SMSF Owners' Alliance
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Not-for-profit public company

RESEARCH PAPER

"AFTER THE BUDGET HYSTERIA"

July 2014

The SMSF Owners' Alliance Limited is a not-for-profit public company established to represent the interests of trustees and owners of Self-Managed Superannuation Funds (SMSFs). Whilst there are other organisations with similar interests and objectives, SMSFOA's distinction is that membership is strictly limited to the trustees and owners of SMSFs.

Prepared by:Malcolm Clyde, Research Director

Introduction

The purpose of this report is to provide a view of the impact of the Federal Budget announcements on the effectiveness of Australia's superannuation system.

We've waited for some of the initial hysteria to fade somewhat in the hope that there may now be some serious commentary on the longer term effect of key Budget measures illustrated in the objective analysis and conclusions in this report.

It may be a surprise to many that, although there did not appear to be many changes to the superannuation system announced in the Budget, the overall impact of other announcements will have quite a dramatic long-term impact.

We commissioned an update of our computer simulation model – the "Pension Sustainability Model" – to illustrate the impact of budget changes. The changes are listed in Appendix A and the existing major model assumptions are summarised in Appendix B.

By far the largest impact is the planned deferral of the Age Pension eligibility age. Our modelling to date has followed the assumptions used in the Henry Report that someone retiring on their superannuation savings will do so at the same age as someone retiring on the Age Pension. Consistent with this assumption, we have therefore now deferred the start date for a simulated superannuation pension to match the planned ages for Age Pension eligibility.

This impact is dramatic – especially for someone born after 1965 (i.e. younger than 50) – because of the compounding effect of an extra 5 years of superannuation savings and earnings together with the reduction of the number of years someone in retirement then has to live off their superannuation savings.

Our model has assumed that Australians will draw on their super to give them a pension, including any part-Age Pension for which they are eligible, at a reasonable replacement rate (see Appendix B #10 for definition) and then when their superannuation and savings run out will revert to the full Age Pension. It ignores the possibility of Australians with a relatively small super balance withdrawing it all, spending it and immediately going onto the Age Pension. This is, in our opinion, a flaw in the current system on which we have previously commented, suggesting, for example, that people should only be able to draw as much from their super in a lump sum that leaves a balance adequate to fund a retirement income greater than the Age Pension.

The other anomaly is the increased gap between proposed Age Pension eligibility and superannuation eligibility. The superannuation eligibility age of 55 may lead some Australians who have inadequate superannuation to retire too early, live off their superannuation for a few years until eligible for the Age Pension and then becoming dependent on Government welfare. Whilst there may not be much evidence of this abuse, it is an anomaly which we believe should be rectified along the lines recommended by the Commission of Audit.

