

The evolution of Australian Superannuation, its policy objectives and tax treatment

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Abstract

Whilst superannuation has been one of the major public policy initiatives in Australia over recent decades, the objectives of the Superannuation system have not always been clear. As a consequence, the Financial System Inquiry (2014) has proposed that the objective for superannuation, *to provide income in retirement and supplement or substitute for the Age Pension*, should be enshrined in legislation and that performance against this objective should be reported upon regularly. In this paper we examined how the Australian superannuation system has evolved over time, from its beginnings in the nineteenth century as a form of non-portable, long-term benefit designed to retain employees, to the 1980s when superannuation became a bargaining tool for productivity gains, and finally with the introduction of the compulsory superannuation guarantee, to the retirement savings system we know today. As the system has evolved, so too has the public policy agenda. In Australia and in most Western democracies, with slower population growth, increased longevity, and a rising ratio of the aged population to tax payers, the costs of supporting retirees have posed a challenge to public finances. Consequently, the role of private pension schemes such as superannuation has become more important as a means of creating a more financially self-reliant generation of older citizens, with less demand on the public purse. In this paper we examine the current Australian superannuation system in terms of three key criteria: the provision of retirement income and a better standard of living in retirement; the adequacy of the system; and its fiscal sustainability. Integral to this outcome is the tax treatment of superannuation savings, and its inter-relationship with the other pillars of the retirement system, the Age Pension and private savings.

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Introduction

Although superannuation (super) in Australia existed as early as the nineteenth century, the vast advance in the system started as occupational superannuation in the 1970s. In these early days, occupational superannuation was a form of fringe benefit not designed to provide retirement income solely, but used as a reward for long service.

In the mid-1980s, superannuation was used by unions to bargain for productivity gains. Although it had features of retirement income provision, superannuation was not dedicated to saving for retirement. Until the early 1990s, saving for retirement was not compulsory and the balance was often withdrawn before retirement. It was the introduction of superannuation guarantee (SG) in 1992 that made the superannuation a system for retirement income provision.

This change in direction and objectives was due to the increased awareness of the impact of demographic change through slower population growth and increased longevity. This trend has resulted in the old age dependency ratio of retirees to tax payers in Australia, rising from 14.05% to 22.12% from 1960 to 2014 (The World Bank 2016). As is in many OECD countries, the Australian government became increasingly conscious of the potential fiscal impact of the Age Pension, health and aged care costs that an ageing population imposes, and the inequity of imposing such costs on a new generation of tax payers.

Retirement savings systems are in the interests of both the individual and the government to boost retirement income, thus greatly reducing the pressure on social security and pension systems. Such schemes were adopted in many OECD countries, and indeed only Ireland and New Zealand in the OECD do not have some form of mandatory, second-tier private pension to supplement the basic safety net of a public pension.

In 1994 the World Bank recommended the adoption of a more comprehensive measure, known as a three-pillar pension system, which was widely promoted by the United Nation (UN) and other parties (The World Bank 1994; Willmore 2000; Holzmann & Hinz 2005). It was comprised of a safety net provision, forced savings and voluntary savings. The system provides further risk diversification in which the second pillar – forced savings – acts as a buffer for the government financed public pension. Australia was an early adopter of this system with the Age Pension, mandated superannuation and voluntary superannuation – a multiple layer protection that placed Australians in a better position to cope with retirement income financing.

In this paper we first examine the development of superannuation in Australia and the evolution of its objectives from its beginnings in the nineteenth century, to the start of occupational superannuation and to the introduction of the superannuation guarantee, a major milestone in the development of the system we know today. Second, we take stock of how the system has progressed over the quarter of a century since superannuation was mandated for all employees, with particular reference to the Cooper Review (2010) and the Financial System Inquiry (2014), and examine the use of superannuation tax concessions by different cohorts of the population. Third, we discuss how the tax treatment of superannuation has changed over time, outcomes from the Henry Tax Review (2009), the interaction between tax and transfer payments as reflected in superannuation and the Age Pension, and implications for the system in the future. The final section draws conclusions as to how superannuation tax concessions may be targeted to ensure that the superannuation system meets its objective *to provide income in retirement and supplement or substitute for the Age Pension.*

Stage 1: Occupational superannuation: an employee benefit

Occupational superannuation isn't new. Its existence dates back to the mid nineteenth century. Around 1850, some banks, large private companies and governments started paying private pension to their senior, long serving employees. As early as 1915, superannuation fund earnings had attracted tax treatment (Nielsen & Harris 2010). From this time until the late 1980s, the system had a EET tax structure, that is a tax exemption on contributions and earnings, but with a full tax on benefits. Aside from a tax adjustment in 1988 from EET to ttt, there was little change in the way superannuation operated for the first 130 years.

Interestingly, the *Income Tax Assessment Act (ITAA) 1915* provided for “excluded” superannuation funds with 5 members or less. This may well have been the forerunner of Self-Managed Superannuation Funds (SMSFs) as this structure opened the door for the self-employed or employers to establish their own funds. However, it is not known if this option was taken up for that purpose and the beginnings of the SMSF structure are more often attributed to the ITAA 1935 where section 23 (a) extended “excluded” superannuation specifically to self-employed funds, with the proviso that there should be no more than 20 members (Lawrence 2014). In the 1970s and 1980s, small funds were either personal super schemes, known as section 23FB funds, which allowed up to \$1500 of annual contributions, or small 23(ja) (non-employee) funds (Wasiliev 2016).

For half of its short history, occupational superannuation was unknown to most employees, as it was only awarded to a small section of the work force, namely finance industry employees, high level managers and public servants (Bateman & Piggott 1996; The Treasury 2001). It was typically offered as an employer benefit which rewarded long term service. While private companies maintained their own superannuation funds, governments at state and federal levels provided larger superannuation schemes to cover public sector employees. The forms and details of contributions and participation in private company superannuation funds were largely undocumented, thus it is hard to track the development of occupational superannuation in the private sector in the 1970s. In the public sector, superannuation was provided at the federal level under the *Superannuation Act 1922* and its subsequent amendments, and by the Superannuation Board, renamed to the Superannuation Fund Investment Trust and the Commissioner for Superannuation in 1976.

The scheme provided two types of accounts, a pension account and a provident account. The former entitled contributors to a pension stream after retirement, while the later provided a lump sum at retirement. The scale of the public superannuation scheme increased from 1960, with the number of accounts doubling by 1976 and tripling by 1987 (Superannuation Board 1971-1978; the Superannuation Fund Investment Trust and the Commissioner for Superannuation 1979-1987). Despite relatively high participation in the public sector, coverage across the working population in the 1970s was very low. In the Australian Bureau of Statistics (ABS) first national survey of superannuation coverage in 1974, only 32% of employees or 38% of employed persons had a superannuation account attracting contributions (ABS 2009a).

Although the majority of employees were excluded from superannuation, there was little motivation to widen the coverage (Howard 1987). From an individual's view, superannuation was not very attractive. With a booming economy, employees seldom stayed with the same employer throughout their working life, and with no requirement for vesting at that time,

members would lose some or all of their entitlements when they changed employer.² Further, retirement income was pretty secure with a public pension in place, and low unemployment meant that workers had no difficulty finding another job to supplement their income. Unions also placed a low priority on occupational superannuation.

Before the era of a centralized wage fixation system, unions had strong bargaining power. To their members, real wage increases were a much better result than a deferred payment. Employers were also not enthusiastic and challenged unions in the High Court about whether superannuation was an industrial matter.³ While the High Court supported superannuation as a legitimate benefit, the preference from employees for wage increases meant that it was not worthwhile for unions to take the time and risk to bargain for superannuation contributions. Even the government at that time did not realize the importance of superannuation. As Age Pensioners constituted only a small proportion of the population, the cost of the public pension system did not create an excessive tax burden. Further, encouraging national savings wasn't a priority for government at that time.

In 1973, the Whitlam government established the National Superannuation Committee of Inquiry chaired by Keith Hancock. The Hancock Inquiry (1976) handed down two distinct recommendations in 1975: a majority recommendation supporting a partially contributory universal pension scheme with an earnings related supplement; and a minority recommendation for a composite system with a non-contributory flat rate universal pension, a means-tested supplement and the encouragement of involuntary savings through expanded occupational superannuation. The latter recommendation relied somewhat on the operation of occupational superannuation, and while the Fraser government rejected both recommendations, it is worth noting that current retirement income arrangements reflect the minority recommendation.

Problems with the occupational superannuation system at this stage were vesting, preservation, portability, and the tax treatment of contributions and withdrawals. These issues were discussed extensively in the literature of the time (Eberhardt 1983; Gunasekera & Powlay 1987; Foster 1988; Plowman & Weaven 1988; Dixon 1993). Preservation and portability were challenged as many superannuation schemes allowed those leaving a position to access the accrued balance to date, and did not allow transfer to new employer's fund. Not only did early withdrawal reduce retirement savings, high tax on early withdrawal also eroded member interest. Further, lump sum withdrawal on retirement were taxed less than income streams, creating incentives to "double dip", for retirees to spend their lump sum in non-retirement-income related activities, while still allowing a claim for the Age Pension as retirement income.

Stage 2: Superannuation as a tool of wages policy

Up until the mid-1980s, the spread of occupational superannuation was through the negotiation of industrial awards. Partly due to the centralized wage system, the unions realized the difficulty in bargaining for wage increases in a period of high inflation⁴, and consequently more

² Occupational superannuation system was mostly operating on a defined benefit (DB) scheme at the time. The accumulated member benefit was forfeited when the employee left the company.

³ See for example 15 May 1986 the High Court ruling on such a case.

⁴ The inflation was as high as 9% in 1986 while wage growth was only 5%.

effort was put into campaigning for occupational superannuation instead (ABS 1994-2014, 2009b). The practice was recognized by the ACTU which soon started to coordinate and assist unions in their campaigns for superannuation benefits. At the same time, the government became more aware of the ageing population's potential demands on the Age Pension, and the need to supplement retirement income through superannuation. As a consequence, both parties pushed to reform the superannuation system which was at the time small, inefficient and separate from the social security system.

