

Pensions and superannuation: the need for change

Response to Financial System Inquiry, National
Commission of Audit and Tax Discussion Paper 2015

May 2015
ISSN 1836-9014

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Overview

The Abbott Government, as part of its ‘budget repair’ efforts, wanted in the 2014 Budget to increase the pension age to 70 and to restrict pension indexation to the price index, meaning that the pension will fall relative to general community standards. It has now walked away from CPI indexation in the face of overwhelming community opposition, but is still looking for pension savings.

However it has refused to find savings in superannuation tax concessions, which cost the budget almost as much as the age pension and are growing so rapidly – 11% a year – that on Treasury projections they will overtake the pension spend by 2017.¹ The Government sought to cut back the slower growing and more equitable part of retirement income assistance, which does the most to alleviate poverty, while leaving alone the faster growing and more regressive concessions. Over fifty percent of the total benefit of tax concessions flows to the top 20% of income earners.²

Both the Commission of Audit, chaired by Tony Shepherd, and the Financial System Inquiry, chaired by David Murray were concerned about the cost and incidence of superannuation tax concessions. So too was the recent Tax Discussion Paper.³ The concessions do not lead to corresponding pension savings, and indeed they cannot.

The pension and tax systems are antagonistic to each other. The pension system directs assistance to the poor; the tax system to the rich. The tax system encourages savings; the pension means test discourages both work and savings. Some of the tax benefits ultimately reduce pension entitlement but the total cost of the pension and the tax concessions, at some \$76 billion, far exceeds the \$55 billion it would cost to simply pay the pension to everyone over 65.

This math led us, in 2014, to a very simple solution. Why not make the pension *universal* – free of means test – and abolish the tax concessions? This would leave enough – even on the Treasury’s conservative ‘revenue gain’ figures - to raise the base pension rate by 25% and thereby ensure that most people gained more on the pension side than they would lose on the tax side. Some 80% of the population are estimated to be net winners – that is, their

¹ The age pension costs \$42 billion pa and superannuation tax concessions will cost the budget \$34 billion in 2014-15 according to the TES. These tax concessions are projected to rise to \$50 billion in 2017, an increase of around 11 per cent per annum. By this time superannuation tax concessions will be the single largest area of government (tax) expenditure. The overwhelming majority of this assistance flows to high income earners. Low income earners receive virtually no benefit. The combined cost of these two policies is \$76 billion. With an ageing population the dual pension/superannuation system will become increasingly expensive. CSRI 2015 p18 put the cost of the tax concessions at \$30b per annum on a TTE basis (Tax contributions, Tax earnings and Exempt payouts) but only \$12b on a TEE basis and even less on an EET basis. We do not regard these expenditure tax bases as appropriate for costing the tax concession under a general regime of income taxation.

² See figure 5. Not only are tax concessions untouched, but the Government plans to abolish the only progressive part of the whole system, the low income contribution for those earning up to \$37,000, and has not proceeded with the previous Government’s plan to tax funds in pension phase when investment income exceeds \$100,000. Apart from the low income contribution, and the high income surcharge introduced by the previous Government on incomes over \$300,000, the super tax system is a flat 15% on everyone irrespective of their actual income, except that those over 60 can reduce the tax on their fund earnings to zero by shifting to pension phase. Over 70,000 individuals have account balances over \$2.5 million, and there are people with balances well over \$10 million - see Clare (ASFA) 2015 p3.

³ Treasury 2015b p69-70

total income in retirement would be higher than under the current system. Particular benefit would flow to people, such as mothers, who had broken labour force histories.⁴

Although this might be regarded as a radical proposal, it should be noted that a similar system is already in place in New Zealand. The New Zealand system achieves very low rates of poverty and very high rates of workforce participation among older people.

Short of the full New Zealand/National Superannuation approach, a number of steps could make the retirement income system more rational. Tax concessions could be pared back along the lines suggested for example by the Henry Future Tax Review (which would tax contributions at the individual's tax rate but provide a uniform percentage rebate) or by the Grattan Institute (who would reduce maximum concessional contributions from \$35,000 to \$10,000 and, like Henry, tax fund earnings in pension phase).