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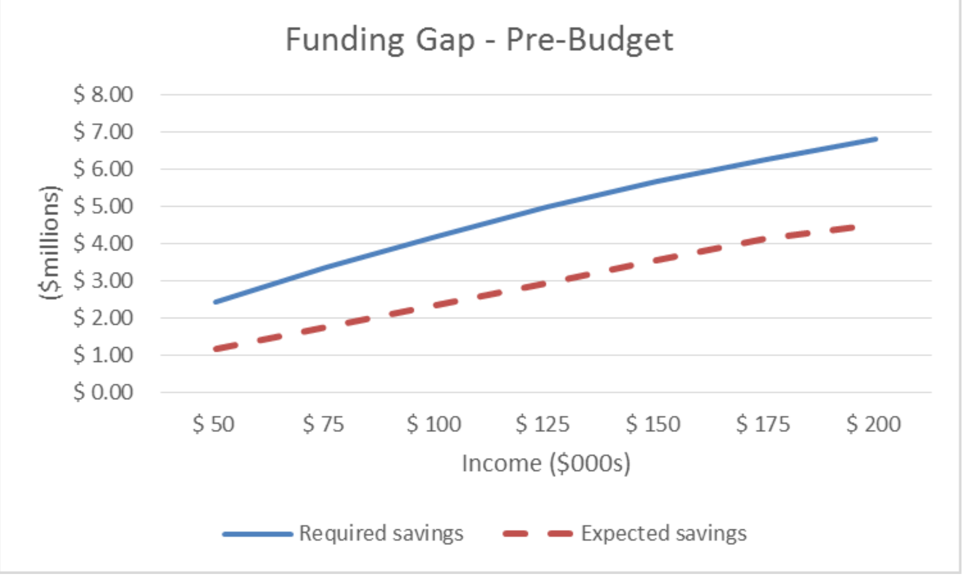
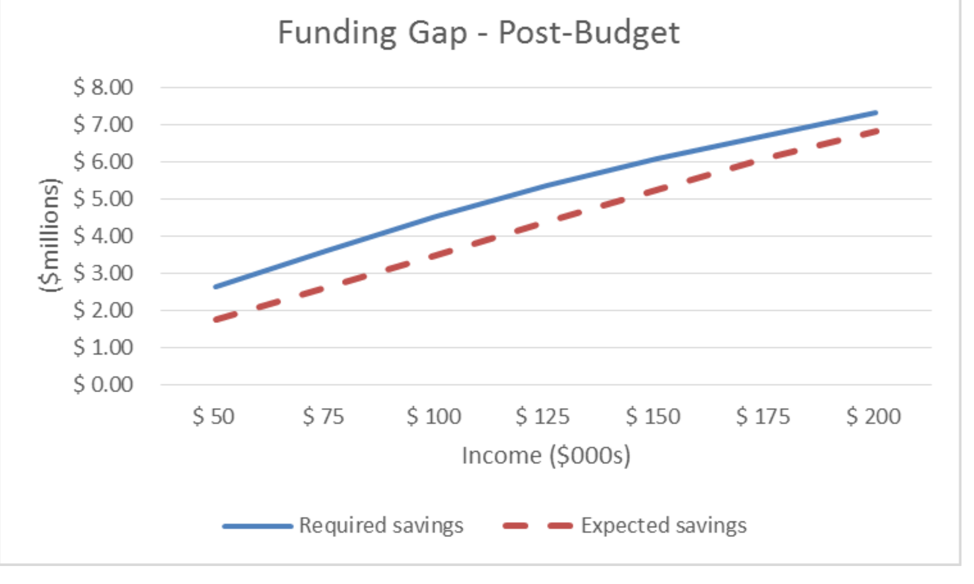
Results

1. **Budget has narrowed the savings 'gap'.**

The amount of super Australians will expect to save by the time they retire increases and the amount they need reduces.

The following graphs show the amount of superannuation savings required for a 30 year-old on a range of salaries to retire on a private pension at a reasonable replacement rate and independent of the Government Age Pension and compares this with the amount expected to be saved in super if contributing at only the Superannuation Guarantee (SG) level. The first one is projected using pre-Budget assumptions and the second one assumes the 2014 Budget proposals are implemented.

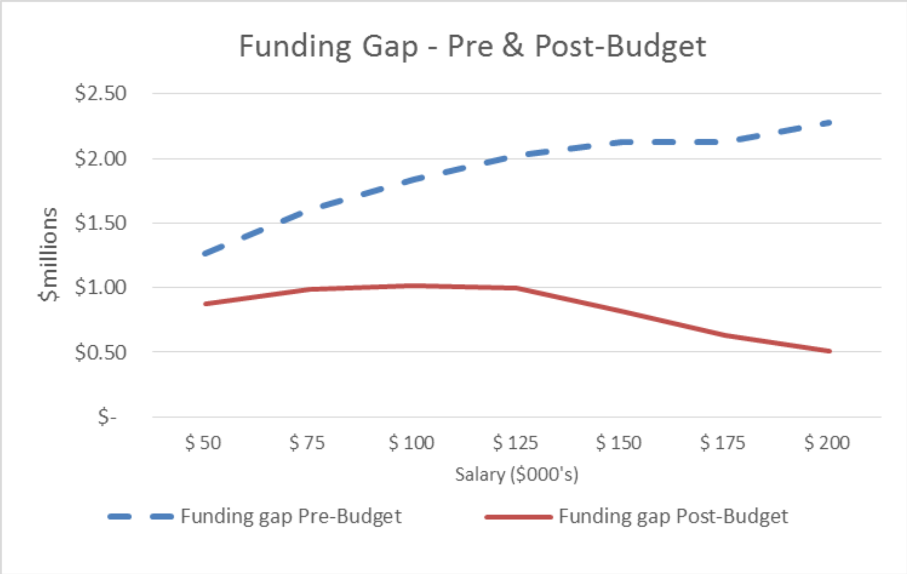




These graphs illustrate the dramatic improvement in reducing the funding 'gap' making it easier for an Australian to retire independent of the Federal Government's Age Pension. However, the reality is distorted somewhat from the simple graphs above by the current system of entitlement to part pensions, the benefit of which is not included in above graphs.

