



ACOSS Submission to Australian Treasury - proposals to simplify superannuation

August 2006

Executive summary

As the peak council of the community and welfare sector, concerned about low income and disadvantaged Australians and social inequality, ACOSS welcomes the opportunity to comment on the Government's 'streamlining superannuation' proposals.

The context for our comments and suggestions regarding the Government's proposals is that:

- The current superannuation system needs reform to better encourage and support saving among low and middle income Australians and to simplify it.
- Given the projected increase in the cost of services for an ageing population over the next 30 years, it is vital that Governments make the best possible use of the funds available for both direct expenditures and tax concessions, including the \$17 billion per year devoted to supporting saving through superannuation whose cost will rise as the population ages.
- Increased participation in the workforce by mature age people would greatly assist people to improve their living standards later on when they retire (because it boosts their savings and reduces the period of retirement those savings have to 'cover'), as well as reducing the costs to Government associated with population ageing and strengthening economic growth.

ACOSS's submission deals specifically with potential effects of the proposals on the equity of retirement incomes, the long term capacity of Government to provide services for an ageing population, and the complexity of superannuation. In addition, we suggest that it would be easier to reconcile these often-conflicting objectives if the reform agenda was broadened to:

- simplify and improve the equity of the current tax treatment of superannuation contributions,
- review tax concessions for mature age people more generally,
- examine a range of options to enable and encourage mature age people to smooth their incomes across the period of retirement.

The benefits of superannuation tax concessions for people on different incomes

Currently \$17 billion is spent every year on tax concessions and other support for superannuation – almost 80% of the cost of the Age Pension, and rising. Given that half of all retirees today and one third in 45 years time rely on the maximum rate pension, ACOSS is concerned that the balance between public spending on pensions and superannuation is shifting too far away from an emphasis on the most disadvantaged.¹

Superannuation tax concessions are poorly targeted to those who find it hardest to save for retirement – those on low and middle incomes. For example, the 15% contributions tax 'saves' an individual on the top tax rate (earning \$150,000) 32 cents in tax per dollar contributed to superannuation by their employer, but an individual on the lowest tax rate (earning \$20,000) saves just 2 cents per dollar contributed. The annual tax concessions for Superannuation Guarantee contributions (9% of wages) for the high income earner in this

¹ Treasury 2004, *A more flexible and adaptable retirement income system*. Treasury 2005, *Tax Expenditures Statement* and Australian Taxation Office 2006, *Portfolio Budget Statement*.

example are worth \$4,253 compared to \$27 for the low income earner. This is inefficient as well as inequitable, because low and middle income earners are less likely to save, and more likely to rely on the Age Pension, in the absence of public support for saving through superannuation.²

A high level of compulsory saving *exclusively* for retirement also disadvantages many low income earners because they forego part of their income during working life, when their budgets are often very tight - for example, while unemployed, purchasing a home, or raising young children - in order to attain a higher standard of living after retirement than they had previously. Compulsory long term saving would be more beneficial for low income earners if part of their superannuation savings could also be used for these and similar purposes, especially where this raises their investment in human capital and other assets that will benefit them in retirement.

The financial gains from the proposed changes to superannuation and the Age Pension would accrue mainly to high income earners, since they are the most affected by benefits taxes and the assets test. This is confirmed by the Government's modeling, which indicates that:

An individual retiring at age 65 in 2007 would see their retirement income rise by:

- zero if they receive a lump sum benefit of \$100,000
- \$10,522 or 5.6% if their lump sum benefit is \$200,000
- \$43,522 or 12.2% if their lump sum benefit is \$400,000.

An individual retiring with a lump sum benefit after receiving superannuation guarantee contributions over 40 years of working life would see their retirement income rise by:

- zero if they had earned \$20,000 per year
- \$37,318 or 8.7% if they had earned \$50,000 per year.
- \$116,241 or 14% if they had earned \$100,000 per year.³

There is a case for easing the pensions assets test, since retirees must achieve a return of at least 7.8% on additional savings to offset the reduction in their pension under this test. However, the proposed easing would also mainly benefit pensioners with substantial assets. Assisting people on lower incomes to save for retirement should be the highest priority. It is difficult to assess the effects of the proposed easing of the assets test in the absence of separate data on the cost and distributional effects of this proposal.

ACOSS welcomes the proposed tightening of the tax treatment of large employer termination payments that are not preserved for retirement (taxing amounts above \$140,000 at marginal income tax rates). We suggest this be taken a step further by taxing these payments in a similar manner to redundancy payments, rather than treating them as part of the superannuation system for tax purposes.

The effects on future public revenue

The cost to revenue of the proposed changes (\$1.6 billion per year in the short term) could rise substantially over the next two decades as the population ages and more people retire with larger superannuation benefits. This revenue loss would come at a time when future Governments are under pressure to finance health and other services for older and other disadvantaged Australians. It is therefore important that the Government prepare and release projections of the future cost of each of the proposed changes before a final decision is made.

² Source: ACOSS calculations. The Government co-contribution for low income earners adds a small element of progressivity to the system, but it represents just 6% of the overall cost to Government of tax concessions for superannuation.

³ Australian Government 2006, op cit.

One option to offset the loss of future public revenue if the proposed changes go ahead is to reconsider the targeting and effectiveness of a wider range of existing tax concessions for retirement incomes. For example, a couple over 65 years generally has a tax free threshold of \$41,360 compared with around \$21,000 for a single income couple of workforce age.⁴

In addition to the direct loss of revenue from taxes on superannuation benefits, there is a risk that the proposed abolition of these taxes, together with the recent easing of restrictions on contributions to superannuation by mature age people, could open up opportunities for some to avoid tax on their other income – for example by ‘churning’ their wages through their superannuation account. These risks should be carefully assessed.

The complexity of the superannuation system and need for simplification

There are at least four different tax treatments of superannuation contributions, depending on their source. The same dollar invested in superannuation is taxed differently depending whether it comes from an employee, their employer, their spouse, or from a self employed person. The tax treatment of benefits is so complex that most fund members require costly financial advice when they reach retirement, simply to untangle the effects of the tax and Age Pension systems on their retirement benefit choices.⁵

The proposed changes would make the tax treatment of benefits much simpler. Many different tax treatments for superannuation benefits (depending when the contributions were made, the form of the benefit – e.g. lump sum or pension – and what proportion of the benefits are derived from personal or employer contributions) would be replaced by no tax at all.

One of the main reasons for imposing taxes and other rules on superannuation benefits is to encourage people to draw down their retirement savings as smoothly as possible over the entire period of retirement. This is desirable to maintain people’s living standards throughout retirement, and to ensure that the \$17 billion in public support for superannuation is used effectively for this purpose, rather than for other purposes such as transfers to adult children.⁶ A balance must be struck between giving people the flexibility to use their retirement savings to best meet their needs, and ensuring that superannuation is used for its main purpose. This could be achieved using a much simpler and ‘lighter’ system of regulation or taxation than the present one. For example, the British system limits lump sum benefits to no more than 25% of overall superannuation assets.

Simplification should not stop at the benefits end of the superannuation system. The complex and inequitable tax treatment of *contributions* from different sources should also be tackled. This could be done in a way that addresses the equity concerns raised above. The overall package of reforms would make superannuation fairer as well as simpler.

The proposed changes have far reaching implications for the future living standards of retirees, public revenue, and the distribution of income. These decisions should be informed by the best available data on these implications, and by thorough going public discussion. These changes should not be rushed, notwithstanding the windfall gains that would accrue to a minority of retirees in the short term.

ACOSS makes the following recommendations to extend and improve the proposed reforms. Such proposals would best be considered as part of an independent inquiry into the equity, simplicity and effect on future public revenue of superannuation reform to ensure that changes now contribute to the fairness and sustainability of the superannuation system.

⁴ Treasurer’s media release 2006, *Australians set for more tax cuts and benefits from 1 July,2006*, and ACOSS calculations.

⁵ See ACOSS *Fairness and flexibility: Making superannuation work for low and middle income-earners*. ACOSS Paper 123.

⁶ This has been an objective of retirement income policy for some time. The Treasury noted last year that: “The Government has restrictions on contributions past age 65, and compulsory cashing at age 65 if the member is no longer working part-time, to reduce the risk that concessionally taxed benefits are used for estate planning and not genuine retirement income purposes.” Treasury submission to Senate Select Committee Inquiry on Superannuation (2005), p8.

ACOSS recommendations for superannuation reform

R1.

(1) An independent inquiry, for example by the Productivity Commission or the relevant Senate Committee, should be conducted to examine the effects of proposed changes to retirement incomes policy announced in the 2006 Federal Budget from three perspectives: equity, simplicity and the effect on future public revenue.

(2) The proposed changes should not proceed until this Inquiry is completed and its recommendations are considered.

(3) The Government should provide to the inquiry all relevant data on the likely effects of the proposed changes on public revenue and the level and distribution of future retirement incomes.

R2.

The taxation of superannuation should be comprehensively simplified and made fairer by also reforming the tax treatment of *contributions*. We recommend:

- taxing all contributions from after-tax income regardless of their source,
- taxing employer contributions in the hands of the employer at marginal rates of personal income tax and removing the 15% tax for employer contributions,
- replacing all present tax concessions for contributions (apart from the FBT exemption for superannuation) with a simple two tier annual tax offset for all contributions up to an annual ceiling.

R3.

If the proposed changes to retirement incomes are projected to reduce future public revenue by substantially more than the 'short term' estimates provided in the Budget Papers, the Government should review the overall tax treatment of retirement incomes to find offsetting revenue savings.

R4.

Superannuation fund members should be encouraged to smooth their retirement incomes over the full period of retirement, in a simpler way than the present complex rules. Options include:

- capping the proportion of total superannuation assets that can be withdrawn in any single year, taking account of life expectancy,
- replacing existing taxes on superannuation benefits with a single rate of tax on total annual benefits paid (whether lump sums or pensions) that exceed a high annual level,
- raising the tax rate for benefits paid to non dependents (such as adult children) on the death of a superannuation fund member from 15% to 30%.

R5.

The preservation age for retirement savings should be raised more rapidly from 55 to 60 years, except in cases of severe disability or full time caring responsibilities, to align with the age at which the new tax arrangements come into play.

R6.

Employer 'Eligible Termination Payments' (golden handshakes) should be taxed at the recipient's marginal rates above the tax free threshold applying to redundancy payments, unless they are immediately rolled over into superannuation and fall within the proposed annual contribution limit.

