HOUSEHOLD SAVING AND INVESTING FOR LIFE-CYCLE EVENTS: GOVERNMENT INCENTIVES AND INSURANCE BONDS

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Individuals face difficulties in developing and executing optimal lifetime savings and investment plans, product complexity continues to grow, and there are increasing demands on government to support individuals' financial needs. Within this context, this paper examines the rationale for government policies aimed at influencing household savings and investment decisions — focusing on the financing of life-cycle events and the design of suitable financial products to achieve desired outcomes.

If individuals are the rational, well-informed, homo-economicus of the textbooks, there appears little role for governments to interfere through taxes, subsidies, or grants to affect saving and investment decisions.

Taking that perspective, one reason for intervention could be the possible existence of externalities associated with those decisions, but these are hard to pinpoint. One exception might be that government welfare safety nets, such as the age pension induce sub-optimal life-time savings. Another reason for intervention might be equity (income redistribution) arguments — although micro-economic theory suggests that lump-sum transfers not attached to any particular form of expenditure are preferable because they maximise consumer choice and welfare.

However, there is considerable evidence from the field of behavioural economics that individuals do not act as the economics textbooks assume (Ritter 2003). Discount (time preference) rates appear to be too high to be consistent with optimal life-cycle savings and investment. 'Framing' of choices affects decisions, as does specification of 'default options' requiring an opt-out decision. Even though money is 'fungible', individuals appear to operate 'mental accounts' through which compartmentalisation occurs. Individuals appear to recognise their inability to voluntarily adhere over time to optimal plans and are thus willing to lock themselves into commitments for designated savings objectives over time.

Allied to these considerations is the prevalence of imperfect information. Not only do individuals have difficulty in assessing and factoring into their financial plans provisions for financially critical, life-cycle events, but the complexity of financial products is becoming increasingly incompatible with the general population's relatively low level of financial literacy.

In this environment, bad financial choices can be made, and the opportunity and incentives for producing and promoting financial products, which involve excessive wealth transfer from purchasers to producers, are high. Regulators struggle to keep ahead of such innovations and to prevent the most odious cases, while reliance of individuals upon financial advisers to assist in decision-making has problems of its own.

Consequently, there is a case for examining whether and how government policies can best be designed to influence household saving and investment behavior in desirable ways, particularly by encouraging dedicated private saving for major life-cycle outlays. Such an approach, which some might regard as paternalistic, is partly a reaction to perceived deficiencies in the previous *caveat emptor* approach, which relies on the foundations of disclosure, education, and financial advice.

Influencing savings–financial investment behaviour

It is possible to analyse the alternative approaches available to government by considering the tax/transfer treatment accorded to financial products at the three stages of their life. Special treatment can be accorded at the time of purchase, during the currency of the product, or upon maturity/exit from the product. There are also options for providing advantageous tax treatment, subsidies, or grants, and these mechanisms can involve either a direct benefit to the individual, or be delivered via preferential treatment of the product producer. Through competition the tax benefit in the latter method is (hopefully) ultimately transferred to the individual.

In Australia, the clearest example of tax/transfer approaches is superannuation. Following the Simpler Super changes of 2006, concessional tax treatment occurs in the following way. First, a tax concession is provided on purchase/entry, with individuals able to make contributions from pre-tax income. Second, a tax concession is provided during the currency of the product (the accumulation phase) through the preferential tax treatment accorded to superannuation funds at source on investment earnings. Third, exit from the product (the decumulation/retirement phase) sees accumulated earnings distributed ‘tax-free’ to the recipient.

In contrast, a bank deposit involves no special tax treatment on entry (funds are from post tax income), interest income is taxed during the life of the product, and there is no tax at maturity. Table 1 illustrates various investment product types, where ‘T’ indicates full taxation, ‘t’ indicates concessional taxation, and 0 indicates no taxation. There are clearly substantial tax distortions across different financial products.