Although there is a considerable improvement on the Pre-Budget situation, there is continuing eligibility for part-pension payments by many Australians who appear to have adequate superannuation.

The following highlights the improvement in the funding gap by comparing on the one graph the gap Pre-Budget with the projected funding gap Post-Budget

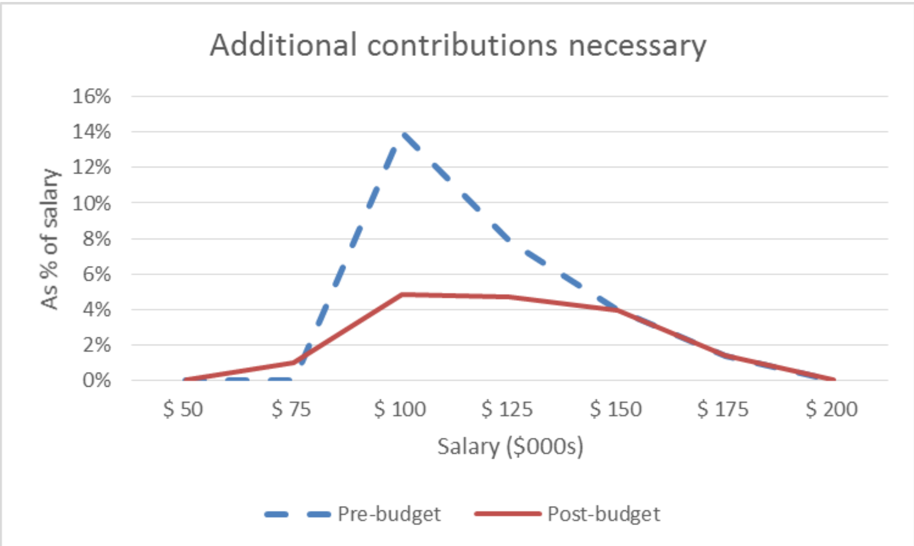


2. Existing caps less of a constraint but remain a problem under current system

Pre-Budget, Australians earning above average weekly earnings (AWOTE) needed to make additional contributions above the SG level in order to fund a reasonable pension but were constrained in many cases from doing this by the current caps on contributions.

No changes to the cap levels were announced in the 2014 Budget, but the other changes announced have the effect of reducing the level of additional contributions necessary and the number of years in which an Australian would be constrained by the cap.

We have assumed in our modelling that most Australians would only realistically be in a position to make additional contributions after 50 years of age as there tend to be other priorities at a younger age. The following graph shows the additional contributions necessary (as a % of salary) for 30 yr-old Australians on a range of salaries to save enough in super.



This graph shows that the level of additional contributions necessary Post-Budget is generally lower and more consistent across income levels.

However the caps on contributions continue to be a problem for older Australians who have been saving only for a few years under the current system and whose contributions have been constrained by caps.

The higher cap of $35,000 for older Australians is not indexed and by 2020 the 'standard' cap of $25,000 reaches that figure because of indexation and the extra advantage of higher caps for older Australians disappears. We suggest that the $35,000 cap for older Australians be indexed and retained for a few more years to allow them to become independent of the Age Pension.

Furthermore, although for the younger Australian taxpayers the existing cap appears to be adequate, we reiterate our earlier suggestion that the Government introduces some flexibility. A system of, say, rolling 3-year caps similar to the non-concessional contribution cap will reduce any disadvantage for women and other taxpayers who are more likely to have broken work patterns.

3. **Lifetime tax payments to Government higher**

The third result of interest is that the level of tax payments to the Government is higher Post-Budget than under the earlier assumptions and therefore, because of the lower dependence on the Age Pension, the positive budgetary impact is substantial over time.

The following shows the lifetime tax payments net of pension receipts by a 30 yr-old on a range of incomes in today's dollars Post-Budget compared with the same estimates based on Pre-Budget assumptions.