1. Major problems with the present system

The present tax treatment of superannuation is complex and inequitable. The system is also inefficient in meeting its key objectives of strengthening retirement incomes and reducing reliance on the Age Pension because it encourages early retirement, the dissipation of retirement savings through lump sum benefits and the use of superannuation for estate planning purposes.

Complexity

The present tax treatment of superannuation is very complex. This is the outcome of a series of ad hoc changes made over the last 23 years to address fundamental inequities and inefficiencies in the system. Unfortunately, none of the previous reforms restructured the system in a comprehensive way to resolve the basic problems.

A further source of complexity is that changes made to one 'stage' of the system, for example the taxation of contributions or fund earnings, required adjustments at the other stages, for example the taxation of benefits.

Ideally, the tax treatment of all three 'stages' of superannuation – contributions, fund earnings and benefits - would be reformed in an integrated way. This could either be achieved by taxing superannuation on an *income basis*, akin to bank savings, or on an *expenditure basis* (see table below):

- Under an income tax system, contributions are made from after-tax income and fund earnings are taxed at the individual's marginal tax rate. Benefits are not taxed.
- Under an expenditure tax system, deductions would be allowed for contributions, fund earnings would not be taxed, but benefits would be taxed at marginal rates.

Figure 1: Alternative tax treatments for superannuation

	Contributions	Fund earnings	Benefits
Income tax treatment	Taxed (made from after-tax earnings)	Taxed (like bank interest)	Untaxed (like bank withdrawals)
Expenditure tax treatment	Untaxed (full deductions allowed)	Untaxed	Taxed at marginal rates
Current system	Taxed at low rates (usually a flat 15%)	Taxed at low rates (a flat 15% or less)	Taxed at low rates (usually zero unless benefits are large)

Instead, Australia has a hybrid system that taxes contributions, fund earnings and benefits concessionally. The tax treatment of both contributions and benefits is very complex. Despite this complexity, the overall system is still inequitable and costly to public revenue.

The fundamental problems with our concessional tax treatment of contributions, fund earnings and benefits are structural biases in favour of saving by high income earners, salary sacrifice at the contributions phase, lump sum benefits at the benefits stage, and early retirement. Despite two decades of reform, these basic problems remain.

The fundamental problem with the tax treatment of *contributions* is that employer contributions are privileged, because they are made from *before-tax* income. In contrast, contributions by employees and self employed people are made from *after-tax* income. This particularly benefits high income earners because the marginal tax rates on their earnings are higher. High income earners therefore benefit most from salary sacrifice arrangements. Attempts to reduce these biases in favour of employer contributions and high income earners have generated much complexity. They include:

- the superannuation surcharge (subsequently abolished)
- the 15% tax for employer contributions
- the income-tested co contribution scheme

- the separate system of deductions for self employed people
- a set of rules to distinguish between self employed people and employees.

Another source of complexity in the system is the special tax arrangements to encourage married individuals to contribute on behalf of their partners.

The result is that there are four separate tax treatments for superannuation contributions, depending on their source (see table below).

Figure 2: The four different tax treatments of superannuation contributions

Source of contribution	Tax treatment
Employer	No tax collected by employer, Flat tax of 15% on transfer to super fund
Employee	Earnings taxed at marginal rates, Capped co-contribution for low & middle income earners
Self employed	Earnings taxed at marginal rates, Capped deductions for contributions ⁷
Spouse	Earnings taxed at marginal rates, Capped tax offset for contributions on behalf of spouse

The tax treatment of *fund earnings* is relatively straightforward – they are taxed at the flat rate of 15%, or two thirds of that rate in the case of capital gains. Flat taxes are, however, less equitable.

The fundamental reasons for complexity in the treatment of *benefits* are various attempts to smooth benefit payments over the period of retirement (mainly to discourage large lump sum payments and ensure that superannuation is not used for estate planning purposes) and to redress the above inequities of the tax treatment of contributions and fund earnings. The simplest way to resolve these problems would have been to require all benefits to be paid as life pensions, as many other countries have done. These could either be taxed at marginal rates (if contributions and fund earnings are untaxed), or not taxed at all (if contributions and fund earnings are fully taxed).

A further source of complexity at the benefits stage is the ‘grandfathering’ arrangements that accompanied certain major reforms of the taxation of benefits, in order to ensure that benefits accumulated from contributions made before each change were not adversely affected. Thus, for example, benefits paid from contributions made before 1983 are still taxed under the arrangements that applied before that year. This means that that portion of a member’s benefit must be separately identified.

An additional source of complexity in the tax treatment of benefits is policy responses to financial innovation. The tax system identifies two types of benefit – ‘lump sums’ and ‘pensions’ - and taxes them differently. However, financial innovation has blurred that distinction. For example, the beneficiaries of allocated pensions can draw down ‘lump sums’ to meet particular needs, in addition to their regular pension. Instead of redesigning the tax treatment of benefits comprehensively, new tax arrangements have been introduced to deal with each new wave of financial innovation.

The outcome of a succession of ad hoc changes to taxes on benefits is a very complex system. The tax rate applied to benefits varies according to whether:

⁷ The existing cap would be removed under the Government’s proposal.

- the benefit is a lump sum or pension, and the type of pension,
- the recipient is the fund member or a beneficiary of the fund member,
- it is derived from contributions made before or after 1983,
- it is derived from contributions that attracted tax concessions,
- it exceeds 'reasonable benefit limits' calculated over the person's lifetime.

The effective tax rate applied to benefits is also influenced by special tax concessions for retirees such as the Senior Australians Tax Offset.

Equity and incentives to save

Superannuation is taxed concessionally to meet three goals: to improve people's retirement incomes, increase private saving, and reduce reliance on the Age Pension.

An equitable system would offer a higher public subsidy, per dollar invested, to low and middle income earners than to high income earners. This design principle is followed in most overseas social insurance systems, which usually cap benefits for high income earners and cross subsidise benefits for people who had low earnings throughout their lives.

A 'bias' towards support for saving by low and middle income earners would also help achieve the above three goals more efficiently. This is because, in the absence of public subsidies for superannuation, low and middle income earners are less likely to save for retirement and enjoy adequate retirement incomes than high income earners. After reviewing the international literature on the effectiveness of incentives to save, the OECD recently concluded that tax concessions for private saving are likely to be more effective if they were redirected towards low and middle income earners rather than high income earners.⁸

From the standpoint of saving incentives, a further problem with the existing 15% flat tax on employer contributions is that its benefits are 'invisible' to most low and middle income earners, though most high income earners are likely to be aware of them through their financial advisors. Many low and middle income earners are likely to perceive the contributions tax as an 'extra' 15% tax rather than a concessional rate of tax.

High income earners are also less likely to rely on the Age Pension, with or without tax subsidies for superannuation. Yet many receive more financial support for their retirement from tax concessions than they would receive on the maximum Age Pension.⁹

Although it contains some progressive elements, the present system of tax concessions is biased in the opposite direction - towards high income earners and against low and middle income earners. The two major tax concessions for superannuation are the flat 15% taxes on employer contributions and fund earnings. These cost \$9.1 billion and \$6.4 billion per year respectively, comprising 90% of the overall annual cost of all public subsidies for superannuation (see table below in section dealing with 'cost to revenue'). Both these tax concessions are regressive.

The vast majority of *superannuation contributions* come from employers, through the Superannuation Guarantee or salary sacrifice arrangements. The effect of taxing employer contributions at a flat rate of 15% instead of the marginal tax rates that would normally apply to wages is regressive. For example, the 15% contributions tax 'saves' an individual on the top tax rate (earning \$150,000) 32 cents in tax per dollar contributed to superannuation by their employer, but an individual on the lowest tax rate (earning \$20,000) saves just 2 cents per dollar contributed. The annual tax concessions for Superannuation Guarantee

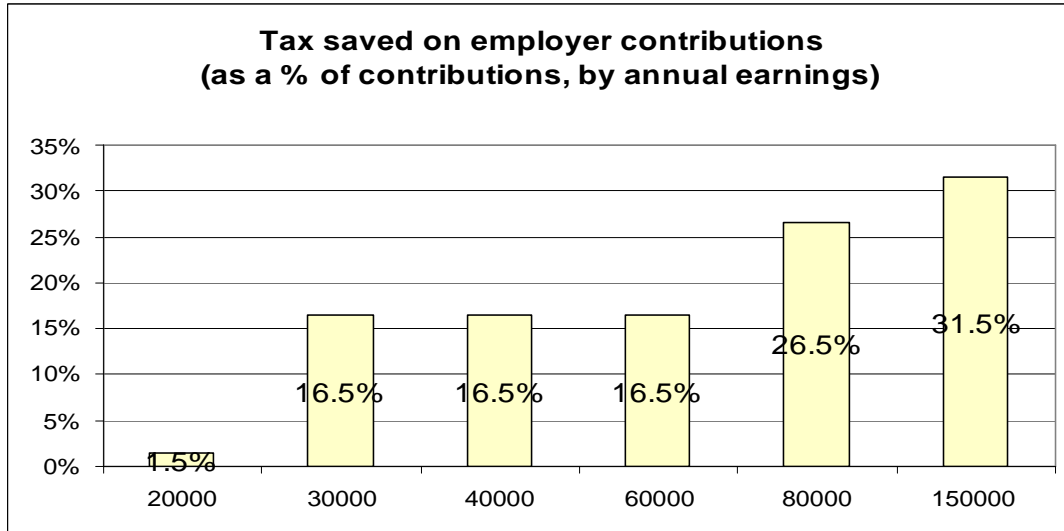
⁸ Antolin et al 2004, *Long term budgetary implications of tax favoured retirement plans*, OECD Economics Department Working paper No 16. The paper argues that: 'Encouraging a more balanced participation [in tax assisted saving schemes] across income levels may not only be desirable from a strict equity perspective, ...it may also lead to better results in terms of boosting private saving.' p19. Annex 2 provides an overview of US research on the effectiveness of tax incentives for saving.

⁹ This is especially so for those with significant 'pre-1983 contributions'.

contributions (9% of wages) for the high income earner in this example are worth \$4,253 compared to \$27 for the low income earner.¹⁰

The tax subsidies obtained for employer contributions for employees on different wage levels is shown in the graph below.

