The Big Policy Debates: A Discussion of the Key Issues

Catherine Nance May 2015

1: FS Inquiry

2: Re:Think Tax Discussion paper

3: IGR

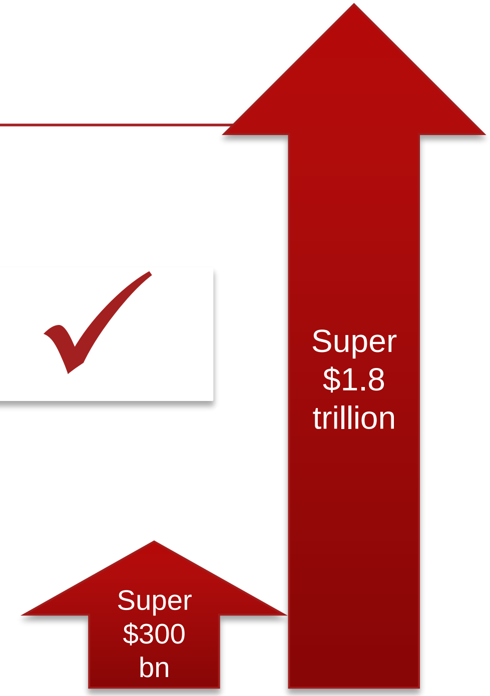
Background

Overall Australian financial systems have performed well in meeting financial needs of Australians and facilitating productivity and growth

- So radical reform not required, more of a "refresh"

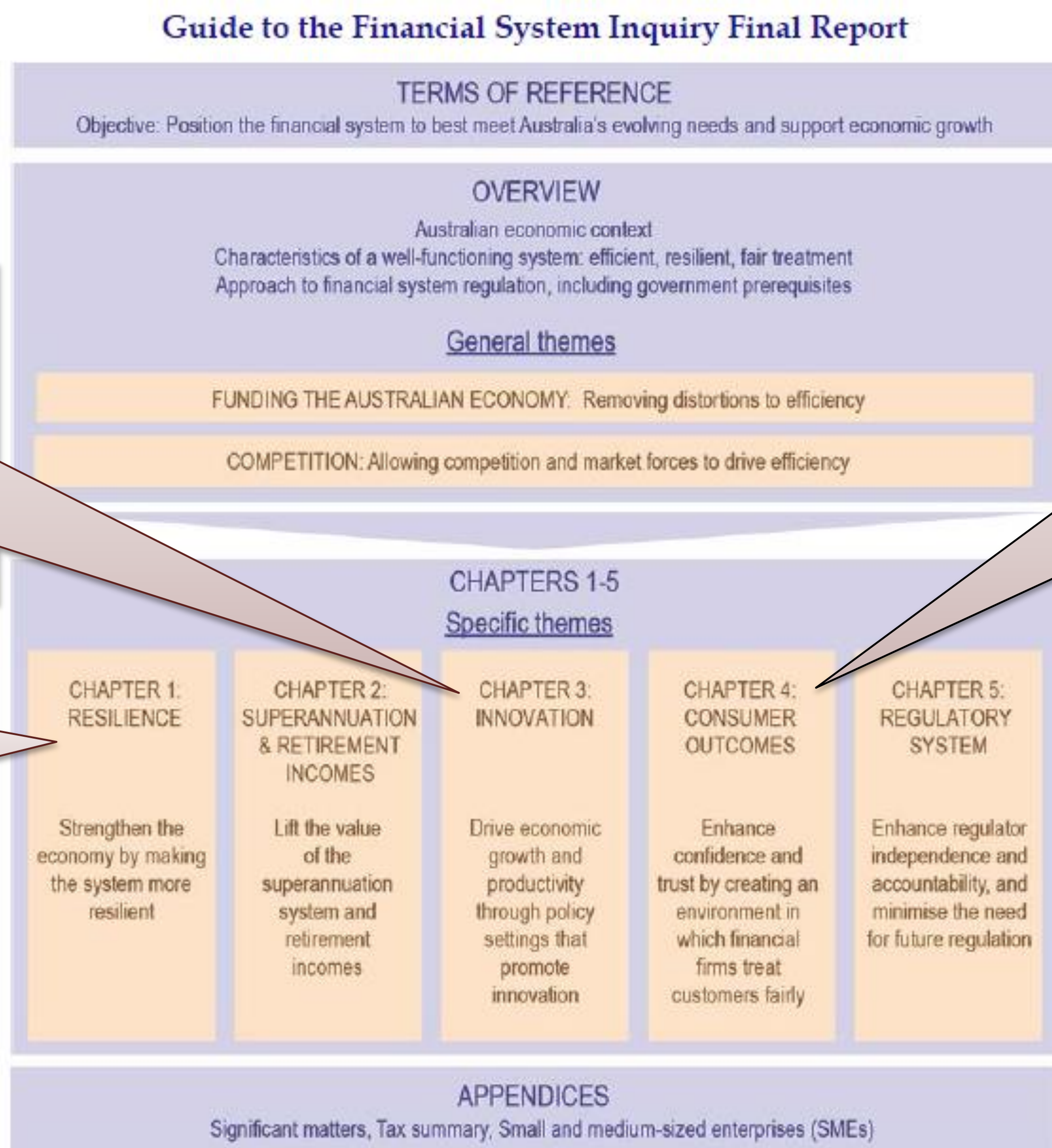
What has changed in 16 years since Wallis

