



# FINANCIAL SYSTEM INQUIRY

CHAPTER FOUR

## FEDERAL BUDGET SUSTAINABILITY

# CHAPTER 4 - FEDERAL BUDGET SUSTAINABILITY

This chapter canvasses the potential of life insurance and superannuation as major policy devices for dealing with Australia's ageing population.

Specifically, this chapter will demonstrate that:

1. the financial services industry has through superannuation successfully privatised public sector expenses and risk arising from Australia's ageing population;
2. superannuation and retirement policy changes could further improve superannuation's contribution towards long term budget sustainability;
3. superannuation laws could be amended to further promote adequacy in retirement; and
4. the life insurance industry can be leveraged by privatising risk and public sector expenses incurred by the National Disability Insurance Scheme and the Disability Support Pension.

# RETIREMENT INCOMES POLICY

One of the primary objectives of establishing the superannuation system in 1992 was to reduce pressure on the federal budget as Australia's population ages considerably in the approach to 2050. In the second reading speech for the superannuation guarantee bill in 1992, Treasurer John Dawkins stated:

"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. The increased self-provision will also enable future Commonwealth governments to improve the retirement conditions for those Australians who were unable to fund adequately their own retirement incomes."

Successive intergenerational reports have highlighted the ageing population faced by Australia and many other OECD member nations.

## INTERGENERATIONAL PERSPECTIVE

The 2010 Intergenerational Report (IGR) presents the cost of our ageing population and the pressures on intergenerational finances from a public finance viewpoint. Self sufficiency in retirement will become an important factor as the budget will be under increasing strain over the next half century.

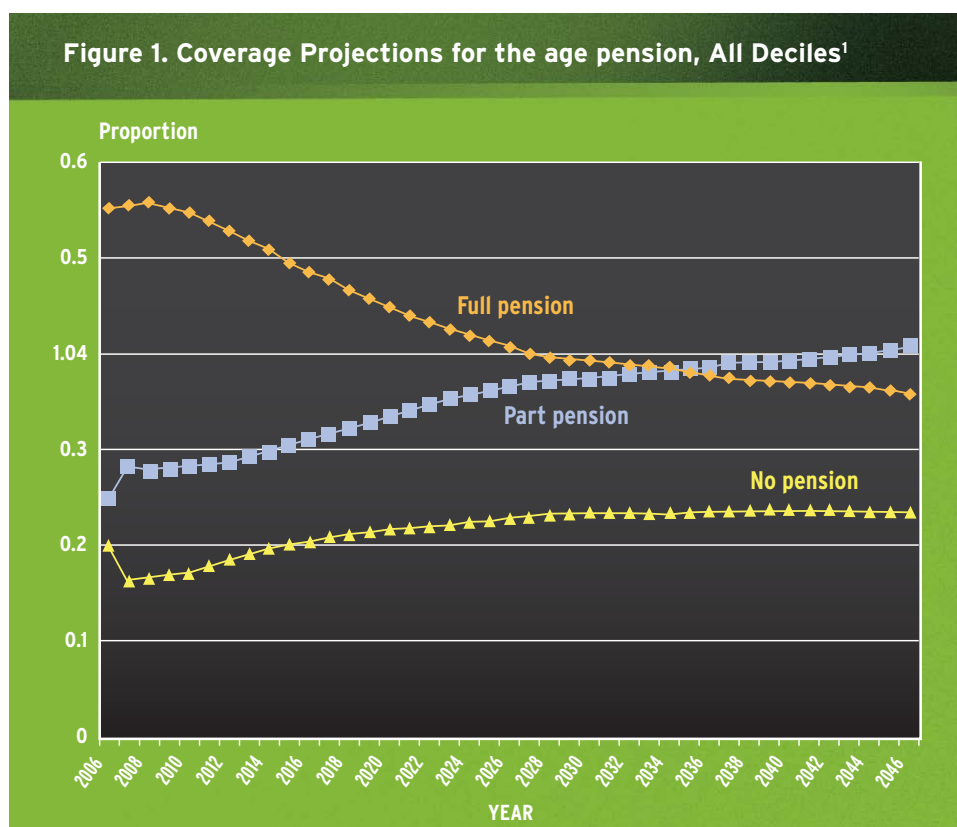
Specifically, intergenerational public finances will be pressured by the ratio of working aged people relative to retired people almost halving, from around 5 today to just 2.7 by 2050. The proportion of Australians of working age will fall by seven percentage points to 60 per cent of the total populace in 2050.

The problem of a shrinking tax base will be compounded by increased spending on health and pension costs. The IGR predicts that between 2010 and 2050, the proportion of Australians aged 65-84 will double, whilst the proportion of people aged 85 and over will quadruple.

As a result, the Intergenerational Report estimates that total government spending will rise to 27.1 per cent of GDP by 2050, compared to around 24 per cent of GDP by 2010.

Age pension expenditure is projected to be a significant contributor to this increase, itself rising from 2.7 per cent of GDP in 2014 to 3.9 per cent in 2050. **Figure 1** below demonstrates that under current arrangements the proportion of retirees receiving a full age pension will fall from over 50 per cent today, to around 35 per cent by 2050, whilst the proportion of retirees receiving the part pension will increase from under 30 per cent to 40 per cent over the same period. The number of retirees receiving no pension will also increase modestly to slightly above 20 per cent.

**Figure 1. Coverage Projections for the age pension, All Deciles<sup>1</sup>**



In spite of the government's increase to the age pension eligibility age to 67 in 2009, the total number of people of eligible age to receive the age pension is projected to increase by around 150 per cent between 2009-10 and 2049-50.

Other areas of age related expenditure are also forecast to increase significantly. Aged care expenditure is projected to increase from 0.8 per cent of GDP to 1.8 per cent health costs, partially attributable to age related health care, will almost double by 2050 to 27 per cent of GDP.

<sup>1</sup> Rothman, G. The Adequacy of Australian Retirement Incomes - New Estimates, 2007

Real spending on those aged 65+ years is forecast to increase seven fold, while real health spending on those aged 85+ years is expected to increase twelve fold. This is driven by both improving longevity, the increasing size of the populations in those age groups and high standards of health care.

These significant projected stresses on public finances mean that increasing individual provision of retirement income, as opposed to public provision, will become essential.

To date, the superannuation system has started the process of reducing public sector costs associated with ageing. Because the superannuation system is not yet mature, the full benefits of privatising future pension costs are not yet evident.

Compulsory superannuation began in 1992 at 3 per cent. The Superannuation Guarantee (SG) increased from 3 to 9 per cent by 2002. It increased again from 9 to 9.25 per cent on 1 July 2013. Under the governing legislation, it is due to reach 12 per cent by 2019. This means that the first people to benefit from the full complement of 12 per cent superannuation and complete a 40 year working career will not retire until 2060.

As demonstrated below, the superannuation system has already reduced age pension outlays by \$5.7 billion each year and this is forecast to increase to \$11.1 billion each year by 2030. It also contributes an unquantified increase in living standards in retirement, including the quality of health care and housing for older Australians, which similarly reduces federal and state government health outlays.