The establishment of industry-based superannuation funds gave unions more control to facilitate the provision of retirement benefits for their members, and enhanced their bargaining power with employers. Industry funds also made employee superannuation benefits more valuable, as they provided some degree of portability within an industry. Among the better known early industry funds were the Federated Storemen and Packers Union (FSPU) which started the first union superannuation scheme in 1978, and the Metal Unions Superannuation Trust and the Building Unions Superannuation Scheme established in 1984-1985.

The ACTU played an active role in negotiating with the government in the matter of occupational superannuation, and in 1986 the ACTU successfully gained support from the Hawke government and secured a 3% employer superannuation contribution (also known as productivity award superannuation, PAS) in Accord II. In December 1987 the Hawke Government introduced the *Occupational Superannuation Standards Act 1987* which prescribed standards for the vesting of employee benefits, preserved benefits to the age of 55, gave employees more involvement in their superannuation funds, and increased the security of member benefits.

With the introduction of Reasonable Benefit Limits (RBL) in 1988, steps were also taken to encourage the use of income streams as opposed to lump sums, and to limit the total amount of concessional tax superannuation any one person could receive over a lifetime. From the commencement, withdrawals over the limits of \$400 000 for a lump sum and \$800 000 for an income stream were penalised with higher taxation rates. Limits were indexed over time from 1994-95 and reached \$678 149 and \$1 356 291 respectively by 2006-2007 (ATO 2016). In the words of Paul Keating the RBL provision “was introduced as an equity measure to make certain that the concessional tax superannuation provisions were shared fairly across the community and not concentrated to the benefit of a few” (Keating 2007).

Coverage improved substantially with the introduction of the PAS. Whereas less than a third of female workers were covered prior to 1987, the proportion of females rapidly increased to over 75% in 1992, as did the proportion of older and younger workers, who were often working part-time (ABS 1979, 1983-88, 1990-92). While superannuation was originally targeted at higher level workers, such as managers and professionals, the inclusion of super into awards meant that the proportion of ordinary workers increased markedly, so that by 1992 for example, 70% of sales persons were covered (ABS 1979, 1983-88, 1990-92). Coverage of superannuation had always been high in industries with a larger public sector component (over 60% and around 90% in 1987 and 1992 respectively), such as Public administration and defence, Communication, Electricity, gas and water, but a competitive labour market meant that the private sector needed to offer similar benefits to workers, so by the early 1990s the private sector had almost caught up (ABS 1979, 1983-88, 1990-92).

Stage 3: Super as a retirement income system

In his statement “Security in retirement: Planning for tomorrow today”, Dawkins (1992), Federal Treasurer from 1991 to 1993 in the Hawke-Keating Government, argued strongly for a mandated superannuation savings system. Dawkins’s statement detailed the government’s planned retirement incomes framework which “... now combines three central tiers. The Age Pension and social security system interacts with both compulsory and voluntary superannuation arrangements, with the compulsory tier of the Superannuation Guarantee (SG) Charge operating largely through the existing tax-assisted arrangements.” The objectives of the system were outlined as:

The increased self-provision for retirement will permit a higher standard of living in retirement than if we continued to rely on the Age Pension alone. It would also enable future governments to improve the retirement conditions for those Australians unable to fund their own retirement adequately. Lastly, self-provision will increase the flexibility in the Commonwealth's Budget in future years, especially as our population ages, and will increase our national savings overall, thus reducing our reliance on the savings of foreigners to fund our development.

This statement acknowledged the need for an extension to the existing voluntary occupational superannuation system to achieve a higher savings level for retirement and recognized the urgent need for much greater self-provision to be achieved through superannuation savings.

In 1992, the Senate Select Committee on Superannuation reviewed and reported on various superannuation issues which led to significant changes in the superannuation system. In the same year, the Hawke-Keating government passed *the Superannuation Guarantee (SG) (Administration) Act 1992*, thereby extending occupational superannuation to all employees along with the opportunity to make additional voluntary contributions. Shortly after, the *Superannuation Industry (Supervision) (SIS) Act* was implemented to regulate the superannuation industry. From its commencement, the SG was expected to rise over time and it was then estimated that an average worker with a compulsory contribution of 12% could retire after 40 years on an income of at least 40% of average weekly earnings (AWE).⁵ Supplemented by the Age Pension, the system could in the future deliver an adequate retirement income. Australia thus became the first and one of the few countries to implement the three-pillars of retirement income provision recommended by United Nation (UN).

One year after the introduction of the SG, Fitzgerald (1993) was commissioned by the Federal government to undertake a thorough review of national saving in Australia. In his report to the Treasurer, he commented on the superannuation system and its role in national savings and pointed out that “... a goal of well over 60% income replacement is needed if most people are eventually to depend on superannuation alone”, “... which would clearly require higher than 12% contribution” and “... 18% of earnings might be an appropriate ultimate target”. He also addressed some of the potential issues posed to the system, for example, the “double dipping” issues; consolidation of super accounts; the simplification of the tax system and prudential issues; extension to self-employed individuals; interaction with housing finance both before and after retirement; and employee co-contributions for low income earners. Fitzgerald stressed the

⁵ The proposed compulsory contribution of 12% consists of 9% employer contributions and 3% employee co-contributions.

need to increase household savings through superannuation, recognized its importance in supplementing national savings, but played down the critical role superannuation in national saving.

Subsequent to the Fitzgerald Report (1993) a number of amendments were made to superannuation legislation. These included government co-contributions for low income workers, and a guarantee of portability between funds. Further, superannuation benefits were prevented from being withdrawn prior to the preservation age under normal circumstances. The scope for “double dipping” was also greatly reduced by a few measures: the preservation age was gradually lifted from 55 to 60 to narrow the age gap between preservation age and the eligibility age for the Age Pension; and the tax concessions for superannuation pensions or rollover annuities were introduced to encourage retirees to take income streams rather than lump sums.

In May 1996, Treasurer Costello commissioned a review of the financial system, to examine developments in the period since financial deregulation took place in the early 1980s. In the Final Report of the Wallis Financial System Inquiry (1997), measures were proposed to encourage competition and choice in superannuation funds, including the introduction of the SMSF structure. In 1999, the Australian Tax Office (ATO) took over responsibility for the regulation and oversight of SMSFs. From 2001 to 2005, a number of reforms were introduced to the financial services sector which result in a dramatic reduction in the number of APRA regulated superannuation fund (Taylor & Asher 2016). At the same time, the number of SMSFs doubled from \$271 515 in 2004 to \$556 998 in 2015. Assets held in SMSFs increased from \$127 494m in 2004 to \$589 911m in 2015, accounting for 29% of the \$2 trillion total superannuation assets (ATO 2013, 2015).

However, it was not until July 2005 that the *Superannuation Legislation Amendment (Choice of Superannuation Funds) Act 2004*, was passed in Federal parliament. This legislation, first announced in the 1997-98 budget, required employers to provide workers with a choice of superannuation funds to receive their SG contributions. Consequently, an employee changing jobs could retain the same superannuation account.

At the same time, further amendments to the *SIS Act* were made to increase the flexibility of the retirement system through *Transition to Retirement*. The purpose of this initiative was to allow workers to access their superannuation savings once they reach the preservation age without having to retire or leave their job. It was thought that this initiative would support a gradual shift to part-time work, with access to superannuation to supplement reduced employment income. The reality has proved to be somewhat different, with the (Productivity Commission 2015, p.39) concluding that *Transition to Retirement* is more likely to be used as a tax planning vehicle as the majority of workers accessing this scheme are full-time workers, and are relatively wealthy.

Major changes to tax schemes were introduced in the Simpler Super Reforms (2007). The Age Based contributions Limit (ABL) was replaced by a uniform concessional contributions limit with a transition period in which contributions limit for individuals aged 50 and over are higher. Concessional contributions include compulsory employer contributions, any additional employee contributions, salary sacrifice payments, and contributions from the self-employed. The RBL was abolished and substituted with a non-concessional contributions limit of \$45 000 (indexed) over three years under the bring forward rule. Benefit withdrawal after age 60 is tax free, effectively adopting a tTE tax regime.

SUPERANNUATION CONTRIBUTIONS

The main features of the modern superannuation system in Australia are its compulsory saving component, the Superannuation Guarantee and the regime of voluntary contributions.

Superannuation Guarantee (SG): Employers are required to make quarterly prescribed superannuation contributions on behalf of their employees to a complying superannuation fund or pay a superannuation contribution charge (sum of superannuation guarantee liability, interest, administrative cost). The SG covers all employees except those over 75⁶, part-time workers under 18, or those earning less than \$450 per month⁷. The initial minimum contribution rate of 3%, increased to 9% by July 2012, and is now proposed to further increase to 12% by 2025.

Just as the inclusion of superannuation in Awards under the PAS legislation led to much broader coverage across different groups of workers, the SG further expanded access to superannuation benefits. By 2013, the overall coverage of superannuation among employed individuals is around 90% (ABS 1994-2014). There is a further substantial improvement in the gender inequality in the coverage of superannuation. The disparity between males and females employees reduced from 5.5% in 1993 to -1% in 2013 (ABS 1994-2014). Coverage for individuals in age bands 25 to 54 years exceeded 85%, and almost half of the 65-69 year olds were covered in 2007, although many were no longer in the workforce or met the requirement for the SG. Cover was also extended to almost half of younger cohorts in the 15-19 and 20-24 age groups, although employers were not required to contribute for employees younger than 18 years old (ABS 2007). A similar broadening of coverage could be observed for income groups, and except for the two lowest income brackets, over 80% had employer contribution made on their behalf consistent over the last two decades (ABS 1994-2014). The relatively low coverage in the lowest bracket can be explained by the low income threshold. Most markedly following introduction of the SG, the coverage of private sector workers grew from less than 75% to almost 90% in 2013, reducing the gap with the public sector which had coverage exceeding 97% in 2013 (ABS 1979, 1983-88, 1990-92, 1994-2014).

Despite the wide coverage of superannuation among employees, compulsory retirement saving was not extended to the whole population. The overall coverage of superannuation amongst employees was stable at around 90% by 2012, although across the wider community only around 80% were covered at the time of retirement (Productivity Commission 2015).

