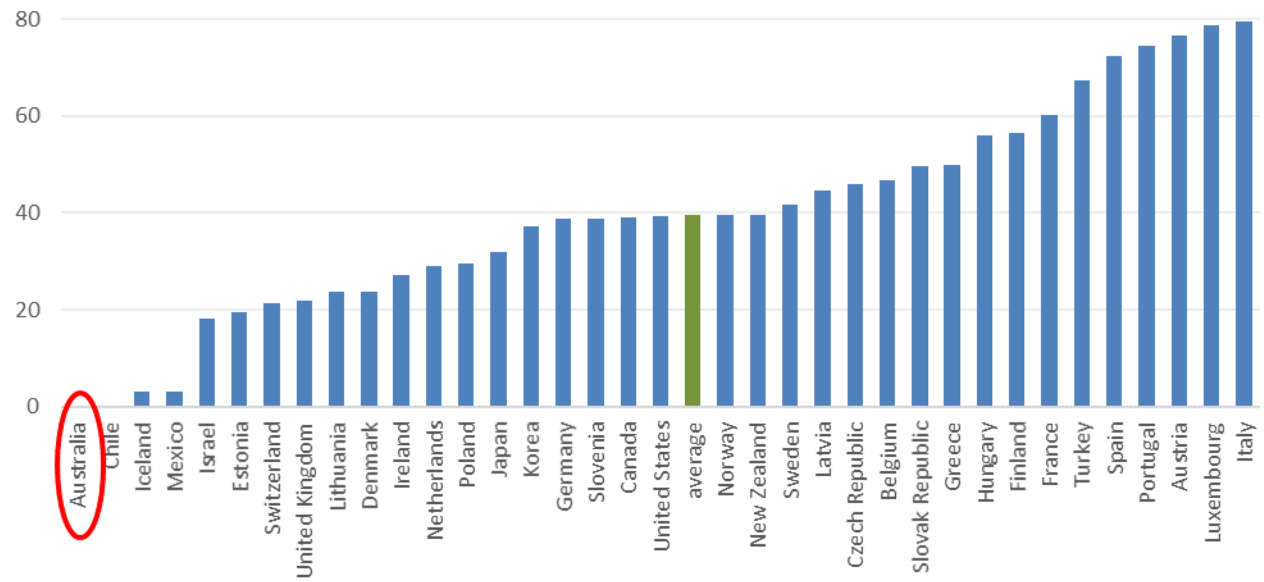
[22] OECD Pensions at a Glance 2019, Table 5.5.
[23] OECD Pensions at a Glance 2019, Table 7.5. Defined as gross wages before deductions of any kind, but including overtime pay and other cash supplements paid to employees.

Figure 3 – Government spending on age pension for average income worker



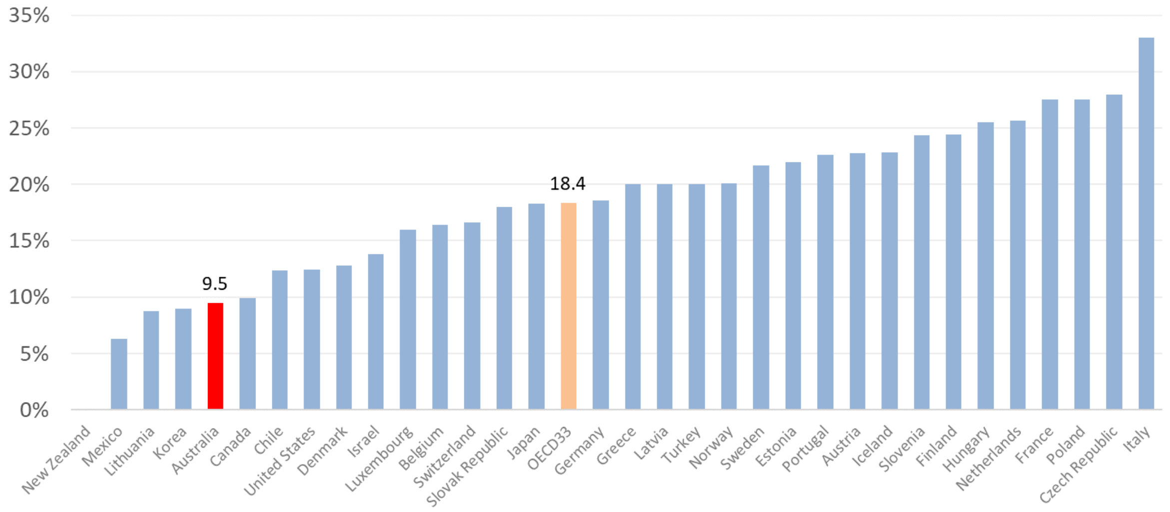
Source: OECD Pensions at a Glance, 2019, Table 5.3. This is the Government spending on pensions for a retiree in their first year of retirement.

The results in Figure 3 are for average income retires; but even for retirees at incomes of 150 per cent of average, Australia and Chile still are the only countries that initially provide no Government spending – all other OECD countries provide some pension to this group at the time of retirement.[24]

The comparatively low level of retirement contributions in Australia is shown in Figure 4 below. Mandatory contributions in Australia at 9.5 per cent are among the lowest in the OECD, and well below the OECD average of 18.4 per cent. Note in some other countries mandatory contributions fund age pensions, but Australia funds our Age Pension from general tax revenue.

[24] Source: OECD Pensions at a Glance, 2019, Table 5.3

Figure 4 – Mandatory pension contribution rates for an average worker



Source: OECD Pensions at a Glance 2019, Figure 1.15. Figures are for 2018.

6.3 Forecasts for adequacy

6.3.1 Replacement rates

According to the OECD data in Section 6.1 above, the current replacement rate for retirees, other than low income earners, falls well below the target replacement rate of 70 per cent:

- For people on average earnings ($86,000)[25], the retirement replacement rate is 41 per cent.
- For people on 150 per cent of average earnings ($129,000), the retirement replacement rate is 43.8 per cent.

This strongly supports the case for an increase in the rate of the SG to 12%.

The Grattan Institute reports on the superannuation system support the use of replacement rates as the best measure of retirement income adequacy.[26] These reports argue Australia's system provides replacement rates that are equal to or above 70 per cent – but this is for various reasons that have been critiqued by Rice Warner and Mercer;[27] one significant reason for the Grattan result is the use of an inappropriate discount rate, as discussed in the following section.

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[25] OECD Pensions at a Glance 2019, Table 7.5. Defined as gross wages before deductions of any kind, but including overtime pay and other cash supplements paid to employees.
[26] Daley, Coates, Wiltshire, Emslie, Nolan & Chen (2018) *Money in retirement: More than enough*; and Coates, Mackey & Cowgill (2020) *No free lunch - higher superannuation means lower wages*.
[27] See: https://www.ricewarner.com/increasing-the-sg-costs-much-less-than-you-think/ and https://www.mercer.com.au/our-thinking/superannuation/why-grattans-got-it-wrong-on-super.html

Retirement incomes may also be inadequate in the future for other reasons, including declining superannuation returns, increasing longevity, and increased costs of ageing. These issues are explored further in the remainder of this section.

6.3.2 Desired growth rate of retirement incomes (the discount rate)

A key issue for determining the replacement rate for retirees is the desired growth rate for retirement incomes (which is also the **discount rate** for retirement income calculations).

If the discount rate is inflation, then it is assumed that retirement incomes only need to keep pace with the cost of living (or CPI). If however the discount rate is wages, then it is assumed that retirement incomes should grow more strongly, at the rate of general wages growth (which usually grows faster than CPI).[28] In the latter case, retirees are assumed to benefit from economy-wide growth in wages and productivity.

The choice of discount rate has a large impact on replacement rates. The Henry Tax Review found replacement rates for average income earners were somewhat inadequate (63%) if the CPI discount rate is used; but were clearly inadequate (52%) if the wage discount rate is used.[29] Similarly for Grattan Institute research – changing the discount rate from CPI to wages results in a reduction of the replacement rate by 13–14 percentage points in all scenarios.[30]

While there are complex and detailed arguments about which of these two approaches should be used (CPI vs wages), these debates are largely academic because the Australian public has made it very clear that the desired growth rate for retirement incomes is wages. The Age Pension currently grows in line with wages growth – and recent attempts to change this growth rate to the lower CPI growth rate, even temporarily, were decisively unsuccessful.

The overwhelming community support for the 'wage growth' standard for the Age Pension means this should be used as the desired growth rate for retirement incomes more broadly.

It might be argued that the Age Pension should use the wage growth standard but the retirement income system more broadly should use a different standard, but this view is internally inconsistent and does not make sense, as the Age Pension is one of the pillars of the overall system. This view also generates some odd results:

- Retirees with superannuation savings would be expected to make do with slower income growth than retirees who are on the full Age Pension. It is unclear why this is desirable.

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[28] Research by the RBA indicates real wages growth over the longer term generally matches productivity growth. See: https://www.rba.gov.au/publications/bulletin/2019/mar/the-labour-and-capital-shares-of-income-in-australia.html

[29] Table F.2 of Australia's future tax system (2009) *Retirement Income System: Report on Strategic Issues*.

[30] Table 4.3 of Daley, Coates, Wiltshire, Emslie, Nolan & Chen (2018) *Money in retirement: More than enough*

- Retirees with superannuation savings that are depleted would go from having a lower desired income growth to a higher desired income growth. This seems incongruous.
- The discount rate for determining adequacy (CPI) is different from the discount rate used for net present value calculations (often much higher than CPI – see Section 6.5.2 below).

Research recommendation 2: when the Review examines incomes over the whole retirement period, the Review should use wages growth as the desired growth rate for retirement incomes, not CPI (inflation), because using wages is consistent with community preferences for the Age Pension to grow by wages, and using CPI would generate incongruous and anomalous results.

6.3.3 Superannuation returns

Retirement income adequacy depends heavily on the assumed superannuation returns, as the impact of compounding over decades can be large. As an example, $1.00 contributed today at age 20, after tax becomes $0.85, which then turns into the following amounts at age 65:

Table 1 – impact of compounding in superannuation returns

If rate of return is…	Then savings at 65 are…
5.5%	$7.85
6.5%	$11.62
7.5%	$17.14

Source: FSC calculations based on assumptions from Table 2.

This shows the large impact of differences in returns. Even a small reduction in returns from 6.5% to 6.4% reduces the retirement balance by $0.45, just over half the size of the contribution at age 20.

Most relevant studies find superannuation returns have been around 6.5% to 7.2% per year.[31] However, it is quite uncertain that these returns will continue into the future. Bond yields have fallen dramatically over recent years, while equity returns have remained strong.[32] This implies a large increase in the equity premium, which appears unsustainable in the long term. So, if bond yields remain low, equity returns will very likely decline over time to be much closer to bond returns. This will mean a decline in overall superannuation returns.

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[31] See footnote 406 of Daley, Coates, Wiltshire, Emslie, Nolan & Chen (2018) *Money in retirement: More than enough*.

[32] The S&P/ASX 200 Total Return (gross) index grew by 11.9% p.a. in the three years to 3 February 2020. The RBA has said: "In many cases, [bond] yields are close to, or have reached, historic lows, and in some cases are negative" see: https://www.rba.gov.au/publications/smp/2019/may/box-b-why-are-long-term-bond-yields-so-low.html

If a substantial decline in superannuation returns occurs, this will have a large impact on retirement savings. Either retirees will be worse off, or Governments will have to spend much more on the Age Pension, or both. The work by the Grattan Institute suggests the Government bears more of the burden, except for higher income retirees.[33] Work by the ANU suggests reducing superannuation returns by 1 percentage point will lead to the optimal SG rate going up by 0.5 to 1.0 percentage points – again with the Government picking up some of the cost of the foregone returns.[34]

Regardless, the risk of lower returns supports the need for an increase in the SG, either to insure against retirement incomes falling even further below benchmarks (see section 6.1 above), or protect the Government against significant increases in Age Pension spending, or both.

Research recommendation 3: the Review should examine the potential impact of lower superannuation returns on retirement incomes and the Budget.

6.3.4 Longevity and future costs of ageing

Adequacy forecasts also depend on longevity and the costs of living in retirement.

It is well known that Australians are living longer, and this increases retirement income needs.

The inadequacy of Australian retirement incomes (see Section 6.1 above) is made worse when increases in longevity are factored in. The OECD projects substantial improvements in life expectancy at retirement, with women in Australia expected to live 3.8 more years and men 3.9 more years at retirement, comparing 2061 with 2015-2020.[35] Any life expectancy increases mean retirement incomes fall even shorter of adequacy as savings will need to cover more retirement years. Furthermore, the probability of actually dying in the year of life expectancy is low (in other words, there is wide variation around the average). This means retirees either need to invest in longevity insurance (for example, annuities) or increase retirement savings to self insure.

The costs of living in retirement are also increasing. Many of these costs are being met by the Government, which is causing increased Budget pressures over time. The Parliamentary Budget Office (PBO) has argued[36] that an ageing population would subtract 0.4 percentage points from growth in revenue and add 0.3 percentage points to growth in spending over the

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[33] The Grattan report finds a reduction in superannuation returns by 0.5 percentage points results in replacement rates falling by about 3% at or below average earnings, and by about 10% in the top decile – see Figure D.1 of Daley, Coates, Wiltshire, Emslie, Nolan & Chen (2018) *Money in retirement: More than enough*.
[34] Khemka, Tang & Warren (2020) *The 'Right' Level for the Superannuation Guarantee: A Straightforward Issue by No Means*. The change in Government spending due to lower investment returns is not clear in this report.
[35] OECD Pensions at a Glance 2019, Figure 6.3
[36] See: https://www.aph.gov.au/About_Parliament/Parliamentary_Departments/Parliamentary_Budget_Office/Publications/Research_reports/Australias_ageing_population_-_Understanding_the_fiscal_impacts_over_the_next_decade

decade 2019 to 2029. The total cost to the budget of ageing is forecast to be $36bn per year by 2028–29 in today's money. This includes increased Age Pension spending of $9bn, increased health spending of $3bn and increased aged care spending of $5bn.

This result assumes the Government is paying for all this increase – but if retirees are expected to increase their contributions to costs then there is a greater need for increases in retirement incomes.

Research recommendation 4: the Review should examine the potential impact of increased longevity and increased costs of ageing on retirement incomes and the Budget.

6.4 Superannuation preservation age

The preservation age is the age where a super fund member can generally start withdrawing from their super fund, and therefore broadly the age where super fund members are able to retire or cease working. The setting of this age has a large impact on retirement balances.

6.4.1 Adequacy and the preservation age

If a worker delays retiring by one year, they:

- Receive an additional year's worth of SG contributions (plus any voluntary contributions they make);
- Receive an additional year's worth of accumulated growth; and
- Draw down on their superannuation for one less year.

The impact of this delay on retirement balances can by quite substantial, as shown in research commissioned by the FSC – for every year that the preservation age is increased the savings gap is reduced by around $100–140 billion.[37] Similarly, continuing to work for an additional two years at half time hours, while salary sacrificing 10 per cent of salary into super, adds an extra 7 years of retirement income, while working for an additional five years adds 23 years of retirement income.[38]

Engagement in the workforce also has significant mental and physical health benefits for older Australians.

The possible burden for some mature workers of a higher preservation age is reduced by the availability of transition to retirement arrangements, which allow mature workers to reduce the number of hours they work while continuing to receive superannuation contributions and drawing down super to supplement the reduced income.[39]

The data suggests people are retiring later. According to the HILDA Survey the mean age of men at retirement rose from 62.1 years in 2003 to 66.1 years in 2015. For women it rose

[37] Rice Warner – Retirement Savings Gap as at 30 June 2014.
[38] Allen Consulting Group (2007) *Australia's national saving revisited*, report for IFSA, page 68.
[39] See: https://www.moneysmart.gov.au/superannuation-and-retirement/income-sources-in-retirement/income-from-super/transition-to-retirement

from 61.3 years in 2003 to 63.8 years in 2015. [40] In addition, there has been large increases in employment of those aged over 55 over the past 20 years.[41] Government agencies would have significant data on retirement, and the Review could benefit from investigating this further.

Research recommendation 5: the Review should investigate the reasons for decisions to retire, and delay retirement, particularly making use of data held by Government agencies.

6.4.2 Fiscal impact of preservation age

The Government Budget would also be improved by an increase in the preservation age, because fewer future retirees would be eligible for the Age Pension as they would have higher personal savings and spend less time in retirement. Mature age workers would also pay additional income and contributions tax while they continue to work.

Further, those who work beyond the age of 60 years are also likely to receive lower total Age Pension payments as they will draw down less of their savings during the critical years between superannuation eligibility and Age Pension eligibility.

Higher levels of mature age workforce participation would also have significant benefits for the broader economy. The first report from the Advisory Panel on the Economic Potential of Senior Australians in 2011, concluded that using the existing skills and experience of older Australians would provide a benefit to the Australian economy of $10.8 billion a year.

The conclusions of the advisory panel are consistent with the FSC's recommendation that the superannuation preservation age should be gradually transitioned to 62 years.

Detailed modelling of a change in the preservation age was done by the Productivity Commission in 2015,[42] showing the change would provide significant Budget savings, boost retirement savings, and increase labour force participation. The change has been considered in other research.[43]

Increasing the superannuation preservation age to 62 would also restore the five year gap between the preservation age and the Age Pension eligibility age.

Research recommendation 6: The Review should consider the costs and benefits of increasing the superannuation preservation age to 62 years.

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[40] Melbourne Institute (2017) Household, Income and Labour Dynamics in Australia Survey: Selected Findings from Waves 1 to 15.

[41] The share of 55 year olds and older that are employed is 35 per cent, compared to 22 per cent 20 years ago, see: https://www.rba.gov.au/speeches/2019/sp-dg-2019-11-26.html

[42] Productivity Commission (2015) *Superannuation Policy for Post-Retirement*, Commission Research Paper.

[43] Chomik and Pigott (2012) *Mature-age labour force participation: Trends, barriers, incentives and future potential*, ARC Centre of Excellence in Population Ageing Research; Actuaries Institute (2012) *Policy Positions – Retirement Incomes*; Kurdna and Woodland (2010) *Simulating Policy Change Using a Dynamic Overlapping Generations Model of the Australian Economy*.

6.5 Superannuation guarantee

6.5.1 The need to increase the SG

It is important for the Superannuation Guarantee to continue to increase to 12 per cent, as is currently legislated. This will address existing concerns including:

- Retirement incomes being meagre in Australia compared to other OECD countries for middle income earners and those earning somewhat above average incomes (see Section 6.1 above);
- A desire to increase self-sufficiency in retirement, reduce pressure on the Age Pension and increase the long-term sustainability of the pension; and
- The need to address the risk of significant declines in superannuation returns, increase in longevity, and increased future costs of ageing.

An increase in the SG can also be a win-win for the community in financial terms, as an SG increase will benefit retirees, the Government's Budget, or both.

6.5.2 Why an increase in the SG is beneficial for the community

A higher SG sets aside money today, which can be used either to boost retirement incomes, or reduce the cost of the Age Pension to the Government. These future uses of the SG, when discounted to today's money, would be greater than the amount put aside, as long as the return on SG savings is greater than the discount rate. So the Budget, individuals, or both, must be better off in net present value terms as long as superannuation earns returns above the discount rate (which is what relevant research assumes, see Box 1).

Using superannuation returns of 5.98% per year and a discount rate of 5%, means super effectively has a 0.98% return *in net present value terms*. This gain can either go to the Government, or to individuals, or both – in any case the sum of the gain to Government and gain to individuals *must* be positive.

Several examples are shown in Table 2 below. If an SG contribution of $1 is made at age 20 for a worker, the contributions tax of 15% is applied, meaning the super balance is $0.85 and the Government has $0.15 today. This $0.85 is withdrawn from the super system at age 65, when it has grown to $11.62 (at 5.98% return per year).