Superannuation, however, is fundamentally an intergenerational policy. It will take decades rather than years for the fiscal benefits of the system to be evident. Tax concessions afforded to the superannuation system today will generate savings to the government decades from now, making complete evaluation of the superannuation system difficult. In the relatively short time in which Australia has enforced mandatory savings through superannuation, however, the system is clearly beginning to reduce public sector costs associated with ageing.

## AGE PENSION AND SUPERANNUATION

The FSC commissioned NATSEM to consider the savings superannuation was achieving for the federal budget through reduced pension outlays. NATSEM found that in 2013-14, the savings related to the age pension from the superannuation system and superannuation-based income streams totals \$5.7 billion each year.

Of this, \$3.1 billion relates to payments to pensioners and the remainder to persons aged over 65 years who otherwise may receive an age pension if they did not have super assets/income. By way of comparison, total age pension outlays were \$36 billion in 2013-14.

NATSEM forecast that higher aggregate superannuation savings will result in lower age pension outlays in the future.

**Figure 2.**

YEAR	AGE PENSION SAVINGS (CURRENT DOLLARS)
2013	\$5.7 billion
2020	\$7.6 billion
2030	\$11.1 billion

Source: NATSEM 2014

This confirms that the superannuation system has begun the task of reducing the Commonwealth's costs of grappling with an ageing population whilst simultaneously improving standards of living for Australian retirees.

This is occurring despite the significant gaps between the superannuation and pension systems which is leading to lower age pension savings.

### RECOMMENDATION

The inquiry finds that the superannuation system has commenced the task of reducing age pension outlays which will only increase as the system matures over the next forty-five years.

## SUPERANNUATION TAXATION AND PUBLIC FINANCES

Superannuation is a long-term policy designed to alleviate age-related costs that threaten the stability of public finances. It also has a significant impact on the immediate Budget forecasts, in terms of both the tax concessions afforded to contributions and fund earnings.

The \$1.7 trillion superannuation system is making a significant contribution to government revenue. As demonstrated in the Budget, \$8.5 billion in tax is forecast to be paid by superannuation funds in 2013-14.<sup>2</sup>

As markets have continued to return to growth after the financial crisis, current taxation settings will result in government revenue benefiting from strong receipts from both contributions tax and earnings tax.

In the 2007-08 financial year, superannuation savings equalled only \$1.13 trillion<sup>3</sup>. With strong market growth, superannuation funds contributed over \$12 billion to government revenue, or 50 per cent more than under 2011-12 market conditions. Similar revenue streams can be expected in the near term if markets continue to perform strongly, albeit with adjustment for a structurally higher Australian dollar and low interest rates and bond yields.

Treasury forecasts that within 25 years superannuation savings will reach \$7 trillion, or 130 per cent of forecast GDP.

Earnings tax receipts on a large pool of savings could, over the cycle, be expected to increase in proportion to the size of the pool across the cycle. The 2013-14 Budget outlined the forecast growth in revenue from superannuation funds as illustrated in **Figure 3**, with tax receipts from superannuation funds expected to balloon to \$14.3 billion in 2016-17.

<sup>2</sup> 2013-14 Commonwealth Budget, Statement 5

<sup>3</sup> APRA Statistics June 2011, page 32



Figure 3. 2012-13 government revenue projections<sup>4</sup>

	ACTUAL		ESTIMATES		PROJECTIONS	
	2011-12 \$m	2012-13 \$m	2013-14 \$m	2014-15 \$m	2015-16 \$m	2016-17 \$m
<b>Individuals' and other withholding taxes</b>						
Gross income tax withholding	143,978	151,660	164,660	178,100	192,120	204,820
Gross other individuals	32,992	35,940	37,490	41,580	46,640	51,580
/less: Refunds	23,537	26,750	26,800	28,350	30,250	32,100
<b>Total individuals' and other withholding taxes</b>	<b>151,433</b>	<b>160,850</b>	<b>175,350</b>	<b>191,330</b>	<b>208,510</b>	<b>224,300</b>
Fringe benefits tax	3,964	3,890	4,320	4,740	5,080	5,390
Company tax	66,726	86,132	73,969	74,860	80,666	85,213
<b>Superannuation funds</b>	<b>7,852</b>	<b>7,800</b>	<b>8,480</b>	<b>10,210</b>	<b>12,850</b>	<b>14,270</b>
Resource rent taxes(a)	1,293	1,740	3,420	3,530	4,180	5,340
<b>Income taxation revenue</b>	<b>231,268</b>	<b>242,412</b>	<b>265,539</b>	<b>284,670</b>	<b>311,286</b>	<b>334,513</b>

Earnings tax levied on a pool of domestic savings as large as 130 per cent of GDP clearly offers a strong source of government revenue under current tax policy settings, underpinning the long-term fiscal sustainability of the superannuation system.

## TAX CONCESSIONS

The Treasury estimates that the concessional treatment of superannuation cost \$31.8 billion (gross) in 2012-13 in forgone revenue, including the concession treatment of superannuation earnings and contributions.

Costing of superannuation concessions depends on a counterfactual. The 'revenue forgone' method used by the Treasury assumes that the alternative would be full marginal tax rates on the relevant income. However, the removal of concessions for superannuation would cause income earners to seek other tax effective investments, such as investments in negatively-geared property or not some at all.

The Treasury has estimated that, after taking account of such behavioural responses, the cost of superannuation concessions would be around 30 per cent less than the usual revenue forgone method (Charter Group 2013, p. 9). In this instance, the age pension would remain the government's largest retirement income expenditure.<sup>5</sup>

Accordingly the headline tax concession figure is reduced by:

1. reduced pension outlays; and
2. accurate forecasting.

### RECOMMENDATION

The inquiry recognises that superannuation is an increasingly large contributor to government revenue and that superannuation tax concessions have been overstated.

<sup>4</sup> 2013-14 Commonwealth Budget, Statement 5

<sup>5</sup> From [http://www.pc.gov.au/\\_\\_data/assets/pdf\\_file/0005/129749/ageing-australia.pdf](http://www.pc.gov.au/__data/assets/pdf_file/0005/129749/ageing-australia.pdf) at 202



## RETIREMENT POLICY

The intersection between superannuation and the broader retirement policy framework heavily determines the effectiveness of the compulsory superannuation system.

Public policy should support a sustainable superannuation system which, in turn, is calibrated to reduce public sector costs of ageing.

The age eligibility arrangements surrounding the age pension must maximise private savings and simultaneously minimise public expenditure. There is, therefore, a need for public policy to carefully determine the age eligibility for both the age pension and superannuation access.

The dynamic between pension access and preservation age was considered by the Harmer Review which found that one third of people fully expend their superannuation savings after reaching preservation and then require the age pension.<sup>6</sup>

Life expectancy in Australia has continued to consistently increase strongly. For Australians born today, the average male is now expected to live to 83 years and the average female to 87 years.<sup>7</sup> This is a significant increase from 80 years and 85 years respectively only ten years ago.<sup>8</sup>

Over the same period superannuation policy settings have failed to be adequately adjusted to accommodate not only improved longevity, but also the aging of the large 'baby boomer' cohort.