The pension asset test is a form of annual wealth taxation for pensioners and the Government has announced moves to tighten it. However, the impact of this policy will be to increase the implicit wealth tax rate well above the rates of return investors normally receive on their investments. Hence there becomes little point in saving for retirement (beyond the asset test threshold) except in tax-sheltered vehicles like superannuation. It is an absurd policy to have a super-concessional tax system for superannuation savings while having a super-punitive policy taxing the same savings in the pension means test. While the ALPs tax policies go some way to redressing the tax issue they fall well short of what is really required.

The pension asset test moves are even more bizarre considering that the Government had a much better option before it in the form of pension deeming as suggested by the Henry and Shepherd reviews as the best way to include assets in the means test.

TAI's suggested national superannuation (NS) approach is a comprehensive plan which would provide a major rationalisation of what is currently a complex, incoherent and regressive set of retirement income policies. Short of NS, we consider a number of more incremental proposals to improve the pension and superannuation systems. A simple easing of means test tapers, combined with asset deeming and a – say - \$10 billion reduction in tax concessions, would make the retirement income system much less distorting and maintain incentives to save for the middle income band while improving incentives work.

Recommendations of Financial System Inquiry (FSI – Murray, Chair)

The FSI reported in October 2014 and made 44 recommendations relating to 5 specific themes. The theme this paper relates to concerns Chapter 2 - *Superannuation and Retirement Incomes*.

The Australia Institute has written extensively on superannuation and tax matters over the past 6 years. We review these official reports in the light of those writings.

Brief summary of FSI Chapter 2

The superannuation system has major strengths but “is not operationally efficient due to a lack of strong price-based competition” [i.e. administrative costs are too high. In the Interim Report Murray noted that that operating costs and fees appear high by international standards⁵]. “Superannuation assets are not being efficiently converted into retirement

⁴ Ingles and Denniss 2014 ‘*Sustaining us all in retirement*’. See also Cameron P 2013 “*What's choice got to do with it? Women's lifetime financial disadvantage and the superannuation gender pay gap*” TAI Policy brief No 55 July

⁵ FSI Interim Report pxxiii, Murray 2014a (July)

incomes due to a lack of risk pooling and over-reliance on individual account-based pensions.” [In essence, people are running down lump sums at the minimum rate due to fear of outliving their pension and having a low standard of living in retirement while leaving, on average, large bequests.]

“The Inquiry’s recommendations to strengthen the superannuation system aim to:

- Set a clear objective for the superannuation system to provide income in retirement.
- Improve long-term net returns for members by introducing a formal competitive process to allocate new workforce entrants to high-performing⁶ superannuation funds, unless the Stronger Super [Cooper] reforms prove effective.⁷
- Meet the needs of retirees better by requiring superannuation trustees to pre-select a comprehensive income product in retirement for members to receive their benefits, unless members choose to take their benefits in another way.”⁸

Specific recommendations are shown in Figure 1:

Figure 1: Murray Financial System Inquiry recommendations.

Number	Description
9	Objectives of the superannuation system <i>Seek broad political agreement for, and enshrine in legislation, the objectives of the superannuation system and report publicly on how policy proposals are consistent with achieving these objectives over the long term.</i>
10	Improving efficiency during accumulation <i>Introduce a formal competitive process to allocate new default fund members to MySuper products, unless a review by 2020 concludes that the Stronger Super reforms have been effective in significantly improving competition and efficiency in the superannuation system.</i>
11	The retirement phase of superannuation <i>Require superannuation trustees to pre-select a comprehensive income product for members’ retirement. The product would commence on the member’s instruction, or the member may choose to take their benefits in another way. Impediments to product development should be removed.</i>
12	Choice of fund <i>Provide all employees with the ability to choose the fund into which their Superannuation Guarantee contributions are paid.</i>
13	Governance of superannuation funds <i>Mandate a majority of independent directors on the board of corporate trustees of public offer superannuation funds, including an independent chair; align the director penalty regime with managed investment schemes; and strengthen the conflict of interest requirements.</i>

Source: Murray financial System Inquiry, Chapter 2: Superannuation and retirement incomes, pages 89-142 □

⁶ ‘High performing’ is code for “low fee”. The Grattan Institute has shown that the 2 features are very closely correlated (Minifie 2014 p42-43).