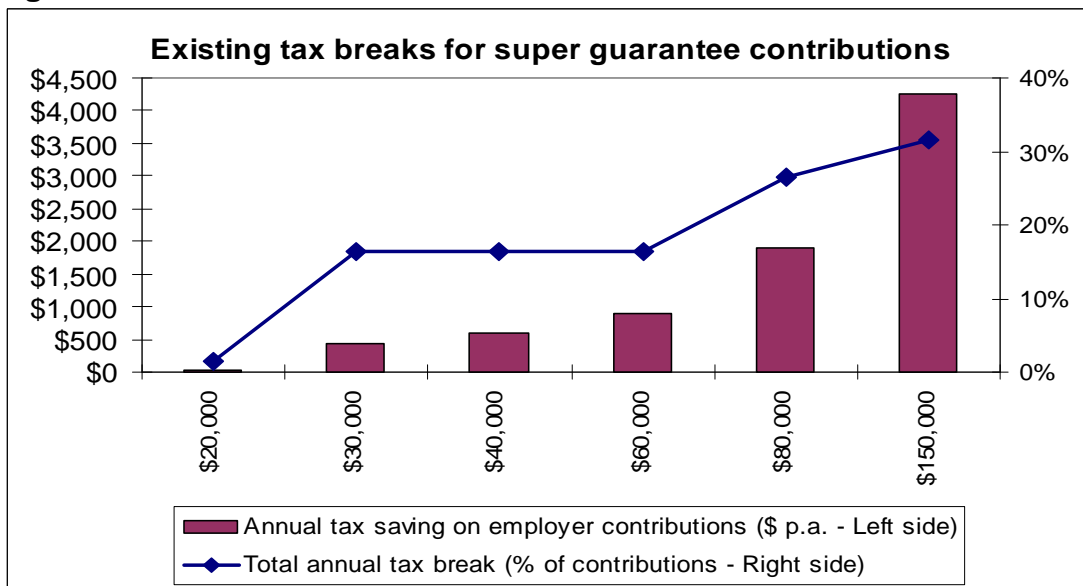
Figure 3:



Source: ACOSS calculations.

The graph below shows the annual value of this tax concession for Superannuation Guarantee contributions (9% of earnings), in dollars per year and as a percentage of contributions made. Many high income earners take further advantage of this tax concession by sacrificing salary for additional employer contributions, so the value of the tax concessions received by high income earners is typically much higher than indicated here.

Figure 4:



Source: ACOSS calculations.

¹⁰ Source: ACOSS calculations.

The tax concession for *fund earnings* is structured in the same way as for employer contributions. Instead of being taxed on interest payments at their marginal tax rate, fund members are effectively taxed at the flat rate of 15% or less.¹¹

The income tested co-contribution for low and middle income earners does not offset the regressive effect of the other tax concessions for superannuation.¹² Part of the reason for this is that it comprises only a small percentage (6%) of overall public subsidies for superannuation (see table below). Further, it is possible that the co-contribution itself is regressive from the standpoint of *family* incomes, since those who can best afford to make voluntary contributions are the partners of high income earners. In the absence of data on the family incomes of those who benefit from the co-contribution, this is difficult to assess.

Taxes on *benefits* are broadly progressive, but their effect is limited by the high tax free threshold for lump sum benefits, various tax offsets for superannuation pensions and the other income of retirees, the low rates of tax applying to contributions derived from contributions made before 1983, and the non taxation of benefits derived from contributions that did not attract a tax concession. At present, most lump sum benefits fall below the tax free threshold of \$129,751, though this will change as benefits rise over the next 20 to 30 years. The 15% tax offset for complying superannuation pensions the Senior Australians Tax Offset, and the Low Income Tax Offset combine to exclude most superannuation pensions from tax.

The above analysis shows that superannuation tax concessions are strongly regressive in overall terms. This raises concerns about their effect on wealth and income inequality among retirees in future, as superannuation assets increase. Research by NATSEM suggests that wealth inequality will increase substantially over the next 20 to 30 years. Given that a growing proportion of all wealth (almost 50% by 2030) will be held by retirees, this suggests that on current trends both wealth and incomes are likely to be much less equally distributed among retirees in future.¹³

Cost to public revenue

Superannuation tax concessions and the co-contribution currently cost the Government 78% of the cost of Age Pension, and they are likely to outstrip the cost of the Age Pension in future years. Although Australia is relatively well placed to meet the fiscal costs of supporting an ageing population, the rising cost of superannuation tax concessions will make it more difficult for future Governments to provide the necessary health care and other services needed by future retirees.

The major superannuation tax concessions and other subsidies, and their estimated cost in 2006-07, are detailed in the table below. The cost of the Age Pension in that year is also indicated in the table.

¹¹ The effective tax rate is usually lower due to the effects of dividend imputation and the concessional tax treatment of capital gains.

¹² The co-contribution subsidises personal contributions to superannuation, at a rate of up to \$1.50 for every dollar contributed, depending on the person's income. Its maximum annual value is \$1,500. The maximum subsidy is paid to individual employees on less than \$28,000 per year, provided they contribute at least \$1,000 to superannuation. The co-contribution is income tested so that no subsidy is paid for employees earning \$58,000 per year.

¹³ Kelly 2002, *Simulating trends in future wealth inequality*, NATSEM Paper to 2002 Conference of Economists.

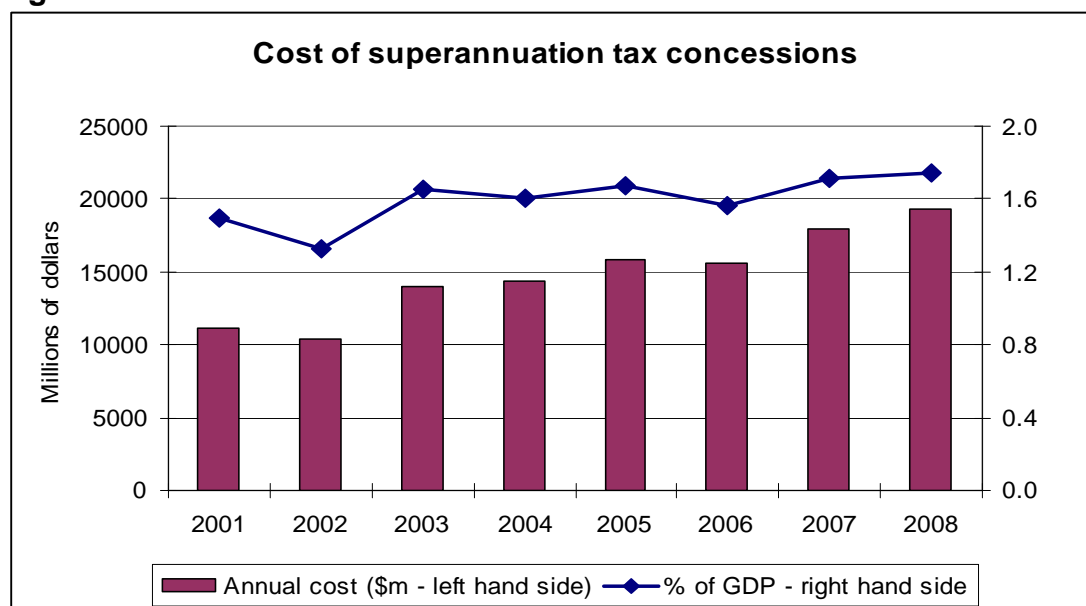
**Figure 5:
Current tax concessions and other subsidies for superannuation (06-07)**

Tax concession or subsidy	Description	Cost in 2006-07 (millions of dollars)
15% flat tax on employer contributions	Earnings are taxed at 15% in hands of fund instead of marginal tax rates	9,100
Co-contribution for employee contributions ¹⁴	Up to \$1,500 per year for employee contributions (income tested)	1,348
Deduction for self employed people	Full deduction for first \$5,000 contributed plus 75% of remainder	420
Tax offset for contributions on behalf of a spouse	18% tax offset for contributions of up to \$3,000 for a low income spouse	13
15% flat tax on fund earnings	Interest earned by the fund is taxed at 15% instead of the fund member's marginal rate	6,400
Capital Gains Tax concession for funds	Capital gains of funds are taxed at a lower rate	210
- Partly offset by taxes on lump sum benefits	Lump sum benefits above a special tax free threshold may be taxed	-159
Total ¹⁵		17,333
Note: Cost of Age Pension		22,095

Sources: Treasury 2005 *Tax Expenditures Statement* and Australian Taxation Office 2006, *Portfolio Budget Statement*.

The graph below shows that their cost is projected by the Treasury to rise over the current decade. Treasury projects that the cost of these superannuation tax concessions will rise by around \$1 billion per year from 2005-06 to 2008-09.

Figure 6:



Source: Treasury 2005, *Tax Expenditure Statement*.

¹⁴ Cost comprises \$1,098m for the co-contribution itself and \$250m for its tax free status.

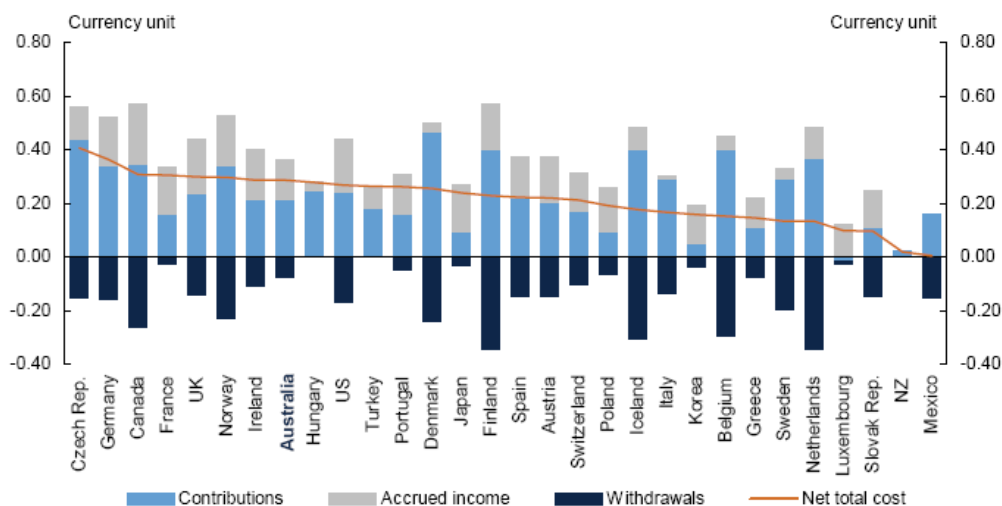
¹⁵ \$16,235 in tax concessions plus \$1,098 for the co-contribution.