The pension age was set in Australia at age 65 over 100 years ago. At this time, average life expectancy was 30 years lower and many people had private insurance offered by mutual and life insurance offices.

The FSC submits that the retirement system can be reformed to more effectively address the challenge that an ageing population presents to government finances. We detail a number of policy options below that would enhance the system's ability to achieve its intended purpose. These options include:

1. Increasing the preservation age;
2. Tightening age pension eligibility;
3. Opening the longevity product market; and
4. Increasing the Superannuation Guarantee Charge to twelve per cent.

<sup>6</sup> Harmer Review 2009

<sup>7</sup> 3302.0.55.001 - Life Tables, States, Territories and Australia, 2010-2012

<sup>8</sup> 3302.0.55.001 - Life Tables, Australia, 2003

These changes would significantly enhance the superannuation system's ability to achieve its intended purpose of improving living standards in retirement whilst reducing the cost of an ageing population for the government.

### Preservation Age

Increasing mature age workforce participation is a key lever in which the government can improve output in the Australian economy and strengthen government finances over the long-term in the face of an ageing population.

An effective measure to boost participation is to increase the preservation age, the age at which an Australian can access their superannuation savings, to increase retirement savings and reduce age pension reliance.

The preservation age is currently transitioning from 55-60 years based on an individual's date of birth as outlined in **Figure 4**.

**Figure 4. Transitional arrangements for preservation age<sup>9</sup>**

DATE OF BIRTH	PRESERVATION AGE (YEARS)
Before 1 July 1960	55
1 July 1960 - 30 June 1961	56
1 July 1961 - 30 June 1962	57
1 July 1962 - 30 June 1963	58
1 July 1963 - 30 June 1964	59
After 30 June 1964	60

The FSC recommends that the superannuation preservation age be increased. Research by Rice Warner Actuaries shown in **Figure 5** indicates that for every year the government increases the preservation age, national private retirement savings would be increased by \$200 billion.

**Figure 5. Total Retirement Savings Gap - delaying retirement age (\$billion)<sup>10</sup>**

AS AT 30 JUNE 2011	MALES	FEMALES	TOTAL
Retire at age 60	1,333	993	2,326
Retire at age 61	1,248	889	2,137
Retire at age 62	1,111	794	1,905
Retire at age 63	1,000	722	1,722
Retire at age 64	878	641	1,519
Retire at age 65	701	588	1,289
Retire at age 66	573	494	1,067
Retire at age 67	453	383	836

<sup>9</sup> <http://www.ato.gov.au/Super/Self-managed-super-funds/Accessing-your-super/Preservation-age/>  
<sup>10</sup> FSC & Rice Warner Actuaries, Longevity Savings Gap Report, 2012

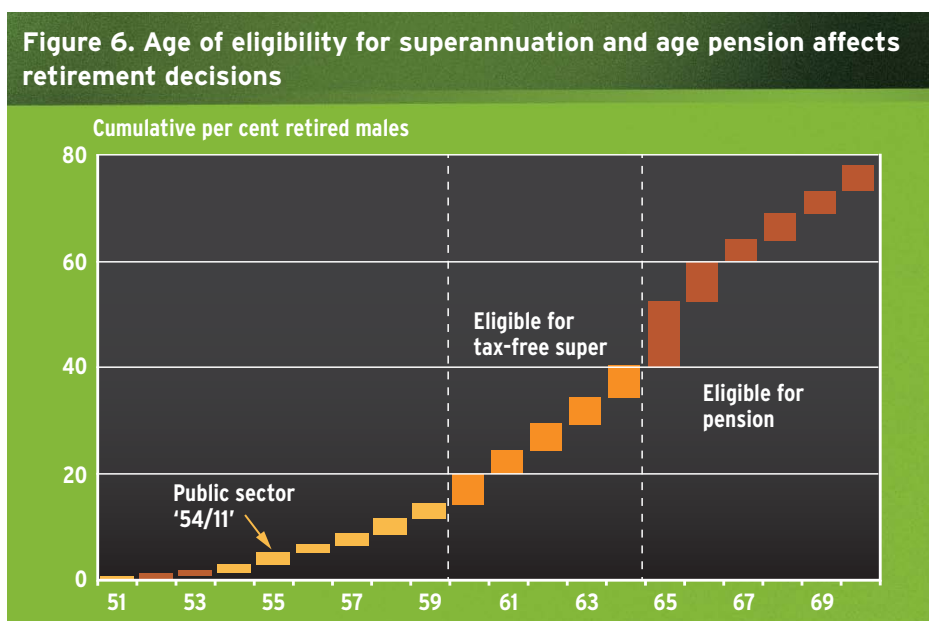
This is measured by determining the shortfall in retirement savings needed to provide an adequate retirement income and the extent to which each one year increase in the preservation age increases retirement savings and decreases the shortfall.

There would also be a significant positive budget outcome from increasing the preservation age which has been supported by the Productivity Commission<sup>11</sup> and the Grattan Institute.

## GRATTAN INSTITUTE RECOMMENDATIONS

The Grattan Institute modelled increasing both the preservation age and the age pension eligibility to 70 years by 2035. The estimated saving to the Commonwealth budget would be \$12 billion by 2023 and \$15 billion in 2035 (today's dollars).<sup>12</sup>

As the increase in the preservation and the age pension age interact significantly, it is difficult to disaggregate their respective impact on labour-force participation; however **Figure 6** demonstrates that retirement rates accelerate as individuals become eligible to receive tax free superannuation savings.



Sources: Grattan analysis of ABS (2011a). Note: Assumes that differences in labour-force participation rates between cohorts 1 year apart in age reflect retirement rates.

Up to age 60, only 2 per cent of people in the labour force retire each year; however this number jumps up to 5 per cent at 60 year until 65 years. The rate of retirement jumps again at age 65 as individuals become eligible for the age pension, due to the ability to substitute their income with the age pension.

<sup>11</sup> Productivity Commission, An Aging Australia: Preparing for the Future, November 2013 at 201 [http://www.pc.gov.au/\\_data/assets/pdf\\_file/0003/129747/ageing-australia-overview.pdf](http://www.pc.gov.au/_data/assets/pdf_file/0003/129747/ageing-australia-overview.pdf)

<sup>12</sup> Grattan Institute, Balancing Budgets: Tough Choices We Need, November 2013 at 30 [http://grattan.edu.au/static/files/assets/ceacf10a/801\\_Balancing\\_Budgets.pdf](http://grattan.edu.au/static/files/assets/ceacf10a/801_Balancing_Budgets.pdf)

However, it can be expected that a higher preservation age would result in retirement rates for those in the 60+ cohort reflecting those rates around 57-59 years, which is around 2 per cent, rather than 5 per cent. 60 years is an arbitrary point that has no direct bearing on an individual's ability to continue to work.

A higher preservation age is also supported by the general proposition that those drawing down their super between 60 and 65 generally have higher incomes and higher wealth. The benefit to the economy is greater as such people pay more tax through both their savings and income. This is particularly important in increasing older worker participation.