- Rapid growth of superannuation assets from $300 billion to $1.8 trillion
- Failure of (Wallis) assumption that disclosure in itself would be sufficient to safeguard consumers



Out of scope issues

- Tax – as all tax issues will be dealt with as part of the white paper
- Preservation age, Age Pension & Adequacy
- Life insurance issues re increase in TPD claims and under-insurance – as Industry is already addressing these issues



Productivity Commission Inquiry into costs and benefits of improving use of private and public sector data

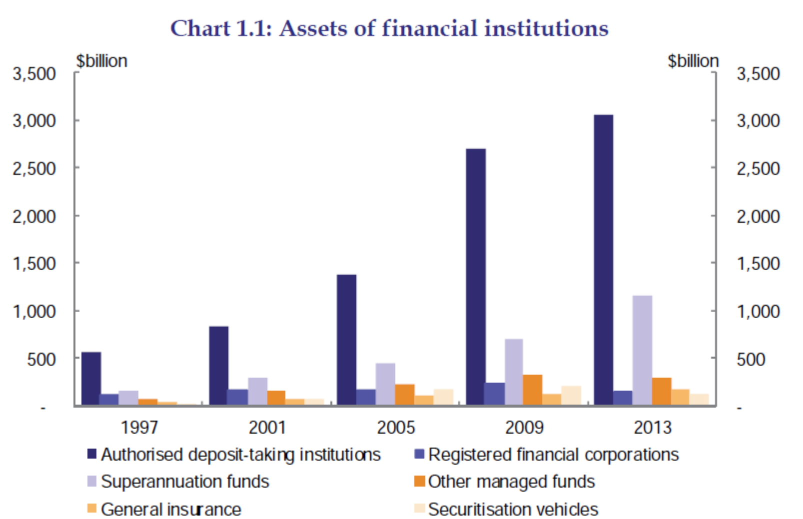
Strengthen the banking system

Product intervention power
Improve standards of advice
Improve disclosures

Capital markets

Super will be the major source of funding for our economy over the next few decades

- Super is the largest component of wealth management and at $1.8 trillion is already larger than the ASX market cap of $1.6 trillion
- Projected to exceed bank assets by 2030 and be $9-$13trn by 2040
- Already 30% of assets are in post-retirement phase, but by 2040 this is projected to increase to 45%



Note: Refers only to domestic operations and does not include assets of banks' overseas subsidiaries and branches. Registered financial corporations include money market corporations (for example, merchant banks) and finance companies (for example, debenture issuers).
Source: Reserve Bank of Australia.[9]

Superannuation

The Inquiry’s recommendations to strengthen the superannuation system aim to:

- Set a clear objective for the superannuation system to provide income in retirement.

  To provide income in retirement to substitute or supplement the Age Pension

- Introduce a formal competitive default super process if fees do not reduce by 2020
  - New workforce entrants will be allocated to a select number of high-performing superannuation funds, unless the Stronger Super reforms prove effective by 2020
- Comprehensive income product in retirement
  - Members would pre-select a comprehensive income product in retirement unless they choose to take their benefits in another way
- Majority of independent directors on Boards

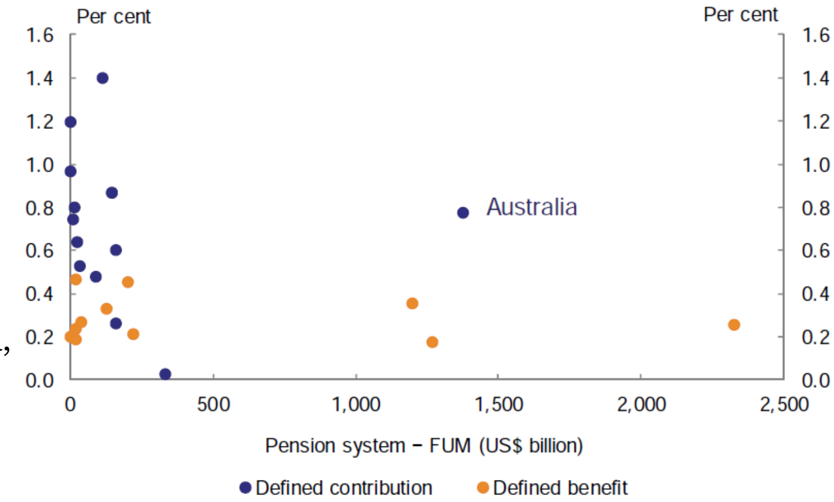
Efficiency of Super

Super delivers significant choice and diversity of funds but operating costs and fees appear high by international standards

- Compared to the OECD average annual expense rate of 0.4% pa, Australia has an average expense rate of 0.8% and average fees charged of 1.2% pa of funds under management.
- Competition has led to feature rich, more costly super
- Possible factors when comparing costs include:
  - Higher allocation to equities & alternatives, lack of economies of scale, shift towards modern administration platforms, increased member engagement, inclusion of advice & lack of competition due to disengagement and complexity
- The lack of stable policy settings is a factor in increasing costs and reducing confidence and trust