Earnings	$50k	$75k	$100k	$125k	$150k
Pre-Budget	($0.4m)	$0.2m	$1.0m	$1.6m	$2.3m
Post-Budget	$0.2m	$1.0m	$1.9m	$2.8m	$3.6m
Increase	$0.6m	$0.8m	$0.9m	$1.2m	$1.3m

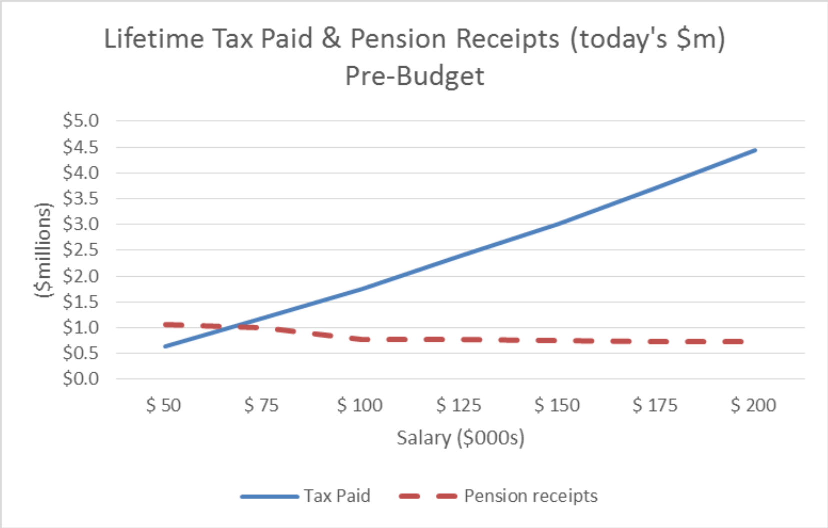
The improvement in net tax payments to Government increases with income.

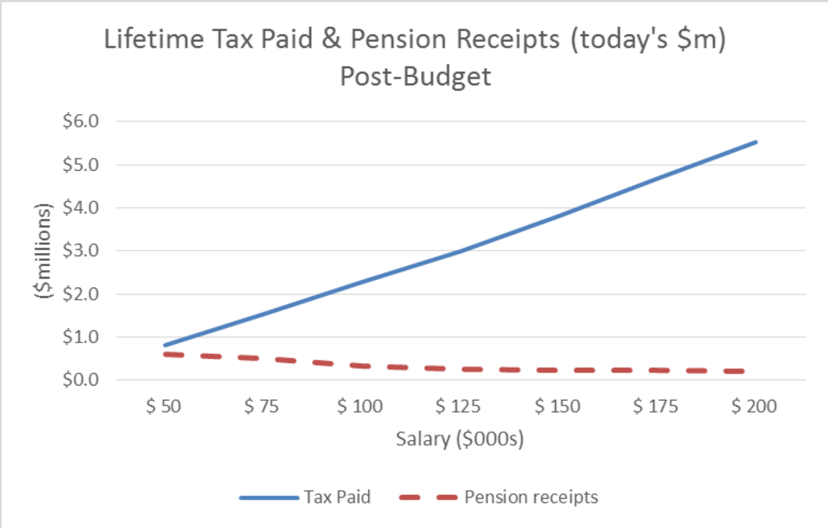
4. **Variation in tax concessions with income**

The other matter worth reviewing is the issue of whether tax concessions increase with income. There has been some media commentary about this subject implying that those on higher incomes are receiving unfairly large tax concessions.

We maintain that these are misleading and perhaps ideologically driven comments. The reality is that those on higher incomes pay substantially more tax even after superannuation tax concessions. One of the issues with our tax and welfare system is that most Australians do not pay any tax net of welfare. They are net recipients of welfare from the Federal Government. This does not sound like a fair welfare and tax system which should extract a fair amount of tax from most Australians whilst ensuring that only a minority, who have been unable for good reason not to provide for themselves, are supported by the Government.