Treasury made no projections in its *Intergenerational Report* of the cost of these tax concessions over the next three decades, but the ageing of the population over this period suggests that it will increase more rapidly beyond 2010. The Institute of Actuaries calculates that by 2025, the 15% employer contributions tax will raise about the same amount of revenue (as a proportion to GDP) as it does today, but the 15% fund earnings tax will raise more than twice the present amount. This suggests that the revenue *foregone* by Government, because it taxes both contributions and fund earnings at a flat rate of 15% instead of marginal tax rates of individual fund members, will rise significantly as a proportion of GDP over the next 20 years.¹⁶

OECD research also indicates a substantial increase in the cost to revenue of tax concessions for superannuation in Australia over the next 40 years, mainly due to the higher cost of tax concessions for fund earnings.¹⁷

International research cited in the *Warburton-Hendy Report* indicates that the cost of Australia's tax concessions for superannuation is already relatively high. The graph below is derived from a study by Yoo and De Serres for the OECD. It ranks the cost of Australia's tax concessions as eighth highest among the 30 OECD nations. The yellow line shows the estimated overall cost of tax concessions per dollar contributed to superannuation on behalf of an average wage earner.¹⁸

Figure 7:
Value of superannuation tax concessions per dollar contributed by an average wage earner



Source: Yoo and de Serres (2004).

Source: Warburton & Hendy 2006, *International comparison of Australia's taxes*, Australian Government.

Despite our high ranking in terms of the cost of superannuation tax concessions, *overall* Australian expenditure on support for retirement incomes is relatively low by OECD standards. The reason for this is that private superannuation savings are not the major source of retirement incomes in most OECD countries. Most OECD countries spend a great deal more on compulsory publicly-run social insurance schemes than they do on tax concessions

¹⁶ Institute of Actuaries 2006, *Tax free superannuation benefits, a future revenue problem?*

¹⁷ Antolin et al 2004, op cit. The OECD estimates that from about 2020, the rising cost of tax concessions for fund earnings will be offset by higher revenues from taxes on benefits. However, their modelling of taxes on benefits is based on a very simple set of assumptions, which may not be accurate for Australia.

¹⁸ See Warburton & Hendy 2006, *International comparison of Australia's taxes*, Australian Government; and Yoo & De Serres 2004, *Tax treatment of private pension savings in OECD countries*, OECD Economic Studies No 39.

for private savings. By contrast, Australia lacks a national social insurance scheme, and our Age Pension is set at a much lower rate than most overseas social insurance benefits.¹⁹

For these reasons, the rising cost of superannuation tax concessions is unlikely to trigger a 'fiscal crisis' in future. Nevertheless, their future cost must be balanced against the needs of future retirees for health care and other services, which require higher public expenditures. Otherwise, there is a risk that large increases in public subsidies for retirement incomes would coincide with higher public expenditure on these services. This would give rise to inter-generational equity concerns, and potentially to conflicts between generations over the distribution of public resources.

Early retirement and the smoothing of retirement savings

Discouraging 'early retirement' before the age of 60 years is an important public policy objective, given the ageing of the population and its effects on labour supply, economic growth, and public finances. Importantly, early retirement undermines the incomes of retired people because their savings are lower than they would otherwise be, yet the period of retirement they must support is longer. By allowing fund members to draw down their benefits from the age of 55 years, the superannuation system encourages early retirement, especially among the relatively well off. Further, there is a ten year gap between the preservation age for superannuation (55 years) and the age of eligibility for the Age Pension (65 years). This is illogical and may encourage some people to draw down large lump sum benefits to increase their future Age Pension entitlements. Although under current legislation the preservation age will rise to 60 years by the year 2025, this is much too slow and will not affect the present cohort of mature age workers.

Another important objective for retirement income policy is to reduce incentives for relatively well-off retirees to use their superannuation for purposes other than improving retirement living standards – for example to spend a relatively high proportion of their superannuation benefits early on in order to claim the Age Pension later, or to set part of their superannuation aside for their adult children. A balance must be struck between these objectives and that of encouraging mature age Australians to continue to work and save by offering them the flexibility to make superannuation contributions later in life.²⁰

The current system attempts to encourage people to 'smooth' their retirement incomes over the entire period of retirement, by:

- requiring a draw down of benefits once retirees reach 65 and are no longer working, or once they reach 75 years;
- not taxing investment income derived from superannuation assets that are being used to pay a pension that complies with certain standards;
- taxing large lump sum payments,
- offering a tax offset for complying superannuation pensions,
- taxing 'death benefits' transferred to family members other than surviving spouses and dependent children, albeit at a low rate.²¹

These arrangements are complex, and arguably fail to achieve their purpose.

¹⁹ OECD 2003, *Economic surveys – Australia*; Casey et al 2003, *Policies for an ageing society*. OECD Economics working paper No369.

²⁰ The Treasury recently noted that: "The Government has restrictions on contributions past age 65, and compulsory cashing at age 65 if the member is no longer working part-time, to reduce the risk that concessionally taxed benefits are used for estate planning and not genuine retirement income purposes." Treasury submission to Senate Select Committee inquiry on superannuation (2005), p8.

²¹ Note that this is *not* an inheritance tax. It is imposed to stem the use of tax supported retirement savings for purposes other than retirement.

Retirees can withdraw all of their superannuation benefits as a lump sum, of which at least the first \$129,751 is tax free. A majority still use lump sums rather than pensions, despite the generosity of the tax treatment of pensions. The problem of 'double dipping' (dissipating a lump sum superannuation benefit and then relying on the Age Pension) is often exaggerated. However, an emerging trend for people to carry higher levels of debt into retirement, and to use lump sum benefits to pay this off is of concern because it effectively allows people to bring forward the expenditure of their retirement savings. If superannuation is to be used for purposes other than retirement, it would be fairer and more transparent to allow all fund members to draw down up to set proportion of their savings for those purposes, rather than restrict this option to those who have access to financial innovations such as longer-term home loans with lines of credit.

A further concern is the use of publicly subsidised retirement savings for estate planning purposes. In effect, this means that many high income earners obtain a substantial tax break to pass their estate onto their adult children. Benefits passed on to adult (non dependent) children on the death of a superannuation fund member are nominally taxed at the low rate of 15%, though the actual tax rate is either higher or lower in some cases. This tax can be avoided if a retiree gifts part of a lump sum superannuation benefit to their children, or transfers these funds to a testamentary trust. However, the lump sum tax and Reasonable Benefit Limits constrain these strategies.

Given the rising value of superannuation assets, and financial innovation, more superannuation assets will be passed onto adult children tax-free in future years. NATSEM estimates that the overall value of inheritances will rise from \$8.8 billion in 2000 to \$60 to \$70 billion in 2030.²²

2. The Government's proposals

The Government announced in its 2006 Budget that taxes would be removed for superannuation benefits for most people aged 60 or over, new limits would be imposed on superannuation contributions, and the pension assets test would be eased.

The following changes are proposed, effective from July 2007:

- Removal of taxes from superannuation benefits for persons aged 60 years or more receiving lump sums or pensions from 'taxed' funds (the vast majority of funds that have paid tax as these benefits accumulated) from July 2007. This includes removal of 'Reasonable Benefit Limits'.
- New annual limits on contributions to superannuation funds that pay tax free benefits would be introduced:
 - \$50,000 per year for contributions attracting tax concessions (including employer contributions), and
 - \$150,000 per year for fully taxed (e.g. personal) contributions.
- for a five year transitional period, up to \$100,000 a year could be contributed from sources attracting tax concessions.
- Extension of a full tax deduction, and the Government co-contribution, to contributions by self employed people.
- Removal of rules requiring the drawing down of superannuation assets once a fund member over 65 years old retires from employment, or reaches the age of 75 years.
- Simplification of rules relating to the draw-down of superannuation pensions attracting tax concessions.

²² AMP-NATSEM 2003, *You can't rely on the old folk's money*. Income and wealth report No 5.

- Tax to continue to apply, generally at 15%, to payments to non-dependents (that is, other than partners and dependent children) on a fund member's death.
- The age pension assets test to be substantially eased by reducing the taper rate from \$3 per \$1,000 to \$1.50 per \$1,000, though the income test would still apply.
- Employer 'Eligible Termination Payments' (golden handshakes) to be taxed at either 15% or 30% up to \$140,000 (depending on the employee's age), and subsequently at the top marginal rate, in place of the present Reasonable Benefit Limits.

The proposed changes would sharply reduce the complexity of the taxation of benefits, though they do not include simplification of the tax treatment of contributions. Another positive feature is that they would encourage more people to retire after 60 years.

The proposed simplification of the tax treatment of benefits would come at the expense of equity. Generally speaking, only high income earners or those with substantial superannuation assets would benefit. This is tempered by the fact that many high income earners are already able to avoid tax on their benefits under the present system. The lower contributions ceiling for middle and mature age employees would also reduce the scope for people on high incomes to take advantage of the tax free status of benefits. However, the inequitable tax arrangements for contributions would remain largely in place.

The proposed changes would reduce revenue from superannuation for future Governments, as more retirees would benefit in future from the removal of taxes from benefits. Further, if the new system is not carefully designed, the removal of taxes from benefits could facilitate personal income tax avoidance or estate planning by some retirees on relatively high incomes.

Effects on complexity

The Government's proposed changes would dramatically simplify the tax treatment of benefits by abolishing taxes at this stage for most retirees over 60 years of age. This is consistent with the 'income tax treatment' of savings discussed above.

There are major benefits from simplifying the tax treatment of benefits in this way. Substantial resources are wasted on financial advice to find the best way to structure benefits to reduce tax. Investment decisions are biased in this direction, to the detriment of retirees and the efficient functioning of financial markets.

However, in the absence of more comprehensive reform, pressures could emerge to either reintroduce taxes on some benefits, or to more closely regulate their payment. These pressures could come from three directions.

First, concerns will be raised about the equity of a superannuation system that privileges contributions made by high income earners and leaves large benefit payments free of tax. This concern drove many of the complex changes introduced since 1983. It is likely to grow as inequality among retirees increases in coming years. Reforming the tax treatment of contributions to make it fairer would address this problem.

Second, the tax free status of superannuation benefits could be used by well off retirees to reduce the tax they would otherwise pay on their earnings (see discussion of revenue effects below). This could lead to the introduction of complex anti-avoidance rules.

Third, in the absence of either taxes on benefits or stricter regulation of their timing, there will be few mechanisms to ensure that benefits are effectively used for retirement purposes only. In theory, retirees themselves have an interest in using their superannuation to maintain consistent living standards throughout retirement. However, there is a risk that new tax arbitrage or estate planning opportunities that may be opened up for those on the highest incomes. This could lead to pressures to introduce complex anti tax-avoidance rules, or to tighten access to Age Pensions in future years.