This value is available to the Government (column 2 in Table 2 below) or the individual (column 3) or a mix (column 4). These figures are converted into today's dollars using a 5% discount rate. Other assumptions and details are in Box 1.

In all cases shown below, the sum of the net present value to the Government and individual is positive and well above than the original contribution of $1.

Table 2 – Example of present value of superannuation contributions

	Future benefit of super goes to:		
	Government	**Individual**	**Mix (50/50)**
Future value of super: Government	11.62	0	5.81

	Future benefit of super goes to:		
	Government	**Individual**	**Mix (50/50)**
Future value of super: Individual	0	11.62	5.81
Present Value for Individual	**0**	**1.29**	**0.65**
Present value of super for Government	1.29	0	0.65
Present value of contributions tax (net of tax otherwise paid)	-0.15	-0.15	-0.15
Present value of earnings tax	0.23	0.23	0.23
Net Present Value for Government	**1.37**	**0.08**	**0.73**
Sum of Net Present Values	**1.37**	**1.37**	**1.37**

Source: FSC calculations based on Grattan work. Totals may not add due to rounding. See Box 1 for details.

This simplified example shows either the Government and the individual, or both, benefit in present value terms from an additional dollar contributed to the superannuation system. For every dollar saved in superannuation, the present value of the benefit is $1.37. This result may be surprising but it is simply a demonstration of the benefits of compounding.

Box 1 – Details of calculations in Table 2

In the calculation of the benefit to Government:

- the Government has an initial loss of revenue: assuming the superannuation contribution would otherwise have been paid out as income to the individual and taxed at their marginal tax rate, and assuming this rate is 30%, the Government has a net loss of revenue of $0.15;
- the Government gains tax revenue on the super fund earnings each year; and
- the Government in some scenarios benefits from reduced Age Pension spending (second and fourth columns).

The examples assume if an SG contribution is not made, the money is instead paid to an individual as normal income, which is then spent rather than saved – however if the individual saves outside of superannuation, the net benefit shown in Table 2 is reduced. However, the estimated tax on alternative investments is overstated, see Section 8.2.3 below.

The calculations assume superannuation returns of 5.98% per year and a discount rate of 5%, based on assumptions in work by the Grattan Institute.[44] Work by ANU[45] assumes real returns after fees and taxes of 2.8%, and uses a discount rate of zero or 2%.

Note super returns could easily be lower in the future, as argued in Section 6.3.3 above, but then discount rates would be reduced as well.

6.5.3 Does the Government or individuals benefit from an SG increase?

Research indicates the superannuation system works as intended in relation to an SG increase:

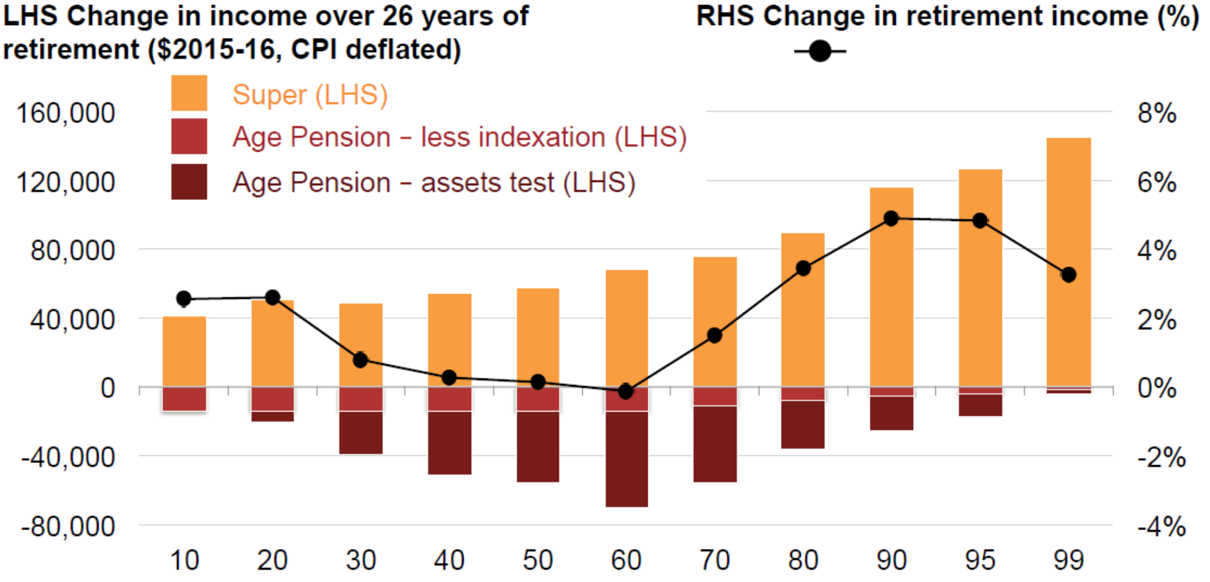
- An SG increase boosts retirement incomes at the low income end (more so if the SG low income threshold is removed – see Section 6.6.1 below).
- The SG increase offsets the Budget cost of the Age Pension for middle income earners.
- At higher income levels, the SG increase is enabling more people to be 'weaned off' the Age Pension.
- At the highest income levels, the benefit form an increase in the SG is effectively zero, because of the operation of the SG maximum contribution base (**MCB**): employers are not required to make additional SG contributions for that portion of

[44] Daley, Coates, Wiltshire, Emslie, Nolan & Chen (2018) *Money in retirement: More than enough*. The after tax return of 5.98% is a superannuation earnings rate of 6.5%, before tax and after fees, then applying an effective tax rate of 7.95%.
[45] Khemka, Tang & Warren (2020) *The 'Right' Level for the Superannuation Guarantee: A Straightforward Issue by No Means*.

salary above the MCB.[46] The MCB is currently $221,080 per year,[47] but will fall to $208,333 per year if the SG goes to 12%,[48] further reducing the number of high income earners that benefit from the SG increase.

This summary is consistent with work from the Grattan Institute, BetaShares/CSIRO (discussed in Section 8.4.1 below) and ANU.[49] A graph from the Grattan Institute work is shown in Figure 5 below.

Figure 5 – Grattan projection of impact of SG increase from 9.5% to 12% by income decile



Source: Page 39 of Coates & Emslie[50]

The net impact on retirement incomes in Figure 5 is shown in the black line.

At the very high end, the Grattan work has an error – it does not incorporate the impact of the MCB for SG contributions discussed above. The MCB broadly means a SG increase to 12% has little or no impact on people earning above $208,333 per year. The 99 percentile is approximately the same yearly income, so this means the increased superannuation savings for this 99% percentile in Figure 5 above should be much closer to zero – and the change in retirement income figure (the black line) should also be close to zero.

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[46] Employers might voluntarily increase contributions for employees with salary above the MCB, but then this would be a voluntary contribution not an SG contribution, and they might only do this for contributions that are below the concessional contributions cap.
[47] See: https://www.ato.gov.au/rates/key-superannuation-rates-and-thresholds/?anchor=Maximumsupercontributionbase
[48] At this income, a 12% SG equals the concessional contribution cap.
[49] Daley, Coates, Wiltshire, Emslie, Nolan & Chen (2018) *Money in retirement: More than enough*; and Khemka, Tang & Warren (2020) *The 'Right' Level for the Superannuation Guarantee: A Straightforward Issue by No Means*.
[50] Coates and Emslie (2019) *Money in retirement: will we have enough? An update to the Grattan Retirement Income Projector*, 12 April 2019

6.5.4 Other research arguing against SG increases

There are recent papers arguing against increases in the SG by ANU and the Grattan Institute.[51] These papers broadly argue that an SG increase will either make the Budget or individuals worse off in today's money. However, the examples in Section 6.5.2 above show this conclusion does not work – as long as the discount rate is lower than the return on superannuation savings, then because of compounding, increased superannuation savings *must* make either the Budget or individuals (or both) financially better off in today's money.

Other aspects of the Grattan research have been critiqued by Mercer and Rice Warner in substantial detail.[52] The base case in ANU research also has several unrealistic assumptions, including that people do not have broken work patterns, do not retire early, and do not live to a very old age. Amending any of these assumptions, as is done in various alternate scenarios, increases retirement savings needs.

6.6 Improving coverage of the SG

6.6.1 Low income threshold

Employers are only required to make SG contributions on behalf of an employee when the employee is earning above a $450 per month threshold. This threshold is becoming less relevant over time, for the following reasons:

- The increasing prevalence of employees with multiple jobs: 14.4 per cent of employees held more than one job in 2011–12, a figure that increased to 15.6 per cent in 2016–17 (see further discussion in Section 6.7.1 below). Multiple job holders are more likely to be affected by the threshold as the earnings from each job will be lower than total employment income.
    - The impact of the $450 threshold on multiple job holders would also be greater because the median wage for people with multiple jobs is much lower, at 17 per cent below the median wage for people with only one job.
- The threshold is little changed from the advent of the compulsory superannuation system and has little relevance to current work patterns.
- The benefit of the threshold for employers has been reducing over time.
    - Most employers have at least one employee to whom they must make superannuation contributions.
    - The contribution rate on an income below $112.50 is less than $11 per week, and therefore adds little to the cost of employment.
    - The introduction of SuperStream is simplifying the processing of contributions for employers, reducing any regulatory impact.
- The long-term nature of superannuation and power of compound growth means that even modest contributions such as $11 per week may have a significant impact on

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[51] Daley, Coates, Wiltshire, Emslie, Nolan & Chen (2018) *Money in retirement: More than enough*; and Khemka, Tang & Warren (2020) *The 'Right' Level for the Superannuation Guarantee: A Straightforward Issue by No Means*.
[52] See: https://www.ricewarner.com/increasing-the-sg-costs-much-less-than-you-think/ and https://www.mercer.com.au/our-thinking/superannuation/why-grattans-got-it-wrong-on-super.html

the quality of an individual's retirement. A contribution of only $11 per week to an individual's superannuation savings, based on annual investment growth of 7.5 per cent, results in a retirement balance of $140,000 after 40 years.

- Any contributions for employees below the $450 per month threshold are likely to receive the Low Income Super Tax Offset, so the benefit of SG contributions for this group would be magnified.

The $450 per month threshold equates to $112.50 per week, or approximately seven hours of work at minimum wage. There is no reliable data on the number of employees that would fall within this category or the magnitude of the foregone contributions that result from the threshold.

Research recommendation 7: The Review should examine the costs and benefits of removing the $450 threshold for SG contributions, including assessing the number of employees affected, their demographics, the impact on retirement incomes, and the long-run impact on the Budget.

6.6.2 Parental leave

The Commonwealth Paid Parental Leave (**PPL**) scheme provides for 18 weeks pay at the minimum wage. The PPL scheme does not provide for superannuation contributions.[53] The absence of a superannuation component is an important contributor to lower retirement outcomes for Australian carers and has a disproportionate impact on female employees who are more likely to take work breaks to care for children. Research by ANU indicates being out of work for five years means the optimal SG rate should increase by around 4.0–5.5 percentage points.[54]

The current PPL scheme has a Budget cost of $2.18 billion in 2018–19.[55] With the SG currently at 9.5 per cent, introducing an SG component to the current scheme would likely cost the Budget around $207 million per year – offset in the longer run by reduced Age Pension spending (see Section 6.5.3 above).

The significant impact of lower or zero SG contributions during a break to care for a child is a product of the compounding effect of a long term investment. Maintenance of a SG contribution an employee would have otherwise received would have a significant effect on reducing the long-term savings gap of Australians who take breaks to care for a child, predominately female employees.

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[53] See: https://www.humanservices.gov.au/individuals/services/centrelink/parental-leave-pay
[54] See page 22 of Khemka, Tang & Warren (2020) *The 'Right' Level for the Superannuation Guarantee: A Straightforward Issue by No Means*. The modelled scenarios relate to early retirement, which the paper argues has similar impact to career breaks. Grattan Institute results suggest career breaks have a smaller impact, but this is likely because lower superannuation is offset in the Grattan results by higher Age Pension spending.
[55] Department of Social Services Annual report 2018–19, page 70.

Under this proposal the Commonwealth PPL scheme would retain its existing eligibility criteria, reducing the cost to the Commonwealth and ensuring the scheme remains targeted to middle and lower income employees. This would also help ensure the scheme has the effect of reducing Age Pension reliance in the longer term.

Research recommendation 8: The Review should examine the costs and benefits of providing SG contributions on the Commonwealth's Parental Leave Pay scheme.

6.6.3 Unpaid super

The Productivity Commission found unpaid SG contributions were worth about $2.8 billion per year in 2016–17, which was 4.2 per cent of all SG contributions in that year (see Final Report, section 6.2). The impact is especially felt by low income and young workers. The missing SG contributions have various adverse effects:[56]

- The cost to a typical superannuation member would be a reduction of 7.6% in retirement balances, when the impact on foregone super returns is included.
- Some fund members would lose insurance cover, because some disability and income protection insurance policies rely on regular contributions to remain valid.
- Tax revenue from super contributions and earnings would be lower.
- Spending on Age Pension would be higher, given the reduction in retirement balances.
- Businesses that fail to pay SG have an unfair competitive advantage over businesses that are compliant with their SG obligations.

Importantly, the Commission also found that other policies, now implemented, would mean the extent of this problem will be "much reduced". In particular, the Commission argued the expansion of Single Touch Payroll (STP) to all employees was "critical" to this issue. Other important policies are increased penalties for SG non-compliance and increased reporting of contributions by super funds.[57] The Commission also argued a central superannuation clearing house was not needed to address this issue.

The FSC supports these conclusions.

Research recommendation 9: The Review should update and assess the progress in reducing the extent of SG underpayment given the implementation of relevant Government policies. This research should cover the impact of underpayment on the gender superannuation gap and on disadvantaged groups.

[56] Some of these examples are from the Productivity Commission Final Report, page 316.
[57] Productivity Commission Final Report, page 317.

6.7 The changing nature of work

6.7.1 Multiple jobs

The superannuation system is not well designed for people who hold multiple jobs simultaneously, or people who switch jobs frequently. The impact is particularly felt by employees who are defaulted into new super funds at each new/concurrent job; who cannot exercise choice; and who earn under the $450 per month SG contribution threshold.

The latest ABS data on multiple concurrent jobs for 2016−17 shows:[58]

- There were 2.1 million Australians holding multiple jobs, an increase of 0.3 million since 2011–12.
- The proportion of employees with multiple jobs has increased over the same time period from 14.4 per cent in 2011–12 to 15.6 per cent in 2016–17.
- Women are more likely to hold multiple jobs, with 17.5 per cent of women holding more than one job during the 2017 financial year, compared to 13.8 per cent of men.
- One in four people under the age of 30 held more than one job, with the rate highest around age 19.
- While 26 per cent of multiple job holders worked all of their jobs in the same industry, the large majority (74 per cent) worked across multiple industries – meaning they are more likely to have accounts in two or more different default super funds and pay duplicate fees and charges as a result.
- 409,100 people held three jobs concurrently in the 2017 financial year; and 166,700 people held four or more concurrent jobs.
- The median employment income for people with multiple jobs was $40,491, which is 17 per cent below the median of $48,908 for people with only one job.

The above figures only relate to people holding multiple concurrent jobs; there are also additional people who change jobs frequently. Including this second group would further add to the numbers of Australians who face issues with the current superannuation system. Substantial data on multiple consecutive jobs would be in the ABS's Linked Employee-Employer Dataset (**LEED**) and the Review could examine this data in more detail.

Research recommendation 10: The Review should assess the extent of multiple job holding in the Australian economy (both those holding multiple concurrent jobs, and those frequently changing jobs), assess how the current retirement income system caters for these Australians, and the potential for changes to the system to improve how the retirement income system caters for them.

6.7.2 Changing work patterns

Concerns are frequently expressed that technological change, including automation, is causing substantial dislocation to the labour market. For example:

[58] See: https://fsc.org.au/resources/1828-growing-number-of-multiple-job-holders-emphasises-need-to-fix-superannuation-defaults/file

- In 2018 the chief economist of the Bank of England, Andy Haldane, gave a warning that "large swathes" of the population could become "technologically unemployed".[59]
- In 2017 the McKinsey Global Institute predicted that 800m people in 46 countries, or roughly a third of the workforce, could lose their jobs to machines by 2030.[60]
- One of the original alarming predictions was made in 2013 work by Carl Frey & Michael Osborne who argued about 47 per cent of total US employment was at risk of automation.[61]

If these concerns turn out to be true in Australia, this would have many harmful impacts on households and families including large reductions in SG contributions and hence retirement savings. Significant numbers of households would be worse off during working years due to mass unemployment, as well as worse off in retirement due to lower SG contributions earlier in life.

However, there is little evidence to date in Australia of the main expressed concern, of mass technological unemployment. The financial services industry provides a case study — productivity has increased in our industry, including through automation,[62] yet employment in the industry has at the same time increased.[63]

The broader data provides a similar story, that technological change/automation is not having a detrimental impact to date:[64]

- The employment to working age population ratio is currently at levels similar to historical highs of 2008.
- Job tenure has not declined.
- Casualisation has remained broadly unchanged for the past 20 years.[65]
- The incidence of long hours of work has declined.
- The proportion of employees wanting to work different hours (either less or more than they currently work) has been declining.
- The proportion of employees hired on temporary contracts or by labour hire firms has not been increasing over the past decade.[66]
- There has been no clear increase in income inequality, and perhaps a decline since 2001.[67]

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59 BBC Radio 4, 20 August 2018. See https://www.bbc.com/news/business-45240758
60 McKinsey Global Institute (2017) "Jobs Lost, Jobs Gained: Workforce Transitions in a Time of Automation"
61 https://www.oxfordmartin.ox.ac.uk/publications/the-future-of-employment/
62 See FSC (2019) State of the Industry Report, pages 6–7.
63 See ABS Labour Force, Australia, Detailed, Quarterly, Table 6.
64 Source unless otherwise specified is Jeff Borland & Michael Coelli (2017) "Are Robots Taking Our Jobs?" *Australian Economic Review*, 50(4), December 2017, pp377–397
65 See also: https://www.rba.gov.au/publications/confs/2019/pdf/rba-conference-2019-lass-wooden.pdf
66 See page 25 of Natasha Cassidy & Stephanie Parsons (2017) "The Rising Share of Part-time Employment", *RBA Bulletin*, September Quarter
67 Productivity Commission (2018) *Rising inequality? A stocktake of the evidence* Productivity Commission Research Paper, August. See: https://www.pc.gov.au/research/completed/rising-inequality/rising-inequality.pdf

There is also limited evidence of the growth of the ‘gig economy’ having a major impact on the labour market. In particular, the number of workers classified as independent contractors has actually declined over recent decades.[68]

There has been a substantial increase in part time work but this could be seen as a beneficial change as it means more parents (particularly women) are able to remain in the workforce. A large majority of employees are working part time by choice, although the proportion of employees who are required to work part time has been increasing.[69]

This is not to indicate the labour market is all perfectly fine. Low wages growth is an important concern. This directly impacts on superannuation by reducing SG contributions and hence retirement savings. It is arguable that low wages growth is partly caused by technological change suppressing wages growth. On the other hand, speedy technological change should go hand in hand with strong productivity growth, and this is not evident in the data to date. Some economists attribute slow wages (and economic) growth to a *lack* of innovation – there is *too little* automation rather than too much.[70]

Another measure of some concern is perceptions of job security have been declining.[71] This may indicate innovation and automation is increasing the perception of employment insecurity problems, even though this may not be showing up in other data.

6.7.3 The future of work

The historical data cited above provides no guarantee for the future, and the nature of work may be quite different in the future from today. This could easily mean ongoing reductions in the coverage of the SG, as fewer workers are classified as employees and more classified as self employed. This will reduce retirement incomes, increase Government spending on the Age Pension, or both.