Chart 4.1: International comparison of superannuation (pension) expenses

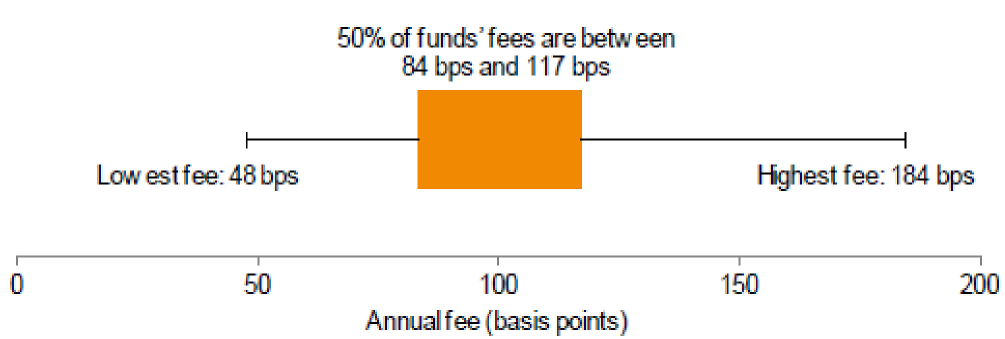
Annual expenses, as a percentage of funds under management (FUM)



Source: Grattan Institute.[20,21]