Voluntary Contributions: Employees can make additional voluntary contributions to their super from either pre- or post-tax income. Pre-tax contributions include salary sacrifice and additional contributions under an annual concessional cap. Salary sacrifice is a concessional pre-tax contribution, where employers deduct contributions from an employee's salary and make contributions on their employee's behalf for a range of nominated expenses. Not all employers allow salary sacrifice. Post-tax non-concessional contributions are typically at the end of the financial year and include contributions from a spouse, excess concessional contributions above the cap, contributions in excess of the capital gains tax cap, and transfers from foreign pension funds.

⁶ The age limit was initially 65 (Dawkins 1992) and was increased to 70 from July 1997 and to 75 from July 2013.

⁷ An opt-out mechanism also exist for monthly income below \$900.

The overall utilisation of voluntary contributions among employees is low. Less than one third of employees make any form of voluntary contribution. Feng (2013) studied extensively the decision to make voluntary contributions. Figure 1 shows the participation pattern of individuals who were covered by a superannuation scheme in 2007. Participation in voluntary contributions increased dramatically with age. Post-tax contributions (mainly personal contributions) are more popular in all age groups, than pre-tax contributions such as salary sacrifice. As people enter their middle age, a small proportion of individuals utilize both types of voluntary contributions to save more and receive more tax benefits. Participation in voluntary contributions also rises with income. Feng *et al.* (2014) show a substantially positive relationship between income and salary sacrifice based on ABS micro-data. The participation in post-tax contributions is considerably higher for median to high income workers (ABS 2007). Men are more actively involved in voluntary contributions than women, however, after controlling for other characteristics, Feng (2013) showed that this variation is mainly driven by gender differences in income. A distinct pattern also exists between public and private sectors where public sector employees use post-tax contributions more often (ABS 2007). This could be the result of many public sector employees still having a DB scheme, or that they are covered by a DC scheme that involves individual contributions as a default.

Unlike the SG where employers mostly contribute the mandated minimum rate, by making additional voluntary contributions workers have the freedom to choose their own (total) contribution rate. Individuals who make only one type of voluntary contribution, are likely to save between 5 and 10% more than employees with only compulsory employer contributions. However, if both pre- and post-tax contributions are made, individuals save 20 to 25% more than the SG rate. The level of voluntary contributions is directly related to age, with employees taking advantage of the superannuation system when they reach preservation age by contributing half (55-64) and almost all (65-69) of their income into their superannuation fund to maximize tax concessions (ABS 2007), although contribution rates among different income groups are relatively stable.

Interest in making voluntary contributions has faded slightly over the past decade. While in 2000, over 30% of median to high income workers made voluntary contributions, by 2007 this had fallen to around 20% of workers in the same income group (ABS 2000, 2007). This pattern is also observed in Feng and Gerrans (2014) study of Mercer master super trust members which covers the period 2002 to 2012. While on an individual level, the likelihood of making voluntary contributions increases with longevity in the fund, new members are substantially less likely to make a voluntary contribution. A similar pattern of declining voluntary contributions was noted by the Charter Group (2013) which expressed concern that this trend may align with declining trust and confidence in the system, possibly as a result of frequent policy changes. They proposed a regular survey of superannuation fund members to monitor issues of trust.

THE SUPER SYSTEM (COOPER) REVIEW

A quarter of a century after the introduction of the SG, the superannuation system continued to develop in accordance with the objectives outlined in the Dawkins's (1992) statement and the Fitzgerald Report (1993). By 2013, coverage of full-time employees had reached 94% and funds under management totalled around \$2 trillion in 2015. Awareness of the impending rise in the proportion of older Australians had grown, and led to a realisation of the need to integrate superannuation into the retirement income system to enhance the adequacy of retirement incomes and reduce the burden on the Age Pension.

The Super System Review (Cooper Review) was initiated in 2009 with the support of the superannuation industry to review the progress of the system, and examine the governance, efficiency, structure and operation of Australia's superannuation system (2010). The Final Report handed down recommendations around ten broad areas of reform, and two major initiatives, namely MySuper and SuperStream.

To facilitate growth in account balances for superannuation fund members, the Cooper Review introduced a choice architecture with three types of superannuation fund: MySuper (the default investment strategy maintained by professionals), choice funds (that allow member to choose investment strategies but managed by professionals) and self-managed superannuation fund (SMSF, individual maintained superannuation arrangement). It further proposed that MySuper, designed to accommodate the majority (around 80%) of superannuation members, should be a whole of life product to include both accumulation and decumulation phases. The Review also recognized the sole purpose of superannuation and suggested that savings should only be used to fund retirement income, and insurance introduced into the fund should only cover benefits to death, total and permanent disablement (TPD) or as income protection.

The Cooper Review also recommended SuperStream, a package of measures designed to increase the efficiency of superannuation funds by standardizing back office operations. It was argued that Tax File Numbers (TFN) should be used as the primary identifier of member accounts, in order to reduce the number of inactive or lost member accounts. Aside from streamlining the data communication between superannuation funds, a series of governance and regulatory recommendations were made which included better disclosure of superannuation fund portfolio holdings, investment strategies and associated risks and returns to allow members to compare between funds.

The recommendations from the Cooper Review were largely accepted by government, leading to widespread consultation with industry, and the subsequent implementation of legislative change. Over the financial years 2012-2014, 44 legislative changes passed through parliament pertaining to the superannuation system.

CHARTER OF SUPERANNUATION ADEQUACY AND SUSTAINABILITY

In April 2013, the ALP federal government announced that it intended to establish a Council of Superannuation Custodians, an outcome of the Cooper Review. This Council was to monitor a proposed *Charter of Superannuation Adequacy and Sustainability*, assess future superannuation policy against this Charter, and report annually to Parliament, including recommending improvements to the super system.

According to Bill Shorten, the then Minister for Superannuation, the Council of Superannuation Custodians would “act as an impartial, expert superannuation body which protects the integrity of the scheme and ensure the policy settings are consistent with the core objects, values and principles” (Power 2013).

The 5-member steering group, known as the Charter Group reported to government on 5 July 2013. In this Report (2013) the stated objectives of superannuation were to:

- *provide an adequate level of retirement income;*
- *relieve pressure on the Age Pension; and*

- *increase national savings, creating a pool of patient capital to be invested as decided by fiduciary trustees.*

The Charter Group defined four principles as a basis for the Charter on Australian superannuation which they felt should be enshrined in legislation: adequacy, sustainability, certainty and fairness. On assuming government in late 2013, this initiative was discontinued by the Abbott Government.

THE FINANCIAL SYSTEM INQUIRY

In November 2013, Treasurer Joe Hockey (2013) announced a Financial System Inquiry to review and make recommendations on:

- *How the financial system can more efficiently allocate Australian sourced capital to minimize our exposure to volatility in global capital markets;*
- *How we can best balance competition, innovation and efficiency, with stability and consumer protection;*
- *The role and impact of new technologies, market innovations and changing consumer preferences; and*
- *International integration, including international financial regulation.*

The Committee chaired by David Murray, former Head of the Commonwealth Bank of Australia, took particular note of major changes that had occurred since the Wallis Review (1997), 16 years previously. These included the growth of the superannuation system, the widespread increase in technology in the financial sector, and the reregulation that had taken place following the Global Finance Crisis which initiated in 2007.

The retirement phase of superannuation received particular attention in this review. To that point, policies had focussed largely on the accumulation phase of superannuation, but with the maturing of the system and an increasing number of people moving into retirement, the focus had shifted to decumulation. Recommendations were made concerning clarification of the objectives of superannuation, the need for retirement income projections to be advised to members on a regular basis, a smoother transition from accumulation to decumulation phases, and for trustees to develop a Comprehensive Income Retirement Product, for the purpose of ensuring better retirement income streams and assisting members to manage their longevity risk.

In particular, Recommendation 9 stated that the Government should:

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

The objective proposed by the Inquiry was *to provide income in retirement to substitute or supplement the Age Pension*. This simple statement was supported by a number of subsidiary objectives, namely to:

- *Facilitate consumption smoothing over the course of an individual's life;*
- *Help people manage financial risks in retirement;*
- *Be fully funded from savings;*
- *Be invested in the best interests of superannuation fund members;*

- *Alleviate fiscal pressures on Government from the retirement income system; and*
- *Be simple and efficient, and provide safeguards.*

In its response the government accepted almost all of the Inquiry's recommendations, and with respect to Recommendation 9, undertook that by the end of 2016 it would "develop and introduce legislation to enshrine the objective of the superannuation system." (Australian Government 2015)

Accordingly, on 6 March 2016 Federal Treasury released a Discussion Paper on *The Objective of Super (2016a)*. The brief paper commences with reference to Dawkins statement of 1992, and states an intention to enshrine the objective as recommended by the FSI into superannuation legislation.

The paper emphasises the objective *to provide income in retirement to substitute or supplement the Age Pension*, clarifies the point that superannuation is to fund a person's retirement, and is not to be used for wealth accumulation and retirement planning. The three key aspects of the objective are its ability to deliver on retirement income or standard of living in retirement, adequacy and fiscal sustainability.

A notable change in the objective of superannuation from the earlier Dawkins and Charter Group statements is the reference to "substitute" for the Age Pension. In these earlier statements, the role of superannuation was to improve retirement incomes or "relieve the pressure on the Age Pension" (Charter Group 2013), but not necessarily replace the Age Pension. This indicates a more ambitious approach to retirement savings, given the relatively low average balances of the majority of the population.

Tax treatment of superannuation

Tax treatment of retirement savings is an important component of the superannuation system. Superannuation tax concessions provide an incentive to encourage retirement savings, but how such incentives are distributed is often contested at a political level, due to differing social policy philosophies, and also because of the budgetary impact of superannuation tax concessions, and Age Pension transfer payments. It is probably not surprising then to note that superannuation tax concessions have been a feature of 13 Budget speeches in the 24 years since the SG was introduced (Swoboda 2014). Political and budgetary objectives can mean that changes to superannuation tax concessions are inconsistent with retirement system objectives, and there is also evidence to suggest that these continuous changes to superannuation policy have undermined trust in the system (the Charter Group 2013).