Of particular interest for the future of work is the sharing economy, which describes the use of digital platforms to allow buyers and sellers to trade with each other directly. While physical marketplaces have existed for millennia, digital platforms have greatly reduced the cost, and increased the reach, of these marketplaces. If an individual uses a digital platform to sell their own labour this is sometimes known as the ‘gig economy’.

Gig economy work could easily fall outside the definition of employment for the SG, and even if work in the gig economy is treated as employment, it could fall below the $450 per month threshold for application of the SG.

The coverage of superannuation has been increasing for some time, as shown in the graph below. However, the increase has been slow, and has largely levelled off in the past few

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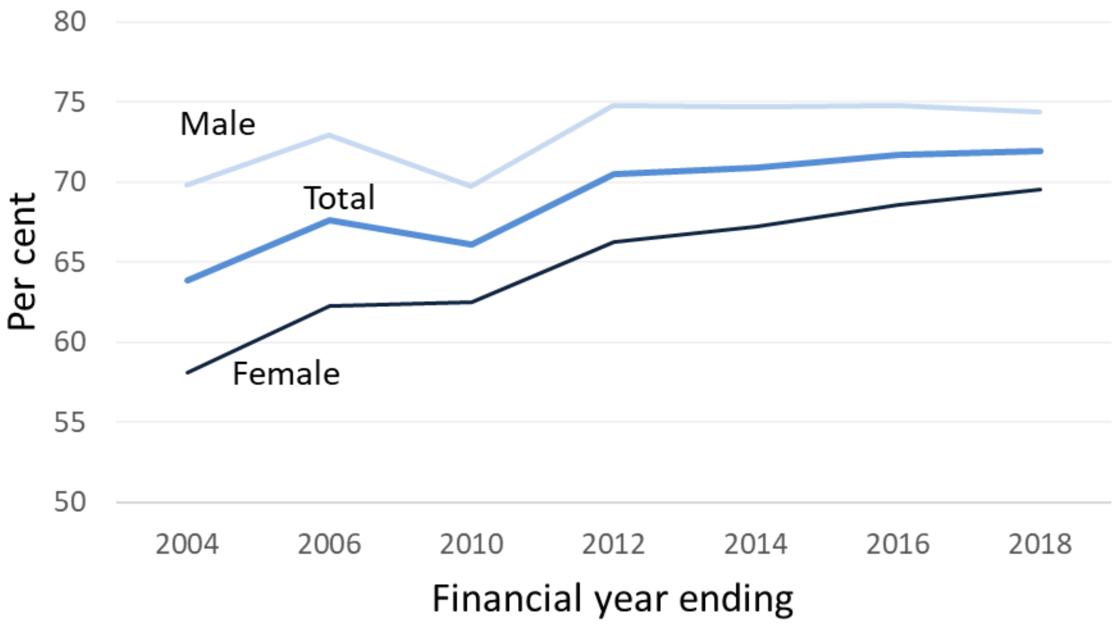
[68] See: https://apo.org.au/sites/default/files/resource-files/2018/12/apo-nid209706-1248346.pdf and: https://www.rba.gov.au/publications/confs/2019/pdf/rba-conference-2019-lass-wooden.pdf
[69] See page 20 of Natasha Cassidy & Stephanie Parsons (2017) “The Rising Share of Part-time Employment”, *RBA Bulletin*, September Quarter.
[70] The theory of secular stagnation, as described by Larry Summers here: http://larrysummers.com/2016/02/17/the-age-of-secular-stagnation/
[71] See page 25 of Natasha Cassidy & Stephanie Parsons (2017) “The Rising Share of Part-time Employment”, *RBA Bulletin*, September Quarter; and Graph 5 of James Bishop & Natasha Cassidy (2017) “Insights into Low Wage Growth in Australia”, *RBA Bulletin*, March Quarter.

years. This slow growth could be for a variety of reasons — one could be the growth of the gig economy (another may be more employees are working multiple jobs, all of which fall below the $450 minimum threshold for SG contributions – see Section 6.6.1 above).

Figure 6 – Coverage of superannuation, 2004 to 2018



Source: ABS Household Income and Wealth, Australia, 2017–18, Table 12.2.

If some predictions for ongoing growth in the gig economy are accurate, this will mean the coverage of the SG will decline. This suggests the coverage of SG needs further consideration.

This is particularly important because Australia does not have any mandatory SG requirements relating to self employed workers. Australia's position in this matter is unusual; most OECD countries have contribution requirements relating to this group of workers, as shown in Table 3 below.

Table 3 – Contributions requirements to mandatory and quasi-mandatory pensions for the self-employed, OECD countries

Mandatory or quasi-mandatory contributions to earnings-related scheme				Mandatory contributions to basic pensions only	No mandatory pension contributions
Employee-like	**Reduced contribution rate**	**Only flat-rate contributions mandatory**	**Regular contributions mandatory only above income thresholds**		
Canada	Austria	Poland	Austria	Ireland	**Australia**
Czech Republic	Belgium	Spain	Chile	Japan	Denmark
Estonia	France	Turkey	Finland	Netherlands	Germany
Greece	Chile		Latvia	United Kingdom	Mexico
Hungary	Iceland		Slovak Republic		
Korea	Israel		Turkey		
Lithuania	Italy				
Luxembourg	Latvia				
Slovenia	Norway				
United States	Portugal				
	Sweden				
	Switzerland				

Source: OECD Pensions at a Glance 2019, Australia highlighted

A variety of policy responses should be considered to address this issue and other issues relating to the future of work:

- Removing the $450 per month low income threshold for the SG – discussed in Section 6.6.1 above.
- Expanding the coverage of some form of SG contribution to independent contractors
- Reducing the red tape applying to individual deductible contributions to super – See Section 9.2.3 below.
- An in-depth review of the impact of the future of work on superannuation and retirement incomes.

Research recommendation 11: The Review should conduct further study into the impact of potential future work patterns on retirement incomes, including the costs and benefits of extending some form of contribution to the self-employed.

6.8 Early access to super

6.8.1 Integrity of superannuation savings

Superannuation benefits should generally be preserved to provide income in retirement. Early access to superannuation for other purposes is inconsistent with the preservation principle.

However, there will be circumstances where the benefits of early access to superannuation for an individual will exceed the benefits of preserving balances until retirement, such as in cases of genuine financial hardship, or under certain medical conditions where the individual is suffering a life threatening condition or treatment is required to alleviate acute/chronic pain.[72]

Early release of superannuation benefits should generally be a last resort where other sources of financial support have been exhausted. It is not an appropriate replacement for existing health and income support policies.

The rules around early access to superannuation should be able to be administered fairly and effectively. Rules that are highly subjective in nature will increase red tape, expense and difficulty for applicants, trustees and Government.

The Government reviewed the rules for early release of superannuation in 2018–19 but this review is yet to be finalised.

6.8.2 Opting out of SG, or providing early access, to pay for housing

It has been suggested that there should be an option for individuals to opt out of the SG, partly or fully, or access mandatory SG contributions to pay for other things, particularly housing.[73] These two ideas are similar in that they both reduce the effective SG contributions in the superannuation system.

The FSC has significant concerns with these ideas.

The main argument used for these proposals is that many Australian households are finding it difficult to afford the purchase of a family home and releasing money that would otherwise be in superannuation would assist in enabling this purchase.

This is a flawed argument. Providing significant financial assistance for housing will just push up house prices, given the unresponsiveness of supply of housing.[74] This will mean:

- An increase in wealth for those who already own a home. On average, these households are wealthier and older.
- New purchasers of housing will likely be no better off – they will have a house but reduced retirement savings.[75]
- Those still unable to buy a house but wishing to do so will be worse off as houses will be more expensive. Their retirement savings would be unchanged.
- Renters could be made worse off if rental yields remain unchanged (unchanged yields mean the dollar value of rent would have to go up if house prices increase)

The combined result of these factors means the policy change is likely to increase inequality without substantially increasing home ownership.

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[72] See FSC submission at: https://fsc.org.au/resources/935-2018-02-16-early-release-of-super-fsc-submission-no-sig/file
[73] See for example https://www.afr.com/policy/tax-and-super/super-for-housing-still-on-the-table-20170316-guzols and https://www.abc.net.au/news/2019-05-28/millennials-voluntary-superannuation-housing-property-market/11156580
[74] See https://www.ahuri.edu.au/__data/assets/pdf_file/0012/13242/AHURI-Final-Report-281-Housing-supply-responsiveness-in-Australia-distribution-drivers-and-institutional-settings.pdf and https://onlinelibrary.wiley.com/doi/abs/10.1111/j.1467-8462.2012.00679.x
[75] In the long term it is unclear if superannuation provides higher, lower, or similar rates of returns to housing, once tax differences are removed.

In broad terms, housing will be more affordable (ie cheaper) if supply is increased or if demand is decreased. Allowing SG to be used for housing works in the opposite direction by *increasing* demand.

Housing is nevertheless important for retirement; the data suggests households that rent are most likely to be disadvantaged in retirement.[76] However early access to SG is not the way to address this issue.

Appropriate support for retirees who rent needs to be considered as part of the retirement income system, but this should not be a replacement for other housing affordability measures.

More broadly than housing, reducing SG contributions to spend today will come at a cost in the future because retirement savings will be lower. As noted in Section 6.5.2 above, fund members, the Government, or both, will be made worse off in present value terms from reducing superannuation balances for spending today. For many middle income earners, early access to SG contributions would mean a corresponding increase in Government spending on the Age Pension (see Section 6.5.3 above) – so for this group early access to SG contributions is equivalent to an individual getting a cheque from the Government, which the Government pays for when the individual retires. It is hard to see why this is a good policy outcome.

Early access to SG would also reduce retirement income adequacy, which is already inadequate for many Australians, see Section 6 above.

In summary, early access to compulsory SG contributions is poor policy that contradicts the goals of the superannuation system and will cost the Government money in the long run. Early access to pay for housing would likely be inequitable and fail at its main goal of increasing housing affordability.

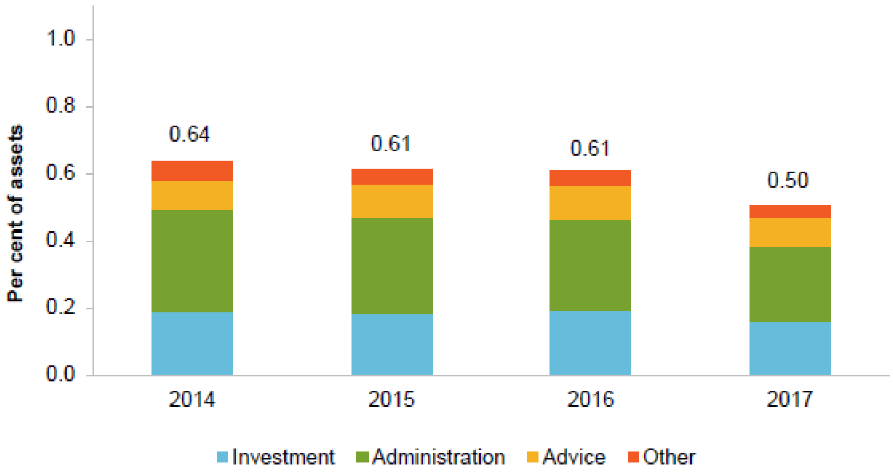
6.9 Fees

6.9.1 Trends in superannuation fees

The fees charged on superannuation accounts in Australia have been declining for some time as a proportion of assets, and are expected to decline further. This is shown in the following graphs from the Productivity Commission's final report into superannuation.

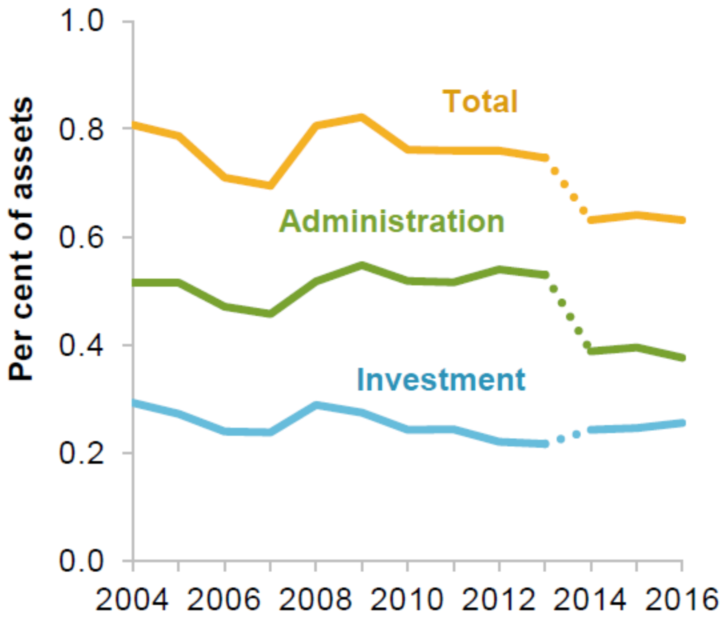
[76] When housing is included in calculations, the prevalence of old age poverty is generally 10%, but 70% for older renters who live alone. See page 48 of CEPAR (2019) *Housing in an ageing Australia: nest and nest egg?* CEPAR research brief, November 2019

Figure 7 – Fee revenue as proportion of assets, large super funds



Source: Productivity Commission Final Report, Figure 3.5.

Figure 8 – Reported costs as a share of assets, large super funds



Source: Productivity Commission Final Report, Figure 3.6.

While the dollar value of costs and fees has increased, this is not particularly relevant in an industry that is growing strongly in dollar value of assets under management.

Some factors that are likely to contribute to reducing costs as a share of assets include:

- Mergers and rationalisation of super funds, with the number of large funds declining by 86 per cent from 2004 to 2018.[77] The Productivity Commission has found that the

[77] APRA annual superannuation bulletin, 2018, table 3a.

evidence for economies of scale in the superannuation system is 'compelling', with larger sized funds having lower costs, although it is not entirely clear if cost reductions are passed through as lower fees.[78]
- Consolidation of products within funds, to reduce complexity and administration costs.
- Increased competition between funds.
- The ending of advice-related commissions. Some commissions were grandfathered, but legislation to remove this grandfathering comes into effect on 1 January 2021, further reducing costs after that date.
- The ongoing regulator investigation of poorer performing superannuation products, including products that charge high fees.
- Various policy and systemic changes that should reduce costs particularly the introduction of SuperStream and the capping of fees for low-balance accounts.

However, the increasing volume of regulatory change, often with extremely short and uncertain implementation timeframes, may be keeping costs higher than they would otherwise be – even when the goal of these changes is to reduce account balance erosion.

One example of this is the Protecting Your Super (**PYS**) reforms, which were complicated by:

- delayed passage of legislation;
- last-minute legislative amendments when the Bill was finally passed;
- short implementation timeframes, creating difficulties in both technical implementation and member communications; and
- drafting issues creating delays and uncertainty in the implementation phase.

While the FSC supported the PYS reforms, all of these factors increased the complexity and cost of implementing the changes. Ultimately these costs to funds flow through to member fees.

Other factors that may be preventing further fee reductions include:

- the impact of ongoing increases to regulator levies;
- unnecessary red tape which adds costs without improving member outcomes (see Section 9.2 below); and
- lack of a product modernisation scheme to address legacy products, particularly those with high fees, in the superannuation system (see Section 9.3 below)

It is important for the Government to address these factors. Superannuation fees can and should be lower, and the barriers to fee reductions should be addressed as a priority.

[78] See: Productivity Commission (2018) Economies of scale in superannuation, Technical Supplement 8 to the Inquiry Report *Superannuation: Assessing Efficiency and Competitiveness*

Research recommendation 12: The Review should assess the main opportunities for policy change to reduce costs for super funds, and hence reduce fees, without impacting member outcomes.

6.9.2 International comparison of fees

International comparisons of Australia's retirement income system are important and the FSC refers to these comparisons elsewhere in this submission. However, for superannuation fees these international comparisons are quite problematic and should be treated with abundant caution.

Some issues with the international data are detailed below.

First, Australia has a number of inherent features that increase costs compared to other jurisdictions, but are largely or entirely outside the control of the industry, so they should not be attributed to the industry. The features include:[79]

- Australia has a larger share of defined contribution members. A defined contribution (**DC**) scheme is costlier to run than a defined benefit (**DB**) scheme as it involves individual transactions and member accounts, more member communication and often the provision of investment choice to members. These cost increases do not occur with DB schemes.
    - Employer sponsored DB schemes have traditionally received in-kind support from the employer which means that many expenses are not shown as costs to the pension scheme.
- Australia's super system allows choice of fund for most individuals, and portability of balances between funds. While this increases competition and choice, it also increases costs compared to countries that do not have this capability.
- Australia's system includes investor-directed products, particularly SMSFs, that have fee structures that may not be strictly comparable with other countries. Both the Productivity Commission and SMSF Association have noted the issues with measuring and evaluating costs for SMSFs.[80]
- The Australian system has complex taxation rules affecting contributions, investment income and some benefits. By contrast, in most other pension systems the taxation is paid by the individual when the benefits are received, so the pension scheme has no interaction with the country's tax system. The Australian arrangements have higher costs than other systems.
- The Australian system features the provision of death, TPD and disability insurance. Many other countries do not include insurance as part of their pension savings. While the insurance premiums in Australia are normally paid from members' accounts, the inclusion of insurance adds compliance and benefit design costs as well as broadening the questions that member helplines need to answer.

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[79] Much of this material is sourced from this article: https://www.professionalplanner.com.au/2019/11/the-truth-about-super-fees/

[80] Productivity Commission Final Report, section 3.6; and https://www.pc.gov.au/__data/assets/pdf_file/0014/230414/subdr194-superannuation-assessment.pdf

- The Australian system has significant value of retirement savings in legacy products which charge higher fees, and the existence of these high costs is largely a result of regulations outside the control of industry (see Section 9.3 below). It is not clear the extent to which this issue affects other jurisdictions.
- The Australian industry has a much higher allocation to equities, infrastructure and property than almost every other retirement income system in the world. These investments can have substantially higher ownership and transaction costs. These investments however can generate higher returns after fees, an essential point missed if the focus is solely on fees.

These issues mean comparisons of Australian fees with other countries are generally not comparing like with like.

Second, the OECD data may not cover the entire pension system of each country included.[81]

Third, the data is likely to be inconsistent in the cross-country treatment of indirect fees, which are the fees included in the net returns of underlying assets but not separately disclosed.[82] For Australia, this issue may be addressed with the implementation of RG97 which requires funds to report on all fees and costs on a look-through basis; but the approach in other countries is mixed.[83]

Fourth, the various Australian policy changes highlighted earlier in this section are having large impacts on fees, so backward looking comparisons of fees can mislead in relation to the current situation facing retirement savings systems.

Fifth, independent analysis has acknowledged the problems highlighted above with Australian and international fee data and comparisons of that data. In particular, the Productivity Commission argued the quality of Australian data is 'poor', which makes analysis of this data on fees 'heavily compromised'.[84] At the very least, this means the OECD data for Australia is of poor quality, but this quality issue may also exist with the data for other countries.