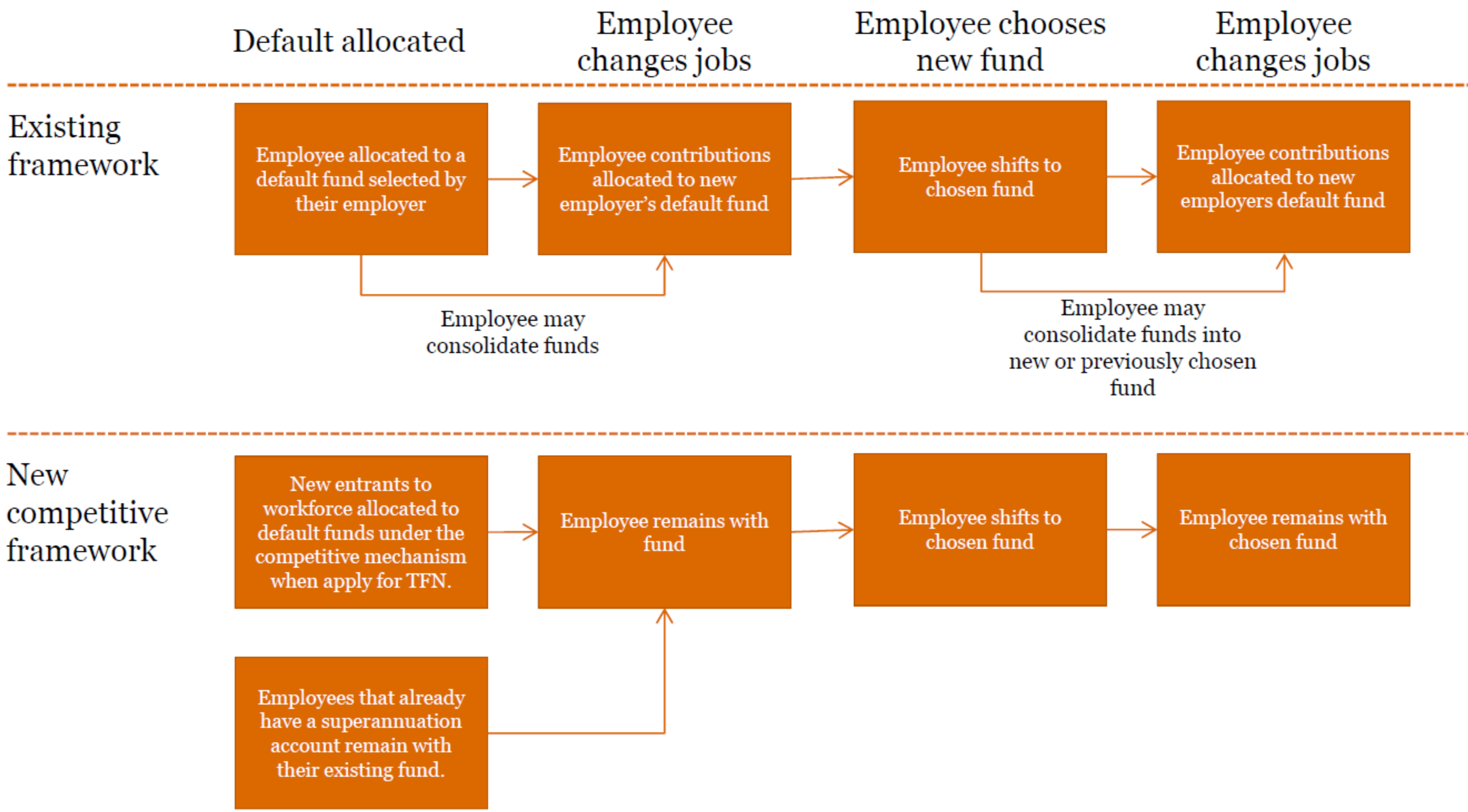
Chart 3: Range of MySuper fees

For a $50,000 balance in 2014



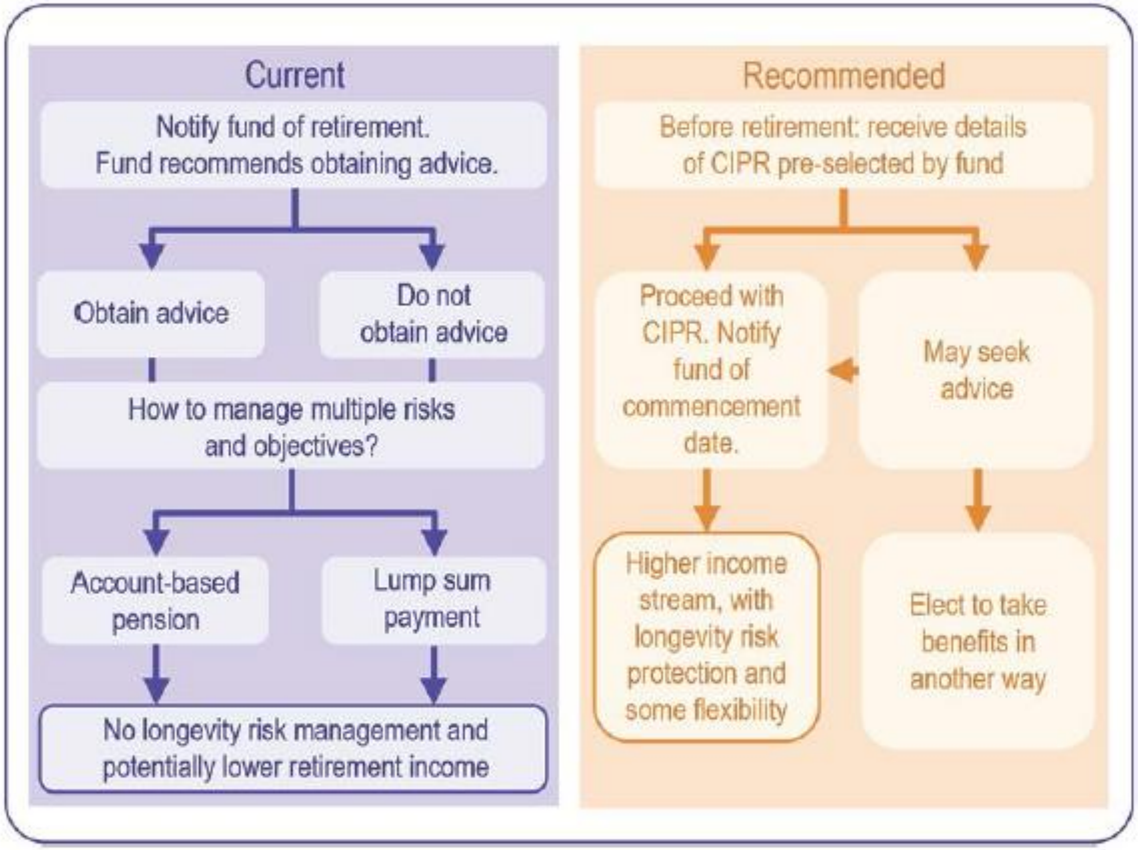
Source: Rice Warner, using a combination of APRA data and product disclosure statement information.[43]

Formal competitive process



Comprehensive Retirement Income Product

Figure 8: Stylised example of decision making for superannuation benefits



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Why do we need tax reform?

Current level of expenditure vs revenues is unsustainable

The problem is ..

- 40 years of projected budget deficits
- -1.8% GDP deficit in primary cash balance now (~$29 billion pa)
- 60% GDP net debt in 2054-55 , up from **15%** now (~$240bn)

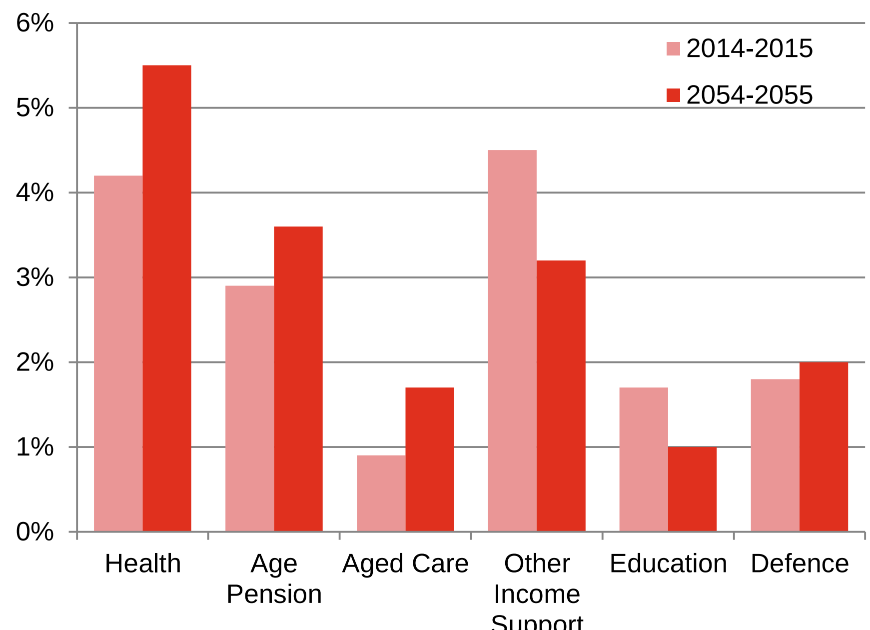
To pay for this..