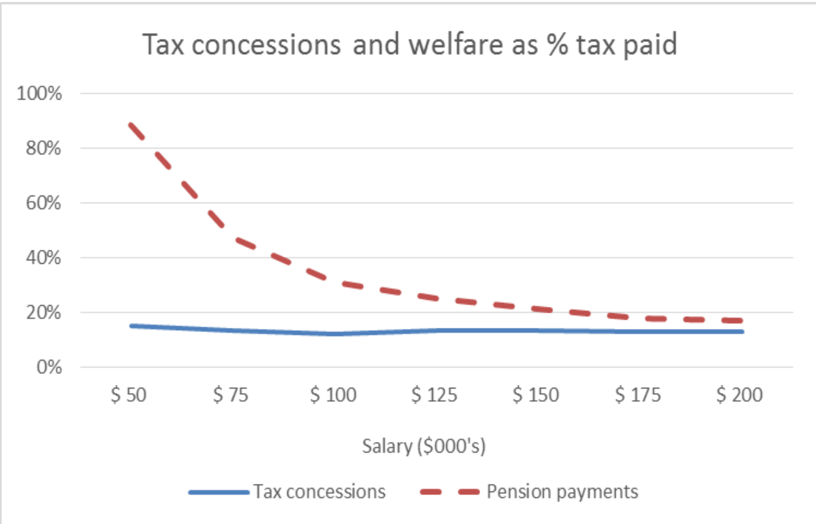
The following shows projected lifetime tax payments and pension receipts for a 30 yr-old on a range of incomes contributing as much as possible into super to retire on a reasonable pension. The first graph show this Pre-Budget changes and the second graph after taking into account 2014 Budget announcements.





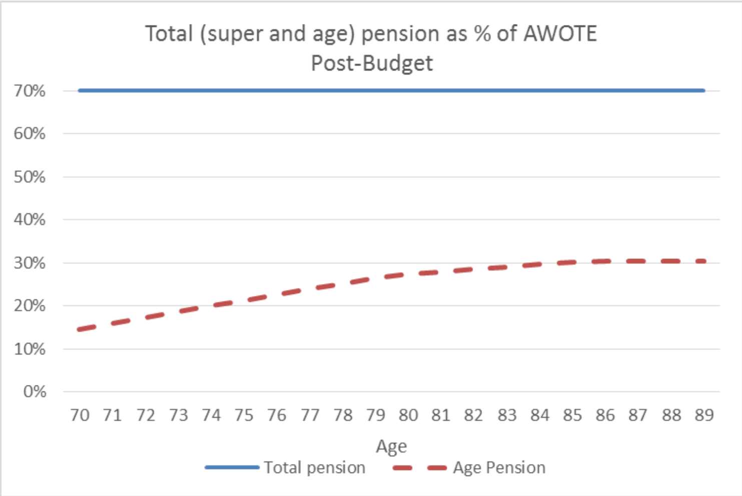
It is clear from a comparison of these graphs that the contribution by tax payers is much higher using Post-Budget assumptions and that the gap between tax paid and pension receipts widens dramatically with income.

Another way of considering this is looking as the tax concession and pension receipts as a percentage of total lifetime tax paid.



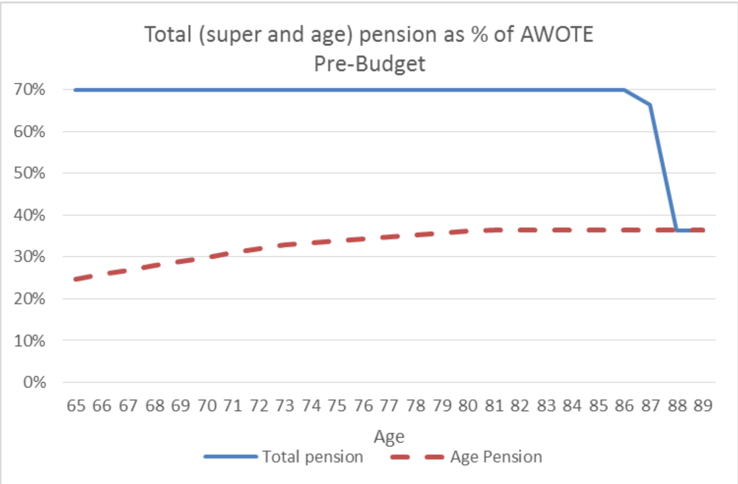
An example may help illustrate this:

Bob is a 30 year old tradesman on average earnings. When he retires at 70 he will have paid a total of $1.8m in taxes over his working lifetime after taking into account the $276,000 in superannuation tax concessions he has received whilst contributing into super at the SG level. Although he will have nearly $2m in superannuation on retirement, he will immediately become eligible for part-Age Pension and receive $2.1m in pension welfare during his retirement. Note that not only is his welfare greater than his tax concession, it is also greater than his lifetime tax payments.