⁷ As discussed later the Cooper reforms are not likely to shave more than 0.1% off the aggregate fund expense ratio of 1.2%.

⁸ Murray 2014b FSI, Executive summary

Murray's view on the Cooper (Super System Review⁹) reforms

Murray appears sceptical about the efficacy of the Cooper reforms embodying MySuper default funds, although he is willing to give them a bit more time before the government should take further action. In particular he notes that large rises in funds under management have not produced the expected levels of economies of scale in funds management and that fees, at around 1.2% of assets, are still far too high and are markedly reducing the final accumulations which are theoretically available.

Summary of FSI Tax Appendix 2

We here include only a few of these comments that are relevant to our main interest.

Tax treatment of superannuation: Tax concessions

Tax concessions in the superannuation system are not well targeted to achieve provision of retirement incomes. This increases the cost of the superannuation system to taxpayers and increases inefficiencies arising from higher taxation elsewhere in the economy, and the distortions arising from the differences in the tax treatment of savings. It also contributes to the broader problem of policy instability, which imposes unnecessary costs on superannuation funds and their members and undermines long-term confidence in the system...

In his interim report, Murray noted that “the large number of individuals with very large superannuation balances suggests the superannuation system is being used for purposes other than providing retirement incomes” [i.e. for aggressive tax planning – a result we predicted in 2009¹⁰]. “The large number of accounts in excess of \$5 million each could each receive annual tax concessions more than five times larger than the single Age Pension”. Murray showed that 2 per cent of accounts accounted for 30 percent of super assets, and 10 percent of accounts for 60 percent.¹¹ Self-managed super funds (SMSFs) now control a third of all super assets (that is, \$650 billion in \$2,000 billion total), despite being restricted to a small minority of fund members. Not all large balances are in SMSFs, but many are. ASFA notes that 70,000 people have super balances in excess of \$2.5 million.¹²

Tax treatment of superannuation: Differentiated tax rates on earnings

Murray notes that

Earnings are taxed at 15 per cent in the accumulation phase, but are untaxed in the retirement phase. This can act as a barrier to funds offering ‘whole-of-life’ superannuation products and increases costs in the superannuation system.

Aligning the earnings tax rate between accumulation and retirement would reduce costs for funds, help to foster innovation in whole-of-life superannuation products,

⁹ On 29 May 2009 the then Labor Government commissioned the Super System Review chaired by Jeremy Cooper, “to make recommendations to ensure that the superannuation system has a sharper focus on operating in members’ best interests.” Government’s Response to Cooper Review: Stronger Super, Government of Australia 2010