- 43% of taxpayers will be in top 2 tax brackets by in 2025 up from **27%** now (that is with incomes >$80,000 paying 39% tax (37% plus 2% MCL)

Driven by ..

- 18% GPD in Age related costs in 2054-55 (including other government health costs, up from **13%** now (~$200 bn pa) i.e. a 40% increase
- 11% GPD in Commonwealth Age related costs in 2054-55 up from **8%** now ($128 billion pa)

Commonwealth costs as Per cent of GDP



Source: IGR 2015, where Age Pension costs exclude proposed changes to indexation

Superannuation tax concessions – the facts..

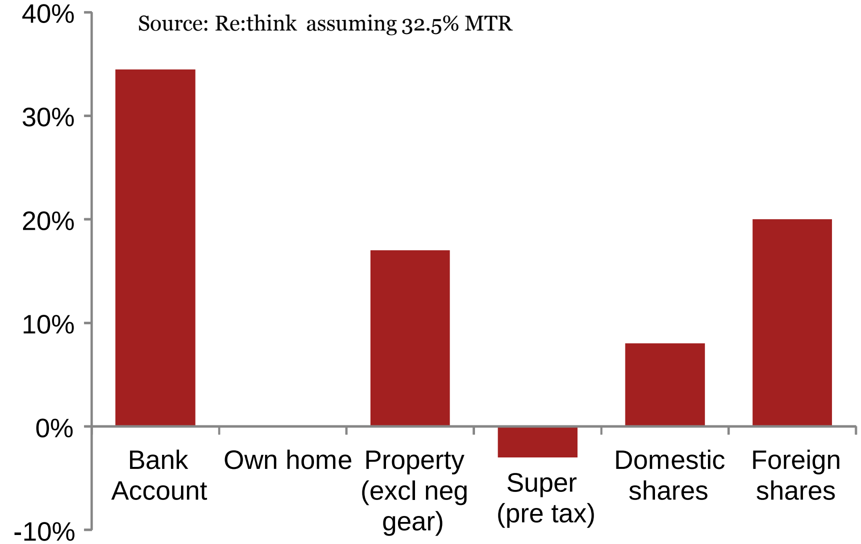
Superannuation pre tax is most concessional savings after home for most (excl. negative gearing)

Superannuation contributions tax concessions

Taxable income	MTR*	Super tax	Super tax concession
$0-$18,200	0%	15% less LISC	**0%**
$18,201-$37,000	19%	15% less LISC	**15%**
$37,001-$80,000	32.5%	15%	**17.5%**
$80,001-$180,000	37%	15%	**22%**
$180,001 -$300,000	45%	15%	**30%**
$300,000	45%	15% + 15% Div 293	**15%**

**Plus MCL 2%, TBR levy 2% for >$180,000 excluding LITO and SAPTO*

Comparison with other savings



Superannuation contributions caps

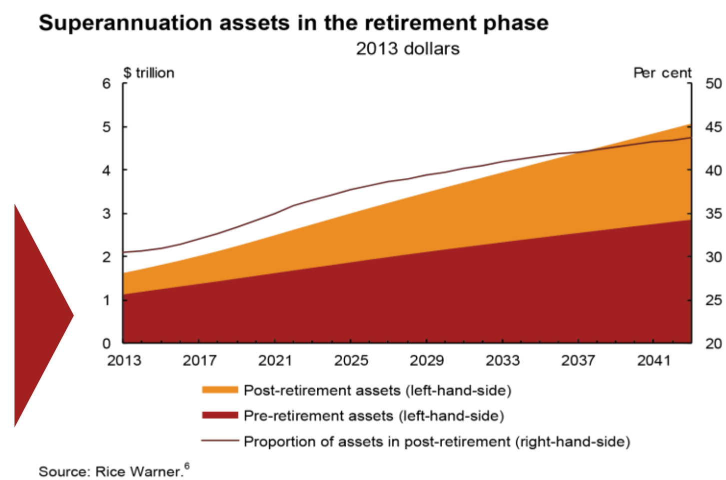
- Pre tax $30,000 pa ($35,000 >= 50)
- Post tax $180,000 pa

Superannuation investment income tax

- 15% accumulation phase, 10% CGT > 12 months (ETR 8-10%)
- 0% retirement incomes phase (will become unsustainable)

Superannuation benefits tax

- 0% (excluding pre preservation age & untaxed schemes)



Superannuation tax concessions – the facts and the myths!