Tax concessions on superannuation contributions can incentivise individuals to save for their retirement, but may also undermine the neutrality of savings decisions. Individuals making salary sacrifice are effectively lowering their taxable income and thus reducing their tax liability, and for higher income earners, post-tax contributions are rewarded as individuals can gain tax concessions from their superannuation investment returns in the form of tax free income in retirement. Given the wide disparity in incomes across superannuation account holders, issues of equity are paramount. While wealthier income earners may be persuaded by the tax incentives, lower income earners may be harmed by such a tax scheme. For example, the employer contributions tax of 15% can be a tax impost on lower income earners who would not otherwise be subject to personal income tax.

Over time there have been a number of initiatives to address the latter issue. From July 1997, the government offered a tax offset for personal contributions made on behalf of a low income spouse. Eligible individuals were able to claim a tax offset of 18% for contributions up to \$3 000 if the spouse's income was less than \$10 800, with the offset being phased out completely when the spouse's income reached \$13 800. The *Superannuation (Government Co-contribution for Low Income Earners) Act 2003* was also introduced to assist low income earners by matching post-tax contributions made by individuals whose income is below a threshold, gradually phasing out at a higher threshold. Matching rates varied across financial years, but generally, low income earners received half to one and a half dollar for each one dollar they contributed up to \$1 000 contributions, with low and high income thresholds set for various years.

Some of the most significant changes to the taxation of superannuation were contained in the Howard Government's 2006 Budget reforms under a "Plan to Simplify and Streamline Superannuation". On 15 March 2007, the *Tax Laws Amendment (Simplified Superannuation) Bill 2006* and nine other related Bills, were passed with bi-partisan support. This legislation included significant changes to the taxation of superannuation including a fundamental change to the tax regime which had been in place since the earliest days of superannuation. Up to this point, tax had been paid on benefits received in post-retirement, but concessionally on contributions or earnings (i.e., a ttt system). Under the new reforms contributions by employers and earnings would be taxed at low rates, but withdrawal from superannuation for those over 60 would be exempt from tax (i.e., a ttE system).

In addition, the RBLs were abolished and replaced with a low rate cap for withdraw between the preservation age and 60 years to mitigate the problem of "double dipping". Age based maximum concessional limits were gradually replaced by a fixed maximum concession limit. Maximum non-concessional caps were also introduced and capped at \$150 000 per annum; or \$450 000 averaged over three years. Workers were offered the opportunity to make a last "undeducted" (non-concessional) contribution of up to \$1 million by 1 July 2007. Members were no longer required to access their superannuation at 65 years, and the age limit on contributions was extended to 75 years. Government co-contributions for low income workers were also extended to the self-employed.

As a consequence, superannuation contributions doubled in 2006-07, with voluntary contributions growing three fold (Kelly 2013). The new scheme appeared to have incentivised individuals to maximize their benefits.

THE HENRY REVIEW

In the 2008-09 budget year, the government announced a comprehensive review of Australia's tax system to better position Australia in dealing with its social, economic and environmental challenges (Henry *et al.* 2009). The team led by Ken Henry delivered the report in December 2009. The Review and its earlier papers looked closely at taxation on retirement incomes in particular tax on superannuation, and was concerned with three aspects on superannuation: the inequality of tax concessions between low and high-income earners, the adequacy of superannuation savings with respect to tax on investment returns, and the "double dipping" issue.

The Final Report recommended abolishing the tax on superannuation contributions as follows:

Recommendation 18: *The tax on superannuation contributions in the fund should be abolished. Employer superannuation contributions should be treated as income in the hands of the individual, taxed at marginal personal income tax rates and receive a flat-rate refundable tax offset.*

- a. *An offset should be provided for all superannuation contributions up to an annual cap of \$25 000 (indexed). The offset should be set so the majority of taxpayers do not pay more than 15 per cent tax on their contributions. The cap should be doubled for people aged 50 or older.*
- b. *An annual cap on total contributions should continue to apply.*
- c. *The offset should replace the superannuation co-contribution and superannuation spouse contribution tax offset.*
- d. *Compulsory superannuation contributions made by employers should not reduce eligibility for income support or family assistance payments. They should also not form part of the calculation for child support.*

With respect to the tax on earnings within the fund:

Recommendation 19: *The rate of tax on superannuation fund earnings should be halved to 7.5 per cent. Superannuation funds should retain their access to imputation credits. The 7.5 per cent tax should also apply to capital gains (without a discount) and the earnings from assets supporting superannuation income streams.*

The Henry Review also recommended a gradual co-ordinated rise of pension eligibility age and superannuation preservation age to 67, and the government offering of immediate annuity and deferred annuity products to reduce “double dipping” and allow a person to hedge longevity risk. However, the Review indicated that a compulsory purchase of an annuity upon retirement was not necessary which greatly reduced the effect of these recommendations.

Amongst other superannuation issues addressed by the Henry Review was the need to improve awareness of the retirement income system as the system matures and balances grow, and to have easier access to information to assist individuals in managing their superannuation. Accordingly, the Review recommended that employers pay compulsory contributions at a higher frequency and report them to their employees, and that the government should provide a superannuation portal to allow people to manage their superannuation, linking government agencies and providing retirement information. In addition, it was recommended that tax file numbers (TFNs) be used to assist tracking superannuation records.

With respect to the Age Pension means test, Recommendation 88 suggested replacing the income and asset tests with *a comprehensive means test based on a combined measure of employment income, business income and deemed income on assets*. All assets would have a deeming rate applied, but the means test exemption for the family home would continue up to a high indexed threshold, with a deeming rate to apply above that threshold. Personal use assets would similarly have a high capped exemption.

Of the 138 Henry Review recommendations, only a small number were adopted by government, including four that related to superannuation. These included a proposed increase in the SG from 9% to 12% by 2019/20⁸, an increase in the SG age limit from 70 to 75 years, and the

⁸ The Abbott Government suspended the increase in SG rate by five years in 2014, thus the SG rate will increase to 12% by 2024/25.

reinstatement of \$50 000 concessional contribution caps for those over 50 with superannuation balances under \$500 000. The recommendation for a superannuation contribution of up to \$500 p.a. to be made for people earning up to \$37 000 to effectively refund contributions tax was implemented in 2012 as the *Low Income Superannuation Contribution (LICS)*. The Review therefore partly achieved its objectives of increasing the adequacy of the system, and to a lesser degree, reducing the inequity between high and low income earners. However, the LICS initiative, which was to be funded from the proceeds of the now repealed Mineral Resource Rents Tax, will not continue beyond the 2017 Tax Year.

Subsequent to the Henry Review a further step was taken in 2012 to improve the progressive nature of superannuation tax concessions with *Sustaining the Superannuation Concession Contribution* (more commonly known as Division 293 Tax), which was implemented to double the tax concession on contributions to 30% for those earning more than \$300 000.

TAX AND THE FINANCIAL SYSTEM INQUIRY (FSI)

In its Final Report, the Murray Financial System Inquiry (2014) also made observations concerning the taxation of superannuation. It recommended that the forthcoming Tax Review should consider:

- *Aligning the earnings tax rate across the accumulation and retirement phases.*
- *Remov(ing) tax barriers to enable a more seamless transition to retirement.*
- *Better target(ing) superannuation tax concessions to achieve the objectives of the superannuation system . . . and in doing so, reduce the cost of the superannuation system to Government, reduce distortions to the allocation of funding in the economy, and improve long-term confidence and policy stability in the superannuation system.*

Not only is it suggested that superannuation tax concessions should support the objectives of superannuation, but that policy changes should be publicly reported, implying that any changes should be evidence-based and be justifiable in a public forum.

Past super policy changes have often revolved around electoral or budgetary issues, and have often been exempt from any form of Regulation Impact Statements (RISs), which can carefully and quantitatively assess the benefits and possible unintended consequences of policy changes. Exemptions from an RIS are not uncommon. Policy changes may be exempt either through the Prime Minister's discretion, if the proposed policy change was part of an electoral platform, or if it is part of an inter-departmental carve out. The Office of Best Practice Regulation oversees RIS and follow up post-implementation Reviews. As of June 2015 there were 90 post-implementation reviews to be undertaken on superannuation related matters (Taylor & Asher 2016). Consequently, one might conclude that many policy changes to superannuation have not received the necessary level of objective scrutiny.

In response to another recommendation of the Murray Inquiry, the Productivity Commission is embarking on a project to developing a set of KPIs to publicly monitor the efficiency and competitiveness of the super sector. Having measurable benchmarks and subjecting policy changes to efficient and timely RISs and implementation reviews will be a critical part of monitoring the new objective. These benchmarks together with a more targeted and transparent policy around superannuation would go a long way towards building greater trust in the system, keeping the focus on member benefit, and guarding against unintended consequences of policy changes.

SUPERANNUATION AND THE AGE PENSION – TAXES AND TRANSFER PAYMENT

Despite the commitment to a three pillars retirement system of a means-tested public pension, mandated superannuation and voluntary savings (including voluntary super), announced as early as Dawkins statement of 1992, there has often been a failure to treat the retirement system as an integrated whole in policy terms.

The three pillars are strongly linked so a change to the policy settings of one, often has an impact on the others. In its report on *Superannuation Policy for Post-Retirement*, Productivity Commission (2015, p.24) noted that *the roles of the pillars are not always clear and incentives are not always compatible or well understood.*

If the purpose of superannuation tax concessions is to incentivise the superannuation system so that it achieves its objective of substituting or supplementing the Age Pension, then policy should consider the integrated retirement system. In particular, there is a need to consider how benefits are allocated through the superannuation and Age Pension systems.

Figure 2 demonstrates how Age Pension payments and superannuation tax concessions impact across each income decile. It is clear from this figure, that there is a regressive element to superannuation tax concessions. While assistance to most income deciles is relatively equal at around \$265 000, there is a disproportionate level of support for those in the top decile with taxable incomes of over \$180 000. The 90th, 95th and 99th percentiles benefit from an average of \$350 000, \$425 000, and \$515 000 respectively (Ingles & Stewart 2015). It should be noted however, that this 2012 figure does not include the introduction of the 2012 Division 293 tax which applies a 30% tax rate to concessions for those in the highest income group earning over \$300 000 per annum (95th and 99th percentiles).