¹⁰ Ingles 2009a

¹¹ Murray 2014a p2-120-121 Figure 4.3

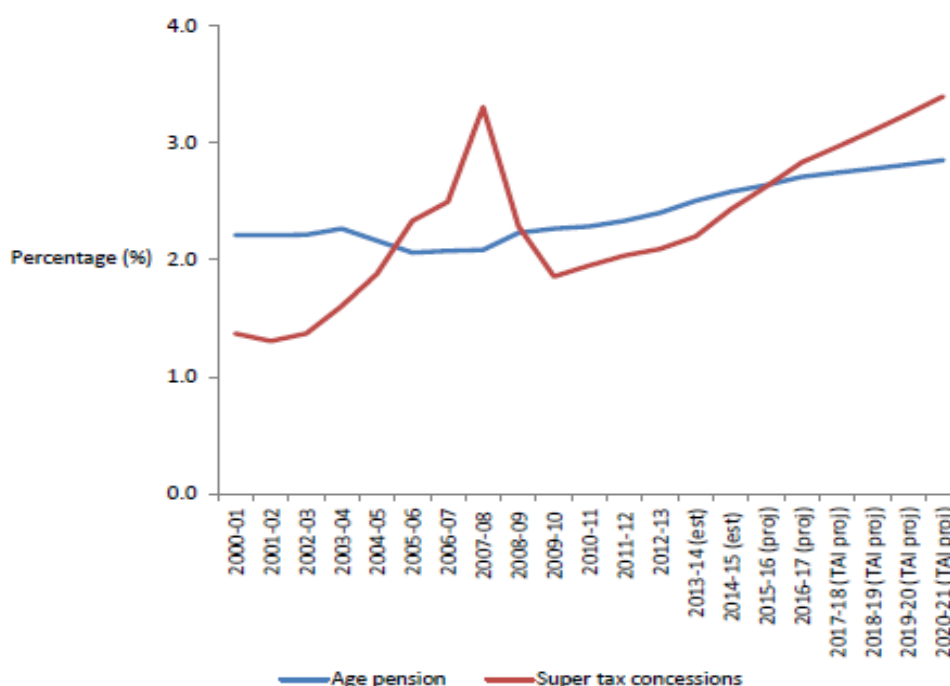
¹² Clare 2015 p3

*facilitate a seamless transition to retirement and reduce opportunities for tax arbitrage.*¹³

National Commission of Audit (NCOA - T Shepherd, Chair)

The NCOA was not asked to report on tax expenditures, a rather glaring omission as such expenditures now cost the budget over \$128 billion¹⁴ [7.7% of GDP] and some of these are growing faster than many direct expenditures. For example the superannuation tax expenditure (TE) is currently \$38.1b compared to an age pension cost of \$42.1b (2014-15) and the TE is growing at 11 per cent pa compared to the pension cost growing at just over 6 percent. As a consequence the TE is set to overtake the pension cost in 2017 – Figure 2.

Figure 2: Cost of the age pension and cost of superannuation tax expenditures



Source: Ingles and Denniss, 2014, *Sustaining us all in Retirement* Figure 1 p3; projections as a per cent of GDP

The NCOA were not altogether unmindful of this omission, noting that

*any longer term consideration of superannuation tax concessions would be best considered in the context of the Government's White Paper on Tax Reform. The Commission notes that many superannuation tax concessions disproportionately benefit high income earners, when compared to taxation at marginal tax rates under the progressive income tax system.*¹⁵

Some have argued that the current system is not regressive because those with higher superannuation receive a lower pension. Some studies show that net assistance by income class is fairly uniform except at the top end, where the very high tax benefits outweigh the

¹³ Murray 2014 App. 2

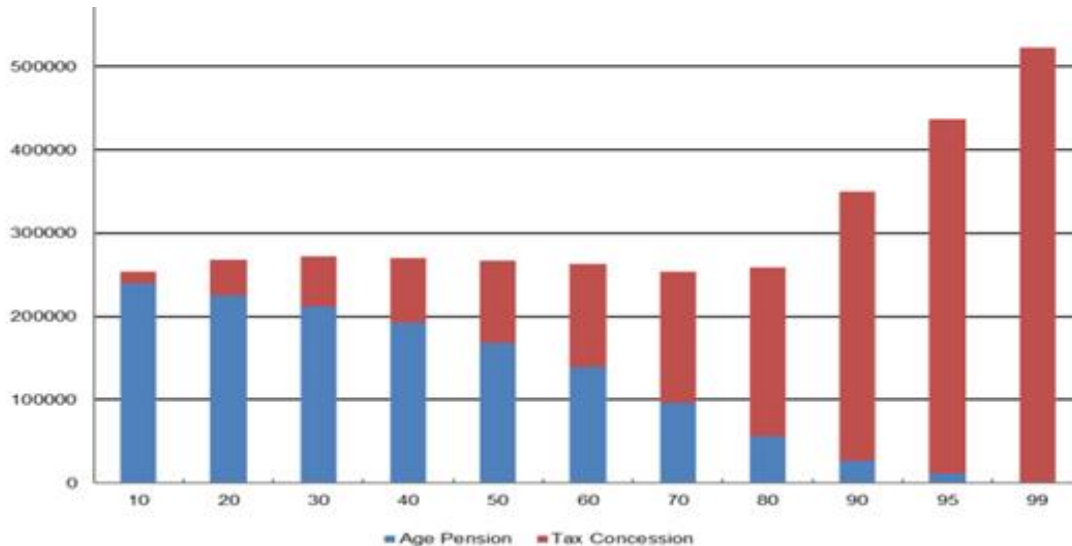
¹⁴ Budget Paper No 1 2013-14 Appendix E: Tax Expenditures has estimates for total TEs from 2009-10 to 2016-17. These totals are not provided in Budget Paper 2014-15 although there are estimates of large measured tax expenditures (Appendix B to Statement 5 and Attachment C to Part 3).

