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By email: prebudgetsubs@treasury.gov.au

Dear Stephen

2014-15 Pre-Budget Submission

We welcome the opportunity to provide this submission for you to consider as you prepare the 2014-15 Budget. We have a concern about the escalating cost of both income support in retirement and the equity of superannuation tax concessions. We believe some relatively small steps could be taken in this Budget to improve the overall fiscal position.

About Rice Warner

Rice Warner is an Australian business which supplies consulting advice and research to the financial services industry. Over the last three decades we have built a strong reputation for innovation and have a large number of prestigious clients who respect and value our opinions. Our independence allows us to provide unbiased advice in all our activities.

Our firm conducts significant work in superannuation. One of our ongoing projects prepared for the Financial Services Council is an annual analysis of the Retirement Savings Gap (RSG) for the Australian population of working age. The RSG is the difference between the amounts required to be saved for retirement for Australians to maintain a comfortable living in retirement less the amounts likely to be accumulated at retirement.

Our last published figure for the RSG was $836 billion though this figure will be updated over the next few months to allow for the forthcoming increase in mandatory employer contributions to 12%. We expect the figure will fall but the gap will still be significant.

Fiscal Problems around Superannuation

The Mid-Year Economic and Fiscal Outlook showed a continued deterioration in the nation's finances.

The largest Tax Expenditure is the concessions made to superannuation. Treasury estimates these will be $40 billion in 2014-15 rising to more than $50 billion two years later. About half of this amount relates to the concessional rate of tax on fund earnings.

Simultaneously, income support for seniors (mainly the Age Pension) now exceeds $40 billion and will rise rapidly as the baby-boomer generation (those born between 1946 and 1964) retires over the next decade. These figures show that past generations failed to become self-sufficient in retirement and the cost associated with this under-provision must be borne by current taxpayers.

Clearly, these figures illustrate that the government recognises the importance of superannuation in providing for better retirement outcomes. It does this through generous concessions for superannuation to encourage self-sufficiency in retirement as well as providing a safety net in the form of the Age Pension.

The stark finances show that the fiscal position of superannuation and retirement support needs to be reviewed. Government revenue faces the concurrent imposts of increasing tax concessions to those currently building their retirement savings and payments to an increasing number of people moving into retirement who have not been able to build sufficient retirement savings. However, that review is outside the scope of the current Budget.

In this submission we set out some practical measures which could be introduced in the forthcoming Budget to moderate the costs to the taxpayer of the Age Pension and of superannuation tax concessions.

Equity in superannuation

The superannuation system is very complex and various governments have attempted to introduce broad equity across the system. For example, the previous government had an initiative to rebate the tax paid by low income earners on employer contributions paid on their behalf. The rationale for this adjustment was that the tax rate charged to these contributions was 15% which was not concessional given the tax rate on their personal income. While this is a sound measure to restore equity, it was to have been funded by the Minerals Rent Resource Tax so its implementation has been deferred indefinitely.

Shift to pensions

The Australian superannuation system is growing strongly, fuelled by the mandatory employer contributions (now 9.25% of salaries) and real earnings over extended periods.

Rice Warner has forecast funds to increase over the next 15 years at a compound annual growth rate of 8.1% a year.

Table 1. Summary of projections results (2013 dollars)

Market segment	Today 30 June 2013		In 5 years 30 June 2018		In 15 years 30 June 2028		CAGR
	($M)	(%)	($M)	(%)	($M)	(%)	(% p.a.)
Not-for-Profit Funds	643,058	39.8	838,645	39.5	1,260,555	37.6	7.7
Commercial Funds	466,910	28.9	621,271	29.3	1,092,446	32.6	9.0
Self-Managed Super Funds	507,200	31.4	660,729	31.2	1,000,177	29.8	7.8
Total superannuation market	1,617,169		2,120,645		3,353,178		8.1

We note that 30% of all superannuation assets are held in retirement pensions and this figure will rise to nearly 40% over the next 15 years as set out in Table 2.

Table 2. Retirement projections results (2013 dollars)

Market segment	Today 30 June 2013 ($M)	Today 30 June 2013 (%)	In 5 years 30 June 2018 ($M)	In 5 years 30 June 2018 (%)	In 15 years 30 June 2028 ($M)	In 15 years 30 June 2028 (%)	CAGR (% p.a.)
Not-for-Profit Funds	84,967	17.3	163,135	23.5	372,027	28.5	13.7
Commercial Retirement Products	158,632	32.2	199,215	28.7	349,373	26.7	8.6
Self-Managed Super Funds	248,528	50.5	330,846	47.7	586,168	44.8	9.1
Total retirement market	**492,128**		**693,196**		**1,307,567**		**9.9**
Retirement assets as percentage of all superannuation assets		**30.4**		**32.7**		**39.0**	

Proposed change to tax on pensioner earnings

The previous government was concerned about wealthy retirees holding significant assets within a superannuation pension on which they paid no tax on earnings. It attempted to address this with a convoluted process which would have incurred considerable administration costs for the industry.