In their detailed analysis of the treatment of superannuation tax concessions and the Age Pension, (Ingles & Stewart 2015) model the impact for individuals and the economy of five different tax options which would support retirement savings, but in a more principles-based, neutral and equitable manner than is currently the case. They conclude that “a more coherent retirement tax and transfer system can be achieved by reducing tax concessions and making the age pension means test less harsh” (p. 51).

Ingles and Stewart (2015) contrast the generosity of superannuation tax concessions with the relatively high effective tax rate imposed on Age pensioners through asset and income tests. They argue for a non-means tested age pension, and point to the distortion in decision-making that occurs through the structure of the existing means tests, and the potential loss of older workers from the workforce as a result. They also argue for preserving the neutrality of the tax system by ensuring that “in the long term, the tax and transfer treatment of retirement savings should be aligned with the treatment of savings in general” (p. 52).

RE: THINK TAX REVIEW

To guide discussion on the review of taxation, the Treasurer released a discussion paper, *Re:Think: Better Tax, Better Australia*, on 30 March 2015. The tax review was initially intended to take a broad ranging view of the entire tax system in order to support improvements in productivity and encourage workforce participation, for the purpose of fostering jobs, growth and opportunities. The outcome, rather than a White Paper, will be announced as part of the 2016 Budget Papers.

The Discussion Paper (2015c) focusses on superannuation in *Chapter 4 Savings*. Arguments are advanced for and against the concessional taxation of savings. It is pointed out that there is a lack of neutrality in how various forms of saving are taxed in Australia, and that the generous taxation of superannuation and housing has resulted in large levels of saving in these assets.

It is noted that the tax preferred treatment of saving through home ownership is not dissimilar to many other OECD countries. In Australia the family home is exempt from capital gains tax and any tax that might apply to the imputed rent or use of the house, and although it is exempt from Land Tax, it is subject to stamp duties and municipal rates levied by local and state governments. The primary home is also exempted from the means test for transfer payments such as the Age Pension. It is also stated that, given the central importance of the home for Australian families, there is a strong consensus that it would not be appropriate to tax either the imputed rent on owner occupied housing or capital gains derived from it (p. 67).

The case for tax concessions on superannuation is made on the basis that superannuation contributions are compulsory and cannot be accessed until retirement, and that an incentive is needed to encourage people to save for retirement. On the other hand, it has been argued that as the SG is mandated, it should not require an incentive in the form of tax concessions (Warren *et al.* 2015).

It is also noted that while pre-tax contributions and earnings are generally taxed at flat rates, the level of concessionality differs depending on the individual's marginal tax rate. Those with high incomes receive the greatest tax discount relative to their marginal tax rates, and will generally save a higher proportion of their income. A summary of the current tax treatment of superannuation is given in Table 1.

When examining the allocation of tax concessions across income levels it is evidently regressive with higher income tax brackets receive greater benefits, in fact the top 20 percent of income earners receive around 40% of all tax concessions by value (The Treasury 2012). This reinforces the point made in Figure 2, however once again it should be noted that this table does not allow for the introduction of the 2012 Division 293 tax on incomes over \$300 000.

Concessions need to be viewed, however, within the context of Australia's full retirement income support arrangements, including the means-tested Age Pension.

Discussion

In the quarter century since the SG was introduced, the Australian superannuation system has grown substantially both in terms of member coverage and industry development. While superannuation has been recognized as an indispensable part of the retirement income system it has yet to show its strength and impact on population ageing.

In this section we examine the performance of the superannuation system with respect to the primary objective of *providing income in retirement to substitute or supplement the Age Pension*, and its sub-objectives. In particular, we focus on its ability to deliver on the three key aspects specified in *the Objective of Superannuation Discussion Paper (2016a)*, that is retirement income and a better standard of living in retirement, the adequacy of the system, and fiscal sustainability.

RETIREMENT INCOME OR STANDARD OF LIVING IN RETIREMENT

While retirement income refers to income stream, standard of living is broader, and may include the use of assets such as the family home.

Retirement income: Retirement incomes for most Australians will be a combination of the Age Pension, income from account-based pensions (ABPs), and risk management products such as annuities. In addition to a regular income stream, retirees may occasionally require access to capital for major purchases such as upgrading a motor vehicle, replacing white goods, home modifications, holidays or unexpected health costs. Access to aged care or health costs may also be of concern for older Australians. For some, there is also a strong desire to preserve some part of their retirement savings as a bequest. The desire to ensure flexible access capital in retirement for these precautionary and bequest motives has been shown to minimise the amount retiree's drawdown, in some cases resulting in an inadequate level of retirement income (Wu *et al.* 2014).

The Age Pension is designed to provide a safety net for those unable to save enough through their working life to generate retirement savings, or to supplement the insufficient retirement savings of others. It provides an income for the majority of older Australians, with around 70 per cent of retirees receiving the Age Pension, and 60 per cent of those receiving the maximum rate (The Treasury 2015a, p.65). This take up rate is one of the highest in the OECD, second only to Denmark. By contrast more than two thirds of OECD nations have a public pension take up rate of less than 20% (2015, p.53). As the superannuation system matures and balances increase it is expected that the proportion of Australians on the full Age Pension will decrease.

Eligibility for the Age Pension depends on residency and age. Residents must have lived in Australia for over 10 years and be living in Australia when applying (with some exceptions for refugees). Qualifying age depends on the year of birth. Since its introduction in 1908, the eligibility age for men has been 65 years, and despite the fact that male life expectancy has increased by 25 years since, the eligibility age has only increased only slightly over the past decade. For those born before 1952 eligibility for the Age Pension is 65 years, gradually increasing to 67 years for those born after 1956.

The value of the Age Pension is adjusted biannually in line with the consumer price index (CPI) or the Pensioner and Beneficiary Living Cost Index (PBLCI), whichever is the greater. If necessary, further increases ensure that the combined couple rate does not fall below 41.8% of national pre-tax Male Total Average Weekly Earnings. The single maximum basic rate of

pension, excluding supplements, is 66.33% of the combined couple rate. At March 2016 the full Age Pension (including pension and energy supplements) was \$22 721 for a single or \$34 252 for a couple. For people retiring today aged 65, Rice Warner estimates that the value of the Age Pension is equivalent to a capital sum of \$816 000 for couples, \$419 000 for a single male and \$482 000 for a single female (Actuaries Institute 2015).

Under the income test, the pension payment decreases by 50c for every \$1 of income earned above \$162 per fortnight (or \$288 for a couple), until it reaches \$1 909 per fortnight (or \$2 922 for a couple). In addition, there is a “Work Bonus” income test concession designed to encourage people to continue to work. It allows pensioners to earn up to \$250 a fortnight without it being assessed as income under the income test. The combination of the Work Bonus and the minimum threshold, allow a single pensioner with no other income to earn up to around \$10 450 each year without it affecting their pension.

Under the assets means test, for home owners payment is reduced by \$1.50 per fortnight for every \$1 000 of assets over and above the threshold (\$205 500 for single and \$291 500 for a couple). For non-homeowners the thresholds are \$354 500 for a single person and \$440 500 for a couple. The family home is exempt from the asset test.

Rent Assistance is available for private renters whose rent exceeds a specified amount and varies with number of dependents and marital status, with the maximum single rate of \$130.40 per fortnight in March 2016. This gives an accrued maximum annual entitlement of \$3 390 per annum.

The two most common **retirement income streams** – ABPs and annuities – are both assessable under the means test provisions of the Age Pension. ABPs purchased before 2015 are only partly assessed under the income test. Account-based pensions purchased after 1 January 2015 are assessed the same as other financial investments such as cash, shares and managed funds. That is, the entire balance of ABPs is now subject to deeming rules for the assets test of the Age Pension. Under the deeming provisions financial investments are assumed to earn a certain rates of income regardless of the level of income actually generated.

Superannuation balances: With the maturing of the superannuation system there is a greater diversity of superannuation outcomes. In 2013-14 the average superannuation balance for people approaching retirement age (55-64) was \$322 000 for men and \$180 000 for women, a significant increase on the corresponding balances in 2003-04 of \$160 000 and \$83 000 respectively. At the same time, around a quarter of the population has no superannuation (ABS 2007).

In contrast to this, Self-Managed Superannuation Funds (SMSF) balances are significantly greater. As at 30 June 2014, the average SMSF trustee balance was \$573 808, with a median balance of \$279 818, which compares with the average account balance of a non-SMSF member of \$45 000 in 2015 (ATO 2015; APRA 2016). These larger balances can at least be partly explained by the average older age of SMSF members. Whereas 82 per cent of SMSF trustees are aged 45 years or older, the majority of non-SMSF members are under 50 years.

There is also a small number of very large balances. According to ASFA figures, in the 2011-12 financial year there were just under 500 super accounts with balances in excess of \$10m – these retirees withdrew an average of \$1.5m per year tax free (ASFA 2015, p.17). With 24 million active superannuation accounts this is a very small proportion of the population. Given the current limits on concessional caps, these large balances are likely to be a legacy issue from

days when caps were more generous and the one-off 2007 \$1 million contribution cap. However, such balances do draw attention to the use of non-concessional caps, which remain generous.

For most people, superannuation balances remain modest on retirement, understandable given that they will only have been making contributions for around half of their working lives. Further, around 20 per cent will have no superannuation when they reach the preservation age, increasing to 40 per cent as they approach Age Pension eligibility at 64 years. Given current low average balances, retirement savings are fairly quickly exhausted and only 17 per cent of individuals have any remaining super from the age of 80 (Productivity Commission 2015).

However as future cohorts enjoy the SG for all of their working lives, this will change. Given the scheduled increases in the SG going forward, we estimate that a worker on an average gross income of \$78 000, making only mandatory SG contributions throughout his working life to retirement at age 67, will be able to achieve a minimum balance of around \$500 000, to completely substitute for the Age Pension.