## PRODUCTIVITY COMMISSION RECOMMENDATIONS

The Productivity Commission similarly concluded that the preservation age has an important effect on labour supply. The Productivity Commission concluded that the preservation age was the most significant trigger for premature retirement, and recommended increasing the preservation age to improve the efficacy of the superannuation system.

The Productivity Commission reported:

In principle, the preservation age should consider life expectancy and the age pension eligibility age as relevant factors. A preservation age linked to life expectancy would provide a financial incentive to stay in work for longer, and as noted earlier for the age pension, provide a shift in expectations about the age to retire.<sup>13</sup>

In reaching this conclusion, the Productivity Commission also noted the recommendation of the retirement paper attached to the Henry Tax Review that supported the preservation age being gradually increased to align with the age pension eligibility age.<sup>14</sup> This recommendation bolsters support for linking both the age pension eligibility age and the preservation age to life expectancy.

<sup>13</sup> [http://www.pc.gov.au/\\_data/assets/pdf\\_file/0005/129749/ageing-australia.pdf](http://www.pc.gov.au/_data/assets/pdf_file/0005/129749/ageing-australia.pdf) at 201

<sup>14</sup> Treasury 2009, p. 16

## BENEFITS FOR PUBLIC FINANCES AND THE ECONOMY

Public finances would be improved by an increase in the preservation age as fewer future retirees would be eligible for the age pension as they would have higher personal savings through super and spend less time in retirement. Mature age workers would also pay additional income and contributions tax whilst they continued to work.

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

Higher levels of mature age workforce participation would also have significant downstream benefits for the economy. The first report from the Advisory Panel on the Economic Potential of Senior Australians concluded that using the existing skills and experience of older Australians would bring a windfall for the Australian economy of \$10.8 billion a year.<sup>15</sup> The report also found that engagement in the workforce has significant mental and physical health benefits for older Australians.

## BALANCING THE IMPACT ON AUSTRALIANS

The possible burden for some mature workers of a higher preservation age is reduced by the availability of transition to retirement arrangements, which allow mature workers to reduce the number of hours they work whilst continuing to make superannuation contributions.

There remain, however, some cohorts of the Australian public who may be unable to work later in life due to the nature of their work, or as a result of lower life expectancy or poorer health than the broader public. The FSC would support amendments to the early release scheme that allow individuals who are unable to continue work to the higher preservation age to access their superannuation at an earlier stage when medical evidence can establish their inability to work.

<sup>15</sup> Advisory Panel on the Economic Potential of Senior Australians, First Report - [http://epsa.treasury.gov.au/EPSA/content/publications/changing\\_face\\_of\\_society/default.asp](http://epsa.treasury.gov.au/EPSA/content/publications/changing_face_of_society/default.asp)

The FSC proposes a Centrelink assessment that, subject to medical evidence, allows the government to direct a superannuation fund to commute an individual's superannuation savings to an allocated pension, without a tax penalty, in the event they are unable to continue to work before the preservation age is reached. The FSC is also of the view that it would be necessary to grandfather current arrangements. Individuals who have commenced planning for their retirement should not have those plans interrupted as a result of retirement policy changes. The previous transitional arrangement provided for past increases in the preservation age could be suitably adapted for this purpose.

### RECOMMENDATION

The preservation age should increase to at least age 65 and be linked to life expectancy. This will increase private savings within superannuation improve individuals' living standards in retirement, boost government tax receipts and reduce age pension payments. Consideration should be given to aligning preservation and age pension eligibility ages, with early access arrangements.

### Age pension

Eligibility for age pension depends on individuals' date of birth:

- Women born before 1 January 1949 reach qualifying age at 64 and a half, and women born between 1 January 1949 and 30 June 1952 at age 65.
- Qualifying age for men born before 1 July 1952 is age 65.

From 1 July 2017, the qualifying age will increase by six months every two years, up to 67, by 2023:

**Figure 7.**

DATE OF BIRTH	QUALIFYING AGE AT
1 July 1952 to 31 December 1953	65 years and 6 months
1 January 1954 to 30 June 1955	66 years
1 July 1955 to 31 December 1956	66 years and 6 months
From 1 January 1957	67 years



The ageing population, however, requires further immediate reform to the age pension to stabilise intergenerational public finances. The FSC is of the view that the eligibility age should increase but that the process for reviewing and setting the age pension should be considered by actuaries.

This could be achieved by establishing a stronger link between average life expectancy, through the Australian Government Actuary (AGA) Life Tables, and the age pension eligibility age. The independence of the AGA, in conjunction with other evidence based reports, such as the intergenerational Report, would improve the quality of debate around age pension eligibility.

#### RECOMMENDATION

Age pension eligibility age be determined by life expectancy and other evidence based reporting.

### Longevity and retirement products

Most retirees cautiously consume their superannuation savings in retirement, primarily as they have enjoyed superannuation for less than 20 years and currently retire with relatively modest balances. ABS sourced data demonstrates that the average superannuation balance at retirement for females is around \$105,000 and the average male will retire with an account balance of \$197,000.<sup>16</sup>

The FSC supports competitively neutral policy changes to enable a broader array of retirement products to come to market which address longevity risk.

APRA data shows that individuals are increasingly choosing to take their retirement savings as an income stream, rather than a lump sum. APRA has found that the proportion of retirement-age vested benefits paid as pensions increased from 4.3 per cent in 2005 to 5 per cent in 2012, while the proportion of retirement age benefits paid as a lump sum decreased from 12.7 per cent to 8 per cent over the same period.<sup>17</sup>

As superannuation balances continue to grow, however, it would be appropriate for the government to consider policy changes that improve access and create a competitive market for income stream products, including fixed term, lifetime and deferred annuities.

<sup>16</sup> An update on the level and distribution of retirement savings, ASFA, March 2014

<sup>17</sup> Australian Prudential Regulation Authority's Annual Superannuation Bulletin, 2012

Underpinning this recommendation is the need to maintain the capacity for an individual to choose financial arrangements which best suit their individual needs, whilst also allowing trustees to structure products to suit members who do not exercise choice at retirement.

While ensuring that policy settings enable product innovation to meet the new and evolving needs of retirees, an important additional consideration is the potential for such products to deliver budgetary savings in relation to the age pension.

An example of potential savings to government that may be achieved was modelled by Deloitte Access Economics in 2011. This modelling found that if the average take-up of deferred lifetime annuities was \$10,000, the means tests on the age pension and for aged care would result in a saving of three per cent of total Australian government expenditure on the age pension and aged care by 2050.<sup>18</sup>

In this context, the FSC recommends the following framework to enable a more accessible retirement product market:

- Trustees have the option of building into MySuper products a seamless transition into retirement phase where members who do not exercise choice at retirement are moved into a retirement product with a simple direction from the member;
- Members could therefore be transitioned into any product that provides an income stream in retirement, such as an annuity, allocated pension, or a combination of such products;
- Trustees would retain discretion around whether or not to include a retirement product in their MySuper;
- Choice products could similarly have an in-built retirement product, or trustees could instead require members to seek advice (from their fund or their advisor) at retirement as to which retirement products to purchase.