The Financial System Inquiry (**FSI**) also stated the following [emphasis added]:[85]

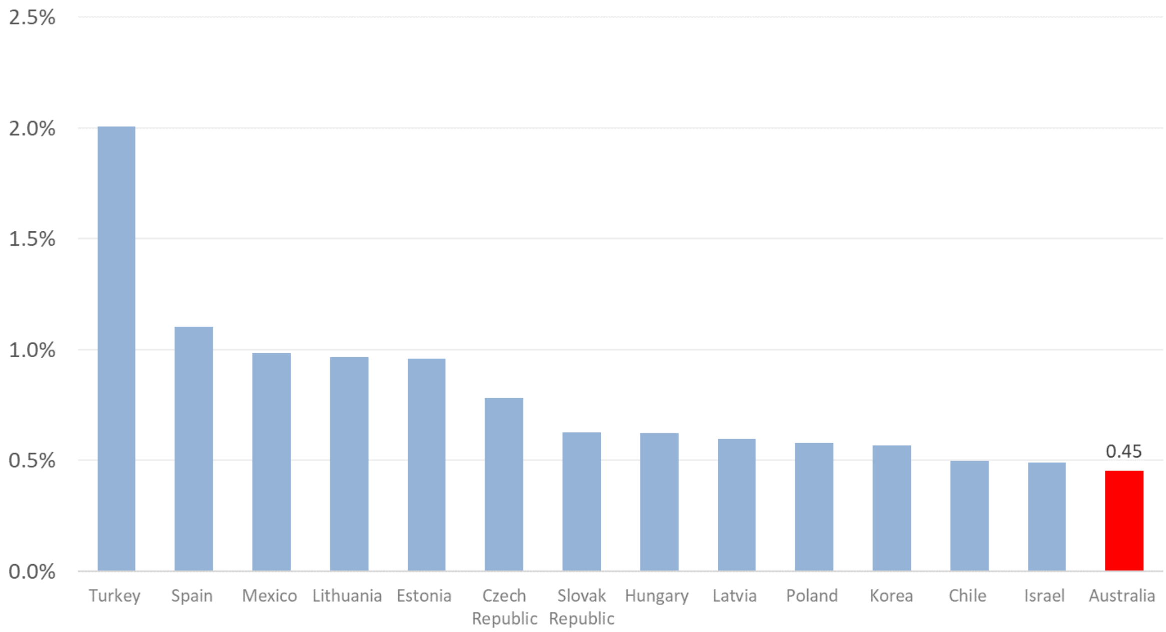
> Submissions challenge the observation that operating costs and fees appear high by international standards. They argue that the different features and structures of pension systems globally make comparisons difficult. A Deloitte Access Economics report, commissioned by the Financial Services Council, argues "… fees can be driven by a number of factors, and may not be directly comparable across jurisdictions". **The Inquiry accepts many of these arguments** and acknowledges

[81] See Productivity Commission Final Report, page 158.
[82] For example a superannuation fund could invest in another managed fund that includes in its net return various fees but does not disclose these fees separately.
[83] See OECD Pension Markets in focus 2019, footnote 13.
[84] Productivity Commission Final Report, page 182.
[85] See: http://fsi.gov.au/publications/final-report/chapter-2/improving-efficiency/

that some unique features of the Australian system contribute to elevated costs and therefore higher fees.

Acknowledging these important concerns, we nevertheless note that there are international comparisons that show Australia is performing well on superannuation fees. The 2019 OECD report Pension Markets in Focus indicates that Australia's superannuation funds have annual fees or commissions charged to members of about 0.5 per cent of assets under management, the lowest of the countries covered in the report, see Figure 9 from the OECD report below.

Figure 9 – Annual fees or commissions charged to members, 2018 or latest year available



Source: OECD Pensions Markets in Focus 2019, Figure 1.20.

In addition, Morningstar's regular international comparison of fees charged by fund managers has repeatedly found Australia's fees are very low. The latest report for 2019 found Australia's fees were equal lowest among the 26 included countries, a ranking that Australia maintained from the previous survey in 2017.[86]

Therefore, even if international comparisons are accepted, this does not mean Australia performs poorly as some have argued.[87]

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[86] Source: Morningstar Global Investor Experience Study for 2019. Australia was equal best with the US and Netherlands. All three countries attained equal first in the 2017 edition of the Morningstar Study.

[87] See for example the Productivity Commission's Final Report which argued "there is evidence (by asset class) that Australian investment management costs are generally high by international standards, including for significant asset classes (such as equities and international fixed income)." (Finding 3.1).

Finally, the comparison of fees is much less important than the comparisons of net returns, because net returns show the retirement outcomes being achieved by members, and fees should be assessed through the lens of their contribution to delivering better retirement outcomes. Therefore it is critical to highlight that Australia has world-class performance on net returns, as discussed in Section 6.10 below.

While there are many issues with international comparisons of fees, the comparisons of net returns remain valid because they reflect the actual retirement income outcomes received by individuals in the relevant country; and many of the points raised explain why Australia might have higher measured costs – these mean Australia's strong net return performance is *despite* the cost disadvantages we face.

Australia's excellent net return performance does not however mean that fees should be ignored – the superannuation system and policy makers should take actions, outlined earlier in this section, to reduce fees over time.

Research recommendation 13: To the extent the Review conducts international comparisons of fees and returns, the Review's focus should be on net returns, and the Review should acknowledge the numerous problems with international comparisons of fees.

6.9.3 Fees and net returns

As noted above, higher superannuation fees are less important than net returns, which are returns after fees. So fee reductions are only worthwhile if they don't compromise net returns.

The Productivity Commission has analysed the relationship between fees and returns, arguing that higher fees are associated with lower net returns,[88] implying that fee reductions have a clear link to better net returns. However, this relationship could be substantially (even overwhelmingly) driven by legacy products and advice commissions:

- Legacy products can have both high fees and lower net returns (see Section 9.3 below). This does not represent the relationship between fees and returns for products currently on sale.
    - This issue also emphases the importance of introducing a modernisation system to allow funds and customers to move into more modern products with lower fees and higher returns. See discussion in Section 9.4.4 below.
- Advice commissions are not charged on new products, and will legislatively end for legacy products on 1 January 2021, so the historical data including advice fees is not representative of what is or will be happening.

The Commission's approach, analysing the relationship between fees and net returns without excluding legacy products and advice commissions, generates an inaccurate view that does not represent the actual relationship for most on-sale superannuation products.

[88] Productivity Commission Final Report, Section 3.5.

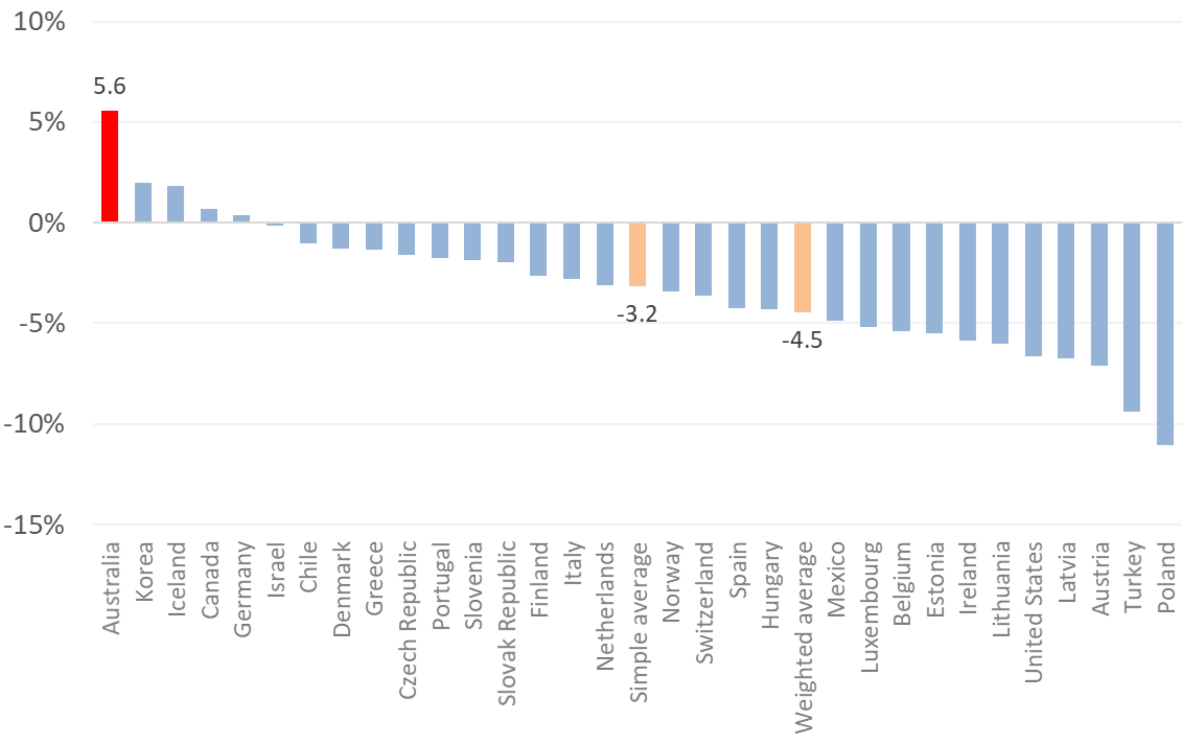
Research recommendation 14: to the extent the Review examines the relationship between fees and returns, this analysis should exclude legacy products and advice commissions.

6.10 International comparison of retirement income performance

The net returns of Australia's superannuation system are very good by international standards.

The average real return of Australia's superannuation system in 2018, net of investment expenses, was 5.6 per cent, which is the highest return of 31 funded and private pension systems included in the OECD report Pension Market in Focus. This is greatly above the OECD weighted average which was a negative return of 4.5 per cent.[89] This is shown in Figure 9 below.

Figure 9 – Annual real return, funded and private pension plans, 2018



Source: OECD Pension Markets in Focus 2019, Figure 1.13.Figures are net returns after investment expenses and inflation.

Australia's outperformance holds over a longer timeframe. The real annual return in Australia for five years to 2018 was 6.7 per cent, which is the highest of the measured OECD countries and well above the average of 2.5 per cent. This is shown in Figure 10 below.

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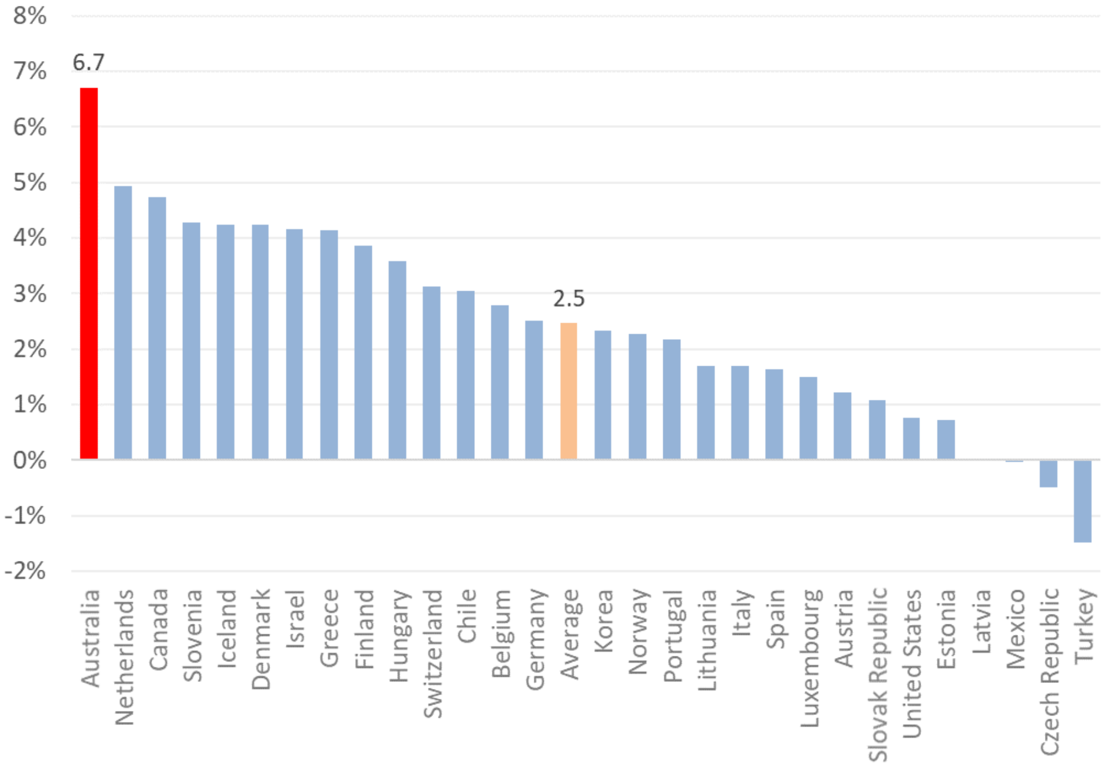
[89] OECD (2019) Pension Market in Focus 2019, Figure 1.13.

This is despite the retirement income systems in many other countries having factors that should promote better returns, for example many other countries have a higher proportion of defined benefit plans that can invest for the longer term and have lower cash needs (see Section 6.9.2 above).

Figure 10 – Annualised real returns, funded and private pension plans, 5 years to 2018

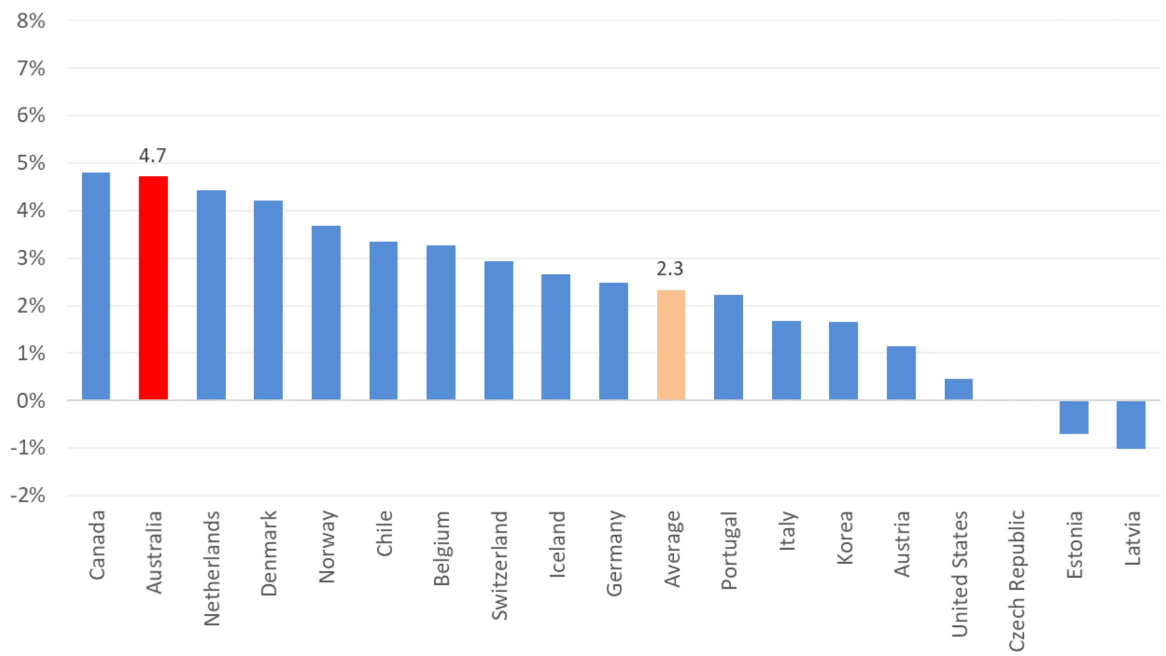


Source: OECD Pension Markets in Focus 2019, Table 1.1. Notes: figures are net returns after investment expenses and inflation. Average is simple (unweighted) average.

The real annual return for Australia over the 10 years to 2018 was 4.4 per cent, well above the average for the included OECD countries of 3.0 per cent; and Australia's real return over 15 years to 2018 was 4.7 per cent, again well above the average for measured OECD countries of 2.3 per cent.[90] The graph of 15 year returns is below.

[90] OECD (2019) Pension Markets in Focus, 2019 Table 1.1.

Figure 11 – Annualised real returns, funded and private pension plans, 15 years to 2018



Source: OECD Pension Markets in Focus 2019, Table 1.1. Notes: Figures are net returns after investment expenses and inflation. Average is simple (unweighted) average. The data coverage is substantially lower than for 5 year returns.

The performance results shown in this section support the case that Australia's superannuation system performs well by developed world standards. This is confirmed by broader analysis in the Melbourne-Mercer Global Pension Index – the most recent version of that index (2019) shows Australia had the third best retirement income system out of the 37 countries included in the index.[91]

This does not mean that there is no room for improvement in Australia. There are many areas where the performance of the system could be further improved such as the default system, a tail of underperformance, red tape, and the continuing burden of legacy products, all discussed elsewhere in this Submission.

It is also important to note that historical investment performance is not a guarantee of future performance, as experts and regulators constantly remind us, and there is a substantial risk that returns in Australia and other developed countries will weaken in coming years. This issue is explored in more detail in Section 6.3 above.

6.11 Insurance in super

Around 12 million Australians hold Life insurance through superannuation.[92] In June 2019, 57 per cent of superannuation accounts had life insurance (for death cover), while 50 per

[91] see https://www.mercer.com.au/our-thinking/mmgpi.html
[92] See Productivity Commission Final Report, page 369.

cent had Total and Permanent Disability (**TPD**) insurance and 22 per cent had income protection (**IP**) insurance.[93]

These insurance products play a critical role in providing Australian households with financial security in the event of unexpected death, disease or disability. In these circumstances having insurance means that Australians have an additional safety net on top of existing government assistance schemes, such as the National Disability Insurance Scheme (**NDIS**) or Disability Support Pension (**DSP**).

The broad coverage of insurance for Australians is due to the superannuation system where most[94] working Australians are automatically provided insurance, unless they elect otherwise.

Under this opt-out model, all members have automatic access to a default level of insurance cover, as determined by their superannuation fund, without the need to undergo individual underwriting or a medical examination. This is of particular benefit for individuals considered 'high-risk' who may be unable to access life insurance on an individually underwritten basis.

The greater economies of scale afforded under an opt-out model means there are lower administrative costs on a per member basis, allowing superannuation trustees to provide insurance at a lower cost for their members than other distribution channels.[95]

In addition to the lower costs associated with group cover, superannuation trustees have a fiduciary duty to consider the cost of insurance for members. Trustees are subject to a covenant under the Superannuation Industry (Supervision) Act 1993 (**SIS Act**), which require them to "only offer or acquire insurance of a particular kind, or at a particular level, if the cost of the insurance does not inappropriately erode the retirement income of beneficiaries".[96]

6.11.1 Budget implications of insurance in super

The Productivity Commission examined the Budget impact of IP insurance and TPD insurance provided inside super in 2018. [97] The modelling covered the impact on all Government Budgets – Commonwealth, State and Territory – and only covered IP and TPD insurance. Life insurance cover was excluded, because of complexities in modelling.

The main benefits to Government budgets from insurance are from taxes on premiums and claims payouts, as well as reduced government spending as a result of people making

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[93] APRA Annual Superannuation Bulletin, Table 14a.
[94] Until recently, this default insurance cover was provided on all superannuation accounts, but recent legislative changes has meant default cover, in general, is or will be provided to people aged over 25 with an active superannuation account (ie the account is receiving contributions) and a balance above $6,000.
[95] The payout ratios on insurance inside super are much higher than the payout ratios for insurance outside super, particularly for life and TPD insurance – see Productivity Commission Final Report, Figure 8.6
[96] Section 52(7)(C) of the Superannuation Industry (Supervision) Act 1993
[97] PC Supplementary paper (2018) Fiscal Impacts of Insurance in Super, Technical Supplement 9 to the Inquiry Report Superannuation: Assessing Efficiency and Competitiveness.

insurance claims. The main costs to governments relate to tax deductions on insurance premiums and the reduction in super balances causing increases in Age Pension spending and reduced tax revenue from super fund earnings

The overall results indicated that in most cases TPD and IP had a neutral or positive impact on Budgets. The main case where there was substantial subsidy from Governments for TPD and IP were for low income earners – indicating Government assistance is making insurance cheaper, or payouts larger, for these individuals. This is a fairly common approach, with the Government providing subsidies to low income earners for many goods and services.

In more detail:

- IP insurance provides substantial savings to the Government for middle- and higher-income couples and individuals.
- TPD insurance has a small impact (positive or negative) on Government Budgets for middle- and higher-income couples and individuals, but provides a reasonably large benefit to Government for higher income singles.
- The net tax concession for IP and TPD insurance is progressive, with a larger concession provided to low income earners and a smaller concession to middle- and higher- income earner.