Annuities: Many argue that while superannuation largely alleviated the problem of inadequate saving for retirement, it lacks the strength to cope with longevity risks and inflation risk (Bateman & Piggott 1996; Bateman 2009). The Henry Review (2009) recommended that life and annuities and other similar products should be developed to help mitigate such problems. While the products are very successful in other markets such as US and UK, the market in Australia is small. Despite a lack of incentives and remaining regulatory barriers, sales of annuities have increased considerably in the recent past due to growing awareness of the need to safeguard against longevity risk highlighted through public policy initiatives such as the recommendation from the FSI on the need for superannuation trustees to develop default *Comprehensive Income Products for Retirement* to manage longevity risk. Regulatory amendments contemplated in Treasury's much anticipated *Review of Retirement Income Stream Regulation* are likely to make annuities more flexible and attractive to the retail market in the future.

Recent modelling by the Australian Centre for Financial Studies (2015) for AIST has shown that, under the current means test, those with superannuation balances of \$100 000 who own their own home but who have few other assets, might expect their ABP income to supplement their full Age Pension entitlements throughout their non-working years. These older Australians enjoy an adequate standard of living \$5 000 above the ASFA modest standard (\$28 489 in 2015 dollars), with a residual balance in their superannuation account of around \$50 000 by age 90.

For those on higher balances of \$250 000 or more, combining the ABP with a part annuity purchased from 25 per cent of the balance on retirement, provides the optimal income mix. The benefits of combining an ABP with a risk management product guards against longevity risk and market risk. The appropriate combination of income stream products will depend on the individual in terms of their wealth outside superannuation, their risk tolerance, and their expectations concerning standard of living.

Standard of living in retirement: Australian households have enjoyed a substantial increase in wealth over the past decade. Households in age groups 55-64 and 65-74 enjoy the highest net wealth, of \$1 240 000 and \$1 230 000 respectively. Incomes and wealth for older Australians have grown faster than for other age groups. Households of persons aged 65-74 are now \$400 000 wealthier than a household of the same age in in 2003-04. The greatest single contributor

to the increase in wealth in these age groups was savings (including superannuation), followed closely by increase in property values and then other financial assets. While debt also has increased over the past decade, this appears to be largely repaid by the time individuals retire (Ralston 2015).

Residential property in Australia is the key means of storing household wealth. The total value of residential property is estimated to be \$5.76 trillion, of which Australians aged over 65 hold more than \$500 billion. The mean value of this property is \$604,700 and around 80 per cent of older Australians own their homes outright (ABS 2015).

Home ownership is an important contributor to quality of life in retirement, and is a critical part of the third pillar of voluntary savings in a retirement system (The World Bank 1994). But while housing wealth has traditionally been an important part of Australian retirement policy (Baxter & McDonald 2005), reinforced by tax and benefit subsidies for owner occupation, it has not been seen as a source of retirement income.

High home ownership rates in Australian have meant that governments provide only a modest Age Pension, as retirees tend to have lower living expenses than non-home owners. When compared with five other countries (Canada, United Kingdom, United States of America, Italy and Finland), (Yates & Bradbury 2010) find that while Australia has the highest before-housing poverty rate among those aged 65 years or over, it has one of the lowest after-housing poverty rates in this same age group.

Hence it has also become increasingly evident that the store of wealth in the family home provides a valuable asset that could well be drawn on in retirement to supplement incomes, and potentially reduce the need for publicly subsidised income support. In an economy with few wealth taxes, and no death duties, the family home has become a means of wealth transfer, or bequest to the next generation. These issues have sparked debate regarding whether the value of the family home, either entirely or up to some capped amount, be included in the means test to overcome what might be seen as publicly subsidised intergenerational wealth transfer (Daley & Wood 2014).

There are several important policy implications for the role of the family home and its central role in ensuring a higher standard of living in retirement. First, there is currently a lack of policy incentives to ensure increased demand for products which allow retirees to draw equity from their homes, and hence a catalyst to innovation to ensure the right products are in place so that the home can become a potential source of income in retirement.

Second, the underlying assumption of home ownership in retirement means that those who are not home-owners are financially disadvantaged. Financial hardship is exacerbated when the retiree does not own their own home. Although the Age Pension means test excludes the primary residence a retiree who owns their home receives a more favourable payment given the value accorded to housing in the assets means test, and the low level of rent assistance. Although the Government provides Rent Assistance it pays a maximum rate of \$3 338 per year, which compares poorly with the ABS estimate of average yearly rent for a single retiree of \$8 946. The shortfall between Rent Assistance and actual rental costs increases the risk of financial hardship (Ralston & Maddock 2015). With declining levels of home ownership in younger generations, this assumption needs to be reviewed.

ADEQUACY

The adequacy of retirement income can be measured either relative to previous employment income, or against an absolute benchmark, which identifies an appropriate level of retirement income for all citizens, regardless of their previous standard of living. Two such methods are replacement rates, often used by the OECD, and the ASFA retirement income standards.

Replacement rates: A common approach to measuring requirement income adequacy is replacement rates, which measure the income a person receives in retirement relative to the income they earned during their working life, acknowledging that people with different levels of wealth will have different expectations of income in retirement.

Replacement ratios for retirees receiving the full Age Pension (designed to cover necessities) will differ depending on the retirees' previous income. For example, for someone who was unable to work and relied on welfare payments, the Age Pension will likely maintain their income and provide them a replacement ratio of around 100 per cent. Alternatively, for a man who earned the average wage, the full Age Pension would represent a replacement ratio of around 30 per cent (Klapdor 2014).⁹

The World Bank suggests target replacement rates for middle income earners should be:

- 78 per cent of net average lifetime wage
- 60 per cent of gross average lifetime wage
- 53 per cent of the net final year wage
- 42 per cent of the gross final year wage (The World Bank 1994, p.295).

The OECD suggests the target replacement rate for a median income earner is 70 per cent of final earnings (OECD Publishing 2009, p.121). With an Australian Male Average Total Weekly Wage (MTAWE) of \$1 684 as of November 2015, this gives a 70% target replacement rate of \$61 152 (ABS 2016).

In 2014, the OECD average net replacement for mandatory pension schemes for low income earners (earning 0.5 times the average weekly wage) was 74.5%, for average income earners was 63%, and the net replacement rate for higher income earners (earning 1.5 times average wage) was 54.5% (OECD Publishing 2015).

OECD figures show Australian net replacement rates in 2014 for male and (female) low income workers of 88.6% (84.6%), for average income workers of 58.0% (53.4%) and for higher income workers of 45.9% (40.9%). While this appears high, it is necessary to remember that the Age Pension constitutes a substantial proportion of this income. In discussing replacement rates, the OECD points out this feature of the Australian retirement system design:

As the defined contribution scheme is not the only component of the overall pension in many countries, the system design is also important. In Australia, for example, the defined-contribution superannuation guarantee is offset by the means-tested Age Pension. Therefore, when the level of return either increases or decreases the capital value of the

⁹ Age Pension combined couple rate is currently benchmarked to 41.76 per cent of Male Total Average Weekly Earnings; the single rate of pension is set at 66.33 per cent of the combined couple rate (around 27.7 per cent of MTAWE).

Superannuation before annuitisation varies accordingly. When the resulting annual payment falls the loss is partially recovered from the Age Pension and vice versa when the annual annuity increases. Therefore, despite having a high contribution rate of 9.5%, increasing to 12% by 2025, there is little variation in the replacement rate in Australia with varying rates of return, in comparison to Israel, because of the Age Pension. (OECD Publishing 2015, p.117)

As outlined in Dawkins's statement, the original plan on implementation of the SG was to target a 12% superannuation contribution rate to achieve a projection of 40% replacement rate on retirement with 40 years of average weekly earnings. Further, The Fitzgerald Report (1993) pointed out that "... a goal of well over 60% income replacement" if the Age Pension is to be replaced by most people. Increasing the SG contribution rate will clearly help in this regard. While the current contribution rate will remain at 9.5% until 30 June 2021, after this date the rate will increase by 0.5 percentage points each year until it reaches 12% on 1 July 2025.

This is especially important for those on lower incomes. While promoting voluntary contributions could be a means of increasing total contributions, and hence more adequate retirement incomes, as this study demonstrates, those most in need of increased contributions are lower paid workers who are far less likely to be either able or willing to make additional contributions on a voluntary basis.

Other options available to increase retirement balances are initiatives to improve operational efficiencies and reduce fees, and hence increase the after-tax net return to members.

The ASFA income standards: A commonly used measure of the adequacy of retirement incomes is the Association of Superannuation Funds of Australia (ASFA) retirement income standards which are an absolute measure based on the cost of living.

The ASFA Retirement Standard benchmarks the annual budget needed by Australians to fund either a 'comfortable' or 'modest' standard of living in retirement. It is updated quarterly to reflect inflation, and provides detailed budgets of what singles and couples need to spend to support their chosen lifestyle. Both budgets assume retirees own their own home outright and are relatively healthy.

A comfortable retirement lifestyle enables an older, healthy retiree to be involved in a range of leisure and recreational activities and to have a good standard of living. It includes the purchase of household goods, private health insurance, a reasonable car, good clothes, a range of electronic equipment, and some domestic and occasional international holiday travel. A modest income will allow for only a few domestic holidays, rare meals from restaurants, minor home maintenance and an older, less reliable car.

The modest income standard, at around \$23 500 for a single person and \$33 784 for a couple, is almost entirely met by the full Age Pension and supplementary payments. ASFA estimates retirees with income of around \$34 000 (single) or \$58 000 (couple) will be able to maintain comfortable income standard throughout their retirement.

FISCAL SUSTAINABILITY

Over the longer term, there is a need for the superannuation system to be fiscally sustainable through the total cost of targeted concession, offset by savings on the Age Pension.

Determining the actual **cost of superannuation concessions** net of the Age Pension is no straight forward task, however. While estimates are available on the cost of tax concessions, these are rarely seen in relation to the transfer payments associated with the Age Pension.

The cost of tax concessions can be calculated in one of three ways. The first two notional tax expenditure models are published annually by the Treasury, as part of the Tax Expenditure Statement.