Effects on equity and incentives to save

The proposed changes would significantly increase income inequality among future retirees.

In the short term, only a minority of retirees would benefit from the removal of taxes from benefits. The reasons for this are that most lump sum payments are still well under the tax free threshold for lump sums of \$129,751 and many recipients of superannuation pensions can avoid tax on these payments due to a combination of the 15% superannuation pensions tax offset, the Senior Australians Tax Offset, and the Low Income Tax Offset.²³

The following table shows estimates from NATSEM of the distribution of superannuation assets in 2002. Although somewhat out of date, these estimates indicate that at most, only the wealthiest 25% of retired households is likely to be affected in the short term by the removal of taxes on superannuation benefits.

Figure 8:
Distribution of superannuation assets in 2002

Quartile (by wealth holdings)	Average superannuation assets
Bottom 25%	\$21,000
2 nd 25%	\$37,000
3 rd 25%	\$57,000
Top 25%	\$111,000

Source: AMP-NATSEM (2004) *Income and wealth report*.

Over the long term more retirees would benefit, but the benefits would be enjoyed disproportionately by those who previously earned high incomes, as the following Government projections of improvements in future retirement incomes (tax savings) for people on different income levels show.

²³ The Institute of Actuaries estimates that the median retirement benefit on retirement is \$115,000.

**Figure 9:
Effects of the Government's proposed changes on retirement incomes**

Table A1: Individual — Lump sum payment

Income (\$/wk)	Benefit at retirement (\$)	ETP tax		ETP (after tax)		Change in after tax benefit	
		Current (\$)	New (\$)	Current (\$)	New (\$)	\$	Per cent
Age 65							
	100,000	0	0	100,000	100,000	(c)	(c)
	150,000	2,272	0	147,728	150,000	2,272	1.5
	200,000	10,522	0	189,478	200,000	10,522	5.6
	250,000	18,772	0	231,228	250,000	18,772	8.1
	400,000	43,522	0	356,478	400,000	43,522	12.2
Age 45 - Superannuation Guarantee^(a,b)							
400	95,125	0	0	95,125	95,125	(c)	(c)
600	144,603	0	0	144,603	144,603	(c)	(c)
800	194,082	2,400	0	191,682	194,082	2,400	1.3
1,000	243,575	10,567	0	233,008	243,575	10,567	4.5
1,500	367,270	30,976	0	336,294	367,270	30,976	9.2
2,000	490,981	51,389	0	439,592	490,981	51,389	11.7
Age 25 - Superannuation Guarantee^(b)							
400	179,228	0	0	179,228	179,228	(c)	(c)
600	274,881	5,744	0	269,137	274,881	5,744	2.1
800	370,535	21,527	0	349,008	370,535	21,527	6.2
1,000	466,242	37,318	0	428,924	466,242	37,318	8.7
1,500	705,376	76,775	0	628,601	705,376	76,775	12.2
2,000	944,563	116,241	0	828,322	944,563	116,241	14.0
Age 45 - Superannuation Guarantee and member contributions^(a,b)							
400	208,202	0	0	208,202	208,202	(c)	(c)
600	288,476	13,380	0	275,096	288,476	13,380	4.9
800	353,592	26,773	0	326,819	353,592	26,773	8.2
1,000	424,035	40,100	0	383,935	424,035	40,100	10.4
1,500	636,076	75,162	0	560,914	636,076	75,162	13.4
Age 25 - Superannuation Guarantee and member contributions^(a,b)							
400	384,199	17,482	0	366,717	384,199	17,482	4.8
600	514,741	40,196	0	474,545	514,741	40,196	8.5
800	595,300	57,441	0	537,859	595,300	57,441	10.7
1,000	706,417	76,799	0	629,618	706,417	76,799	12.2
1,500	1,055,024	134,467	0	920,557	1,055,024	134,467	14.6

(a) See section A.6 for assumptions, including assumed current superannuation balances and level of member contributions.

(b) Incomes above the maximum level shown could be expected to generate a lump sum benefit in excess of the lump sum RBL. Consequently, under current policy, an individual in this position is unlikely to take a benefit solely as a lump sum as excessive benefits tax would be incurred. Instead the individual could be expected to take a benefit as a part pension (Table A2) in order to qualify for the pension RBL.

(c) People on these income levels would continue to pay no tax.

Source: Treasury 2006, *A plan to simplify and streamline superannuation, detailed outline*.

No projections have been provided of the effect of the changes on the future *distribution* of income among retirees. The figures cited above are projected outcomes for hypothetical individuals. They do not indicate how many retirees will fall into each income bracket. This leaves a major gap in our understanding of the effects of the changes on equity.

However, they clearly show that the changes will increase income inequality among retired people.

The Government's estimates indicate that, as a result of the proposed changes, an individual retiring at age 65 in 2007 would see their retirement income rise by:

- zero if they receive a lump sum benefit of \$100,000
- \$10,522 or 5.6% if their lump sum benefit is \$200,000
- \$43,522 or 12.2% if their lump sum benefit is \$400,000.

An individual retiring with a lump sum benefit after receiving superannuation guarantee contributions over 40 years of working life would see their retirement income rise by:

- zero if they had earned \$20,000 per year
- \$37,318 or 8.7% if they had earned \$50,000 per year.
- \$116,241 or 14% if they had earned \$100,000 per year

It is not clear to what extent these projected increases in retirement are due to the removal of taxes from benefits or the proposed easing of the pension assets test. The effects of these two policies on retirement income and public revenue should be identified separately so that each can be assessed. It is difficult for us to comment specifically on the proposed assets test changes in the absence of such data. There is a case for easing this test, since retirees must achieve a return of at least 7.8% on additional savings to offset the reduction in their pension under this test. However, the proposed easing would also mainly benefit pensioners with substantial assets. Assisting people on lower incomes to save for retirement should be the highest priority.

No projections are provided of the effect of the proposed changes on *private saving levels*, and there is little Australian research on the effects of tax concessions on private saving.

It is likely that many people in or approaching retirement will shift more of their savings into superannuation to take advantage of the non taxation of benefits. However, this will not boost *overall* private saving. If a tax subsidy for saving merely shifts savings from one vehicle to another – for example from the property market to superannuation – then it is not cost effective. Saving incentives should raise the *overall* level of private saving, for example by encouraging people to save who do not do so already. They should do so at the lowest possible cost to public revenue, since any loss of public revenue represents a reduction in *public saving*.²⁴

Overseas research on the cost effectiveness of tax incentives for long-term saving yields conflicting findings, because ‘income effects’ run counter to ‘substitution effects’. Typically, this research suggests that between 25% and 50% of the funds invested in tax-supported savings vehicles is additional private saving, that would not have occurred without tax concessions. However, outcomes vary according to the nature of the savings vehicle, the tax concessions, the target group, and the overall tax structure in each country.²⁵

The abolition of taxes on superannuation benefits is unlikely to have a substantial impact on private saving by wage earners under the current preservation age (55 years), for two reasons:

- The changes mainly benefit high income earners, who already have a high propensity to save and a greater capacity to switch savings from one vehicle to another.²⁶
- Reductions in taxes on superannuation benefits only have a highly *visible* impact on the future incomes of those who have already reached ‘retirement age’. A recent Australian survey conducted by Access Economics suggests that ‘up front’ incentives such as reductions in taxes on contributions are more attractive to most current employees than lower taxes on benefits.²⁷

The policy is likely to boost superannuation saving by employees aged *over 55*, mainly because it provides a strong incentive to delay retirement until 60 years. Since mature age people already have a relatively high propensity to save, most of the *additional* saving brought about by the changes would probably come from delayed retirement rather than reductions in current consumption.

²⁴ It might be argued that encouraging people to save more through superannuation would reduce the present tax biases in favour of other investments, especially negatively geared investment in real estate. However, the best solution to this problem is to remove the tax biases that distort investment in the first instance.

²⁵ OECD 2004, *op cit*.

²⁶ High income earners have a wider range of investment choices because they have more income and assets to invest, and greater access to financial advice.

²⁷ Ross 2006, *Super incentives and behaviour*, unpublished paper.

Superannuation savings held by mature age employees can be expected to increase substantially if the policy is implemented. However, the policy provides strong incentives for mature age employees to switch *existing* savings to superannuation and to divert more of their earnings to superannuation through salary sacrifice arrangements. This makes it difficult to predict the net impact of the policy on saving for retirement by mature-age people.

There is a gap in the Government's proposed reforms in regard to saving incentives. Saving incentives for young and middle aged employees are still biased towards high income earners and away from low and middle income earners, who have a lower propensity to save. A significant increase in saving by younger people on lower incomes is likely to have a greater impact on overall private saving and retirement incomes than an equivalent increase in saving by mature age people on higher incomes.

Effects on future public revenue

The Budget Papers indicate that the changes will cost \$1.6 billion in 2007-08. This includes the effect of the proposed easing of the pension assets test. The Institute of Actuaries estimates that the abolition of superannuation benefits taxes alone would cost just \$0.5 billion or 0.05% of GDP in 2006-07.²⁸

It is difficult to assess the effects of the proposed changes over the longer term, since no projections have been provided by the Government. The Government's Intergenerational Report, which examines the future costs of population ageing, do not include projections of future tax revenues, including from superannuation taxes. This lack of information on long term revenue effects is of concern because the major fiscal impact of the changes will probably be felt in 20 to 30 year's time.

The Institute of Actuaries estimates that in 2025 the proposed abolition of benefits taxes would cost up to 0.19% of GDP, which is currently equivalent to \$1.9 billion. On the other hand, Ross estimates that the proposed changes would cost around 0.06% of GDP in 2025. This is currently equivalent to \$0.6 billion.²⁹

On the face of it, these modest cost estimates appear to be inconsistent with the substantial gains in retirement incomes due to the proposed changes that have been modeled by the Treasury. For example, the modeling indicates that an individual earning an average full time wage (around \$50,000) who receives superannuation guarantee contributions only for 40 years would gain 8.7% more retirement income due to the proposed changes. This suggests that many people retiring at 60 years in around 30 years time would gain this much from the changes.

Nevertheless, the Institute of Actuaries' modelling raises concerns about the erosion of future public revenue by *existing* tax concessions for retirees. They estimate that the present average level of retirement income gives rise to a tax rate of just 6%, rising to 11% over the long term. The effective tax free threshold for a couple aged over 65 years is currently \$41,360, which is close to the median full time wage. This effective tax free threshold is high due to the combined effect of the Senior Australians Tax Offset and Low Income Tax Offset. The tax free threshold for a couple over 65 years may be higher than this for those who receive the \$500 Mature Age Worker Tax Offset, and for recipients of complying superannuation pensions who can also take advantage of the 15% tax offset.³⁰

The present tax concessions for mature age people raise the following equity concerns::

²⁸ Institute of Actuaries 2006, op cit.