TABLE 1: Current Australian taxation of investment products

Product	Entry	During	Exit	Comment
Savings account (and term deposits)	T	T	0	Contributions are from after-tax income, earnings are taxed to individuals as they accrue on a 'flow-through' basis, and thus no requirement for taxation on exit when principal is returned.
Shares[1]	T	T	t	Investment is from after-tax income, there is concessional treatment of dividend income (imputation) and deferral of tax on capital gains until realisation, and then at a concessional rate (if held for more than one year).
Complying Superannuation (funded schemes)	t	T	0	Contributions can be made from pre-tax income, there is a concessional tax rate (15per cent on income and 10per cent on capital gains) on super funds (i.e. a 'tax-paid'[2] vehicle), and no tax is payable on withdrawal (past the preservation age of 60) and on death distributions to dependants (i.e. tax-free[3] distributions).
Insurance Bonds	T	T<10yrs t>10yrs	0	Contributions are from after-tax income, fund earnings are subject to 30 per cent rate (i.e. another 'tax-paid' vehicle) and no tax is payable on withdrawal (after the 10-year period) and on death distributions regardless of dependency (i.e. also tax-free distributions).
Owner Occupied Housing	T	0	0	Purchase out of after-tax income (and/or borrowed funds), imputed (self) rental income not taxed, no capital gains tax on sale.
Levered Rental Property or Equity investments	T	t	t	Purchase out of after-tax income, tax deductibility of loan interest, concessional capital gains tax (if held for at least one year).

One issue with concessional tax treatment is that it is regressive in nature, with higher benefits (in the form of tax savings per dollar of investment) flowing to individuals on higher incomes and marginal tax rates. Moreover, the ability of higher income individuals to invest larger amounts in the product also increases the absolute size of their potential tax savings.

This can be overcome in several ways. One is by applying a tax rebate (where the income tax rate payable is reduced by a fixed amount across all marginal tax

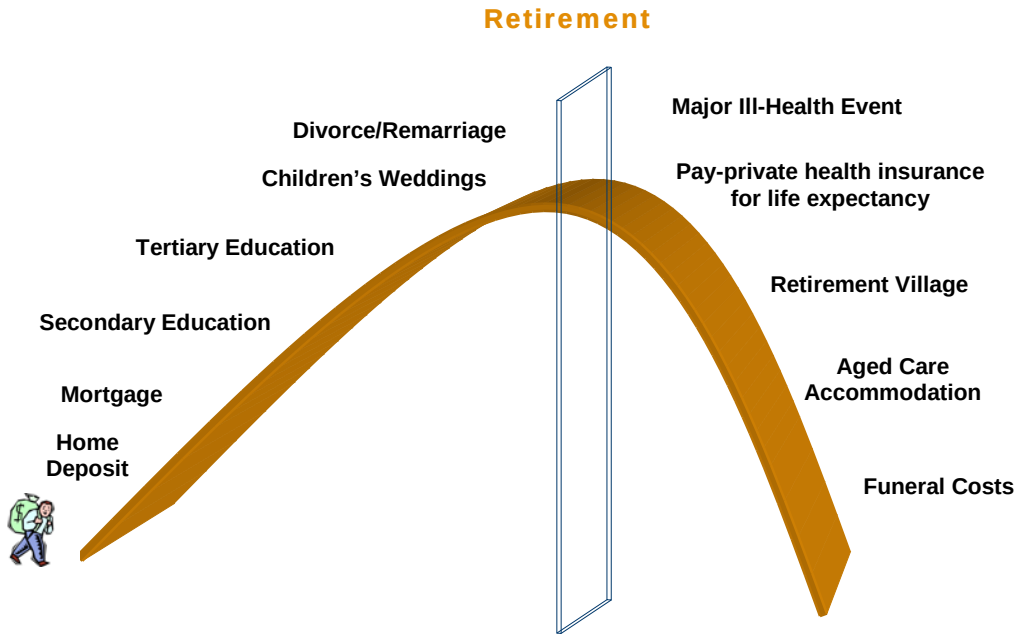
rates). A second is by payment of a government grant, either of a fixed amount or linked (possibly with a cap) to the size of the investment. In both cases, some cap on the amount on which concessional tax treatment is available may be required on equity grounds. While both a tax rebate and grant can, in principle, be structured to have the same fiscal effect, there may be quite different public perceptions and thus incentives associated with each. Moreover, for zero or low tax rate individuals, benefits from a tax rebate will be zero or less than 100 per cent unless they are able to receive tax credits as a cash payment from the tax office.

Life-cycle events and international approaches

Figure 1 illustrates various life-cycle events that can require substantial outlays at different times throughout life. The timing, financial impact and likelihood of such events are often unpredictable, and some are discretionary.