The results show insurance in super generally has a positive impact on Government Budgets,[98] as they demonstrate:

- Restricting IP insurance for middle- and higher-income people, and TPD for higher income singles, could easily cost the Government money in the long term.
- Any short term budget benefit from restrictions on insurance for middle- and higher-income earners is likely to disappear in the long term.
- Restricting IP or TPD for low income earners would provide a long-term benefit to the Government budget, but it will also make low income earners worse off as they would lose the existing Government subsidy.

Note this modelling arguably understates the benefits of insurance in super:

- The modelling appears to exclude taxes paid by insurers, including corporate tax and GST on the insurance margin.
- The modelling does not include the benefit of IP and TPD insurance to individuals which is substantial for those who make a claim.

Research recommendation 15: The Review should assess the modelling by the Productivity Commission of the Budget impact of life insurance inside superannuation, and if possible extend this modelling to include death cover and the benefits of life insurance products to individuals.

[98] The Productivity Commission's summary of these results implied insurance in super has adverse impacts on Budgets, but the summary is not reflective of the actual underlying results.

7 Equity

7.1 Equity of the system as a whole

There are numerous policies that increase the equity of the retirement income system as a whole. The most important equity measure is the means tested Age Pension, which is the primary way that equity is introduced into retirement incomes.

As shown in the international comparisons in Section 6.2 above, Australia is almost unique in the developed world in terms of the strong means test it applies to Government-funded pensions. The OECD data in Figure 3 shows that Australia is only one of two countries (besides Chile) that provides no government income payment at retirement for average income earners. By contrast, Australia provides substantially higher levels of Government payments for individuals whose pre-retirement income is half of the average. This is summarised in the table below.

Table 3 – Government retirement income payments – Australia vs OECD

Pre-retirement Income	Australia's retirement system	OECD average
Average incomes	No Government income payments	Substantial Government income payments
Half of average	Government income payments	Government income payments, but on average below Australia

Source: see Section 6.2 above.

In addition to the Age Pension, there are many policies that address equity in the retirement income system, including:

- The various caps on contributions;
- The Transfer Balance Cap (TBC) or $1.6m cap;
- Division 293 tax on contributions for high income earners; and
- The Low Income Superannuation Tax Offset (**LISTO**) which reduces or removes the tax on contributions for low income earners.

The impact of these policies in total is to make the retirement income system notably equitable by OECD standards.

There are superannuation accounts and SMSFs with high balances but they are held by a minority[99] who built up balances under old contribution rules that have now been substantially tightened – in particular the superannuation accounts with balances above $5 million will disappear over time and are unlikely to reoccur given the contribution caps

[99] The ATO's Self Managed Superannuation Fund annual report for 2016–17 shows 3.4% of SMSFs had assets above $5m, and these SMSFs held 24.6% of all SMSF assets. See: https://www.ato.gov.au/uploadedFiles/Content/SPR/Images/SMSF_Statistical_overview/2016-17/SMSF_Statistical_Overview_2016_17.xlsx

now in place. Hence any analysis based on the current stock of high balance superannuation accounts is misleading.

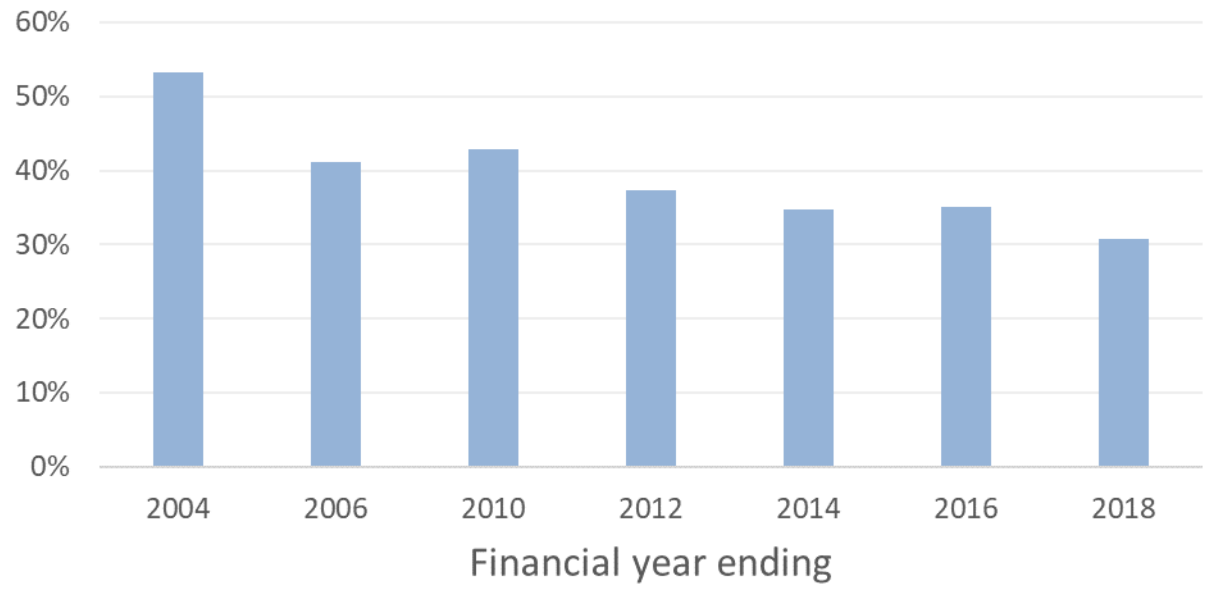
The Panel may wish to consider whether there is any evidence that additional policy intervention is required to speed this process of high balances exiting the system.

The equity of the tax concessions for superannuation are discussed in more detail in Section 7.3 below.

7.2 Gender issues in superannuation

It is well known that women have lower superannuation balances than men, as shown in the data on the gap in median balances in Figure 12 below (the median is a better measure than the average as it is unaffected by very large balances). The gap is shrinking over time but still remains substantial.

Figure 12 – Gender gap in median super balances



Source: ABS Household income and Wealth, 2017–18, Table 12.3. The gender gap is how much median female super balances fall below male median super balances.

Treasury is forecasting this gap to continue its decline over time, but only slowly. Treasury states that in 2020, the average balance at retirement for women is expected to be around 30 per cent less than men. By 2040, this gap is projected to reduce to around 15 per cent, and by 2060 to around 10 per cent. Treasury links this change to a reduced gap in female employment.[100]

[100] See: https://research.treasury.gov.au/treasurys-two-cents/superannuation-balances-retirement

Treasury's comment on the driver of the shrinking gender gap is consistent with the gap being significantly affected by two issues outside the purview of the superannuation system: the gender pay gap, and second, the gender gap in hours worked.

That said, there are many ways the superannuation system can boost retirement incomes for women, and reduce the gender gap in superannuation balances.

Superannuation balances for women are likely to be boosted by the policies to increase compliance with the SG, as discussed in Section 6.6.3 above, particularly because the underpayment of SG disproportionately affects low income workers, which are more likely to be women. Other policies recently introduced are likely to boost women's super balances, including the expansion of eligibility for personal deductible contributions, the expansion of the spouse tax offset, the Low Income Super Tax Offset (**LISTO**), and changes to concessional catch up contributions.

Retirement savings for women should also be boosted by a number of other policy changes including:

- An increase in the SG to 12 per cent. Women are likely to live longer and so have greater retirement savings needs, which will be addressed by boosting the level of the SG. This is discussed further in Section 6.5 above.
- The removal of the $450 per month low income threshold for the SG – see Section 6.6.1 above.
- The payment of SG on parental leave – see Section 6.6.2 above.
- Changes to the superannuation preservation age – see Section 6.4 above.
- Reforms to the default system to prevent the creation of new multiple accounts – see Section 5.1 above.
- Removing restrictions on rollover within a couple, or allowing joint superannuation accounts – see Section 7.2.1 below.
- Making it easy for employers to make higher superannuation contributions to female staff to address any gender gap in retirement savings, including through nationally consistent anti-discrimination legislation.
    - Most state and federal anti-discrimination law contains special measures to allow employers to redress past imbalances where the measures will not constitute unlawful discrimination. Employers can regard this as insufficient clarity in order to proceed with measures such as higher superannuation contributions for female employees.
    - Aligning national anti-discrimination laws will provide clear guidelines and direction for employers who wish to increase superannuation balances for women by 'topping up' contributions.

Research recommendation 16: The Review should examine the impact of recent and potential policy changes on the retirement savings for women.

7.2.1 Reducing the gender gap in superannuation balances

The gender gap in superannuation savings could be reduced by making it easier for rollovers to occur between each of a couple's super accounts or allowing couples to hold a joint superannuation account.

The SMSF Association has provided substantial details around the proposal to facilitate easier rollover for couples in their 2020–21 Budget submission.,[101]

A more substantial change would be to permit joint superannuation accounts, which would involve the consolidation of a couple's separate super accounts and balances into one account. This approach, raised in a Rice Warner paper in 2014:[102]

- Would automatically remove gender difference in superannuation balances for those couples that elect into the system.
- Could substantially simplify arrangements for couples, for example regular spouse contributions would no longer be necessary, and if one partner dies the joint account could just become a single account with no rollover required. It may also address issues relating to the rollover of death benefits.
- Could result in a noticeable reduction in the number of superannuation accounts, and hence the total cost of the superannuation system.

We note that if this policy is introduced, some issues would need to be addressed including:

- How the joint account would be treated for couples that divorce/separate.
- Whether the proposal could be introduced in a way that doesn't substantially increase complexity of the system.
- How to limit the fiscal cost of the proposal.

Research recommendation 17: The Review should consider the costs and benefits of permitting easier rollover of superannuation balances between members of a couple, and allowing couples to have one joint superannuation account. This would consider the impact of these policies on gender equity, retirement income adequacy, complexity and fiscal sustainability of the system, and how separation of couples would be addressed.

7.3 Equity of tax concessions for superannuation

Saving inside superannuation often receives a tax preference over some other types of saving such as bank accounts, with savings in the family home often more concessionally taxed than superannuation.

In most cases, the tax treatment of superannuation in Australia involves a 15 per cent tax on superannuation contributions made from pre-tax income and a 15 per cent tax on earnings before retirement. Superannuation earnings are generally tax free for fund balances in the retirement phase and most withdrawals from super are tax free. In some cases, the

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[101] See: https://www.smsfassociation.com/call-to-phase-out-limited-licensing-and-set-up-new-advice-system/
[102] See: https://ricewarner.com/wp-content/uploads/2015/10/Joint-Superannuation-Accounts_April-2014.pdf

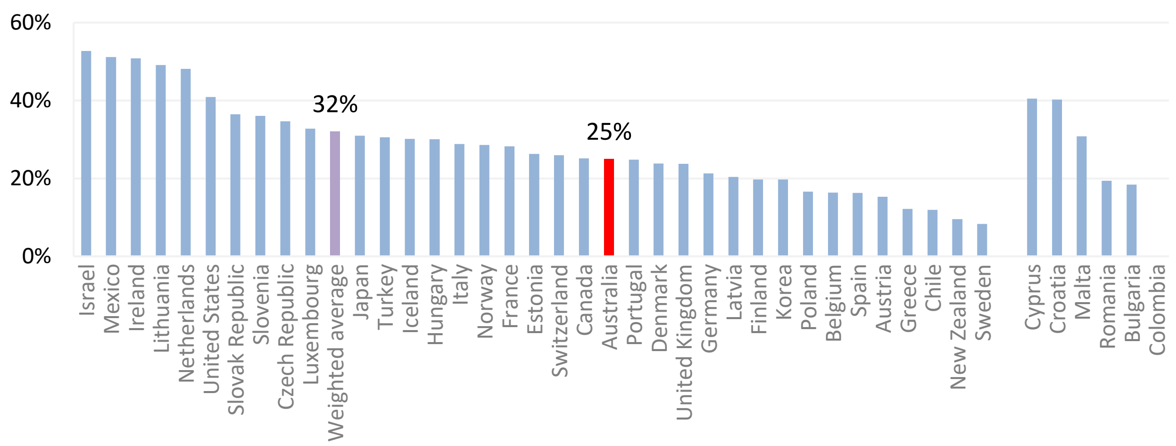
government provides additional tax support to superannuation savings (particularly for low income earners).

The proposition that superannuation is tax preferred is driven by comparisons with the current tax treatment of bank accounts, implicitly assuming bank accounts have the 'correct' or 'ideal' tax treatment. This however is incorrect, as there are good reasons for returns on savings (including interest and dividends) to be concessionally taxed or exempt from tax; and if tax is imposed it should only be imposed on the real returns (ie after inflation). This case is explained in detail in Section 8.2 below.

Consequentially, bank accounts are significantly overtaxed in most cases; and the use of other savings vehicles, including superannuation and housing, allows the average tax rate on all types of saving to be lower, and the 'overtaxation' of saving overall to be reduced.

The tax treatment of superannuation in Australia is also not particularly generous compared to the rest of the developed world. The Australian tax advantages to private retirement savings are compared to other OECD countries in Figure 13 below. Australia is substantially below the OECD average, and is in the lower third of the OECD countries covered. The tax benefit is measured as a proportion of contributions, see Box 2 for discussion.

Figure 13 – Tax advantage provided to average earner investing in pension fund



Source: OECD Pensions Outlook 2018, Figure 2.2. The figure is the present value of taxes saved over a lifetime as a percentage of the present value of contributions. More details of calculations are in OECD (2018) *Financial Incentives and Retirement Savings*. Weighted average is calculated by FSC based on IMF World Economic Outlook figures for GDP at Purchasing Power Parity as at 2018 and relates to the OECD countries only. The unweighted average is 28 per cent.

Compared to other developed countries, Australia has an uncommon tax treatment of private pension plans – we tax contributions and earnings, while many other countries do not tax contributions or earnings, and only impose tax on the withdrawal of benefits.[103] This bring

[103] The Henry Tax review stated "Most countries' retirement income systems use an expenditure tax benchmark" (Final Report, page 97). Also see example table 2.1 of OECD (2018) *Financial Incentives and Retirement Savings*.

forward of tax in Australia would be one reason why our superannuation system provides a lower tax advantage in present value terms.

Box 2 – the OECD's approach to measuring tax concessions for retirement incomes

The OECD approach in Figure 13 to Figure 15 measures each country's tax incentive for retirement savings as a proportion of contributions. Australia's 25 per cent figure means the total value of Australia's superannuation tax concessions is equal to 25% of the value of contributions (both in Net Present Value terms). This is a much better measure of relative generosity than measuring the dollar value of concessions – an issue discussed in more detail in Section 8.2.5 below.

Note even this OECD comparison has issues. The OECD compares the tax treatment of retirement savings products with highly taxed products such as bank accounts.[104] This is problematic because it implicitly assumes that if retirement savings weren't available, then people would save the same amount in another form that is highly taxed – in fact it is more likely that individuals would save in other tax advantaged savings vehicles. This issue is discussed in Section 8.2.3 below.

According to this OECD analysis, the Australian superannuation tax system provides similar tax benefits to low, middle and higher income earners measured as a proportion of contributions. Figure 14 below shows the tax incentive for low income earners compared to the incentive for average income earners – in Australia the incentive is almost exactly the same at low and middle income levels (this is shown in the graph by the green bar being at 100%). By comparison, on average OECD countries provide a smaller tax incentive for low income earners (the red bar is below 100%).

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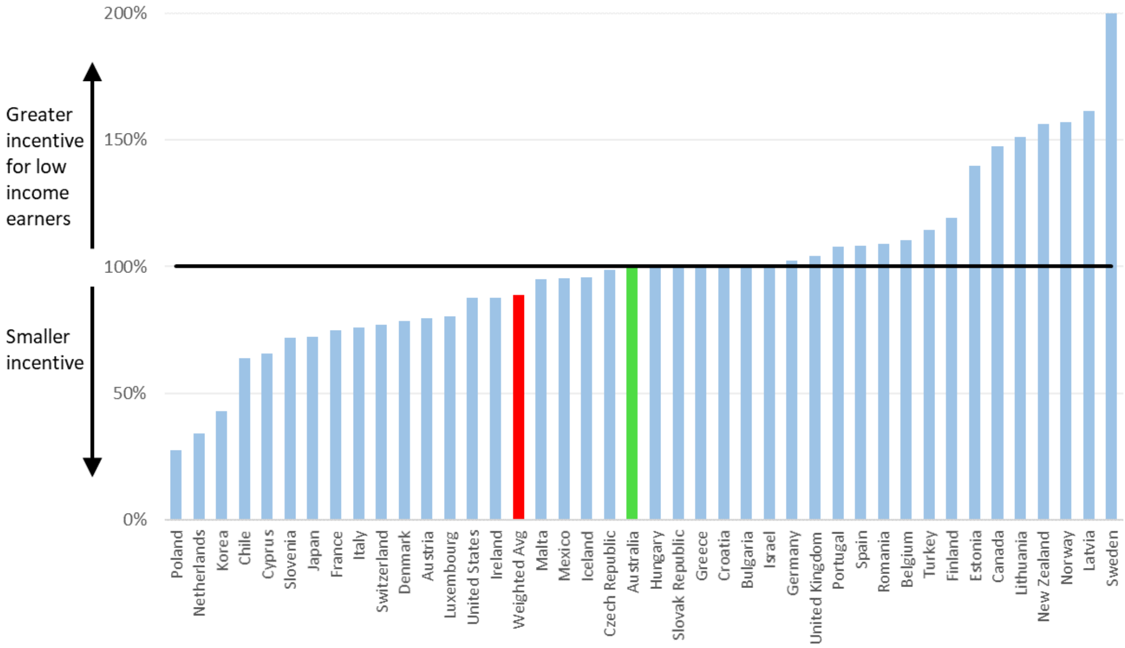
[104] See Pages 44–5 and 56 of OECD Pensions Outlook 2018

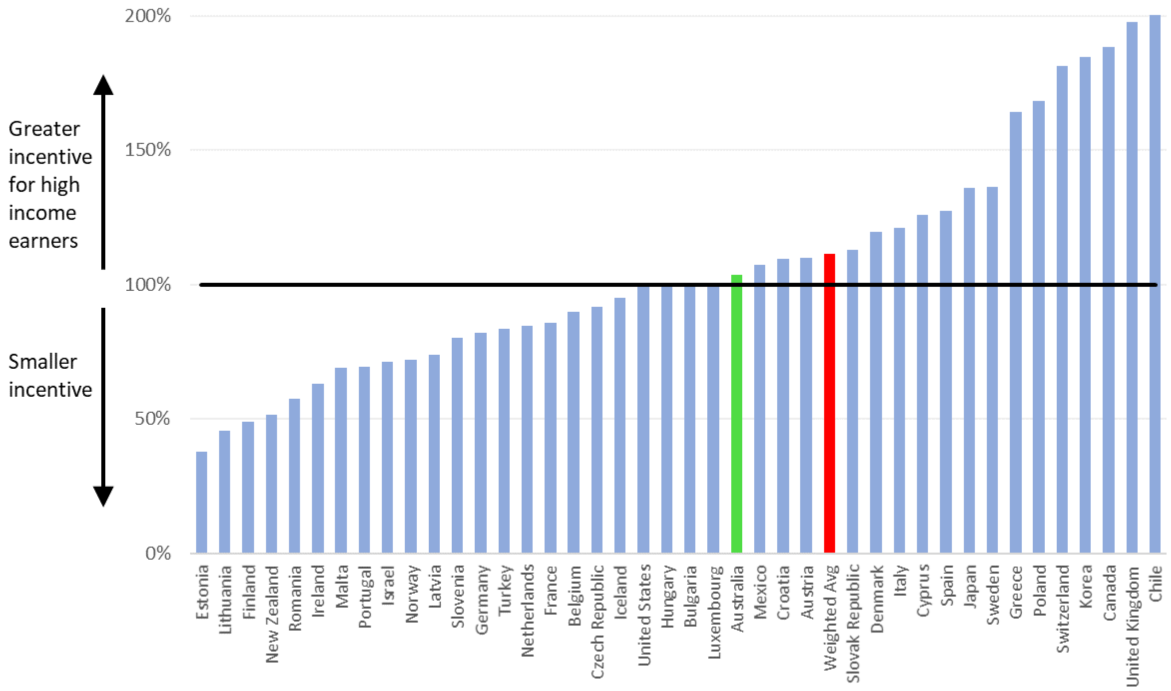
Figure 14 – Pension tax concessions for low income earners compared to average



Source: OECD Pensions Outlook 2018, Figure 2.4. See Figure 13 for further detail.