Super tax concessions are hotly debated, but not all goes to the wealthy & they ignore Age Pension

Cost of super tax concessions

- $30bn pa Treasury estimates based on revenue foregone basis
- $23bn pa Treasury estimates based on revenue gain basis
- $16bn pa after Age pension reductions

Distribution of tax concessions excluding Age Pension

- 67% of tax concessions go to those earning $37,000 to $180,000
- 22% for those earning $180,000 plus

Tax concessions largely balance out over all income bands when Age Pension is taken into account

Superannuation large account balances

- #210,000 (1.5%) have balances > $1m
- #70,000 (0.5%) have balances >$2.5 m
- #475 have pension account balances > $10m

Percentage share of tax concessions excluding Age Pension

Taxable income	Share of total contributions (%)	Contributions	Investment earnings accumulation phase	Investment earnings pension phase
$0-$6,000	1	2	-0.4	0
$6,000-$37,000	14	12	1	41
$37,001-$80,000	43	38	35	29
$80,001-$180,000	33	35	42	22
$180,001+	10	13	23	8

Source: ASFA Mythbusting superannuation tax concessions 2015

Options for reform

Contributions

Super Accumulation phase assets

Retirement Income phase assets

Benefits

- Increase super taxes on contributions

and/or

- Limit contributions

- Increase 0% investment income tax on retirement income (RI) assets

and/or

- Limit the $ in RI products

- Increase benefits tax
- Change Age Pension means test *and/or* indexation

Options for reform – good and bad!

Super item	Change	Major financial impacts
Contributions	Increase tax to MTR less flat 15%	Contributions Tax up (from super and substitution to MTR income) $5bn pa Partially offset by reduced Investment tax revenues from reduced super Less in super LT Age pension costs up Potentially complex to administer and costly
	Limit caps	As above
Investment income	Change both Accum and RI to 7.5%	Total tax revenues down as accumulation assets > retirement ($3-$4bn pa) Mass withdrawal of retirement accounts < $364,000 No incentive to take retirement income stream
	Change RI to 15%	ST and LT tax revenues in theory up but….. Mass withdrawal of retirement accounts < $364,000 LT Age pension costs up
	Retain RI 0% but limit assets (eg to $1.5m) Remove Div Imp Credit refunds	ST and LT tax revenues up If retain 0%, need to consider segregating pension assets Would this impact "high dividend" share prices?
Benefits	Increase tax on LS amounts > $x	ST and LT tax revenues up Retrospective!!!

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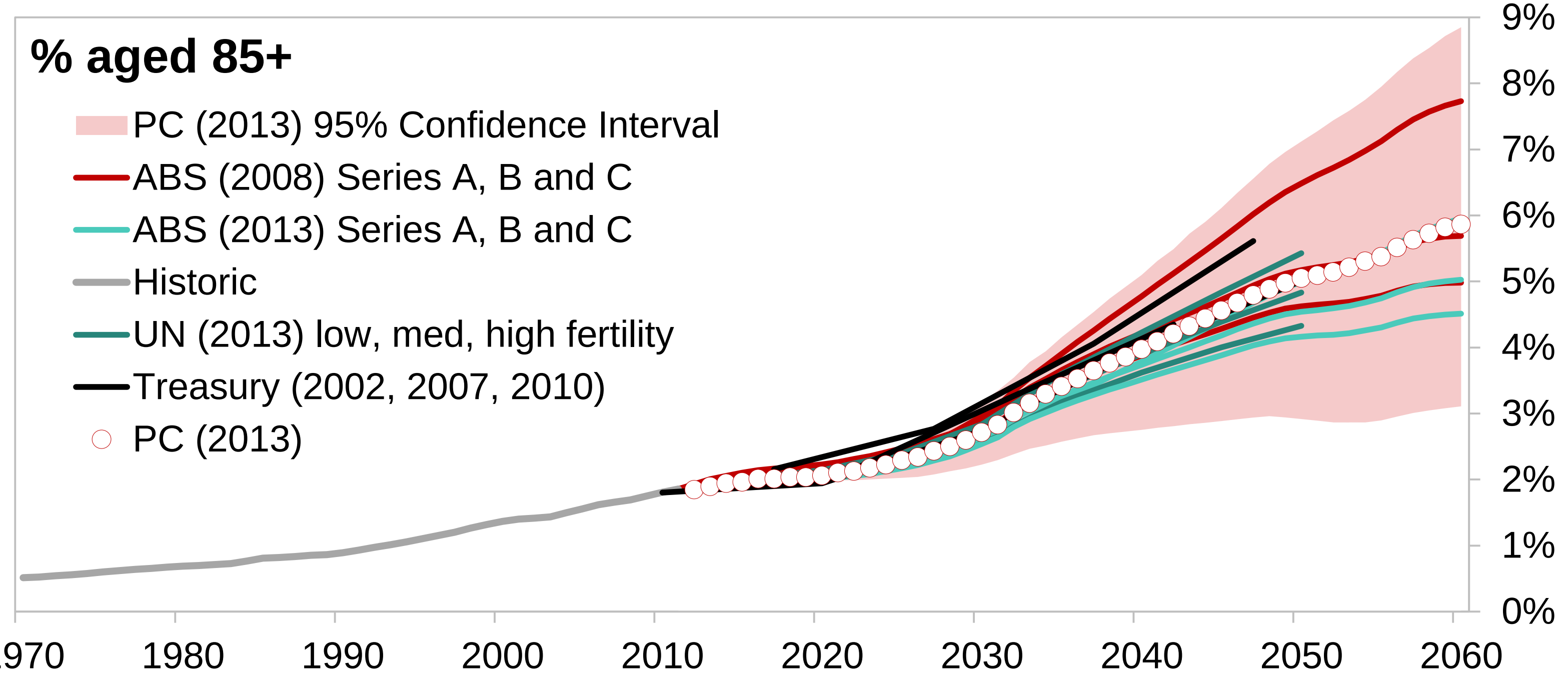
The ageing impact