²⁹ Ross 2006, op cit.

³⁰ Institute of Actuaries 2006, op cit; Treasurer's media release 2006, *Australians set for more tax cuts and benefits from 1 July, 2006*. The median full time wage in 2005 was \$43,200 (ABS 2006, *Employee earnings benefits and trade union membership*).

- People of 'workforce age' are taxed much more highly regardless of their labour force status. For example, the effective tax free threshold for a retired couple cited above is approximately twice that for a single income couple of working age, which is around \$21,000.³¹
- The SATO is also poorly targeted within the retired population. Although most retirees are eligible, it extends to the top 15% of retirees whose incomes are too high to claim the Age Pension. For example, retiree couples with combined income of up to \$62,126 per year can receive it.³²

Care will also need to be taken to ensure that the proposed tax free status of superannuation benefits does not facilitate the avoidance of personal income tax on non-superannuation income by retirees and their families.

Employees aged between 60 and 75 years may be able to divert their wages into superannuation to take advantage of the removal of taxes from superannuation benefits. For example, they may be able to sacrifice up to \$50,000 per year of their wages for employer superannuation contributions while at the same time drawing an equivalent superannuation pension to meet current living costs. This strategy is facilitated by recent changes to superannuation rules allowing fund members to continue to contribute until they reach 75 years of age, as long as they remain employed for at least 40 hours in a single month of every year. Under these circumstances, the maximum tax rate they would pay on their earnings would be 15% in most cases. This is probably higher than the tax currently paid by most retirees, but some on relatively high incomes would currently pay more than this.

In theory, the diversion of earnings into superannuation is not a problem as long as it increases retirement saving and reduces reliance on the Age Pension. However, in this case the wages would not be saved; they would merely be 'recycled' through superannuation.

A further potential risk to the personal income tax base is the possibility that the investment income of high income earners could be diverted into their parents' superannuation accounts, to take advantage of superannuation tax concessions while avoiding some of the restrictions attached to saving through their 'own' superannuation.³³ Such strategies may already be feasible, especially since the recent easing of restrictions on contributions by mature age people. However, they could become more attractive if taxes are removed from lump sum benefit payments.

For example, a middle aged employee may be able to gift contributions to their parent's superannuation account until the parent reaches 75 years (as long as the parent is 'employed' for at least 40 hours in a single month each year), and then receive a tax free gift from the parent equivalent to the contributions plus interest, after the parent withdraws a lump sum benefit.

Effects on early retirement and the smoothing of retirement savings

The Government's proposals to liberalise requirements to draw down superannuation assets over the period of retirement will simplify the present complex system and make superannuation more flexible. However, the problems these rules (together with taxes on lump sum benefits) were designed to resolve would still remain, including incentives for some high income earners to:

³¹ This takes account of the tax free threshold, the Low Income tax Offset and the Spouse Tax Offset. Note that there is a separate tax offset, the Mature Age Worker Tax Offset, to encourage mature age people to remain in employment. The SATO is not needed for this purpose. It is more difficult to justify a special tax offset for the *investment income* of mature age people when people over 65 years will hold approximately half of all household wealth in 25 years time (see Kelly 2002, op cit).

³² ABS 2005, *Household income and income distribution survey 2003-04*.

³³ For example, these adult children could 'bypass' their own contribution limits, and also 'withdraw' benefits from their parent's accounts tax-free before they reach 60 years of age. See for example Wasiliev, *The family that contributes together*, Australian Financial Review 9/6/06.

- draw down a large proportion of their assets early in order to increase future Age Pension entitlements, or
- draw down too little to finance their retirement, so that they can leave part of their superannuation to their adult children.

This would not be of concern if superannuation consisted only of the retirees' 'own' savings. However, a substantial part of those savings are derived from the \$17 billion in public subsidies for superannuation, whose purpose is to improve living standards in retirement and reduce reliance on Age Pensions.

The proposed simplification of rules for the drawing-down of superannuation *pensions* makes sense. However, as a general principle it is not desirable to continue to control the draw-down of pensions while leaving lump sum benefits untaxed and unregulated.³⁴

One way to restrict this and other tax avoidance opportunities that may be opened up by the proposed arrangements is to regulate the *maximum* amount of superannuation benefits that can be drawn down in a given year, as the UK Government does. Broadly speaking, in the United Kingdom, retirees cannot draw down more than 25% of their superannuation assets as a lump sum. Another option is to continue to tax large withdrawals from superannuation accounts, but in a much simpler way.

Other OECD countries generally either impose limits on lump sum benefits or tax them, as the table below indicates.

**Figure 10:
Regulation and taxation of lump sum superannuation benefits in other OECD countries³⁵**

Country	Taxation arrangements
Australia	Tax rates on lump sums vary based on the constituent components. They may contain up to eight different components taxed in seven different ways. The first A\$129,751 (2005-06 value) of the most common component (that is, post-June 1983 taxed element) faces a zero per cent tax rate.
Canada	Lump sum is taxed at marginal rates.
Ireland	Lump sum only available when assets in a personal retirement savings plan first become available to the contributor. Lump sum is limited to a maximum of 25 per cent of the value of the benefit. Lump sum is received tax free.
Japan	Lump sum is 50 per cent taxable at marginal rates.
Netherlands	Lump sum payments no longer available.
New Zealand	Lump sum generally received tax free, but certain employer contributions attract a five per cent fund withdrawal tax on distribution to fund member.
Spain	Lump sum is taxed as employment income. 40 per cent tax reduction available if at least two years elapsed since first contribution.
Switzerland	Lump sums only available for voluntary additional savings. Pensions payable in all other circumstances. Subject to preferential rate which varies but roughly amounts to one third of individual's rate.
United Kingdom	From 6 April 2006 lump sums are restricted to the lesser of 25 per cent of the value of the benefit and 25 per cent of unused lifetime allowance. Lump sum is received tax free.
United States	Taxed at marginal rates.

Source: Various, see Chapter 1 (1.4.1).

Note: Table assumes access at normal point of retirement/access. Different (less generous) tax regimes tend to apply to early access.

Source: Warburton & Hendy 2006, *International comparison of Australia's taxes*, Australian Government.

A further problem with both the present and proposed systems is that the standard tax rate applied to superannuation benefits transferred through a fund member's estate to non dependent relatives - 15% - is too low.

³⁴ The special rules regarding the drawing down of pensions are linked to additional tax concessions (the non-taxation of fund earnings), so it would be necessary to retain these rules in some form. Nevertheless, the broader policy point remains that if the proposed reforms proceed in their present form, pensions would be regulated while lump sum benefits would not.

³⁵ Source: Warburton & Hendy 2006, op cit.

3. ACOSS recommendations

Independent inquiry

A major reform such as this one should be informed by a thorough public examination of the likely impacts on retirement incomes and their distribution, work and saving incentives, and public revenue. Care should also be taken to ensure that the reforms do not have unanticipated side effects, such as opening up major opportunities for the avoidance of tax.

ACOSS is concerned that, to date, no detailed projections have been provided by the Government of the likely effects of the proposed changes on the most important of these variables, the distribution of retirement incomes or public revenue.

We therefore recommend that a substantial public inquiry be conducted, for example by the Productivity Commission or a Senate Committee, to examine these issues, and that the Government furnish relevant data to the inquiry. The proposed changes should not proceed until the inquiry has reported and its recommendations have been considered by the Government. Although this may delay the introduction of the reforms, it is more important in our view to get them right than to meet an arbitrary deadline. Once legislated, the changes will dramatically affect the superannuation system and retirement incomes for years to come.

R1.

(1) An independent inquiry, for example by the Productivity Commission or the relevant Senate Committee, should be conducted to examine the effects of proposed changes to retirement incomes policy announced in the 2006 Federal Budget from three perspectives: equity, simplicity and the effect on future public revenue.

(2) The proposed changes should not proceed until this Inquiry is completed and its recommendations are considered.

(3) The Government should provide to the inquiry all relevant data on the likely effects of the proposed changes on public revenue and the level and distribution of future retirement incomes.

Our broad approach to superannuation reform

ACOSS supports the Government's objectives of simplifying superannuation and encouraging private saving, and later retirement. We recommend that the reforms be extended and enhanced to:

- extend the simplification agenda to the tax treatment of contributions
- improve their equity
- strengthen future public revenue
- discourage large lump sum payments to ensure that superannuation benefits are used for retirement rather than other purposes such as estate planning
- further encourage later retirement
- improve the equity of the tax treatment of benefits on termination of employment.

Reform of taxation of contributions

The simplification of taxes on superannuation benefits should be accompanied by a major simplification of the *tax treatment of contributions*. This would further simplify the overall system and address the equity problems arising from the removal of taxes on benefits. This, in turn would avoid the need for further major rounds of superannuation tax reform, since the *overall* tax treatment of superannuation would be more coherent, simpler and fairer.

Broadly speaking, the removal of most taxes from superannuation benefits should be accompanied by the taxation of contributions on an income tax basis, albeit with generous concessions to support and encourage saving. This is consistent with an 'income tax model' for the taxation of superannuation, as discussed above.

The first necessary step to simplify the taxation of contributions is to require all contributions to be made from *after-tax* income, thus levelling the playing field between contributions from different sources and between high middle and low income earners. There would no longer be any incentive for high income earners to sacrifice salary for superannuation. This could be achieved by requiring employers to deduct income tax at source through the PAYG system *before* making contributions to their employee's superannuation, which employers could easily do. Employer contributions would then be taxed at the same marginal rate as the employee's earnings.

It would then be feasible to replace four existing tax concessions for contributions (not including the FBT exemption for employers, which would be retained up to the proposed annual contribution limits) with a simple tax offset paid annually in the superannuation fund. This tax offset should be designed from 'first principles' – to provide the most assistance to those whose need for public support is greatest and to encourage voluntary saving.

An illustrative example of how this reform might work is provided in *Attachment 1*.

Reform of this kind would also improve the *equity* of the tax treatment of contributions, and its *efficiency* in supporting compulsory saving and encouraging voluntary saving. It would greatly assist low and middle income earners in their efforts to save for retirement.

R2.