The similar comparison for the tax concession for average and high income earners is shown in Figure 15 below. While Australia provides almost exactly the same incentive for middle and high income earners (the green bar is at about 100%), on average other OECD countries provide a greater tax incentive for high income earners (the red bar is above 100%).

Figure 15 – Pension tax concessions for higher income earners compared to average



Source: OECD Pensions Outlook 2018, Figure 2.4. See Figure 13 for further detail. High income is defined as four times average income.

As noted in Section 7.1 above, the small stock of accounts with very high balances are a legacy issue that will disappear over time as the balances leave the system, so any analysis based on the current stock of high balance superannuation accounts is misleading.

Given the analysis above, we consider there is a strong case for concluding that the tax system for superannuation is equitable and does not provide unfair benefits to higher income earners. This is in contrast with some interpretations of Figure 4 in the Review's discussion paper, which has been interpreted as showing that the superannuation tax concessions are skewed towards high income earners. This is discussed in more detail in Section 8.2.5 below.

8 Sustainability

Superannuation is often viewed as a vehicle that is tax preferred and offsets the cost of the Age Pension. These are two important parts of the fiscal impact of superannuation (ie the impact of super on the Budget), and are discussed in detail in this submission. In broad terms:

- the tax concessions for superannuation come at a cost to the Budget – though these costs are greatly overestimated, as discussed in Section 8.2 below.
- Superannuation causes a substantial reduction in Government spending on the Age Pension, due to the operation of the pension means tests, as discussed in Section 8.4 below.

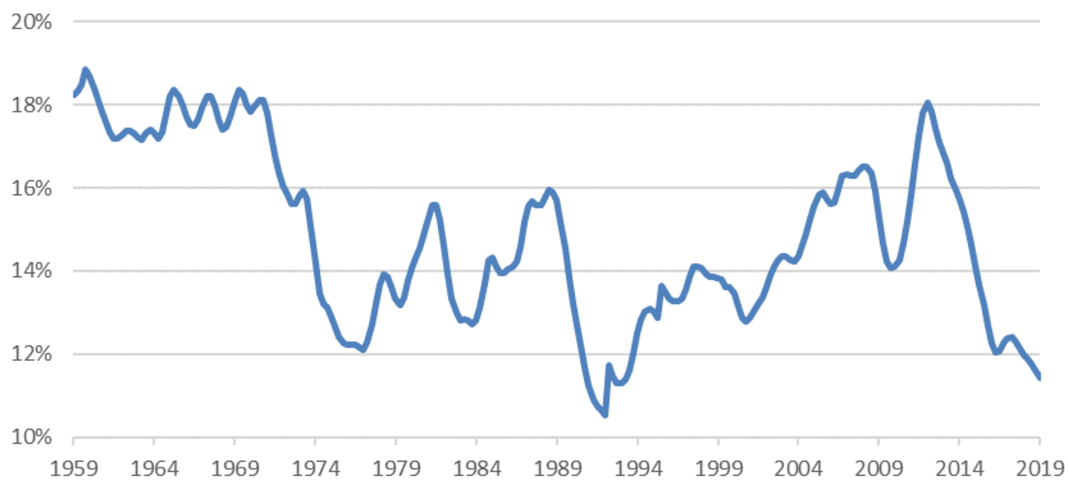
8.1 Superannuation, national savings and the Budget

The impact of superannuation on national savings and therefore the Government Budget is also relevant to the Review. Treasury has estimated the addition to national savings from super to be just under 0.7% of GDP when the system is fully mature.[105] This additional savings has several beneficial impacts on the economy and the Budget.

Higher national savings provides more capital for infrastructure – both private financing of new infrastructure, and the purchase of existing infrastructure, with Governments using the sale proceeds to finance new infrastructure (known as 'asset recycling'). If the domestic capital was not available, Governments would need to step in to fill the infrastructure financing gap.

Increased national savings also reduces Australia's call on global capital markets, lowering the domestic price of capital and meaning businesses are able to expand at lower cost. This is particularly important in the current environment, with local private investment levels at historical lows as shown in Figure 16 below. The poor levels of investment are likely to have adverse impacts on Australia's economic growth[106] which would feed into poorer Budget results.

Figure 16 – Business investment at % of GDP



Source: ABS National Accounts, Table 24. Figures are trend current price.

Higher domestic savings make Australia less vulnerable to shocks in global capital markets, particularly major events such as the Global Financial Crisis (**GFC**). During the GFC, the Government provided a bank guarantee to ensure Australian banks were able to borrow

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[105] See Figure 3 of David Gruen and Leigh Soding (2012) Compulsory superannuation and national saving, available from: https://treasury.gov.au/publication/economic-roundup-issue-3-2011/economic-roundup-issue-3-2011/compulsory-superannuation-and-national-saving

[106] "[I]nvestment, widely construed to include education and facilitating infrastructure, can be inextricably linked to productivity growth. Low investment can be the death knell for MFP [productivity] growth." Source: Productivity Commission (2017) Productivity and Income — The Australian Story, Shifting the Dial: 5 year Productivity Review, Supporting Paper No. 1.

from overseas capital markets at reasonable prices. The Australian superannuation system provided some necessary capital during the GFC; but with a deeper Australian capital market (including from a larger superannuation system) it is arguable that the need for Government intervention would have been substantially smaller.

There are forecasts that Australia is going to run ongoing current account surpluses, particularly caused by our superannuation system.[107] If this eventuates, over time Australia's net foreign debt position will be eliminated and Australia will become much more resilient to financial market shocks.

Research recommendation 18: The Review should examine how the Australian superannuation system has increased national savings and has as a result provided benefits, direct or indirect, to the Government Budget, supporting the objective of sustainability.

8.2 Measuring the tax expenditure for super

The standard approach to measurement of the tax concession (or tax expenditure) for superannuation is highly problematic and means the tax expenditure is probably greatly overestimated. The standard approach compares the taxation of super against the income tax benchmark, with no adjustment for inflation or behavioural change; and often the offsetting benefits to the Budget from superannuation are neglected. These issues are discussed below.

8.2.1 Benchmark for tax expenditures – income vs expenditure

The calculated tax expenditure for superannuation usually compares super against an income benchmark.[108] This implicitly imposes a value judgement that this benchmark is the correct, or ideal, way to impose tax. It may be argued that the comparison is not imposing a value judgement, but the comparison is often interpreted as providing this judgement.

This issue particularly affects the taxation of savings and investment. The supposed tax 'concessions' for many types of saving no longer exist if the taxation of saving is compared to the alternative benchmark of expenditure taxation. In fact, most savings outside of superannuation would have a *punitive* tax treatment compared to this alternate benchmark.

The main reason to use a benchmark of expenditure taxation is that it would be consistent with a well-known result in economics that the returns to savings should not be taxed. Various prominent papers and reviews have stated:

- Gregory Mankiw, Professor at Harvard University: "Perhaps the most prominent result from dynamic models of optimal taxation is that the taxation of capital income

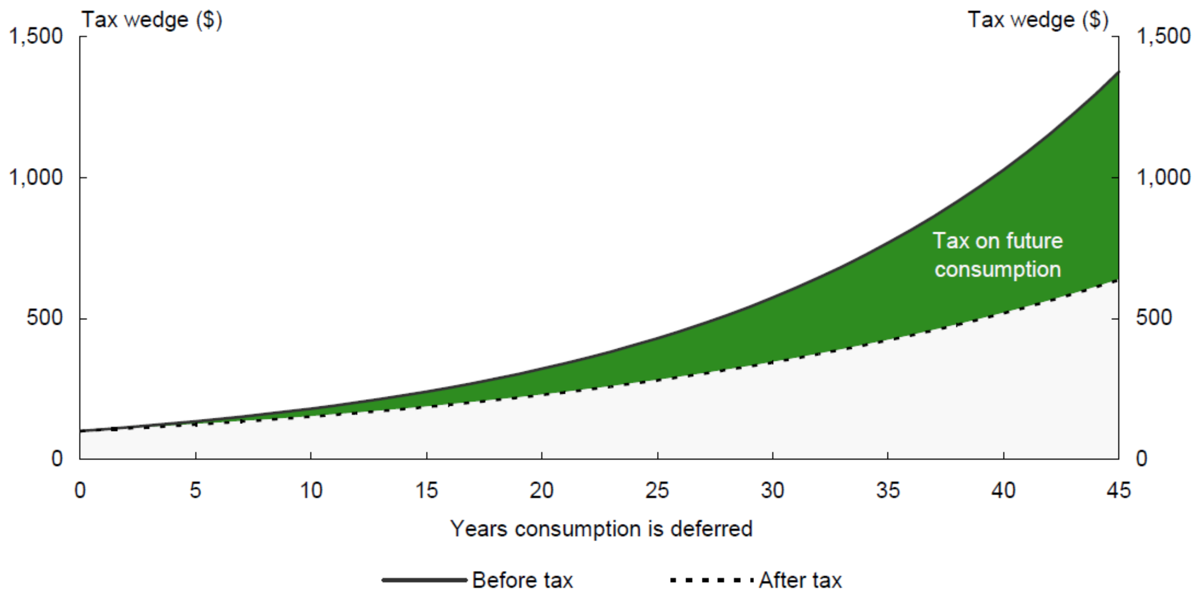
[107] See: https://www.afr.com/policy/economy/australia-headed-for-super-surplus-exante-20190715-p527f4
[108] This is the approach generally taken in the annual Tax Expenditure Statement, now known as the Tax Benchmarks and Variations Statement.

ought to be avoided. This result['s] strong underlying logic has made it the benchmark."[109]

- The Henry Tax Review: "the main forms of lifetime savings for most Australians, superannuation and owner-occupied housing, should continue to be taxed at a lower rate or exempt from income tax — consistent with an expenditure tax benchmark that exempts the returns to saving… Comprehensive income taxation, under which all savings income is taxed in the same way as labour income, is not an appropriate policy goal or benchmark."[110]
- The Mirrlees Review: "By taxing the normal return to savings, we are not taxing the better-off; we are taxing those who spend their money tomorrow rather than today. That seems both unfair and inefficient" (p 293) and "A standard income tax treatment of savings achieves neutrality neither over time nor across assets." (p 295). The Review also stated an expenditure tax is neutral in its tax treatment (p 297).[111]

The Henry Tax Review illustrated this by showing a positive tax on savings (or capital) is equivalent to an ever-increasing tax rate, as shown in the graph below from the Final Report. This shows a 30 per cent tax on the returns to saving has an increasing impact (see green wedge) the longer an asset is held.

Chart A1–6: Tax wedge on future consumption



Source: Henry Tax Review Final Report

It is hard to see how a personal consumption tax at an ever-increasing rate should be an appropriate policy goal, yet this is equivalent to an income tax benchmark.

[109] See N Gregory Mankiw, Matthew Weinzierl & Danny Yagan (2009) "Optimal taxation in theory and practice", *Journal of Economic Perspectives* 23(4), pp147–174.
[110] Henry et al (2009) Australia's Future Tax System Final Report, page 12.
[111] Mirrlees et al (2011) Taxation by design, see: https://www.ifs.org.uk/publications/5353

Despite this, the measurement of the superannuation tax concession implicitly rejects the expenditure benchmark and promotes the income benchmark.

And in practice, most countries impose lower taxes on saving. In particular, most OECD and EU countries impose an expenditure-style tax on retirement savings.[112]

Comparing the superannuation tax expenditure against an expenditure benchmark would substantially reduce the measured size of the tax concession for super.

8.2.2 Inflation in the benchmark

The current income tax benchmark used for measuring tax expenditures is based on a nominal base with no inflation adjustment. The 2019 Tax Expenditure Statement (**TES**) states: "The income tax benchmark incorporates a range of features of the tax system, including the following:…Assessment applies to nominal rather than real income."[113]

As a result, the measurement of tax expenditures incorrectly deals with inflation. It treats as income any compensation for the erosion of the value of money, even though this compensation is not genuine income. For example, an asset growing by 2% per year, with no other income, when inflation is also 2%, is not producing any real ('genuine') capital gains for the owner at all. Taxing the 2% capital appreciation would make the asset owner go backwards in real (after inflation) terms.

The Henry Tax Review expressed concerns with the current approach, finding that "Inflation exacerbates the biases in the current income tax treatment of savings, leading to an increase in the effective tax rate on the nominal return to savings." (Final Report, page 66). Similar concerns were expressed by the Mirrlees Review.[114]

This may not appear to be an important issue in an era of low inflation. But it makes a substantial difference when real rates of return are low, as they currently are for deposits, bonds and other interest-bearing securities. In fact, the issue could be worse when interest rates are <u>below</u> inflation, which is a prevalent situation at the moment.

The current tax expenditure benchmark means if CGT indexation were reintroduced, this would be measured as a tax expenditure. This is clearly not the right result. Notably, when CGT indexation was part of the tax system in 1996, the benchmark at the time did not count this as a tax expenditure;[115] but using today's benchmark, CGT indexation *would* be counted as an expenditure. There are no clear reasons for this change in benchmark.

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[112] See page 3 of OECD (2015) Stocktaking of the tax treatment of funded private pension plans in OECD and EU countries, available from: http://www.oecd.org/daf/fin/private-pensions/Stocktaking-Tax-Treatment-Pensions-OECD-EU.pdf
[113] Australian Government (2020) Tax Benchmarks and Variations Statement 2019, p157.
[114] Mirrlees et al (2011) Taxation by Design, Chapter 13.
[115] Australian Government (1997) Tax Expenditures Statement 1996–97, p60. See also the 1998 TES, p61.

Correctly including inflation in an income tax benchmark would reduce the measured size of the tax concession for super. Note this issue is not relevant if the benchmark is an expenditure tax (see previous subsection) as it does not impose tax on nominal returns.

8.2.3 Behavioural changes in the benchmark

The tax expenditure benchmark also has unrealistic behavioural change assumptions. In general, it is assumed that if contributions did not go to super, they would instead be saved in a bank account. This is a highly unrealistic assumption. If a voluntary super contribution had not been made, many high income earners would not pay the tax rate on bank accounts on their investment income; instead they would invest through a family trust, a low income partner or some other vehicle. Hence the "cost" to Government has been overestimated considerably.

Therefore, correctly including behavioural change in the benchmark would reduce the measured size of the tax concession for super.

8.2.4 Whole of budget impact of superannuation

The tax concession for super also looks at one side of the Budget in isolation and omits the impact of superannuation on Government spending, particularly the Age Pension. Clearly superannuation does reduce Budget spending to pay for retirement incomes, as discussed further in Section 6.5.3 above, and focussing on the tax expenditure alone ignores this impact.

There are piecemeal approaches to do this analysis, but the FSC considers this should be done more systematically, including through the annual Tax Expenditure Statement. The Review's discussion paper does cover the interaction between the super tax concession and the Age Pension in Figure 4 of the consultation paper, but the FSC has concerns with this approach discussed in Section 8.2.5 below.

The Government accepted the recommendation of the Parliamentary Inquiry into the TES that there should be a regular publication of long-run interactions between superannuation and the Age Pension.[116] The Government proposed the whole-of-budget analysis be conducted 'broadly' every five years and the FSC considers the Government should implement this commitment.

More broadly, the FSC considers there should be longer-term estimates of tax expenditures, particularly for those tax expenditures where the short-term impact is substantially different from the long-term impact.[117]

Research recommendation 19: The Review should measure the tax expenditure for superannuation against an expenditure benchmark, factoring in behavioural changes and

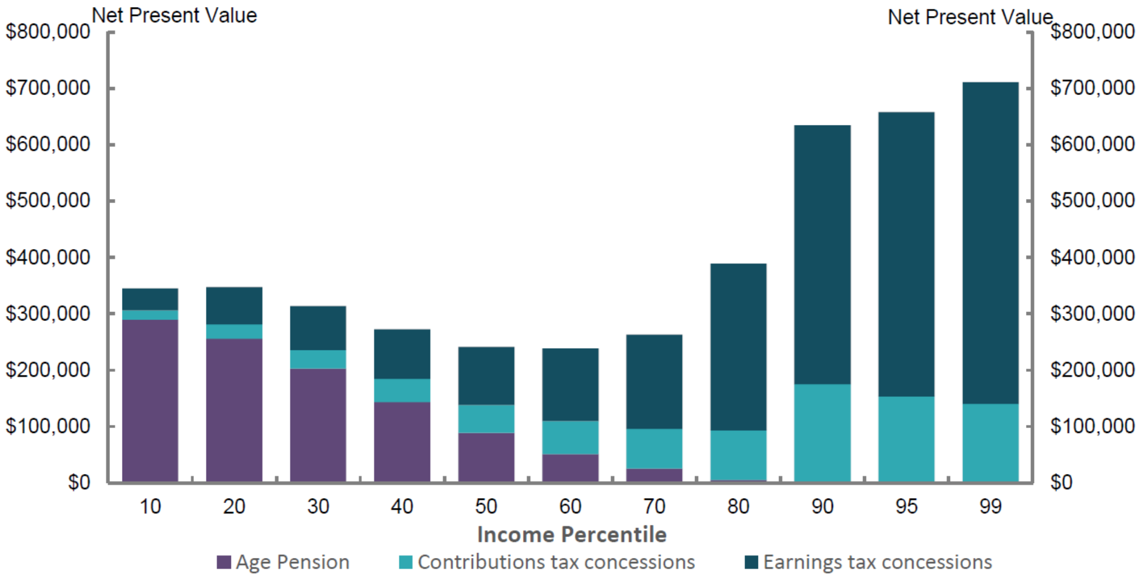
[116] Page 3 of Government Response to House of Representatives Committee on Tax and Revenue Review of the Tax Expenditure Statement, 2015.
[117] This is discussed in more detail in Parliamentary Budget Office (2015) Submission to the Standing Committee on Tax and Revenue inquiry into the Tax Expenditures Statement, 17 September.

the offset against the Age Pension. If the benchmark includes any part of an income tax benchmark, then this benchmark should be adjusted for inflation.

8.2.5 Consultation paper estimate of lifetime support

There are a number of issues with the approach to the superannuation tax concession included in Figure 4 of the Review's Consultation Paper, which is included below.

Figure 4: Lifetime government support provided through the retirement income system[9]



Source: Treasury calculations using a hypothetical cameo model

While it is not stated explicitly, we assume the tax concessions estimate uses the same benchmark as used elsewhere by the Government, such as in the Tax Expenditure Statement. If this reasonable assumption is correct, the issues raised earlier in this section are important:

- the benchmark is income tax, but an expenditure benchmark is more supportable;
- the income tax benchmark involves the taxation of nominal returns, but only real returns should be taxed (ie after removing the effects of inflation); and
- it compares superannuation with a benchmark of bank accounts, but money that is not invested in super is likely to be invested in other tax preferred vehicles.

8.2.6 Equity of tax concessions for superannuation in Review's Consultation Paper

There is an additional issue in Figure 4 from the Review's Consultation Paper: how it treats distributional issues (or equity) of the tax concession for superannuation. The measurement of the tax incentive in this Figure is in dollar terms, not as a proportion of the relevant tax base, such as contributions. This is inconsistent with the usual approach to determine distributional impact of tax concessions, which is as a proportion of the tax base.