Alternative methods of financing such expenditures include: (a) prior savings to accumulate available wealth; (b) borrowing at the time of the event; (c) purchasing insurance, which pays out if the event occurs; and (d) intergenerational (family) wealth transfers. Because many of the events have a discretionary element, standard insurance is often not feasible, and borrowing (at reasonable cost) may not be feasible.

FIGURE 1: Potential life-cycle events requiring significant funding



Source: Austock Life.

Consequently, governments here and overseas have adopted polices aimed at encouraging saving specifically targeted at particular life-cycle events. One motivation may be that, without incentives, individuals will have insufficient savings

to adequately deal with these events. Where that outcome involves additional social costs as well as private costs (such as may be the case if further education by children is foregone, or dependence upon government welfare services result), the cost of government incentives may be outweighed by ultimate social benefits. Another motive may be that these policies are a form of targeted redistributive policies, where the association of tax concessions or subsidies with particular expenditures makes them more politically acceptable to the electorate. Compulsion, as well as tax incentives, is often a strategy.

A further motivation for such incentives is suggested by the view that an 'asset accumulation' approach to welfare policy or 'asset-based welfare' is worthy of more exploration. Using tax/transfer policies and grants (and compulsion) to encourage individuals to accumulate financial assets can lead to greater private responsibility for dealing with possible life-cycle events, rather than reliance upon government welfare. Such involvement with the financial system may also help to promote greater financial literacy and help address widespread apathy, especially among lower income households, to actively engage in their personal wealth accumulation.

This 'asset-based welfare' approach initially popularised by Michael Sherraden (1991) as a method of assisting households to escape from the poverty trap, has been applied in a number of countries and related to a variety of life-cycle events. Tufano and Schneider (2008) provide a review of a number of such schemes, and they are also discussed in OECD (2003) and OECD (2007).

One type of scheme relates to Child Development Accounts found in countries such as Hong Kong, Singapore, South Korea, Belgium, Denmark, and the UK (OECD 2007). Such schemes provide incentives for families to build assets for children (and can facilitate intergenerational transfers) by providing concessional tax rates on earnings and withdrawals and/or government grants (bonus) related to contributions. Another type of scheme is related to Education, and examples include Canada, Singapore and the United States (OECD 2007). While generic tax-preferred savings schemes (unlinked to any final use purpose) have been introduced in a number of countries, many have subsequently been abolished.

Other types of schemes which can be found internationally include tax preference for life assurance policies which involve a savings element, while tax incentives/grants associated with investment in home ownership are commonplace. Most common is tax incentives and compulsion for retirement income savings. Of course, many such arrangements have the effect of moderating progressivity of the tax system by giving tax concessions on savings and investment products which those on higher incomes are best able to exploit.

Life-event products and tax policy in Australia

The tax treatment of financial products not only influences savings–investment decisions but, for long-term savings and investment products, the tax treatment essentially drives the generic product form and its design features. This can be illustrated by reference to superannuation and insurance bonds.

Superannuation

Superannuation is currently the most prevalent form of tax-paid investment, with tax concessions at all stages limited by rules governing investment amounts and access restrictions. 'Tax-free' distributions are made to investors after retirement and to financially dependent beneficiaries upon death.

While superannuation has become the predominant mode for accumulating financial resources, it has limitations for life-cycle financial planning in that it:

- is only about funding one life-cycle event — retirement;
- lacks design features for accumulating any form of lump sum provision, such as those often needed in retirement, for health, retirement accommodation and aged-care related outlays;
- lacks coverage across the whole community — often inadequate for the self-employed and non-existent for the 'non- and never-employed'; and
- is open to the 'double dipping' by allowing lump sums to be taken and spent, with consequent demands on the age pension.

Insurance bonds

Insurance bonds offered by friendly societies and life offices are another tax-paid product, which allow investors to make lump sum or ongoing contributions into a fund with accumulated capital and earnings accessible on a tax-free basis 10 years (or longer) after the initial contribution, or at other earlier times in certain defined events (e.g. death, serious illness).

As a savings vehicle, investors are encouraged to contribute additional amounts of up to 125 per cent of the previous year's contribution each year for the same tax-free maturity date. Contributions are made out of after-tax income and income earned within the fund is taxed at 30 per cent, with no distinction made between revenue income and realised capital gains. This tax treatment is advantageous (relative to direct investment in the underlying assets) for high income earners on marginal tax rates above 30 per cent, but less tax-favored than superannuation and tax-disadvantaged for low income earners.