	By 2054-55
Over 65s	Doubles to nearly ¼ of population
Over 100's	I in 1,000 up from 1 in 10,000 in 1975
Life expectancy	95 M and 97 F (Cohort method incorporating MI)
Healthy life expectancy	70's



Expenditure increases

Health costs

- 4.2% GDP to 5.5% GDP
- $2,800 pa to $6,500 pa

Age Pension

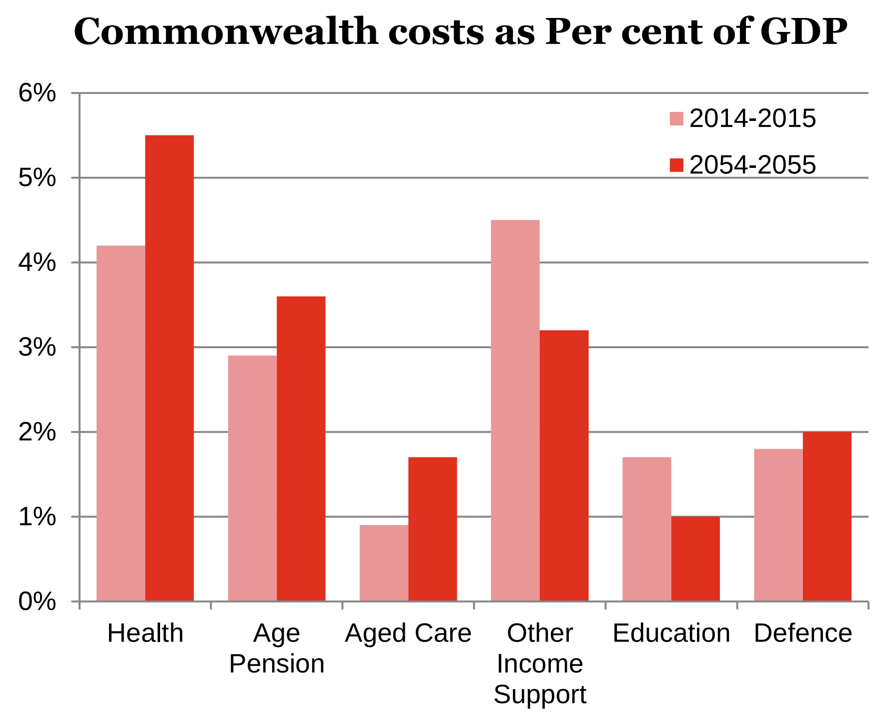
- 2.9% GDP to 3.6% GDP
- $2,000 pa to $4,300 pa

Aged care costs

- 0.9% GDP to 1.7% GDP
- $620 pa to $2,000 pa

Education costs

- 1.7% GDP to 1.0% GDP
- $1,500 pa to $1,900 pa



IGR 2015

Actuaries Institute key recommendations:

1. Make the models more transparent and accessib

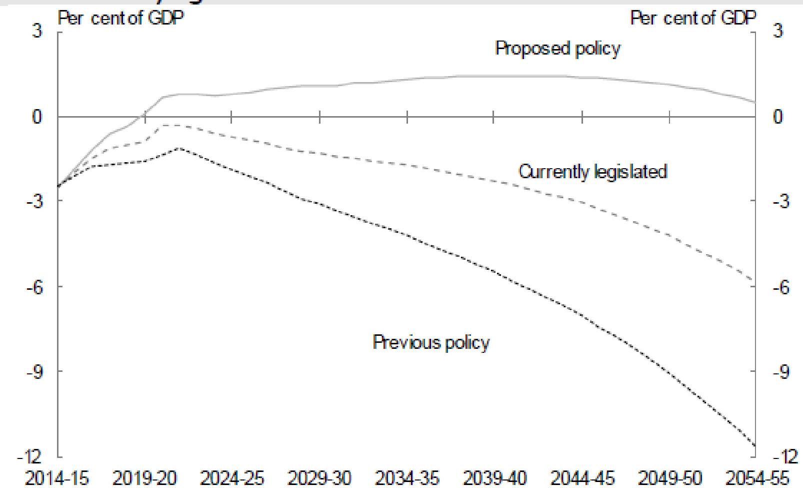
2. Assess impact on cohorts

3. Include state government budgets
   to obtain a true national picture

   - Government's contribution to health expenditure dropped from 44.0% in 2001–02 to 42.4% in 2011–12, whilst State and territory contribution grew from 23.2% to 27.3% over the same period