The taxation of superannuation should be comprehensively simplified and made fairer by also reforming the tax treatment of *contributions*. We recommend:

- **taxing all contributions from after-tax income regardless of their source,**
- **taxing employer contributions in the hands of the employer at marginal rates of personal income tax and removing the 15% tax for employer contributions,**
- **replacing all present tax concessions for contributions (apart from the FBT exemption for superannuation) with a simple two tier annual tax offset for all contributions up to an annual ceiling.**

Strengthening future public revenue

To improve intergenerational equity and help finance future aged care and health services, the Government should ensure that any loss of future public revenue caused by the proposed reforms is at least offset by another source of revenue. This should preferably come mainly from future retirees on relatively high incomes, since they are the principal beneficiaries of the proposed reforms.

R3.

If the proposed changes to retirement incomes are projected to reduce future public revenue by substantially more than the 'short term' estimates provided in the Budget Papers, the Government should review the overall tax treatment of retirement incomes to find offsetting revenue savings.

Smoothing retirement incomes

Some form of regulation or taxation of benefits is needed to encourage people to smooth benefit payments over retirement, reduce reliance on the Age Pension and prevent the use of superannuation tax concessions for purposes such as estate planning and the avoidance of income tax on earnings. These objectives could be achieved in a much simpler way than the present system.

One option is to introduce regulations, similar to those in the United Kingdom (see table above), that cap the maximum level of benefits that can be withdrawn as a lump sum. For example, the rules could prevent retirees from withdrawing more than a certain proportion of their remaining superannuation assets, taking account of their life expectancy. These rules should be generous and flexible enough to meet the diverse needs of retirees.

Another option would be to retain the 15% tax rate applying to benefits above the present tax free threshold for lump sum benefits (\$129,751), or a higher threshold, and to extend this to all benefits including superannuation pensions. This rate of tax would then be imposed on any superannuation benefits paid above the tax free threshold in a given financial year. Other taxes on benefits, apart from death benefits, would still be abolished.³⁶ Since the vast majority of retirees could avoid paying this tax by smoothing their benefit payments over the full period of retirement, there would be a case for removing the present complex tracing or grandfathering rules (for example the distinctions between benefits paid from undeducted and deducted contributions, or pre and post 1983 contributions) This would greatly simplify the system.

Although this option is not as simple as the complete removal of taxes on benefits, it would be just as straightforward for the vast majority of retirees. Most would simply avoid large lump sum benefits. By addressing concerns about the possible misuse of the concessional tax treatment of superannuation benefits by high income earners, it would also avert the need in future to introduce complex anti avoidance rules, or stricter regulation of the payment of superannuation benefits.

Another way to limit the use of superannuation for estate planning purposes is to raise the standard rate of tax on benefits transferred to non dependent family members. However, if large lump sum benefits are still permitted, and are tax-free, this tax could be avoided.

R4.

Superannuation fund members should be encouraged to smooth their retirement incomes over the full period of retirement, in a simpler way than the present complex rules. Options include:

- **capping the proportion of total superannuation assets that can be withdrawn in any single year, taking account of life expectancy,**
- **replacing existing taxes on superannuation benefits with a single rate of tax on total annual benefits paid (whether lump sums or pensions) that exceed a high annual level,**
- **raising the tax rate for benefits paid to non dependents (such as adult children) on the death of a superannuation fund member from 15% to 30%.**

Preservation age

It is likely that the proposed changes would encourage the vast majority of mature age people to retire after 60 years. Under these circumstances, the current preservation age of 55 years would become less relevant. It also undermines the key policy objective of improving workforce participation among mature aged people. We therefore recommend that the preservation age be increased more rapidly to 60 years.

³⁶ There would be a single rate of tax (say 15%) for all superannuation benefits – lump sums or pensions - paid above the threshold within a given financial year.

R5.

The preservation age for retirement savings should be raised more rapidly from 55 to 60 years, except in cases of severe disability or full time caring responsibilities, to align with the age at which the new tax arrangements come into play.

Employer termination payments

A welcome feature of the proposed changes is that employer termination payments (golden handshakes) would be more equitably taxed. There is no justification for taxing these payments in similar concessional fashion to superannuation unless they are rolled over into superannuation and preserved until retirement.

The Government proposes to continue to tax these benefits at the flat rate of 15% or 30% (depending on the employee's age), but to tax any amount above \$140,000 at the employee's marginal tax rate (instead of any amount above the higher Reasonable Benefit Limit, the threshold currently used).

This reform should be taken further. These benefits should instead be taxed as ordinary income, with some allowance for their 'lumpy' nature and the fact that the employee has just left their job. For this purpose, the tax treatment of redundancy payments provides a better model than superannuation, unless the payment is immediately rolled over into retirement savings. If these employer termination payments were taxed in similar fashion to redundancy payments, the tax free threshold would be \$6,491 plus \$3,246 per year of service. Any amounts above this threshold would be taxed at the employee's marginal rate.

R6.

Employer 'Eligible Termination Payments' (golden handshakes) should be taxed at the recipient's marginal rates above the tax free threshold applying to redundancy payments, unless they are immediately rolled over into superannuation and fall within the proposed annual contribution limit.

Attachment 1: Illustrative reform of taxes on superannuation contributions

Under the present system, there are at least four different tax treatments of superannuation contributions depending whether they are made by employers, employees, self employed people, or the spouses of low income earners.

The most costly of these tax concessions for superannuation contributions (costing \$9.1 billion per year, or 84% of the total cost of all tax breaks for contributions) is the 15% tax for employer contributions. This provides very little support for saving by low and middle income earners because it disproportionately benefits individuals on the top marginal tax rates.

For example:

- a person earning \$150,000 a year 'saves' 32 cents in tax per dollar contributed by their employer to superannuation (an annual tax saving of \$4,253 for Superannuation Guarantee contributions),
- a person on \$20,000 'saves' just 2 cents per dollar contributed (an annual tax saving of just \$27 for Superannuation Guarantee contributions).

The reason for this is that the 15% contributions tax is 32% less than the marginal tax rate that would apply to a high income earner, but only 2% less than the marginal tax rate that would normally apply to a low income earner.

In the proposed tax treatment of contributions, all contributions would be made from *after-tax* income. Employers would deduct tax at the appropriate marginal rate from the contributions they make on behalf of their employees. A simple two tier tax offset (rebate) would then replace four different tax concessions for contributions, as shown in the table below.

Figure 1:
Existing tax treatment of contributions and ACOSS illustrative proposal

Source of contribution	Current tax treatment	ACOSS proposal
Employer	No tax collected by employer, Flat tax of 15% on transfer to super fund	All contributions paid from after-tax income (employers collect tax on their contributions). A two tier tax offset for <i>all</i> contributions up to a specified annual limit, paid into the fund at end of each year. (<i>for example</i> , 100% for the first 0.5% AWE, plus 30% for additional contributions up to 12% of AWE) The Government's proposed limits on deductible and non deductible contributions would be replaced with a single cap (for example, \$200,000)
Employee	Earnings taxed at marginal rates, Capped co-contribution for low & middle income earners	
Self employed	Earnings taxed at marginal rates, Capped deductions for contributions ³⁷	
Spouse	Earnings taxed at marginal rates, Capped tax offset for contributions on behalf of spouse	

³⁷ The existing cap would be removed under the Government's proposal.

We model below the effect of an illustrative tax offset for superannuation contributions, to show how this reform might affect the level and distribution of tax support for contributions. It is important to note that this is an illustrative option only, and that the proposed tax offset could be targeted in different ways. Further, we only model the effect on contributions taxes. If the 15% fund earnings tax is retained and most taxes are removed from benefits, the overall system would still offer very substantial tax support for saving by high income earners.

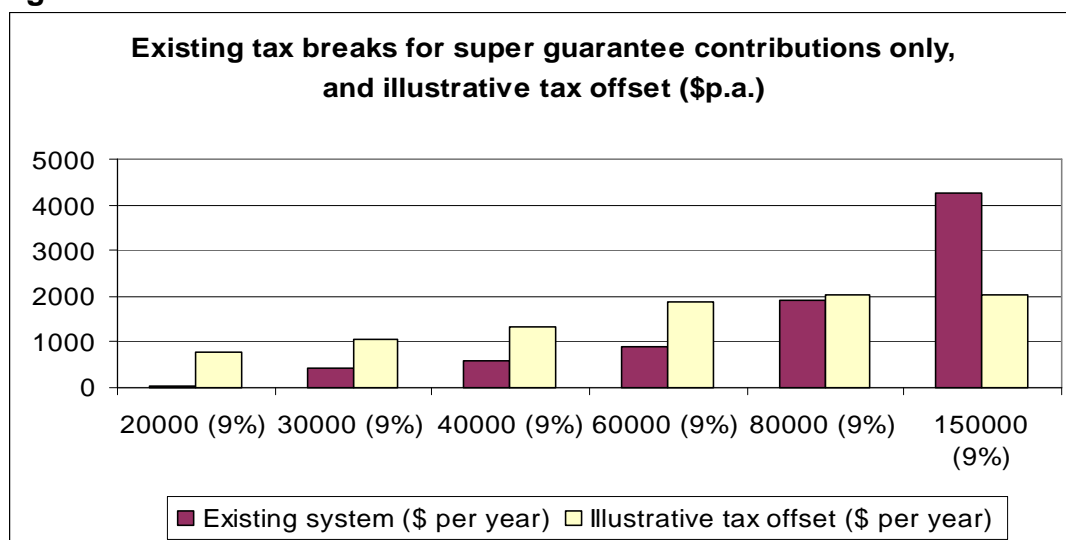
The illustrative tax offset would:

- apply to contributions from all sources, whether voluntary or compulsory
- match contributions dollar for dollar up to 0.5% of average earnings (currently around \$50,000)
- be paid at the rate of 30 cents in the dollar for additional contributions up to 12% of average earnings
- be deposited at the end of each tax year in the superannuation account(s) chosen by the member.

This tax offset has elements that are similar to the co-contribution, but it also applies to employer contributions in lieu of the concessional 15% tax rate, and to contributions for self employed people in lieu of the present deductions, and it is not income tested. Because it replaces the flat 15% tax on employer contributions, it would greatly benefit low and middle income earners while reducing excessive tax subsidies for high income earners.

The graph below shows how replacing existing tax concessions for contributions with this illustrative tax offset would affect the annual tax subsidy available for Superannuation Guarantee contributions for employees at different income levels. The proposed 100% and 30% tax offsets for employer contributions are more generous than the existing flat 15% tax for low and middle income earners. It would at least offset the income tax that would have been paid on their earnings if they were not contributed to superannuation. The capping of the tax offset once annual contributions from all sources reach 12% of average earnings limits the benefits for high income earners. There is no need for an income test.