There is a better way of improving tax equity without breaking this government's promise not to tax retirement benefits. We consider it sensible to have a single rate of tax across accumulation benefits and superannuation pensions. We have argued for this before in past newsletters and speeches and it was also a recommendation of **Australia's Future Tax System Review**.

As the government only taxes 70% of fund earnings, it has an effective gross rate of tax of 10.5% - the actual rate collected is lower due to allowable deductions such as fund costs and insurance premiums. Once pension assets become 40% of all superannuation assets, the effective gross rate will fall to 9%

If the government collected a single rate of tax, it could reduce the rate on accumulation members without a significant rise for pension members. However, a phased introduction would also allow it to collect higher taxes in the next few years which would assist to close the Budget deficit. As assets are growing in real terms, taxes in superannuation are also growing strongly. It might be possible at some future date to reduce the aggregated tax rate below 10.5% when the Budget situation permits.

Table 3 shows the approximate impact of phasing in this tax change moving the tax rate from 15% to 12% over three years. Note that the asset allocation for pensions varies from accumulation so the change is not linear.

Table 3. Additional tax collected

Year and tax rate	Additional tax on pensions	Reduction in accumulation tax collected	Total additional tax
	$B		
2015 FY 12%	5.16	(2.19)	2.97
2016 FY 11%	5.23	(3.14)	2.09
2017 FY 10%	5.28	(4.22)	1.06

If this proposal were implemented, the CGT cost base for assets held by current pensioners would need to be reset to be the value as at the Budget night. This would allow consistent tax treatment at the new tax rate for pension assets, but without retrospectivity.

Impact of Proposed Change

There are several advantages of this proposal including:

- Wealthy retirees will contribute towards reducing the Budget deficit and will pay an equitable share of tax in future. Taxing earnings means that those with larger balances pay more tax which is broadly equitable.
- The long-term rate of 10% would help younger Australians build higher retirement benefits. While these would be extinguished faster if pension earnings are taxed, that could be addressed separately in future.
- There would not be a loss of capital gains tax when members shift from accumulation to pension phase. At present, the deferred tax liability is made void for assets held in pension accounts. If the tax on earnings were the same during the pension phase, this would increase capital gains revenue over the next decade.
- There would be removal of several administrative functions such as the requirement for Actuarial Certificates to segregate assets between accumulation and pension accounts.
- Superannuation administration would be simplified as members would not need to change accounts when they move into pension phase. This would remove the need for an expensive range of extra products.
- The costs of managing Transition to Retirement benefits would disappear as these accounts would cease. It could be argued that these benefits are simply a method of reducing taxes without any long-term increase in national savings.
- The government would not suffer a continuing erosion of revenue over the next decade as the baby-boomers move into a tax-free earnings environment
- The system would be simpler to administer and this would lead to lower costs for members.

We have considered the social impact of increasing taxes on pensioners. It could be argued that low-income earners would be able to avoid the tax on earnings by withdrawing their retirement benefit and taking out a savings account with a bank.

In fact, this is already established behaviour. The majority of members with accumulated retirement benefits under $100,000 already take their benefits as a lump sum and then place it in a bank account. As these members have little personal income, their earnings are tax-free.

Superannuation funds would want to retain retirement benefits as pensions so the onus would be on them to show that the fund earnings after tax and fees will be better than the return made from money left in a bank. As it is a competitive market, members would have good options either way.

The proposed change would also allow the government (if it considered this to be appropriate) to tilt retirement benefits towards lifetime annuities. It could do this by allowing the earnings on assets backing long-term annuities (say, 20 years duration to lifetime) to remain tax-free.

The Age Pension

We consider that the Age Pension needs reform. We attach a newsletter produced in August 2012 which addresses some of the problems. Such reform would need careful analysis but it would make sense to begin with a discussion on the appropriateness of excluding the family home from the means test for the Age Pension.

Anti-detriment measures on death benefits.

This measure is applied by some but not all superannuation funds when assessing death benefits. The measure claws back all taxes previously paid on concessional contributions made on behalf of the member. It was introduced in 1988 when the superannuation and tax systems were quite different and is an anachronism which could be removed.

Removal would not only increase taxes but it would simplify administration for superannuation funds.

We trust these comments will be useful and welcome the opportunity to discuss them.

Yours sincerely

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