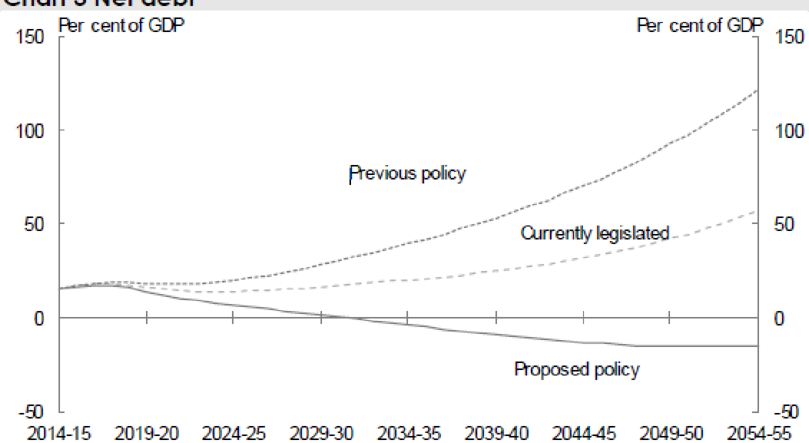
   - Government contributed $29.3 billion (37%) of $79.5 billion of government education funding in 2012-13, meaning states and territories contributed about 63%

Chart 2 Underlying cash balance



Note: Net Future Fund earnings are included in projections of the underlying cash balance from 2020-21.
Source: Treasury projections. Projections assume trend economic growth from 2021-22 to 2054-55.

Chart 3 Net debt

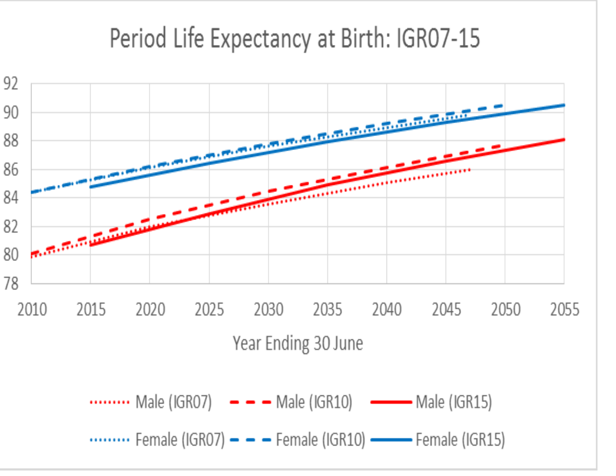


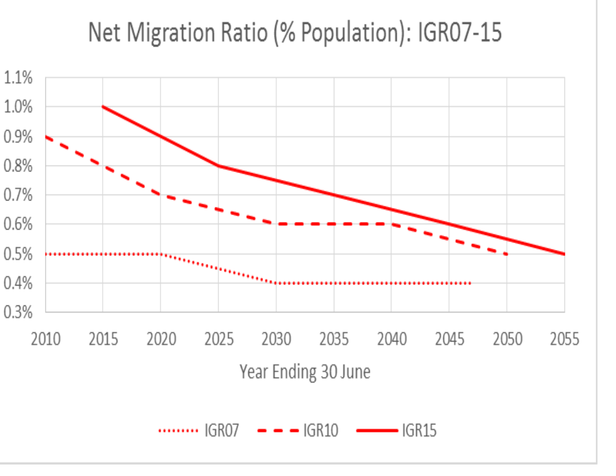
Note: The projections of net debt include net interest payments.
Source: Treasury projections. Projections assume trend economic growth from 2021-22 to 2054-55.

IGR 2015

Actuaries Institute key recommendations:

4. Clearly set out key assumptions and how and why they have changed since previous IGRs
5. Set out the implications of key assumptions
6. Use graphs and tables to more clearly demonstrate the uncertainty around key assumptions
7. Clearly demonstrate and justify the impact of alternative policy settings through sensitivity tests





IGR 2015

Noted following policy areas:

Retirement incomes:

- Resumption of the benchmarking to MTAWE, at some stage
- Means testing arrangements be reviewed to further improve intergenerational and intra-generational equity

Aged Care:

- Cost of aged care is rising and as older people often asset rich and income poor, they will increasingly rely on personal wealth to fund their care and health expenses in later life
- 80% of over 65s own their home and 70% of net wealth for over 75s is in the home
- Recommend options are investigated for older Australians to access housing wealth for aged care and health costs

Health:

- The IGR estimates that Australian Government health spending per person is predicted to rise in today's dollars from $2,800 to approximately $6,500 in 2055
- The Institute's Health Green Paper projects that the working age population might be paying 1.6 times the cost of their own health expenditure by the middle of the century (compared to 1.4 times now) to fund the health care costs of older age groups
- Recommend Government and business develop and adopt employment policies that fully support older workers remaining in workforce

Climate:

- Next IGR should consider the potential financial impacts of increasing climatic events and undertake additional research to improve the capability of government and the private sector to project future economic costs and benefits of mitigation and/or adaptation measures.