Because of their 'life assurance' characterisation, a 'life insured' person is nominated, who may be the investor or someone else. Accumulated funds can

also be accessed before the 10-year period ends (with loss of some tax benefits) or are paid out (as a tax-free distributions) on death of the nominated life insured.

The 1980s and early 1990s were the heyday for insurance bonds,[4] however, from the mid-1990s onwards, they lost support of financial planners and retail investors. A major contributor was the increase in the head-line tax-paid rate to 30 per cent, from 20 per cent in the 1980s and 0 per cent previously, as was the removal of means-tested pension advantages. The 'lost' decade was also impacted by modest investment performance and antiquated investment structures concentrated on capital guaranteed business.

The insurance bond market today is seeing signs of new life with new entrants and existing issuers re-emerging with updated products and expansive investment menus using modern multi-optioned investment platforms.

Insurance bonds and life-cycle events

In the face of escalating challenges for Australian families, relating to educating children, home ownership, ageing, health care, and the work/family balance, there is merit in reviewing the tax treatment of dedicated products offering choice and 'self-reliance' options.

Insurance bonds are designed to build a lump sum to meet planned life-event objectives, or perhaps for unknown contingencies, or even as a nest-egg to draw-down against over a future period. They can 'lock-in' the financial provisioning for important life-events — be it educating children or grandchildren, family health contingencies, aged care and accommodation, or for a funeral. Importantly, the 'lock-in' also allows an early withdrawal option at the cost of loss of tax advantages, providing a 'safety valve' for those investors whose circumstances change and involve a need for liquidity.

Despite the relatively complex tax treatment inside the life office or friendly society, the insurance bond is a relatively simple product with a structure and design features which can be easily explained to investors. As a life-cycle event savings product it holds simple attractions for specifically targeted and peace of mind investment outcomes. The merits of simple financial products requiring simple advice should not be underestimated.

Because insurance bonds are a species of life assurance and can be set up with a range of nominated of beneficiaries, they are suited to intergenerational transfers directed at a specific purpose. These types of nominations are also 'ring fenced' from disputes related to the estate of a deceased investor, and they have certain bankruptcy protections. There are minimal ongoing administrative/accounting requirements for the investor, who does not need to include fund investment earnings in a personal tax return during accumulation or over the bond's tax-free drawdown phase.

A variant on the standard insurance bond is an education scholarship plan issued by a friendly society for the explicit purpose of funding education expenses of the nominated beneficiary.[5] The product design of the more recently developed friendly society education bonds draws upon elements of popular US and Canadian education products. Overseas experience shows that specialised education savings products are not only attractive from investment perspectives, but can also be powerful motivators, and assist in developing the child's independent desire for a good education.

Refining the insurance bond model

Australia's current approach to taxation of savings and investment products involves significant non-neutrality (AFTS 2010). Some part of that reflects explicit policy priorities, such as superannuation and home-ownership incentives, but other components, such as negative gearing into risk investments, are less well founded. More generally, there are relatively few incentives to help individuals become financially self-reliant and plan for the future through non-superannuation vehicles.

There are also well-recognised problems regarding financial literacy and the financial advice industry, which is generally only affordable for higher income individuals. In this regard, it seems appropriate to use the tax/transfer system to 'nudge' individuals into making financial choices better suited to their long-term welfare and consider an 'asset accumulation' approach to welfare policy, involving tax/transfer incentives to accumulate 'merit assets' providing (at least partially) for particular life-cycle events.

The insurance bond structure provides a potential vehicle for achieving these outcomes, but its use is currently inhibited by a number of tax design characteristics. Foremost among these is the 'headline' tax rate. At 30 per cent, it is double the nominal superannuation fund rate and there is no tax incentive (indeed disincentives) for lower income households to use this form of savings vehicle. It is also materially disadvantaged by the generous capital gains tax discount (which for higher taxed investors translates to a 23.25 per cent rate), and there is little discernable tax advantage relative to investors who use private trust and corporate structures where effective taxation can translate to an effective 30 per cent corporate tax rate or better.