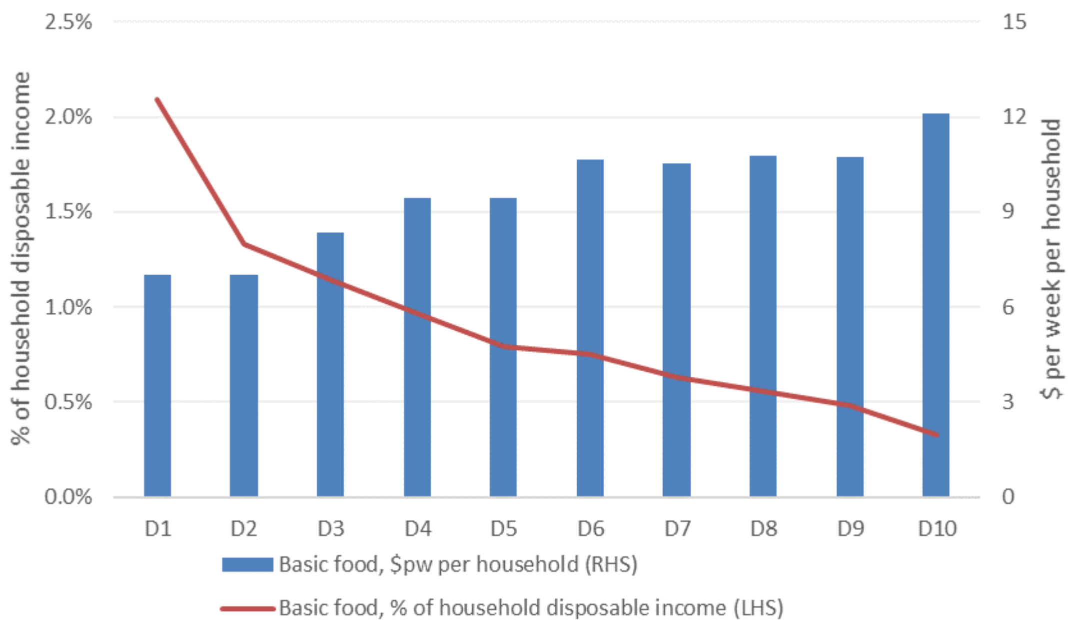
A progressive tax is a tax where the rate of tax increases with income, not where the dollar amount of tax increases with income. Similarly, a tax concession is progressive if the rate of concession (ie the dollar value as a proportion of the tax base) increases with income.

An example of the correct and incorrect approach to examining the distribution of tax concessions relates to the GST exemption for food. The data in Figure 17 below from the Parliamentary Budget Office (**PBO**) shows:

- the dollar value of the GST exemption (broadly) increases with consumption, as shown in the blue columns; but
- the proportional benefit declines with income, as shown in the red line.

Focussing on the dollar value of tax concessions (see blue columns in Figure) would incorrectly lead to the conclusion that the GST concession for food is regressive; while focussing on the relative value (see red line in Figure) produces the correct conclusion that the GST concession for food is progressive.

Figure 17 – Distribution of GST concession for food



Source: PBO (2015) GST Distributional analysis and indicative reform scenarios. D1 to D10 are households placed in ten groups in order of household disposable income from lowest income (D1) to highest (D10). An analysis in the 2019 Tax Benchmarks and Variations Statement has similar results to these (see Chapter 2).

Similarly the superannuation tax concessions should be measured as a proportion of the tax base, that is contributions or income (as appropriate), not as a dollar amount.

The use of the dollar value is a common problem with tax concessions and a number of commentators, including the Grattan Institute, have used this approach to argue superannuation tax concessions unfairly benefit the rich.[118] Note the OECD uses the better

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[118] See Daley, Coates, Wiltshire, Emslie, Nolan & Chen (2018) *Money in retirement: More than enough* and figures 3 and 9 of Daley, Coates, Young, & Parsonage, (2016) *A better super system: assessing the 2016 tax reforms*. Similar arguments are in Figure 2.1 of Wood, Griffiths, & Cowgill, (2019) *Budget blues: why the Stage 3 income tax cuts should wait*.

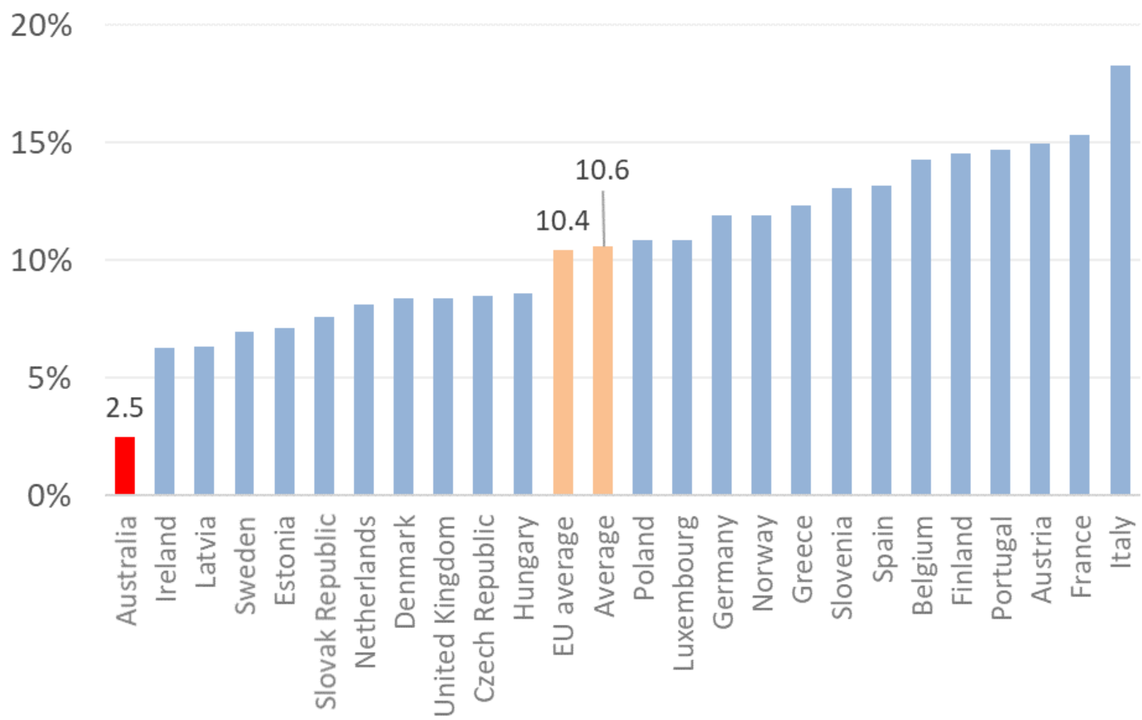
approach, conducting distributional analysis of tax concessions using proportion of contributions; this is discussed in Section 7.2.1 above.

Research recommendation 20: to the extent the Review considers the distributional impact of superannuation tax expenditures, it should analyse these as a proportion of income earned or as a proportion of contributions.

8.3 International comparisons of fiscal sustainability

The Australian private and public pension system operates well to limit the cost of ageing on the Budget, with Australia having one of the lowest levels of spending on Government pensions compared with other advanced countries; and the OECD forecast is for Australia to have the lowest level in 2025, 2035 and 2045 in previous forecasts,[119] and 2050 in its latest forecasts.[120] The OECD projections for 2035 are shown in Figure 18 below.

Figure 18 – Forecast spending on Age Pension as % of GDP – OECD projection for 2035



Source: OECD Pensions at a Glance, 2019, Table 8.5. Except Australia, OECD Pensions at a Glance 2018 database.

This is consistent with work by Rice Warner forecasting Government spending on the Age Pension will continue to decline relative to GDP, even with an ageing population, showing the superannuation system is working well to limit pension costs.[121]

[119] OECD Pensions at a Glance 2018 database.
[120] OECD Pensions at a Glance 2019, Table 8.5.
[121] See: https://www.ricewarner.com/should-the-superannuation-guarantee-move-to-12/

8.4 The Age Pension

Australia's Government income support for retirees, through the Age Pension, is quite different from the systems in many other OECD countries – the Australian Government's pension is strongly means tested, as shown in Section 6.1 above, in particular Figure 3 shows Australia provides no Government income support at retirement for middle and higher income individuals, while almost all other OECD countries provide some Government support for these two income groups.

8.4.1 The Age Pension means tests

FSC supports means testing of the Age Pension to ensure the fiscal (or Budgetary) sustainability of the pension and to ensure superannuation assists in reducing the fiscal costs of ageing. However, there are good reasons to consider the means tests could be delivered more simply.

The current means tests are complex and hard to understand or navigate, and as they interact with superannuation they add to the complexity issues raised in Section 9.2 below. Simpler means testing for the Age Pension (and potentially for aged care) would assist in addressing the complexity issues raised in that section.

A reform worth exploring is merging the asset and income tests, as supported by the Henry Tax Review,[122] which would result in a substantial simplification of the system. The extension of deeming rates to many assets has converted much of the pension income test into an imitation asset test – meaning Australia effectively has two separate pension income tests, with parts of the tests using actual income and other parts using deemed income. This is confusing and complicated.

Research recommendation 21: the Review should examine the costs and benefits of merging the pension income and asset tests into one means test.

The FSC acknowledges and welcomes recent changes to the Age Pension means tests on retirement income products; these changes have reduced the disincentives to use these products.

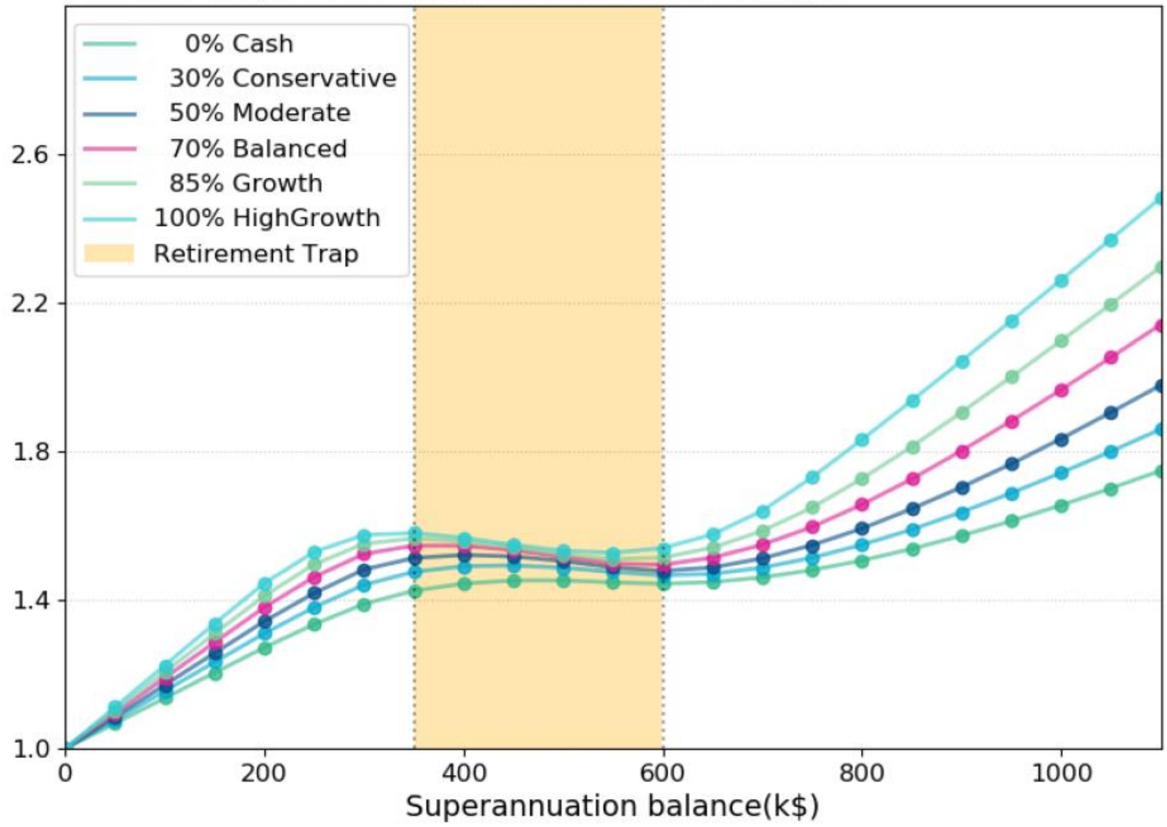
8.4.2 Impact of Age Pension means tests

The setting of the means test overall has to balance up many competing factors.

On some analysis, the current means test has the perverse result of making retirees with higher superannuation balances worse off compared to those with lower super balances. Figure 19 below, from a paper by BetaShares and CSIRO, shows the modelled income of retirees as a proportion of the Age Pension. Between about $350k and $600k, retirees are generally made worse off if their super balance increases (the different lines show the different retirement investment strategies).

[122] Recommendation 88 of Henry et al (2009) Australia's Future Tax System Final Report.

Figure 19 - Retirement income as proportion of Age Pension, by super balance



Source: Figure 1 of Cohen, Chen & Zhu (2019) The Retirement Trap[123]

This analysis indicates that the Age Pension means tests are doing their job of ensuring superannuation reduces the cost of the Age Pension – but arguably they are doing this job too well. The existing means test provides substantial offsets to Government spending on the Age Pension, consistent with the analysis in Section 6.5.3 above.

If the means tests remain unchanged, then:

- This acts as a substantial discouragement of voluntary retirement savings through superannuation or outside superannuation – but with one exception: it encourages retirement savings through the family home (see Section 8.4.3 below).
- Retirement income adequacy for many middle income earners needs to be delivered through increases in compulsory as opposed to voluntary contributions, as voluntary contributions are subject to a hefty penalty – an effective tax rate that is likely to be more than 100 per cent. The case for an increase in the SG is discussed further in Section 6.5.1 above.

[123] See: https://www.betashares.com.au/files/collateral/BetaSharesTheRetirementTrap.pdf

8.4.3 The family home exemption

The family home is a well known exemption from the pension means tests that has widespread community support.

This exemption encourages individuals to save for retirement through the home and discourages savings elsewhere, including through superannuation. It also comes at a large cost to the Budget, through increased Age Pension spending and reduced tax revenue compared to all other savings vehicles, including superannuation.[124] The current policy approach of exempting the family home therefore in turn provides a policy argument for compulsory saving through superannuation – a savings vehicle which has substantially lower cost to the Budget because it is subject to higher tax rates than the family home, and is included in the pension means tests (discussed earlier in this section).

We note the family home exemption reduces the equity of the retirement income system, by preferentially treating just one form of retirement saving. The Henry Tax Review noted this exemption provides an opportunity for high levels of wealth to be sheltered from the pension means test, and recommended that this could be addressed by placing a limit on the value of the exemption.[125] Recent research from ANU[126] estimates there were almost 30,000 Age Pensioners living in a family home worth more than $2m in 2019–20. Pensioners living in family homes worth $1m or more were 13% of pensioner households and $6.36 billion was spent on the Age Pension for this group.

That said, home ownership in retirement is important, with renters significantly disadvantaged in retirement compared to homeowners (see Section 6.8.2 above). Any limits imposed on the family home exemption need to carefully consider the impact this will have on retirement incomes and ensure the system continues to support Australians in achieving a comfortable retirement.

Research recommendation 22: the Review should examine the impact of the exemption of the family home from the pension means tests on retirement incomes, including the impact on adequacy and equity.

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124 The value of the Capital Gains Tax exemption for the family home is worth about $64.5 billion in 2019–20, see 2018 Tax Benchmarks and Variations Statement. Note this exemption is measured against an income tax benchmark that the FSC has concerns with, see Section 8.2.1.

125 Page 44 of Australia's Future Tax System (2009) Retirement Income System: Report on Strategic Issues.

126 Webster & Phillips (2019) Analysis of pensioner home owner house values 2019–20.

9 Cohesion

9.1 Interaction between retirement income system and related systems

The interaction between the superannuation system, the Age Pension and the aged care system have created significant complexity for Australians navigating retirement.

Piecemeal policy changes have added to these issues, with the Age Pension and superannuation access age no longer aligned, and the equity issues with the means test noted in Section 8.4 above.

There is also a strong anecdotal view that individuals change their behaviours due to the complexity of the system, for example by specifically managing their finances to gain access to schemes such as the Health Care Card, or changing spending habits because of uncertainties about the need for capital to access aged care.

While there is a role for retirement income products to assist in managing some of these issues, the complexity of navigating the interactions between these systems emphasises the need for affordable, accessible financial advice in retirement – see Section 9.3 below.

9.2 Complexity in the retirement income system

The retirement income system has been subject to an unprecedented level of scrutiny and regulatory change over the last several years. While much of this has led to improvements in outcomes for members, it has also significantly added to the complexity of the system, including for superannuation trustees and fund members.

For example, retirees have been advised to check at least twenty different items to determine their eligibility for Government assistance and other support for retirement income needs.[127] The Review's consultation paper acknowledges the complex interactions of elements in the system (page 6), including the different means tests for the Aged Pension and for aged care (page 25).

There has been little consideration of the impact this level of ongoing change has on public understanding, confidence and engagement in the retirement income system.

This section considers some particular areas of complexity in the system, including the Transfer Balance Cap (Section 9.2.2 below), but there are many other complexities the Review will be aware of including from other submissions.

9.2.1 Measuring and responding to complexity

Given the complexity of the retirement incomes system noted above, it would be beneficial for the Review to assess the current complexity, compliance costs and regulatory burden of the system and if possible how these measures have changed over time. Some options for measurement include:

[127] See: https://www.firstlinks.com.au/article/20-great-ways-government-helps

- For consumers and financial advisers, surveys of the time it takes to do various super-related tasks, and surveys of understanding, complexity and engagement.
- For super funds, surveys of hours taken on regulatory requirements.
- General surveys of Australians about how the complexity and regulatory burden of the retirement income system impacts on understanding, confidence and engagement.

The Review could also consider various other framework approaches to reduce the regulatory burden, including complexity, of the existing system and limit the potential for future increases, including:[128]

- Assessing whether the policy goals of existing regulations could be delivered in a less burdensome (and less complex) way – see for example the discussion on the Transfer Balance Cap in Section 9.2.2 below.
- Introducing regulatory budgeting, including for the main regulators, which would require measuring the burden (or complexity) of regulation and placing caps on this cost.
- Move the Office of Best Practice Regulation to be an agency separate from any Government Department.
- More tightly enforce requirements for Regulation Impact Statements (**RISs**) on regulations, including requiring that RIS be prepared early in decision making processes for consultation.

Some changes to reduce the regulatory burden of the retirement income system are considered in the rest of Section 9.2; some other areas for improvement include:

- Improving online access to the whole retirement income system, for example through myGov.
- Improve access to financial advice to help navigate through complexity (see Section 9.3 below).

Research recommendations 23 and 24. The Review should:

- examine the best way to measure the complexity and regulatory burden of the retirement income system for consumers, financial planners and super funds, and how this burden has changed over time.
- examine the costs and benefits of introducing framework changes to the retirement income system to reduce the burden of existing regulations and limit the potential for future increases in this burden.

9.2.2 Complexity in contribution caps and transfer balance caps

The superannuation system now has several caps on contributions and a cap on the maximum amount that can be transferred into retirement phase accounts (the Transfer

[128] Many of these recommendations are based on Productivity Commission (2012) *Regulatory Impact Analysis: Benchmarking*, Research Report, Canberra

Balance Cap or **TBC**). These caps add substantial complexities to the superannuation system. The indexation of the TBC is a case in point.

The general TBC is indexed by increments of $100k, but the actual value of the cap will be a different amount below $100k for all individuals who have some money in retirement phase already. For example:

- A fund member who has $160k in retirement phase has only used up 10 per cent of the $1.6m of the general TBC. So they have 90 per cent left in the general TBC. Under the legislation, they have 90 per cent or $90k added to their own personal TBC (taking it up to $1.69m) at that point in time.
- A member who has $1.44m in retirement phase has used up 90 per cent of the $1.6m general TBC. So they have 10 per cent leftover of the general TBC. Under the legislation, then they only get 10 per cent or $10k added to their own personal TBC (taking it up to $1.61m) as at that point in time.