The proportions of Bob's pension paid by the Federal Government and his superannuation over his retirement period are illustrated in this graph which shows them as a percentage of Average Weekly Earnings.

Someone on average weekly earnings does not revert to a full pension under the Post-Budget assumptions though his dependence upon a partial pension is of concern.



By comparison, Bob would have cost the Federal Government more in Age Pension on the Pre-Budget assumptions as illustrated by this equivalent graph.

The partial Age Pension would not only have been significantly higher but he would have run out of his superannuation towards the end of retirement

By comparison Thomas is a 30 year-old professional who is earning three times average earnings. When he retires at 70 he will have paid a total of $8.2million in taxes over his working life after taking into account tax concessions of over $1million. He will be able to fully support himself in his retirement and takes no Government support.

His tax concession is substantially less than the welfare payments and tax concessions paid to Bob who makes no net payment for Government services.

So yes…his tax concession is larger (nearly 4 times Bob's) but it is less than Bob receives in part-pension payments. Significantly, he makes a total contribution to the Federal Government budget of $8.2m which not only pays for Government services but helps pay the shortfall in Bob's Age Pension not covered by his own tax payments

Without that tax revenue from the higher paid, the Federal Government would not be able to function and maintain welfare payments to those who genuinely need support.

Conclusion

We conclude that the changes proposed in the 2014 Budget go a long way towards achieving a more sustainable superannuation system. Government Age Pension costs will be lower and tax receipts higher. Many more individual taxpayers will be able to retire independent of the Government.

The existing system of caps should not constrain most workers who are just commencing their working life from saving enough in super. However, older workers still have a problem unless the higher cap is indexed and workers with broken work patterns are disadvantaged unless a more flexible system of caps is introduced.

Looking ahead

A commentator recently suggested that the Government clearly sets out its objectives for a sustainable retirement system. This is an extremely good suggestion although we believe that earlier views in both the Henry Review and Cooper Report endorsed the World Bank opinion that the purpose of a superannuation system should be to provide:

1. mechanisms by which individual Australian can save enough to provide a private pension equal to 60–70% of their average real after-tax pre-retirement income (reasonable Replacement Rate); and
2. a Government funded pension only as a "safety-net" for a minority of Australians who, for whatever reason, have been unable to achieve the necessary level of savings.

The Henry Review reported the Australian system as being relatively successful, being founded on the concept that the responsibility for providing for retirement is shared between government and individuals, with government's role restricted to providing for minimum and essential need and facilitating self-provision.

However, the recent OECD comparison of retirement systems suggests that we are failing in meeting the above objectives.

The most striking conclusions in this report were that:

- Australia has one of the highest percentage of over 65s receiving a government pension (nearly 80% receive some sort of pension);
- The relative average incomes (public and private) of the over 65s is the lowest (as a percenteage of national mean income) of the OECD countries; and
- Australia has one of the highest poverty rates* amongst over 65s at 36% vs 12.8% average for OECD. *defined as % over 65s with incomes below 50% of meadian national income

So, although the 2014 Budget has started to improve the effectiveness of Australia's retirement system, we have now commissioned a major analysis of alternative superannuation systems that may be more efficient and effective over the long term. We hope and expect that the Government will undertake a serious review of superannuation as part of or flowing from the foreshadowed Taxation White Paper. We would welcome such a review if it is transparent, objective and has a long-term focus.

As referred to in out earlier reports, our earlier superannuation system, in which contributions and superannuation earnings were tax free but all distributions from super in retirement were taxed at income tax rates (referred to as an EET or Exempt:Exempt:Taxed system) may be one better alternative in the long-term for both individuals and the Federal Government Budget. Other commentators have agreed that this could be a better option.

Our preliminary analysis shows that this may allow more taxpayers to realistically save for retirement independent of the Government whilst also improving the Federal Government's budget position over the long-term perhaps helping it to reduce general income tax rates. It should also be a considerably simpler system to administer from the viewpoint of Government, SMSFs and institutions.