## RECOMMENDATION

Retirement phase policy changes should enable a range of products to come to market and allow trustees to assist in better managing transition into the retirement phase.

The FSC recommends that all monies in the retirement phase, either held in an allocated pension or contributing to a deferred annuity, should be tax free to create a level playing field between these products. Similarly, the FSC also recommends that no changes are made to social security policy and that social security should not be used to encourage the uptake of annuities.

<sup>18</sup> Deloitte Access Economics, Fiscal implications for possible tax treatments for deferred lifetime annuities, Challenger Financial Services, 2011

## ADEQUACY IN RETIREMENT

Another important objective of the superannuation system is adequacy in retirement.

Australia has a retirement savings gap of \$727 billion as at 30 June 2013.<sup>19</sup>

According to research conducted for FSC by Rice Warner:

The Australian Federal government encourages Australians to save for their retirement through a range of tax concessions. It also provides the age pension which is an integral part of the retirement income of more than 80% of Australians. The financial services industry has an important role to play in educating about retirement matters and assisting individuals to improve their personal situations.<sup>20</sup>

Superannuation has been in place since 1992. The system will not be mature for another five decades. In that time, the budgetary challenge is to ensure that superannuation savings are maximised while the call on the age pension is reduced.

The report describes the calculation in this manner:

The savings gap is a measure of the current shortfall in national savings between two amounts:

- the amount required to be saved by the nation as a whole to ensure 'adequacy' in retirement to life expectancy
- the amount saved in the superannuation system, and estimated to be saved in future years up to retirement, by the current workforce.

The shortfall can be expressed as a lump sum amount, or an amount that needs to be saved on an annual basis over the future working lifetime of the current workforce.<sup>21</sup>

The age pension is included in the calculation because it reduces the size of the savings gap as it provides a safety net to Australians on top of private superannuation savings. The age pension typically provides around one third of savings required to fund retirement.

<sup>19</sup> RSG P4

<sup>20</sup> RSG P2

<sup>21</sup> RSG P12

Figure 8 presents this information:

**Figure 8**

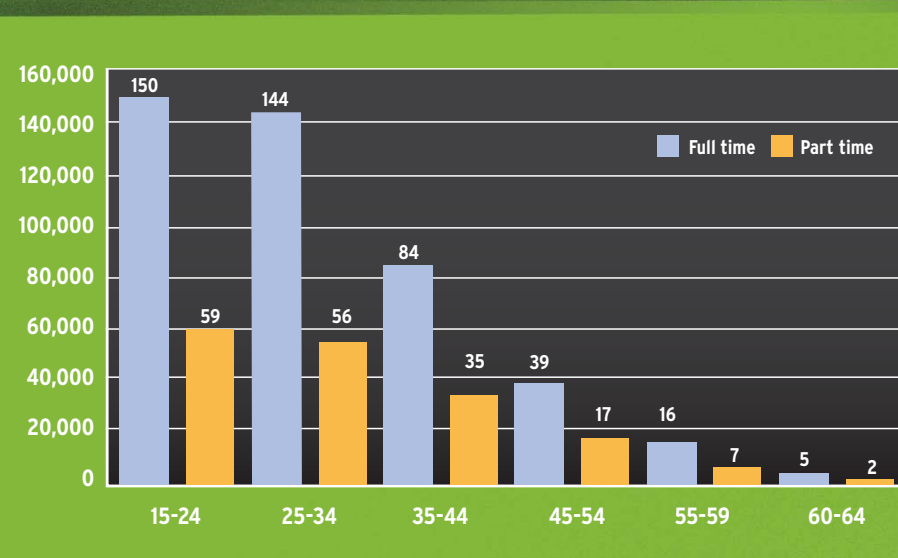
AS AT 30 JUNE 2011	2011			2013		
	Males	Females	TOTAL	Males	Females	TOTAL
Asset (accumulated savings plus future contributions)	1,622	1,380	3,002	1,852	1,440	3,291
Contribution from age pension	436	579	1,014	454	633	1,087
Projected value of all benefits	2,058	1,958	4,016	2,306	2,073	4,379
Liability (target benefits)	2,512	2,341	4,852	2,682	2,423	5,105
Retirement Savings Gap	453	383	836	377	350	727

## 9 TO 12 SGC

The increase to 12 per cent superannuation will generate long-term economic benefits and continue to address the national shortfall in retirement savings that is creating budget challenges.

A University of Canberra NATSEM Report modelled the importance of an increase in the SGC rate to 12 per cent to address the gap by growing individual account balances as shown in **Figure 9**.

**Figure 9. Projected difference in super balance at age 65 by age group and labour force status<sup>22</sup>**



Note: The values shown are the projected differences between SG contributions of 12% and 9% per annum until age 65. The projections assume real wages growth of 1% per annum real superannuation returns of 4%

Increasing the SGC to 12 per cent achieves a long-term benefit for younger working Australians. In particular, employees aged 15 to 24 will benefit from the increase in the SGC to 12 per cent by adding \$150 000 to their retirement savings by age 65. NATSEM concluded

that, “clearly an additional \$150 000 in superannuation will make a major difference to a person's standard of living in retirement and help reduce the fiscal pressure on future governments.”<sup>23</sup>

The figures below shows the additional contribution required to offset the projected retirement savings gap over the future lifetime of each age/sex cohort.

This is shown both as an average additional contribution (above the assumed average employer and member contribution) and as a contribution in addition to the Superannuation Guarantee rate.

**Figure 10. Additional Contribution - 30 June 2013 - Males**

Age Band	Current Average Member Rate	Current Average Concessional Rate	Required Additional Concessional Contribution	Required total contribution Rate
	%			
25-29	0.00%	9.25%	2.58%	11.83%
30-34	0.74%	10.41%	3.10%	14.25%
35-39	1.60%	11.76%	3.66%	17.02%
40-44	2.58%	13.30%	3.97%	19.85%
45-49	3.68%	15.04%	3.47%	22.19%
50-54	4.79%	16.78%	5.61%	27.18%
55-59	5.89%	18.51%	7.14%	31.54%
60-64	7.00%	20.25%	12.05%	39.30%

**Figure 11. Additional Contribution - 30 June 2013 - Females**

Age Band	Current Average Member Rate	Current Average Concessional Rate	Required Additional Concessional Contribution	Required total contribution Rate
	%			
25-29	0.00%	9.25%	3.10%	12.35%
30-34	0.74%	10.41%	3.00%	14.15%
35-39	1.60%	11.76%	2.89%	16.25%
40-44	2.58%	13.30%	3.12%	19.00%
45-49	3.68%	15.04%	4.40%	23.12%
50-54	4.79%	16.78%	6.45%	28.02%
55-59	5.89%	18.51%	6.61%	31.54%
60-64	7.00%	20.25%	6.14%	33.39%

<sup>23</sup> NATSEM Report, Saving Tomorrow April 2010 at 24

The rates increase with age. The older age groups suffer from the fact that they have not enjoyed S4 contributions over their working lifetimes and they have less time over which to amortise the gap.