As a result, every person who has entered into retirement phase will have a different and personal TBC.

When the 2016–17 Budget measures were introduced, the Government and industry were focussed on delivering the initial transfer balance account values and turning off the monitoring of various contribution caps and Transition to Retirement Income Streams (**TRISs**). There was not a need for the Government or industry to focus on the issue of TBC indexation, but this issue is now of more relevance.

The superannuation industry has not in its recent history experienced any caps that vary between individuals in such a way.

In the near future, the ATO will calculate every taxpayer's personal TBC. However:

- The calculation of the TBC is complicated and complexity will increase over time with each indexation of unused caps.
- The situation is difficult to explain to members.
- The individualised TBC is hard for trustees or financial planners to advise on if they are unaware of a customer's total super balances – for example, if the customer has accounts with several providers.

There is a particular issue of concern if fund members act on a personal TBC calculation if this is based on incorrect data. In some cases, the fund member could be subject to a penalty for an error outside their control. The issue is exacerbated if a customer has interests in an SMSF (in addition to an APRA regulated fund) which do not need to report as quickly as APRA regulated funds. Some degree of leniency in administration is warranted.

A method of reducing this complexity is worth exploring:

- There could be one indexed TBC for everyone, regardless of when individuals transferred into a retirement phase account, or how much is in the retirement phase.

- As an alternative, the proportionate reduction for unused caps could only apply at the higher end (i.e. those close to the TBC in the previous year), as opposed to the entire retiree population.
- The TBC could be replaced by taxation of income from retirement phase accounts above a high tax free threshold that mirrors the effect of the TBC.

A large majority of retirees will never get close to $1.6m for the proportional reduction calculation to matter, so the current approach is costly and inefficient to administer and calculate for the majority.

Ultimately, the individualised transfer balance caps are unnecessarily complicated and similar policy outcomes (specifically to limit the tax concession for superannuation accounts in retirement phase) could and should be achieved through other simpler mechanisms.

Research recommendation 25: The Review should examine the red tape caused by the Transfer Balance Cap, particularly the individualised cap that will be introduced shortly, and whether there are ways to achieve the same policy outcome with a reduced red tape burden.

9.2.3 Personal deductible contributions

In 2017, the contribution rules for superannuation were changed so that all super fund members are now able to claim a tax deduction on personal super contributions. This includes owners of small businesses, the self employed, workers in the gig economy, and employees.[129] This measure has been a beneficial change, particularly for employees who may not be offered any salary sacrifice arrangements by their employer. However, FSC members have raised concerns that there are significant red tape barriers to the efficiency of these measures, including the following requirements:[130]

- a super fund member has to notify their fund in writing of the amount they intend to claim as a deduction, and given a maximum two year limit to do so;
- the fund must acknowledge this notice in writing;
- the fund member must not have rolled over any of the relevant contribution into another fund; and
- the fund must not have started paying a super income stream.

These requirements are also difficult for fund members to understand and navigate, particularly the requirement of funds to pro-rata reduce the maximum amount that can be claimed in the event there has been a partial withdrawal from their super account balance. These complex requirements mean a substantial volume of notices need to be rejected as not valid.

[129] Details of who is eligible for tax deductible super contributions is available from: https://www.ato.gov.au/Individuals/Super/Super-changes/Change-to-personal-super-contributions-deductions/
[130] See: https://www.ato.gov.au/Individuals/Super/Super-changes/Change-to-personal-super-contributions-deductions/

These problems would discourage workers in the sharing economy (see Section 6.7.3 above) from providing for their own retirement.

Removal of these red tape barriers would make it easier for people currently not covered by the SG to make contributions and build retirement incomes.

Research recommendation 26: The Review should examine the red tape barriers to the use of personal deductible superannuation contributions and whether there are ways to achieve the same policy outcome with a reduced red tape burden.

9.2.4 Measuring the number of options in the market

A concern is sometimes raised that the superannuation system is more complex than necessary because of the large number of options available. A reference is often made to the Productivity Commission's estimate that there are 40,000 superannuation products in the system .[131] However, this is a misguided and simplistic use of the data. The Commission's report itself agrees that there is some disagreement about how many products there actually are, and that this is difficult to measure (see Final Report, Box 4.1).

The FSC is hopeful this will be addressed by APRA through the Superannuation Data Transformation project, currently underway, which aims to collect information relating to all investment options across the choice landscape.

Regardless, no superannuation member is exposed to 40,000 potential choices when it comes to superannuation. The main reasons for this include:

- the 40,000 option estimate counts the same investment option many times over in different funds/products, particularly the range of external investments available through platform and wrap products, for example, the same index fund may be available for investment through 10 different funds. Counting this fund product multiple times is like saying Weet Bix bought at Coles, Woolworths and IGA are three different cereals;
- the 40,000 figure includes both accumulation and retirement/pension products from the same fund, which may be counted separately when the underlying structure of the product is the same;
- some products/options are only available to employees of a particular business as part of a corporate super plan.
- even among public offer funds, very few of these options are truly available to the wider public without at least some conditions and most of these are offered via selected distribution channels, such as through a financial adviser;
- many options will be attached to legacy products and no longer open to new member contributions – and the FSC has for some time been urging for policy changes to allow these options to be closed (see Section 9.3 below);

[131] See Page 203 of Productivity Commission Final Report.

- in some cases, the different stage of a lifecycle super product could be counted as ‘options’ even though each fund member will be in just one cohort at any time.[132]
- for superannuation fund members who receive financial advice, the adviser will have access to a wide range of options but will generally only present a few to the client based on their expressed goals and preferences, and the application of the existing best interest duty.

The majority of superannuation products across all parts of the industry have tailored their investment options menu to less than 10, which match a self-assessment of an individual’s risk profile for example: Conservative, Balanced, Growth and High Growth. Doing so is the most acceptable method of investing as per financial advice and product provision practices in Australia and globally.

What all these nuances demonstrate is that an individual never has access to 40,000 super products, nor are there actually 40,000 distinct investment options available in the superannuation environment. There is not even a choice of 40,000 total fund and investment decisions to be made by a single member.

Adequate choice of fund in the market is essential to ensure healthy competition and meet the needs of those individuals who are looking for wider variety of investment options.

The default MySuper environment is designed to ensure good outcomes for members who may be disengaged, those with poor financial literacy, or those who simply wish to cede their decisions to the trustee. For these products, there are very limited choices available to the member, greatly simplifying their experience.

The recently introduced Design and Distribution Obligations (**DDO**) should address most of the concerns about consumers being offered products that are unsuitable. Beyond this, requiring the super industry generally to downscale a free market of products would do a great disservice to individuals with a higher level of engagement, access to advice and financial literacy.

9.3 Access to advice

Access to affordable financial advice is critical for many superannuation fund members to assist them in navigating the system and meeting their retirement needs.

9.3.1 Navigating a complex system

The increasing complexity of Australia’s superannuation system (See Section 9.2 above) makes it difficult for many Australians to navigate without financial advice. The Productivity Commission explored the issue of navigating this complexity, noting that:

> *A broader underlying problem is that members at all stages find the super system too hard to navigate, and do not know where to turn for help. While there is no shortage*

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[132] For example, the tables in this article treat different lifecycle stages as different products: https://www.afr.com/news/policy/tax/the-worst-default-super-funds-revealed-20190716-p527nd

of information, many members find it complex, overwhelming and inconsistent with their needs.

…

Access to information and affordable, credible and impartial financial advice is crucial — especially in the retirement phase — and its importance will only grow as the system matures. [133]

Given this complexity, it is unsurprising that financial advice can also reduce worry. A recent survey of people over the age of 55 by Challenger and National Seniors found people were less likely to worry frequently if they had sought financial advice and when they thought the advice met their needs.[134] Other studies have shown financial advice to benefit peace of mind, increase overall happiness and consumers' sense of security.[135] A recent study commissioned by Fidelity Australia found 64 per cent of people with advice felt 'very' or 'reasonably' prepared for retirement, compared to 26 per cent of those without advice; and 50 per cent of people said their mental health improved as a result of advice.[136]

9.3.2 The advice gap

Demand for financial advice will continue to grow as a result of an ageing population – as people age and approach retirement they are more likely to seek financial advice.[137] Around 700 Australians reach the retirement age every day,[138] often with a considerable superannuation balance. Of the 2.6 million Australians seeking financial advice (Investment Trends 2017)[139] most of them will seek advice on superannuation (including self-managed super funds) and loan and investment advice (IBISWorld 2018).[140]

The affordable advice gap affects consumers who are willing to pay for advice but think it is too expensive.[141] In the United Kingdom it widened from 5.4 million people to 5.8 million

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133 Productivity Commission Final Report.
134 National Seniors Australia. *Retirement Income Worry: Who worries and why?* Page 4. See: https://nationalseniors.com.au/uploads/0120203573PAR-RetirementIncomeWorry-ChallengerRpt-FNREV_1.pdf
135 *IOOF*. *The true value of financial advice*. See: https://www.ioof.com.au/about-us/news-and-updates/selected/the-true-value-of-financial-advice
136 See: https://www.fidelity.com.au/insights/investment-articles/the-value-of-advice/
137 ASIC REP 614. *Financial Advice: Mind the Gap*. Page 3 See: https://download.asic.gov.au/media/5054882/rep614-published-28-march-2019.pdf
138 See footnote 4.
139 Productivity Commission. *Competition in the Australia Financial System: Productivity Commission Inquiry Report, Number 89, 29 June 2018*. Page 281. See: https://www.pc.gov.au/inquiries/completed/financial-system/report/financial-system.pdf
140 Productivity Commission. *Competition in the Australia Financial System: Productivity Commission Inquiry Report, Number 89, 29 June 2018*. Page 281. See: https://www.pc.gov.au/inquiries/completed/financial-system/report/financial-system.pdf
141 Open Money. *The UK Advice Gap: Are UK consumers needs for advice and guidance being met?*. Page 2. See: https://assets-global.website-files.com/5dcfc5ecafa6ed691b341c4b/5e0f67d32aef55698c39ca4f_OpenMoney%2C%20The%20Advice%20Gap%20Report%2C%202019.pdf

people between 2015 and 2019.[142] This is largely attributed to reforms to financial advice that took effect in 2013.

As financial advice becomes more expensive, more Australians are likely to rely on the ability to pay for superannuation-related advice from their superannuation balance.

Research recommendation 27: The Review should consider the importance of financial advice when making decisions regarding superannuation, in particular when transitioning to retirement.

9.3.3 Industry change

While demand for financial advice has increased, there has been a reduction in the number of financial advisors over time. There has also been a marked reduction in the number of clients advised by financial advisers as well as more advice businesses reporting lower practice profitability in the past year.[143]

The implementation of the Royal Commission's recommendations will mean a shift to annual renewal of ongoing advice agreements, adopting new professional standards and education requirements, as well as new rules around disclosure and compliance. The nature of these changes will impact the products and services advisors can provide their clients.

There is also increased regulator attention focused on the oversight of advice fees paid from superannuation.

It is important advice does not become expensive and out of reach for Australian consumers who need it at critical points in their life such as retirement.

9.3.4 Reforms to financial advice in Australia

Policy settings that enhance the benefits of advice should form the basis of the Advice component of Australia's system of retirement income. Examples of these include but are not limited to:

- *Resolving uncertainty as to the definitions of personal and general advice:* improve the quality of advice people receive as well as the choices of products they have to meet what are increasingly complex sets of needs.
- *A cautious approach to developing new systems of redress.* This can avoid the unintended consequences of reduced choice and increased costs for consumers that seek advice. This is a prescient consideration when viewed in the context of the recent formation of the Australian Financial Complaints Authority **(AFCA)** and the eventual establishment of the Compensation Scheme of Last Resort **(CSLR)**.

Research recommendation 28: The Review should examine approaches to make retirement advice more affordable and accessible.

142 Ibid.
143 Investment Trends April 2019 Licensee Satisfaction Report.

9.4 Legacy product modernisation

Numerous Australians are being substantially disadvantaged by being locked into out of date products that lack the better returns, better features and easier access of more modern products. Financial services businesses are unable to move customers into more modern products for reasons including large tax or social security penalties. The continuing existence of legacy products has a material detrimental impact on not only retirement balances, but also financial services productivity, competition, innovation and Government spending. The FSC first put forward a proposal for a product modernisation scheme to the Government in July 2005. Since then, recommendations relating to product modernisation (or rationalisation) have been made in a range of reports, including the Superannuation System Review (the Cooper Review) in 2010[144] and the Productivity Commission inquiry into superannuation in 2018.[145] Both ASIC and APRA have also expressed support for a modernisation scheme.[146]

9.4.1 Legacy products are an extensive (and expensive) problem

The Productivity Commission in its 2019 report into the superannuation industry[147] highlighted the extent of the problems caused by legacy products in superannuation. They found that in 2017 there was $162 billion invested in 3.2 million legacy member accounts, which is 10% of the total assets held in APRA-regulated funds. [148]

This implies around 2 million individuals were trapped in legacy superannuation products with poor returns, based on the number of duplicate accounts in 2017.[149]

Almost all legacy products have high fees. The average fee in this tail was 2.2%, which is more than three times the modal (most prevalent) fee of 0.7% (see page 180).

The number of products in the high fee tail has remained steady over time (see page 180). This implies that it cannot just be assumed that the issue of legacy products will gradually disappear over time.

These figures are for legacy superannuation products alone; there are additional non-super legacy products that are relevant to retirement incomes, including old life legacy products that are used in super, as well as older style defined benefit and other products. Incorporating these products would make the extent of the problem even larger. Earlier estimates of the extent of

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144 https://treasury.gov.au/review/super-system-review
145 Recommendation 23.
146 ASIC report 466 *ASIC's work to reduce red tape* in January 2016, see: https://asic.gov.au/regulatory-resources/find-a-document/reports/rep-466-asic-s-work-to-reduce-red-tape/ and APRA submission to Inquiry by the Senate Economics Committee into the *Scrutiny of Financial Advice – Life Insurance* of April 2016.
147 Productivity Commission (2018) *Superannuation: Assessing Efficiency and Competitiveness*, Report no. 91
148 Productivity Commission (2018), Page 115 except where stated.
149 There were about 1.6 accounts per person in 2017, see: https://www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Super-statistics/Super-accounts-data/Multiple-super-accounts-data/

the problem are contained in previous FSC submissions[150] and the FSC is planning to conduct a survey of our members to update these figures in 2020.

9.4.2 Adverse impact of legacy products

There are numerous adverse effects from legacy products. In general, legacy products when compared to modern products can have:

- lower net returns, in many cases resulting in lower retirement incomes.
- higher fees – often significantly higher. For example, legacy products in superannuation have fees that are more than three times the most prevalent fee rate (see Section 9.4.1 above).
- poorer consumer disclosure and reporting.
- increased likelihood of errors, as many processes have to be completed manually.
- worse regulation for consumer targeting and suitability, as legacy products were sold before the introduction of the Design and Distribution Obligations (DDO) regime.
- worse technology and reduced accessibility, for example they are not accessible through the internet or via apps.
- reduced resilience, as systems are out of date and expensive to maintain.

In addition, at an economy wide level, the trapping of consumers in these products:

- adds to product proliferation.
- reduces competition and innovation.
- increases financial system risks.
- reduces scale economies, increasing industry costs.
- reduces the productivity of financial services, dragging down economy-wide productivity.
- reduces savings and wealth.
- increases Government spending on income support, particularly the Age Pension, because of reduced retirement savings.
- reduces tax revenue because lower income/investment returns reduce income tax revenue.

The final two points imply that the lack of a modernisation scheme is likely to be at a cost to the Budget. While it may appear that a product modernisation scheme would result in a cost to the Government in the short term, in the longer term a modernisation scheme may be a net benefit to the Budget as it will boost tax revenue and reduce Age Pension spending.

[150] For example see FSC Pre-Budget submission for 2018–19, available from: https://consult.treasury.gov.au/budget-policy-division/2018-19-pre-budget-submissions/consultation/download_public_attachment?sqId=question.2017-09-12.3768452384-publishablefilesubquestion&uuId=596571344

9.4.3 Barriers to product modernisation

Superannuation deals with the legal barriers to product modernisation in some circumstances, but not all.[151]

There are other significant barriers to modernisation:

- The imposition of Capital Gains Tax (**CGT**) on unrealised gains. This tax can be imposed on the consumers holding the relevant legacy investment product, and also on the vehicle making the investments.
  - CGT relief is available for merging superannuation funds, but only for transfers that are executed as a 'single arrangement' that occurs within a single tax year. This means relief is not available where there are too many members to transfer in one tranche for operational reasons.
  - The CGT issue remains unaddressed for the modernisation of products within a super fund, for life-backed superannuation products, for life insurance products, and for non-superannuation investments.
  - There is also generally an inability to transfer capital losses to new products.
- State stamp duty on investments that back a product (whether super or non-super). Stamp duty typically applies to land held through unit trusts and companies. The CGT rollover relief for merging super funds noted above does not deal with the stamp duty issue.
- Legal barriers that restrict the ability for product providers to communicate with members of legacy products about contemporary products.
- Possible loss of legislated member elections/decisions, for example binding death benefit nominations and elections as a result of the Protecting Your Super **(PYS)** and Putting Members Interests First **(PMIF)** legislation.
- In some cases, any customer transition to a modern product must be done with client consent, generally based on financial advice. Given the cost of personal advice, this may act as a significant barrier to modernisation.
- Loss of grandfathered social security treatment. For example (highlighting added):

  > *a person who is an owner of an account-based pension purchased before 1 January 2015 and the holder of a CSHC [Commonwealth seniors health card] on 31 December 2014, will not have their account-based pension included in the income test for as long as they: continue to hold a CSHC,* ***and retain the same account-based pension****.*[152]

  Other examples of grandfathered social security treatment include:

  - A 100% asset test exemption for complying income streams commenced between 20 September 1996 and 19 September 2004;

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[151] The issue is addressed in some cases for the transfer of fund members to a different fund (a Successor Fund Transfer), but not for the transfer from a legacy product to a modern product in the same fund (an intrafund transfer).
[152] See: https://guides.dss.gov.au/guide-social-security-law/3/9/3/31

- A 50% asset test exemption for complying income streams (including Market Linked Income Streams (**MLIS**)) commenced between 20 September 2004 and 19 September 2007;
- A 'non-assessable portion' income test for account based income streams commenced before 1 January 2015, provided other conditions were also met; and
- A 'non-assessable portion' income test and 'declining asset test' for lifetime income streams commenced before 1 July 2019.

9.4.4 FSC's recommended product modernisation solution

The FSC's recommended approach for the modernisation of legacy financial products is:

- a consumer interest test applied at a collective level;
- transfer of non-tax attributes (e.g. social security benefit grandfathering);
- roll over of all tax attributes to the new vehicle; and
- no tax implications of the rollover itself (including to the extent possible the removal of any stamp duties on the rollover).

The consumer interest test involves the trustee/provider of the relevant product determining that modernisation is in the interests of consumers collectively. The FSC proposes that the test be applied at the collective level, rather than the individual level, to enable the maximum number of consumers and other stakeholders to benefit.

To expedite the modernisation of a large number of legacy products, a worthwhile approach is an institutional mechanism (e.g. tribunal) that would allow for expert independent decision-makers to approve modernisation of products. This would help address the concerns of both consumers and industry by providing greater certainty, transparency and timeliness around a process that has historically proved difficult to negotiate.

Research recommendation 29: the Review should provide updated estimates on the number of legacy products in the retirement income system (including the number of customers affected), the costs of legacy products to the system, and analyse the costs and benefits of a comprehensive modernisation regime for legacy products in the system.