The first and most commonly used is the **revenue foregone** method, which is used in budget estimates. It estimates the tax revenue forgone by government when employers pay superannuation contributions at the 15% tax rate, instead of paying salaries and wages directly to employees, to be taxed at the full marginal rate. A major assumption in this model is that the behaviour of tax payers is not considered, in that salaries and wages would not be diverted to any other form of tax preferred activity such as negative gearing. Current projections for 2015-16 show the cost of tax concessions on contributions at \$16.25 billion, and concessions on earnings at \$13.55 billion, a total of \$29.8 billion. Projections out to 2018-19 suggest that tax concessions on contributions will rise to \$18.75 billion and concessions on earnings will rise to \$18.05 billion – a total of \$36.8 billion, an average annual increase of around 5% (The Treasury 2016b, p.119).

The second method, the **revenue gain** model examines the potential increase in tax revenue that would occur if a tax concession were withdrawn. The revenue gain estimates assume that the tax concessions are removed from the following financial year, and apply prospectively to transactions entered into after that date. They also assume no further voluntary concessions and factor in behavioural choices where tax payers may divert their savings to other tax preferred investments. Revenue gain estimates are lower than the previous method and show an estimated cost of employer contributions of \$15.6 billion in 2015-16 and concessions on earnings of \$12.6 billion. Forward projections for the costs of concessions are \$17.95 billion and \$14.95 billion respectively in 2018-19 – an annual average increase of 4.4% (The Treasury 2016b, p.119).

There is considerable variation in these estimates from year to year as noted by (The Treasury 2016b). Although some factors such as SG contributions are reasonably stable and predictable, other components such as equity returns and anticipated investor behaviour are not. As a consequence, *'the reliability of the estimate for this tax expenditure is clearly identified as 'low' (p. 125).*

Critics, such as the Henry Review (2009) and the Charter Group (2013) point out that these methods produce an inflated cost for super tax concessions as 1.) they do not allow for withdrawals each year, an important factor now that many are moving into retirement, 2.) the assumption that tax payers would pay full tax marginal rates if not contributing to super is unrealistic, and 3.) these costs do not in any way factor in the offsetting cost of long term savings on the Age Pension.

An alternative method proposed by both the Henry Review and the Charter Group is an **expenditure tax benchmark**. This can be either a pre-paid expenditure tax based on direct taxation of labour income with an exemption for saving, or a post-paid expenditure tax based on the taxation of a direct measure of expenditure, or of goods and services. Based on a TEE system, the cost of the concession is the difference between tax paid at the marginal rate, as if the superannuation contribution was treated as income, less the tax paid on earnings in the

fund. Under this method Henry estimated the total cost to revenue of superannuation tax concessions in 2007-8 as \$4.6 billion. “Experimental estimates” of a tax expenditure method were included in the 2013 Tax Expenditure Statement. The revenue forgone on super contributions in 2013-14 was \$16.1 billion, which is offset by taxes paid by the fund on earnings of \$5.8 billion, leaving the net cost of super tax concessions at \$10.3 billion (The Treasury 2014).

Both the Henry Review and the Charter Group endorsed the use of such a model as a better representation of the net cost of superannuation tax concessions.

Age Pension Savings: Perhaps highlighting the lack of integration between the three pillars of the retirement income system, Treasury does not publish regular reports on the impact of the superannuation system in terms of reducing the cost of the Age Pension.

The cost of the Age Pension in 2014-15 was \$41.6 billion, rising to \$44.2 billion the following year, and \$46.2 billion in 2016-17, an average nominal increase of around 5% (The Treasury 2015b Table 9.1). The total cost of the Age Pension at around 3.5% of GDP compares favourably with the OECD average of 7.9% (OECD Publishing 2015, p.179). The extent to which superannuation income has replaced demands on the Age Pension, and therefore generated fiscal savings, is difficult to assess as there is no transparent relationship between the forward estimates on super tax concessions and budget estimates for the cost of the Age Pension.

Figure 3 demonstrates how the dynamics between the Age Pension and superannuation work, using the example of increasing super tax concessions to 12% (the Charter Group 2013). As contributions increase it can be seen that the cost of tax concessions increases (Net Tax Loss % GDP), however this is offset by the reducing expense of the Age Pension (net expense save %GDP). The overall net outcome in budgetary terms (net Fiscal Effect %GDP) shows a positive rising trend.

Preservation Age: An obvious lack of co-ordination exists between the ages for access to the Age Pension and superannuation savings. Age Pension eligibility was increased from 65 to 67 years for males and females from 1996, and an increase in the preservation age was from 55 to 60 years was finally announced in the 1997-98 budget, as recommended by Fitzgerald in 1993. As a consequence, the gap between both markers is 7 years, which means that a retiree may well have drawn down a substantial part of their superannuation savings before the official retirement age occurs and potential for “double dipping”.

The Henry Review (2009) recommended that both the preservation age and Age Pension eligibility be aligned at 67 years, to encourage people staying in the workforce longer, increasing superannuation balances and thus retirement income. An increase to the preservation age was also examined at some length by the Productivity Commission (2015) in *Superannuation for Post-Retirement*. There are some difficulties in raising the preservation age, however, including the fact that a large proportion of the workforce are involuntarily retired prior to the retirement age due to ill health, redundancy etc. There are also some sectors of the community which would have difficulty extending their working life. For example, Aboriginal and Torres Straight Islanders have a life expectancy of around 10 years less than the rest of the population. Therefore, there is an obvious need for a flexible approach to this issue, but increasing the preservation age to 65 years, with flexibility to approve access to some super savings on a case-by-case basis, would better align with the Age Pension, yield a better level of

retirement savings, assist with workforce participation, and contribute to the sustainability of the superannuation system.

Conclusion

As the superannuation system matures there is an increasingly diverse range of super balances. Around a quarter of the working age population has no superannuation, the vast majority of superannuants have a modest balance on retirement, and a small number have large balances that exceed what is needed for an adequate retirement income. In the latter case, superannuation has become a tool of estate planning where tax subsidized savings of the wealthy can be transferred to the next generation as bequests.

To ensure that the superannuation system meets the stated objective *to provide income in retirement to substitute or supplement the Age Pension*, superannuation tax concessions need to be more targeted to include more Australians, to increase the modest balances of lower income earners, and to reduce the excess balances of higher income earners.

First, to understand the extent of tax concessions required, it is necessary to determine what is an adequate standard of living. Given that retirees are a very heterogeneous group, with different income, wealth and expectations, it is realistic to expect that what is an adequate retirement income for one, may not be so for another. Accordingly, it is proposed that there should be a range of potential outcomes that would qualify for support from the tax system, giving flexibility to individuals to target an appropriate level of savings to suit their circumstances.

The OECD (2015) recommends an adequate retirement income as a replacement rate of 70%. That is a low income earner would need an income of 70% of half the average weekly wage, for an average income earner it would be 70% of the average weekly wage, and for a higher income earner, 70% of one and half times the average wage. In 2016, the range of outcomes would be from \$28 000 to \$82 000, based on average weekly income as at December 2015. To support this minimum level of retirement income, the balance required would range from \$500 000 to \$1.5 million.

There is a very high dependency on the public pension in Australia, partly as a legacy of workers seeing the Age Pension as an entitlement after a life time of paying tax, partly as a result of low superannuation balances to date, and partly as a result of storing much of voluntary household savings as wealth in the family home which is means test exempt.

In examining the pattern of tax concessions, it would appear that the majority of concessions are received by high income earners. This is largely explained by the distribution of voluntary contributions, which are correlated with age and income, and come predominantly from older middle and high income earners. For lower income earners to achieve a better retirement income and reduce reliance on the full Age Pension, the level of the SG needs to increase as has currently been proposed to 12%. Incentives to adjust the tax disadvantage of low income earners on contributions, especially given the absence of the LICS from July 2016, and to reduce the accumulation of balances greater than what is required for retirement by income high income earners, also need to be considered.

While current annual caps provide some flexibility for workers to make additional savings over the course of their working life, it is evident that non-concessional caps of \$540 000 every three

years may be contributing to the accumulation of very large balances if used regularly. There is a legitimate use of such concessions on occasion, however, for example rolling in the proceeds of sale from a small business.

To restore equity to the allocation of superannuation tax concessions, to ensure that tax concessions are directed to supporting income in retirement rather than as an estate planning tool, as well as enhance the sustainability of the superannuation system the following suggestions are proposed:

- Increase progressive nature of tax and incentivise low-income earners by taxing SG contributions as if received by employees at the marginal rate less a flat 20% subsidy (as per the Henry Review).
- Maintain existing salary sacrifice and annual contribution caps at \$30 000 per annum and \$35 000 for those over 50 years to encourage voluntary contributions.
- Review post-tax concession limits and impose a lifetime cap of around \$540 000, instead of every three years.
- Reconsider Division 293 Tax which currently applies to high income earners over \$300 000, with a view to extending to all those within the highest tax bracket (over \$180 000 income).
- Apply earnings tax at 15% to both pre and post retirement phases, thereby simplifying the system, allowing a more seamless transition from accumulation to retirement phases, and increasing fiscal sustainability (as per FSI).

In addition to a superannuation income stream, and possibly a part Age Pension, a retiree might expect to purchase some form of annuity product. The latter in conjunction with an account based pension can mitigate longevity, market and possibly inflation risk and therefore protect the adequacy of the income stream in later years. The concept of a Comprehensive Income Product in Retirement as recommended by the Financial System Inquiry is therefore supported as an important part of achieving the objective. The removal of restrictions on innovation of annuity style products through the Review of Retirement Income Stream Regulation will be welcome.

It is also noted that our retirement system is strongly based on the assumption that retirees are home owners. With an increasing number of non-home owners coming through, this should be reviewed and Age Pension allowances for housing costs adjusted to a more realistic level. For home owners, better products are required to allow access to wealth stored in the home to supplement retirement income.