#### RECOMMENDATION

The Superannuation Guarantee should be increased to 12 per cent.

## LIFE INSURANCE

### INTRODUCTION

There are 28 APRA registered life insurance companies operating in Australia, including six active reinsurers. The Australian life insurance industry is highly competitive, with the top six insurers accounting for 75 per cent of industry premium revenue over 2012-13.<sup>24</sup> In the 12 months to December 2013, insurers paid almost \$6.3 billion in death and disability claims representing an approximately 15% increase on the previous year.<sup>25</sup>

The products currently offered by life insurers in Australia play an important role in the community as they protect the insured and their dependents against the financial risks associated with premature death, permanent and temporary disability, unforeseen illness and injury as well as various specified critical medical conditions.

Additionally, annuity products designed to meet retirement and other long-range goals also provide the insured with periodic payments after a specified date. However, Australians remain chronically underinsured.

Individual (or retail) life insurance in Australia is generally voluntary in nature and is risk-rated though the life insurance application process by way of underwriting. The majority of policies issued are guaranteed renewable<sup>26</sup> meaning that insurers are contractually obliged to renew the insurance policies annually until the specified end of the term for that policy notwithstanding any change in the insured's risk profile.

<sup>24</sup> APRA Insight, Life Insurance Industry Overview, Issue 3 2013

<sup>25</sup> APRA Quarterly Life Insurance Performance Statistics, December 2013 (Issued February 18, 2014)

<sup>26</sup> Policies are issued as guaranteed renewable meaning that the insurer must renew cover up to the end of the term of the policy subject to payment of premium, regardless of any change in the insured's risk profile.



Evidence-based underwriting takes into account an individual's risk profile to ensure an equitable treatment of all lives insured. Consequently, the premiums paid by a specific policyholder reflect the relative risk the insured person brings to the insured population compared to the other existing insured lives.

As a fundamental principle of voluntary insurance and the insurer's duty to all policyholders, insurers assess an individual's application for life insurance based on a range of relative-risk criteria. These criteria would include, among other things, the applicant's age, present state of health, past health history, relevant familial medical traits, recreational activities, and various socioeconomic factors. Prudent, evidence-based underwriting and risk assessment of applicants by life insurers is essential to ensure life insurance products remain affordable and accessible for consumers and the industry remains sustainable.

In addition to individual risk-rated insurance described above, consumers in Australia are also able to access life and disability insurance through their superannuation. Group insurance offered through superannuation generally does not require an individual to complete comprehensive underwriting in relation to their individual circumstances as it uses a risk-rating pooling criteria based on the employees within the group scheme, and is largely a market driven by default cover, unless additional voluntary top-up cover is obtained. As a result, the majority of employed Australians have access to life and disability insurance regardless of their personal circumstances.

According to analysis by KPMG, (cited in Chapter 1 of the FSC's submission) insurance coverage held through superannuation represents more than half of all life insurances held by Australians. According to KPMG's analysis, approximately 67% of life insurance and approximately 56% of disability insurance in Australia is held through superannuation.

## ACCESSIBILITY OF LIFE INSURANCE IN AUSTRALIA

Consumer access to life insurance in Australia remains heavily intermediated with products accessible through financial advisers, banks (most often in conjunction with taking on debt such as a mortgage) or, as noted above, through superannuation funds. A small, but growing, proportion of Australians purchase life insurance products direct from an insurer. A breakdown of the distribution channels for life insurance is shown in **Figure 12**.

**Figure 12.**

DISTRIBUTION METHOD	PREMIUM (\$'000)	% OF MARKET
Direct to consumer	1,397,348	11%
Retail (intermediated/advised)	6,911,043	56%
Wholesale/group (superannuation, corporate, master trust)	4,130,725	33%
Total	12,439,116	100%

Source: Rice Warner Actuaries, January 2014

Research has consistently shown that life insurance products are typically products that consumers engage with at particular life stages, for example, when taking on higher levels of debt, marriage, having children etc. as they provide a 'peace of mind' in relation to financial security and a safety net should something unforeseen occur that impacts their ability to earn or provide an income for themselves or their family. As a result insurers tailor their products to meet the needs of those different groups of consumers who are at those relevant life stages.

## THE ROLE OF PRIVATE DISABILITY INSURANCE IN IMPROVING BUDGET SUSTAINABILITY

Just as superannuation is the private sector solution to the costs of an ageing population and private health insurance is a private sector solution to managing health care costs, so too life insurance can be the private sector solution to the increasing budget costs of welfare.

For example, the National Disability Insurance Scheme (NDIS) will cost the Australian government \$19.3 billion over seven years from 2012. It is timely to consider whether the costs of the NDIS could be partially defrayed through private disability insurance provided by the private sector.

We also believe that the costs associated with welfare expenses including the Disability Support Pension (DSP) could be reduced. Higher take up of private disability insurance would reduce pressure on public finances and should deliver a higher standard of living for disabled Australians.

According to research conducted for the FSC by KPMG, roughly 9.5 million Australians, or 44% of the population, could mitigate the economic risks of disability through private disability insurance. Disability insurance can provide a regular income replacement benefit if an individual suffers an illness or injury and is incapable of working either temporarily or permanently.<sup>27</sup>

Research has consistently shown that Australians are significantly underinsured against the social and economic impacts of disability. According to KPMG's analysis, 35% of employed people in Australia do not have any private disability insurance at all and on aggregate, the level of disability underinsurance is estimated to be \$304 billion per annum. Underinsurance is measured against an adequate level of insurance designed to cover basic needs such as mortgage repayments as well as ensuring that standards of living are broadly unchanged following the death or disability of an income earner. Employed Australians aged 45-64 are the most underinsured with an average of just 23% of their "adequate"<sup>28</sup> insurance needs met by private disability insurance cover.

KPMG's research also considered the potential cost savings to government if all working Australians were adequately insured thereby reducing eligibility for DSP benefits.

In order to demonstrate the potential for the life insurance industry to privatise the costs of some disability-related welfare in Australia and to reduce the long-term burden on the Budget, the FSC commissioned Deloitte Access Economics to undertake further, extended research completed in March 2014.<sup>29</sup> This research involved a modelling study that considered the potential for cost savings to be achieved through the introduction of financial incentives and disincentives aimed at improving the level of coverage of private disability insurance. The following provides an overview of the level of Commonwealth expenditure in these areas and key findings from both the KPMG and the Deloitte Access Economics studies.