Simply reducing the headline tax rate would enhance its appeal to individuals on higher tax rates, but would not benefit lower income groups. The overall budgetary cost would depend upon whether a lower headline tax rate induced high-income investors to substitute out of other more tax-favoured investments (such as negatively geared investment properties) or less tax-favoured products such as bank deposits.[6]

And, any attempt to adjust tax rates in such a way as to provide benefits for, and induce targeted long-term saving by, low-income groups without creating further benefits for high-income groups seems likely to have the adverse effect of increasing product complexity. Central to the insurance bond's appeal is its tax-paid nature and consequent non-flow-through of fund earnings to individuals' taxable income. Because taxation of earnings is at the fund level, and there are no tax consequences on exit at maturity, there is no simple mechanism possible for applying differential tax rates for different contributors.

This suggests that a viable alternative would be to provide (capped) government co-contributions (grants) for lower income household contributions to a product which is targeted for specified purposes.

Here, however, the recent experience with the First Home Savers Scheme launched in October 2008 suggests some need for caution. Funds invested into tax-preferred deposit accounts received a government co-contribution and were locked in for four years, after which tax-free withdrawal to purchase a first home could occur. Contributions of at least $1,000 were required in each of at least four financial years. However, if house purchase occurred prior to four years, funds invested could not be used for that purpose but were compulsorily transferred to a superannuation account and thus locked in until retirement age. Recent government changes to the product, which had had very little take-up, allow for the funds to be used to pay down the outstanding mortgage balance after the fourth year in that case.

It is clear that the 'lock-in' period is an important consideration and, in that regard, the current 10-year investment requirement for insurance bonds is worthy of review. For most tax preferred savings products internationally, the term is typically shorter (such as four years).[7] It is also clear that the consequences of the 'early exercise' option are important, with the loss of tax benefits associated with early withdrawal of funds from investment bonds more likely to appeal to investors than the compulsory transfer to superannuation if not used for a specified purpose such as in the original First Home Savers Scheme.

Conclusion

Clearly, individuals have difficulty in assessing and factoring into their financial plans provisions for financially critical, life-cycle events, and there are increasing demands on the welfare state to support the financial needs of individuals. In view of this, there is a case for examining whether and how government policies can best be designed to influence household saving and financial investment behavior in desirable ways.

Government tax/transfer policies can be structured to influence savings[8] and also influence the design of financial products to assist individuals in providing for their own life-cycle financial needs.

When evaluated against other contemporary savings and investment vehicles (such as deposits, unit trusts and superannuation), there is merit in reviewing the insurance bond tax framework.

The insurance bond framework promotes individual self-reliance and asset accumulation, and can operate as a form of 'self-insurance' by offering a disciplined investment environment, designed to encourage long-term savers. And, it has relatively low financial advice requirements.

It may be advantageous to reduce the insurance bonds headline tax-rate, which would reinvigorate them as a voluntary savings facility, thus 'nudging' consumers towards the mentality of private funding for major life-cycle objectives and contingencies. Alternatively, government co-contributions could provide a way of targeting tax concessions at lower income groups.

Notes

[1] Taxation of dividend income could arguably be viewed as non-concessional since franking credits offset company tax already paid and put the overall tax treatment of income flowing into a company equivalent to that paid out as interest on debt.

[2] 'Tax-paid' means that during the accumulation phase of superannuation or an insurance bond, the fund or entity (i.e. life office including a friendly society) meets the fund/entity-level tax payments and reporting obligations, instead of personal tax being paid and reported by the underlying superannuation/bond investor.

[3] 'Tax-free' means the investment proceeds of superannuation or insurance bonds, when able to be accessed post-preservation for superannuation and post-10 years for insurance bonds, or upon death maturity distributions for both, are distributions generally free of personal tax obligations in the recipients' hands.

[4] Between the Life Offices and Friendly Societies - Industry FUM is estimated to have peaked at over $40 billion.

[5] The special feature of these schemes is that withdrawal of funds for eligible education expenses leads to recoupment of the tax-paid on earnings by the fund.

[6] The recently announced proposals to provide a 50 per cent discount on the tax rate on the first $1,000 of interest are also relevant here.

[7] Of note, prior to 1982 Australian insurance bonds were subject to a four year 'lock-in' period.

[8] The evidence on how compulsory savings plans (such as superannuation requirements) and tax concessions affect overall savings levels is mixed (Japelli and Pistaferri, 2003). Attanasio and Wakefield (2010) examine the empirical evidence on how changes in returns on particular products, such as from specific tax changes, affect savings and wealth and also find mixed results, but suggest that the way in which information is presented may be an important determinant of responses.

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