Further, to ensure that superannuation balances are maximized, the preservation age should be raised closer to the eligibility age for the Age Pension, for example to 65 years. It is recognized that flexibility is essential in how this is structured, however, as a significant proportion of the population are unable to sustain participation in the workforce, and therefore rely on being able to draw on superannuation funds prior to accessing the Age Pension. Some provision needs to be made to allow those who cannot continue in the workforce to access some proportion of their retirement income prior to the new preservation age. This should be done on a case by case basis recognizing the circumstances of the involuntarily retired, or some disadvantaged

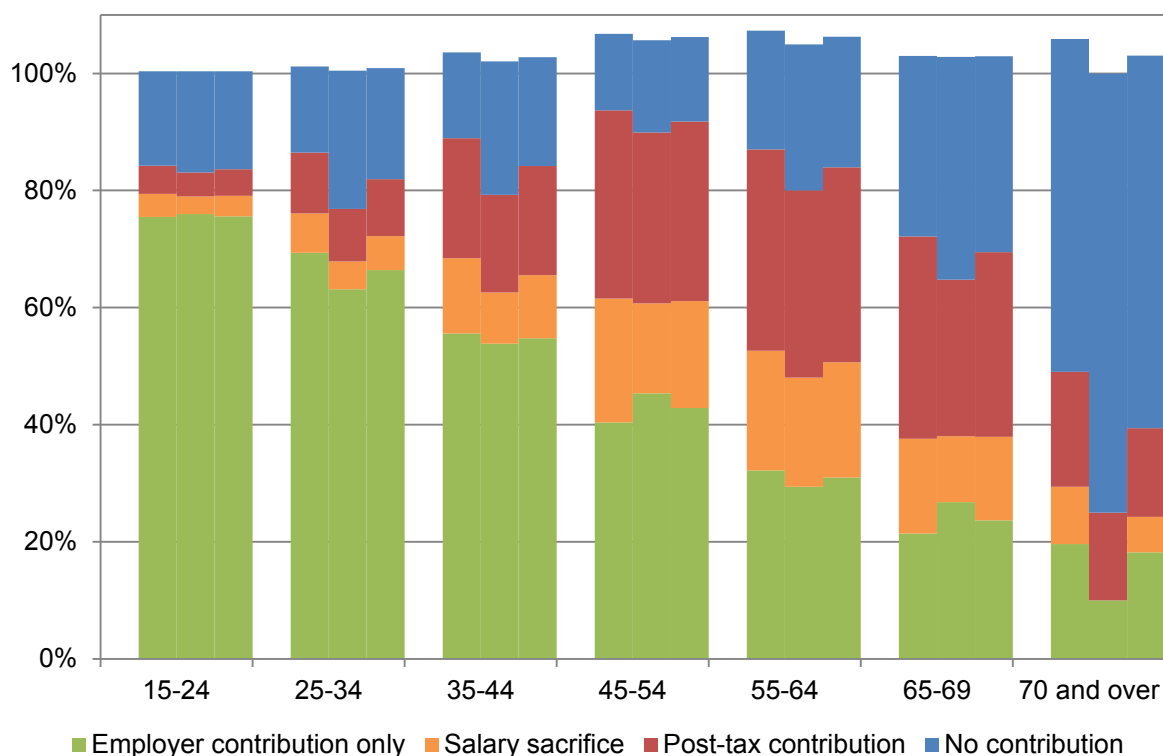
cohorts such as indigenous superannuants with a much shorter longevity than the average population.

To ensure that the objective of superannuation continues to be monitored and achievements assessed, a better framework needs to be developed to measure the cost of super tax concessions and any offsets from savings in the age pension. The current TES measure of tax concessions has been acknowledged as an over statement, and has no bearing on the estimates of Age Pension expenditure. A common framework to assess the impact of policy changes within any part of the integrated three pillar retirement system, would not only ensure an improved allocation of public resources, but provide a transparent means of assessing progress, thereby building better confidence in, and understanding of, the system.

As the benchmarks and processes that pertain to monitoring the achievements of the new superannuation objective apply across the three pillars of the retirement income system, there is a case to suggest that the objective and details are contained in a separate piece of legislation outside the mainstream super system.

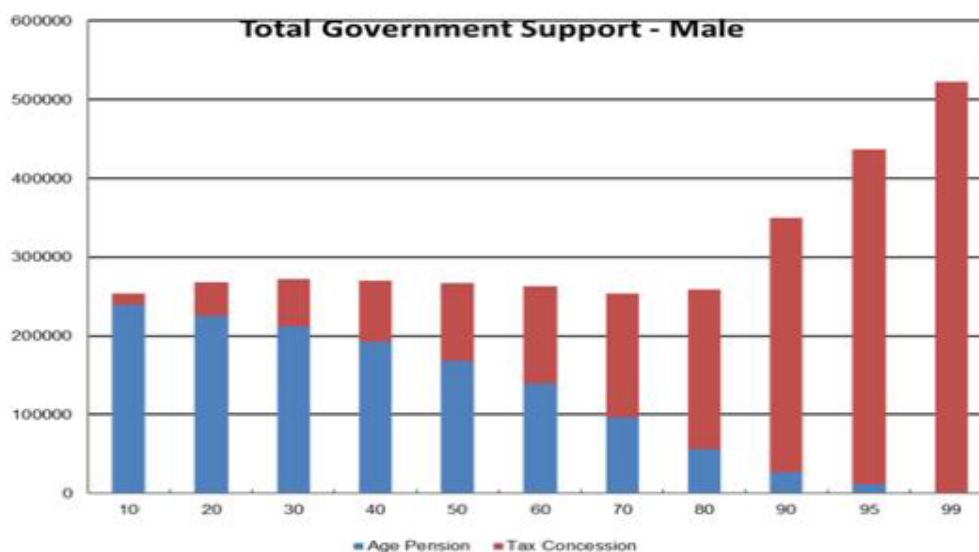
Tables and Figures

Figure 1 Type of Contributions by Age and Sex (2007)*



Note: * All persons who are in the accumulation phase and is covered by superannuation scheme; Column in each age group represent: male, female, all persons (from left to right)
 Source: Employment Arrangements, Retirement and Superannuation, Australia, ABS Cat. No. 6361.0

Figure 2 Treasury estimate of distribution of “total government support” (superannuation tax concessions and age pension) (male)



Source: The Treasury (2012) Figure 2.

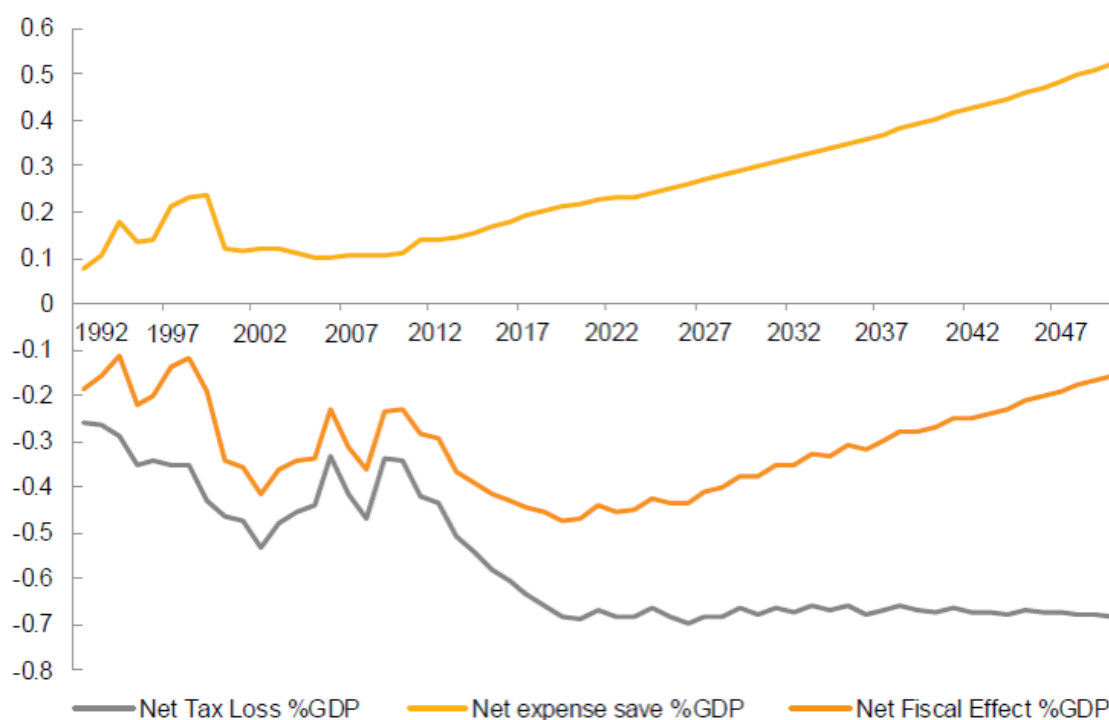
Table 1 Tax treatment of superannuation savings: accumulation funds

Contributions	Earnings	Benefits
<p><u>Pre-tax contributions:</u> taxed at 15%; for high-income earners 30% up to an annual cap (currently \$30 000 for people aged under 50 and \$35 000 for people aged 50 and over). The government effectively refunds the 15% tax for people with income under \$37 000 up to an amount of \$500 (until 2017).</p> <p><u>Post-tax contributions:</u> no additional tax if below an annual cap (currently \$180 000).</p>	<p>Taxed at 15%.</p> <p>Earnings on assets supporting income streams (i.e. pensions) are tax-free.</p> <p>CGT: if asset is sold during accumulation phase, effectively taxed at 10%; if sold while supporting an income stream, tax-free.</p>	<p><u>60 and over: tax-free</u></p> <p><u>Between preservation age and age 60:</u></p> <p>Lump sums are tax-free up to \$185 000 and taxed at a maximum of 15% thereafter.</p> <p>Income streams are taxed at marginal rates less a 15% offset.</p> <p><u>Below preservation age:</u></p> <p>Lump sums are taxed at a maximum of 20%.</p> <p>Income streams are taxed at marginal rates.</p>

Note: Pre-tax contributions include personal deductible contributions. Tax rates on benefits exclude the Medicare levy

Source: The Treasury (2015c, p.69)

Figure 3 Impact of superannuation on cost of the age Pension



Source: the Charter Group (2013, p.11)

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