<sup>27</sup> KPMG, Underinsurance - Disability Insurance Protection Gap in Australia, 2014

<sup>28</sup> KPMG define "adequate" insurance as the level of insurance designed to cover the family's needs until the children become adult and, if relevant, provide ongoing rental support until the partner retires. The healthy partner is expected to continue to work (or return to work if not in employment)

<sup>29</sup> Research commissioned by the FSC undertaken by Deloitte Access Economics, Expanding the coverage of private disability insurance to reduce the economic burden of social disability insurance, March 2014

## DISABILITY SUPPORT PENSION

Social security and welfare spending is the most significant federal budget expense accounting for 35 per cent, or around \$138 billion of government expenses in 2013-14.<sup>30</sup> The DSP accounts for around 11 per cent of this expenditure or \$15.5 billion. DSP expenditure is projected to increase by 15 per cent to almost \$18 billion by 2016-17.<sup>31</sup> In excess of 800,000 people receive DSP benefits and over the past 20 years, DSP recipient numbers have grown more than recipient numbers in any other government income support program.<sup>32</sup> In 2012-13 there were 51,418 new DSP claims granted.<sup>33</sup>

The FSC is concerned about the sustainability of growing DSP expenditure at a time of increased budget pressure.

The benefits of expanding the role of private insurance to improve the standard of living for the disabled and to minimise DSP expenditure have not been well considered by government. With more employed Australians adequately insured against the economic risks of disability, fewer would need to rely on the DSP as a safety net should they suffer an illness or injury and be unable to work. Social outcomes could be expected to improve as income replacement from insurance would enable the standard of living (in economic terms) to be broadly maintained.

In addition to the social outcomes, further KPMG analysis showed that based on current DSP means-testing every dollar of income received from private insurance can be expected to reduce the DSP by 50 cents through reduced eligibility if all employed Australians were adequately insured.

This translates to a government cost saving in the first year, if Australians are adequately insured, of at least \$340 million for each cohort of new disability pensioners even before the tax revenue foregone is taken into account. According to the FSC's research, the cumulative annual savings effect of adequate disability insurance is estimated to be \$2.5 billion per annum in the 10th year, as measured by lower DSP payments.

<sup>30</sup> Australian government, 2013-2014 Budget Paper No. 1, Statement 6: Expenses and Net Capital Investment

<sup>31</sup> Australian government, 2013-2014 Budget Paper No. 1, Statement 6: Expenses and Net Capital Investment, Table 3.1

<sup>32</sup> 2011-12 Budget Review, Disability support pension reforms

<sup>33</sup> 2012-13 Annual Report, Department of Human Services

## NATIONAL DISABILITY INSURANCE SCHEME

The NDIS and the National Injury Insurance Scheme (NIIS) will provide funding for long term, individualised care and support services for those with a significant disability such as attendant nursing care, rehabilitation, and home and vehicle modifications. However, the NDIS and NIIS will not provide an ongoing income replacement benefit where a disability is acquired as provided by adequate disability insurance. Such benefits enable an individual to maintain his or her standard of living and continue to meet financial obligations such as mortgage payments, rent, daily living expenses and education costs for the children in the family.

We do not believe this distinction is well understood among the community.

The Australian government has committed \$19.3 billion over seven years from 2012-13 to fund 53 per cent of the cost of the NDIS with the states and territories to fund the remaining cost. Eligibility for the NDIS will not be means tested and financial support will be available to those who are born with or acquire a permanent disability.

The FSC supports the establishment of the NDIS and the NIIS. However, we submit that the existing funding model is likely to be unsustainable and may ultimately place pressure on the Scheme's long-term viability.

The life insurance industry can effectively privatise public sector costs of providing the disability support pension, NDIS and other social policy initiatives.

## DELOITTE ACCESS ECONOMICS MODELLING STUDY

In preparation for the Inquiry, the FSC engaged Deloitte Access Economics to undertake modelling to consider a policy option of complementary private disability insurance alongside the NDIS.

The Deloitte study considered the potential for budgetary savings to the NDIS and DSP through an enhanced role for private disability insurance. Central to the study is a consideration of the net financial impact of the introduction of appropriate financial incentives and disincentives to achieve improved levels of cover.

It assumed that the introduction of policy settings similar to those in existence today for private health insurance could be expected to encourage Australian taxpayers to hold private disability insurance.

This would meet or exceed the benefits offered through the NDIS while providing sufficient income replacement in the event of illness or injury rendering them ineligible for DSP benefits.

In effect, the study considered the potential savings that could be achieved by government if NDIS eligibility for those who acquire a disability was means-tested, and by extension, reduced eligibility for DSP benefits, while ensuring social policy objectives of the Scheme and other disability-related welfare programs as a safety net would continue to be achieved through partial privatisation of the risk or those on higher incomes.

The research was undertaken based on the principle of the historical role of private health insurance in Australia in reducing public healthcare expenditure.

The Australian government has a policy principle of universal entitlement for health services - through funding public hospital services and national programs and providing subsidies to medical and pharmaceutical services.

This mainly occurs through the Medical Benefits Scheme (MBS) and Pharmaceutical Benefits Scheme (PBS) - funded in part through a Medicare Levy on all taxpayers, and a Medicare Levy Surcharge (MLS) that incentivises higher income individuals and families to take out private health insurance hospital cover. In addition, the Australian government offers a rebate for private health insurance premiums which is also means-tested. The rebate levels applicable for 1 July 2013 to 30 June 2014 are outlined in **Figure 13**.<sup>34</sup>

**Figure 13**

	SINGLES FAMILIES	≥ \$88,000 ≥ \$176,000	88,001-102,000 \$176,001-204,000	\$102,001-136,000 \$204,001-272,000	≥ \$136,001 ≥ \$272,001
REBATE					
< age 65		30%	20%	10%	0%
Age 65-69		35%	25%	15%	0%
Age 70+		40%	30%	20%	0%
MEDICARE LEVY SURCHARGE					
All ages		0.0%	1.0%	1.25%	1.5%

<sup>34</sup> Australian government, Private Health Insurance Ombudsman website, <http://www.privatehealth.gov.au/healthinsurance/incentivessurcharges/insurancerebate.htm>, accessed March 2014



The private health insurance rebate (originally at a standard 30% rate) and MLS were introduced in the late 1990s, along with introduction of differential private health insurance premiums for those taking out and maintaining private health insurance cover before the age of 30 years (Lifetime Health Cover).

The effect on private health insurance coverage in Australia was to increase rates of cover from around 30% in 1997 to around 45% by 2001. In December 2013, 47 per cent of Australians held private hospital cover and almost 55 per cent held general treatment cover.<sup>34</sup>

The study uses the principles of existing policy mechanisms that operate for Australian taxpayers for private health insurance as the basis for considering private disability take up through a range tax incentives (i.e. rebates) and disincentives (i.e. additional surcharge).

### Disincentives

Deloitte research suggested that the introduction of a “Disability Levy Surcharge” (DLS) would perhaps be the strongest policy lever that would ‘push’ individuals to take up private disability cover. A DLS would be a disincentive or a ‘stick’ for those earning over a specified income, in the base case over \$88,000, to take out private disability insurance cover.

In the new modelling, the DLS was based on current policy for the MLS which includes a surcharge of up to 1.5% on taxable income (in addition to the 2.0% Medicare levy) for those without the appropriate level of cover.

Deloitte’s base case models the potential savings for government with an assumption that 10 per cent of the total population were covered by adequate insurance.

That represents an assumption that all taxpayers earning above the income threshold and therefore subject to the DLS would take out cover to avoid the “stick”.