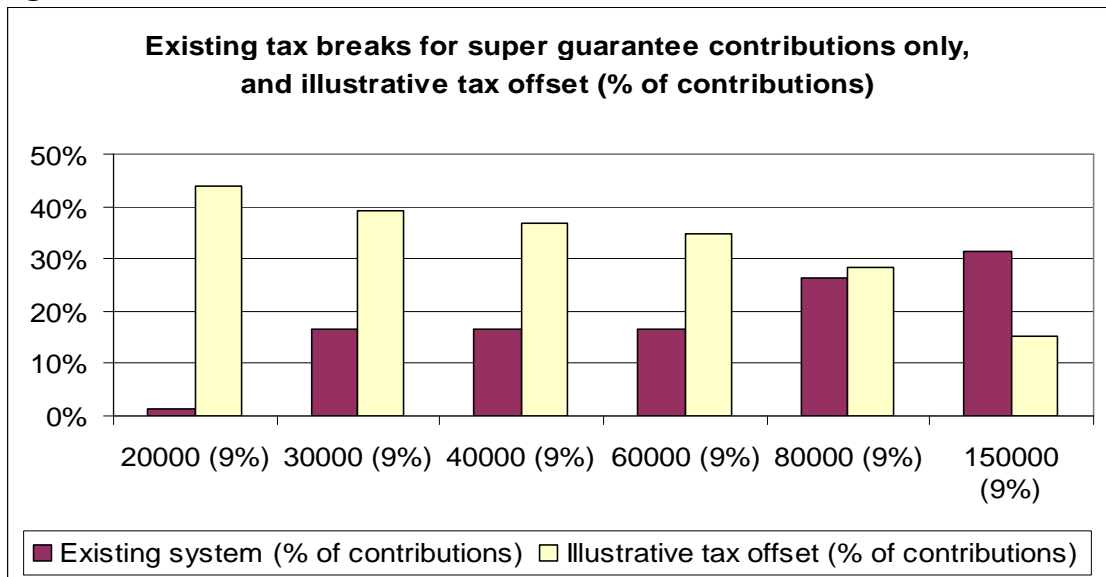
Figure 2:



Source: ACOSS calculations.

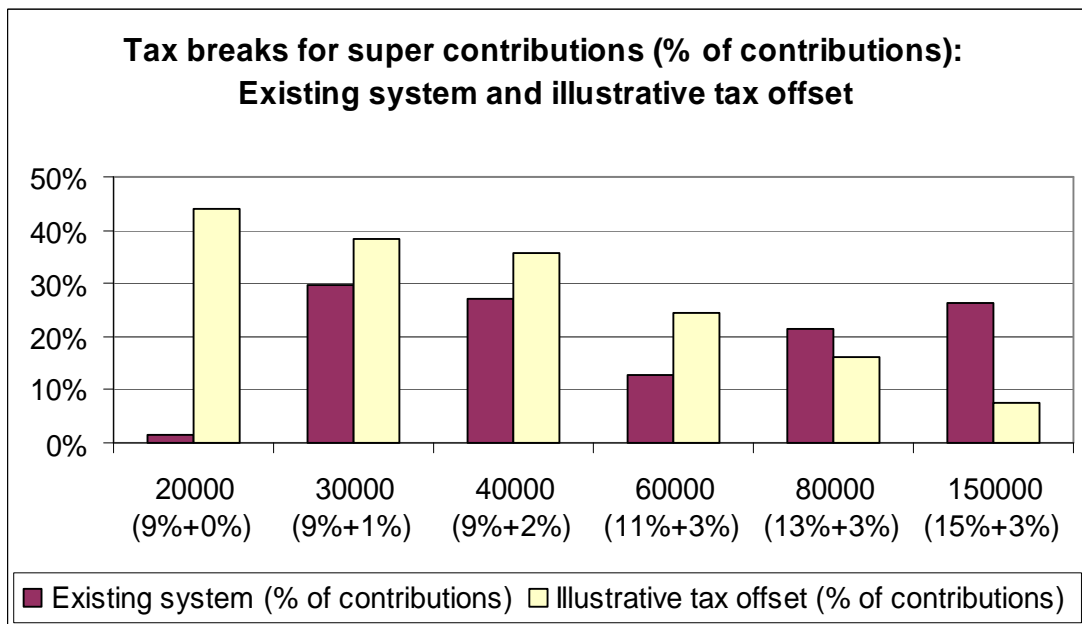
The graph below shows the same results expressed as a percentage of contributions made rather than an annual dollar value.

Figure 3:



The graph below illustrates the effect of the tax offset compared with existing tax concessions (the 15% contributions tax and the co-contribution) in cases where employees make voluntary contributions, or sacrifice salary for superannuation. The assumed employer and employee contributions are indicated in brackets at the bottom of the graph.³⁸

Figure 4:



While in theory the co-contribution may be more generous than the illustrative tax offset for *personal* contributions by some low income earners, most contributions made for low income earners come from employers, which would be much more lightly taxed under the tax offset.

³⁸ For example, '9% + 1%' refers to 9% employer contributions and 1% employee contributions. There is very little data available on the distribution of voluntary and salary sacrifice contributions. We have used data in Bingham 2003, *Impact of private saving and longer careers on retirement incomes*, Colloquium of superannuation researchers, University of New South Wales, to inform the contribution levels in the graph above. This research indicates that the vast majority of low income earners make no contributions at all. We assume that most voluntary contributions by high income earners are made by salary sacrifice as this is more tax effective.

This means that they would be better off overall if the illustrative tax offset were introduced. Further, only a small proportion (around one in five) of employees who are eligible for the maximum co-contribution (those earning less than \$28,000) makes personal contributions to superannuation. Many are likely to be the partners of people on high incomes, since they are in the strongest position to afford to make voluntary contributions. Middle income earners are likely to make larger voluntary contributions, but the value of their co-contribution is reduced by the income test. Therefore, in overall terms the illustrative tax offset is more generous than the existing system for low and middle income earners.

The tax offset modelled above is only illustrative. The rates of the tax offset and the level of the annual 'cap' on tax-supported contributions could be adjusted to target the concession in different ways. Nevertheless, this example shows that it is possible to simplify the system and improve equity at the same time.

Changes along these lines are also likely to improve incentives for saving by most low and middle income earners, compared with the present co-contribution. For example:

- the maximum co-contribution is equivalent to 8% of the earnings of an individual on \$20,000, but the illustrative tax offset would provide tax savings of up to 21% of earnings for their voluntary contributions,
- the equivalent figures for an individual on \$40,000 are 2% from the maximum co-contribution compared to up to 6% from the illustrative tax offset.

Attachment 2: Present tax treatment of superannuation compared with the Government's proposals

1. Present and proposed tax treatment of lump sum superannuation benefits (paid from post-1983 contributions)

The tax treatment of *lump sum benefits* depends on a range of factors, including the age of the recipient and the size and source of the benefits. The following table shows the tax rates that normally apply to lump sum benefits from employer superannuation contributions made after 1983. Since most lump sum benefits are well under the tax free threshold of \$129,751 few of these payments attract tax. Generally speaking, only lump sums paid to former high income earners, or people working in sectors where employer superannuation contributions were made before the Superannuation Guarantee was introduced in 1990, are affected.

Broadly speaking, superannuation *pensions* are taxed at marginal tax rates minus a tax offset of 15% (the tax treatment of pensions is not shown in the table below). However, this tax offset together with the Senior Australians Tax Offset mean that some retiree couples can earn more than average earnings (around \$50,000) without paying tax.

Taxable component		
Taxpayers age	Current tax treatment (for post June 1983)	Proposal
Under 55	20 per cent	20 per cent
Age 55-59	Up to threshold (\$129,751) — 0 per cent Over threshold — 15 per cent	Up to threshold (\$129,751) — 0 per cent Over threshold — 15 per cent
Age 60 and over	Up to threshold (\$129,751) — 0 per cent Over threshold — 15 per cent	Exempt

Source: Treasury 2006, *A plan to simplify and streamline superannuation, detailed outline*.

2. Reasonable Benefit Limits

Reasonable Benefit Limits (RBLs) restrict the overall level of tax-assisted superannuation savings a person may receive over their lifetime. Benefits paid in excess of the RBL are generally taxed at the top marginal tax rate. There is a higher RBL for benefits in the form of pensions (regular payments) than for lump sums. This is to encourage people to take their benefits in the form of pensions.

Lump sum benefits	Pensions	Proposal (beyond age 60)
\$648,946	\$1,297,886	\$0

Source: Treasury 2006, *A plan to simplify and streamline superannuation, detailed outline*.

3. Present and proposed tax treatment of superannuation contributions

Most superannuation contributions are made by *employers* on behalf of employees. These are very tax-effective for high income earners because they escape PAYG tax in the hands of the employer and are only taxed at a flat rate of 15% in the hands of the superannuation fund (instead of the 47% that would apply to wages). Thus, 'salary sacrifice' into superannuation is a common tax avoidance strategy by high income earners. Employers also obtain a tax deduction for contributions made for their employees, up to the annual 'contribution limits' in the table below, and superannuation is exempt from Fringe Benefits Tax.

The Budget proposals would replace these *contribution limits* with a flat annual limit of \$50,000. This is less generous than the present system for mature age employees, though still well in excess of the amounts that the vast majority of employees could afford to forego to save for their retirement.

Personal contributions are made from after-tax income, so they are not taxed in the hands of the fund. However, to prevent people on very high incomes from contributing large amounts to superannuation before retirement to take advantage of the proposed tax free status of superannuation benefit, a limit of \$150,000 per year on the level of personal contributions people can make is proposed (not shown in table below).

Table 4.1: Comparison of taxation on deductible contributions under current system and proposed system

Current contribution rules (as at 1 July 2005) ^(a)		
Contributions below the age-based limits		
<35 years	\$14,603 pa	15% contributions tax
35 — 49 years	\$40,560 pa	
50 — 69 years	\$100,587 pa	
Contributions above the age-based limits		15% contributions tax plus 30% deduction denied
Proposed contribution rules (as at 1 July 2007) ^(b)		
Concessional contributions limited to \$50,000 pa		15% tax

(a) Contributions are deductible up to the age-based limits.

(b) Contributions would be fully deductible. The ATO would identify any contributions made above this limit. These contributions would be taxed at the top marginal tax rate.

Source: Treasury 2006, *A plan to simplify and streamline superannuation, detailed outline*.