However, the challenge, which we acknowledge, would be how to implement any change to the system without adversely impacting any particular group of taxpayers who have made their superannuation savings under the existing system nor adversely affecting the Government's budget in any substantial way. We will consider possible solutions to this in the analysis that we have now commissioned.

Appendix A

<u>Principal changes in assumptions used in the Pension Sustainability Model</u>

1. **Eligibility age for Age Pension and start-date for a superannuation funded pension extended to match the schedule announced in the 2014 Budget so that it becomes 70 for anyone born after 1965;**
2. **Deeming threshold for Age Pension income test reduced to $30,000 for years 2014-15 through 2016-17;**
3. **Age Pension indexed to average weekly earnings (AWOTE) through 2016-17 , then drops to CPI;**

   We have assumed in the long-term that it would not be acceptable for the Age Pension to continue to fall relative to average incomes and so, consistent with the recommendation in the Commission of Audit Report, we have set it equal to the greater of the CPI indexed figure referred to above and 22% of AWOTE;
4. **The Age Pension eligibility thresholds are assumed to be indexed by growth in AWOTE from 2014-15 through 2016-17, then zero for three years and then revert back to indexation by growth in AWOTE;**
5. **A 2% levy is applied to those on top marginal tax rate for three years from 2014-15;**
6. **Other thresholds, such an income tax, medicare levy, super surcharge are assumed to be frozen for another year and then indexed by growth in AWOTE from 2015**
7. **Increases in Superannuation Guarantee levels are deferred as per Government proposal.**

Appendix B

<u>Major assumptions used in Pension Sustainability Model</u>

1. **Superannuation contributions commence at age 30 and life expectancy is 88;**
2. **Growth in Average Full-time Weekly Ordinary Earnings (AWOTE) is 4%p.a.;**
3. **CPI is 2.5%p.a.;**
4. **Growth in actual income for sample workers is 1% p.a. above AWOTE growth (with increases in SG levy in addition);**

   For comparison of workers in different age groups, when the model reports results for workers on, for example, earnings equal to AWOTE it sets their salary so that their <u>average</u> real lifetime earnings are equal to AWOTE;
5. **For calculation of tax concessions, it is assumed that, if there were no super, individuals would still save (outside super) a sum equal to the Superannuation Guarantee level after paying tax;**
6. **The 'standard' contributions cap is $25,000p.a. indexed to AWOTE but only increased in $5,000 increments; for taxpayers over 50, the cap on contributions is the greater of the indexed 'standard' cap and $35,000p.a. (not indexed)**
7. **If contributions attempted to be made at SG level or because taxpayers is trying to make additional voluntary contributions, are contrained by the caps, the excess is assumed to be spent rather than saved (after income tax);**
8. **Savings portfolios (whether superannuation of outside super) hold target level of cash equal to 25% and turn over 10% of share portfolio every year;**
9. **Average returns assumed to be 7% after all fees, comprising 3% capital growth and 4% income (including dividends gross of imputation credits);**
10. **Consistent with internationally accepted practice and the Henry Report, we have assumed that private pension are paid at reasonable replacement rates, assumed to be equal to 70% of real after tax income (as if no additional contributions are made above SG level) averaged over the last 10 years of a workers working life – for someone on or below AWOTE; 65% for someone on twice AWOTE and 60% for someone on or above three times AWOTE – with pro-rata % between these salaries;**
11. **This pension is then assumed to increase by projected growth in AWOTE;**
12. **Income and superannuation tax rates, medicare levy and capital gains discounts are as per legislation;**
13. **Income tax, medicare, super surcharge thresholds, pension asset & income tests are indexed from 2015 by growth in AWOTE;**
14. **Age Pension is as for a single homeowner pensioner and indexed to AWOTE (except as modified by 2014 Budget).**
15. **To be realistic and consistent with the views presented in the Commission of Audit Report, we have now assumed that life expectancy increases from 88 at age 65 assumed in the Henry Report and previously assumed by us. We have used an annual % increase in life expectancy to give a life expectancy at 65 of 90.7 in 2053 as per the Commission of Audit Report and assumed this rate in increase continues beyond that date. For use in the model the life expectancy estimated in this way is rounded to the nearest year.**