### Incentives

The introduction of rebates is (the “carrot”) assumed to be necessary, as in a private health insurance setting, as a lever to assist with the affordability of cover. In this modelling, the rebate level is assumed to be the same as the private health insurance policy. That is, between a ten per cent and 30 per cent rebate for those aged less than 65 with annual taxable income less than \$136,000 for individuals and \$272,000 for households.

<sup>35</sup> Private Health Insurance Administration Council, Membership Statistics, 2014

## Results of base case modelling

The results of the base case scenario modelled demonstrate at a conceptual level the potential for \$13.7 billion gross savings to both the NDIS (\$10.3 billion) and DSP (\$3.4 billion) through the introduction of tax incentives and disincentives. Net savings achieved by the government in this model, were \$3.7 billion for the Commonwealth and \$4.8 billion for state and territory governments after allowing for the cost of the “carrot” (\$5.2 billion in premium rebates) funded by the Commonwealth.

The expected changes in savings and expenditure in the base case scenario are summarised in **Figure 14**.

**Figure 14. Overview of Savings and Expenditure**

PARAMETERS	SAVINGS/(EXPENDITURE) (\$billion)
<b>Savings to the government programs</b>	
NDIS	\$10.3
DSP	\$3.4
<b>Gross Savings</b>	<b>\$13.7</b>
<b>Commonwealth rebates for PDI*</b>	<b>(\$5.2)</b>
<b>Net savings to the governments</b>	
Commonwealth*	\$3.7
States and Territories	\$4.8
<b>Total net savings</b>	<b>\$8.5</b>

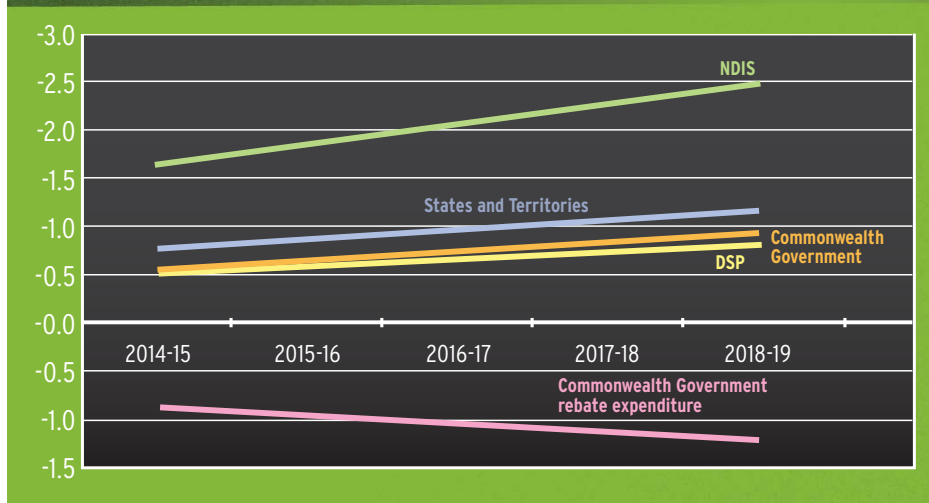
\*The model assumed total cost of incentives were borne by Commonwealth

The savings identified here are based on the specific scenario modelled and are high level findings only.

Further consideration should be given to the appropriate policy settings for incentivising individuals to take out private disability insurance that take into account the features of these types of insurances (including the need for pooled risk rating) and further detailed modelling should be carried out.

**Figure 15** demonstrates the potential savings that could be achieved through improved levels of private disability insurance coverage alongside the NDIS.

**Figure 15. Annual Expenditure and Revenue Impacts of Improved Private Disability Insurance Coverage, by sector (\$bn)**



The research also concluded that:

“From a policy perspective, private disability insurance, supported by a broader base of consumers, would potentially provide a more equitable distribution of the financial burden of disability insurance across people who can afford to pay and need not fall back on the safety net provided by the NDIS. It would also avoid the crowding out of private expenditure among those who can afford to pay, and reduce financial risk to the Australian government (and by extension, taxpayers).”<sup>36</sup>

The potential for the introduction of financial benefits to improve levels of private insurance coverage is also supported by the findings of consumer research recently completed for the FSC by GfK.

When those surveyed without disability insurance were asked to indicate the most persuasive messages to act in relation to taking out income protection cover, the most motivating message to act was the government providing a tax incentive to have insurance (the “carrot” approach), while the second most motivating messages was a minimum level of insurance required to avoid extra taxation (the “stick” approach adopted for private health insurance).<sup>37</sup>

The FSC believes that an expanded, complementary role for the private insurance sector in managing some of the risk that would otherwise remain a public liability would also encourage industry innovation particularly in relation to products and services that could be developed to meet the evolving needs of consumers.

<sup>36</sup> Research commissioned by the FSC completed by Deloitte Access Economics, Expanding the coverage of private disability insurance to reduce the economic burden of social disability insurance, March 2014, p. ii

<sup>37</sup> GfK, A review of consumer attitudes and behaviour in relation to financial protection: Instilling behavioural change to counter under-insurance in the Australian life insurance category, February 2014

It is likely that new long term disability products would need to be developed to provide the same or superior benefits to those available through the NDIS in particular.

We acknowledge that a risk gap could remain between the government schemes and the coverage provided by contemporary industry products. For example, many contemporary private insurance products are unlikely to cover things such as realised congenital risk. Regulatory and product innovation is therefore a necessary element in considering this reform. Participation of life insurers would not be compulsory.

The modelling, based on the existing private health insurance framework, demonstrates the potential for cost savings to be made through improving the rate of private disability coverage in the Australian community.

#### RECOMMENDATION

The FSC recommends the Inquiry:

- considers the role of the private insurance sector in reducing long-term public sector costs of disability-related welfare and in particular the NDIS, NIIS and DSP without compromising living standards of disabled persons; and
- recommends the government undertake further, detailed modelling to determine appropriate policy settings for financial incentives and disincentives to improve the level of private disability insurance coverage.

## CHAPTER 4 RECOMMENDATIONS

1. The inquiry finds that the superannuation system has commenced the task of reducing age pension outlays which will only increase as the system matures over the next forty-five years
2. The inquiry recognises that superannuation is an increasingly large contributor to government revenue and that superannuation tax concessions have been overstated.
3. The preservation age should increase to at least age 65 and be linked to life expectancy. This will increase private savings within superannuation improve individuals' living standards in retirement, boost government tax receipts and reduce age pension payments. Consideration should be given to aligning preservation and age pension eligibility ages, with early access arrangements.
4. Age pension eligibility age be determined by life expectancy and other evidence based reporting.
5. Retirement phase policy changes should enable a range of products to come to market and allow trustees to assist in better managing transition into the retirement phase.
6. The Superannuation Guarantee should be increased to 12 per cent.
7. The FSC recommends the Inquiry:
  - considers the role of the private insurance sector in reducing long-term public sector costs of disability-related welfare and in particular the NDIS, NIIS and DSP without compromising living standards of disabled persons; and
  - recommends the government undertake further, detailed modelling to determine appropriate policy settings for financial incentives and disincentives to improve the level of private disability insurance coverage.