¹⁵ Shepherd, NCOA 2014a Sn 7.1

pension loss (Figure 3).¹⁶ However there are a number of doubtful assumptions underlying such studies; in particular it is assumed that little tax is payable on savings outside of superannuation.

Total benefits by income class cannot possibly be flat because the system as a whole is much more costly than a simple uniform pension at current rates would be. Figure 3 therefore understates the tax assistance flowing to middle and high income groups (the red-coloured part of the bars).

Figure 3: Distribution of total government support by income percentile (male)



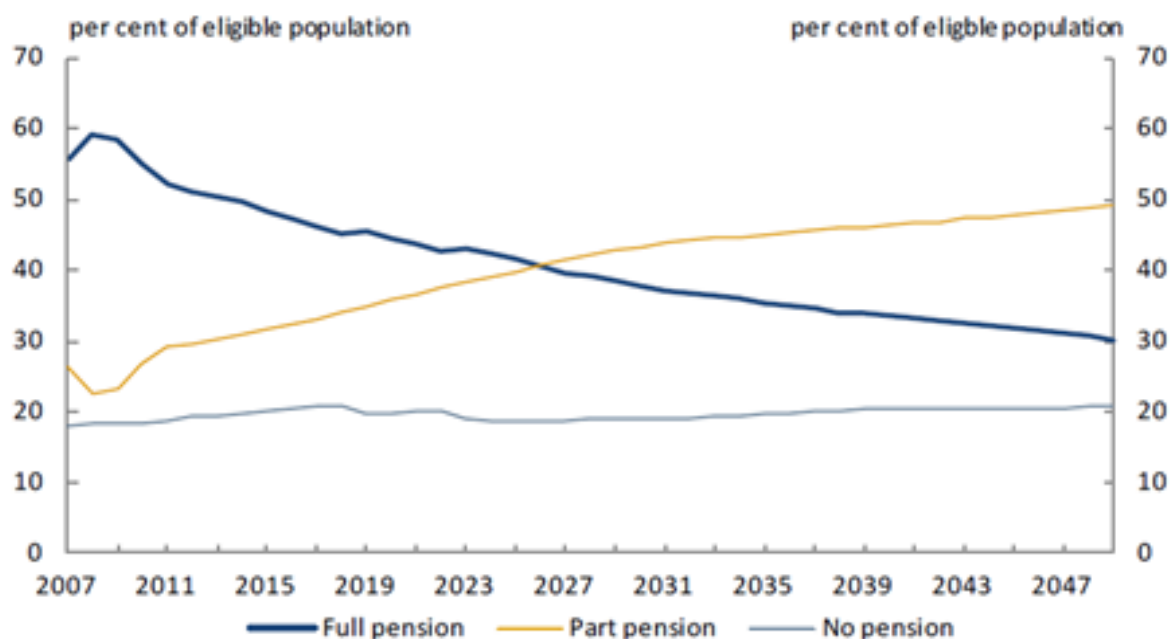
Source: Treasury 2012 “*Distributional analysis of superannuation taxation concessions*”. The vertical axis shows total \$ support over the retirement period; the horizontal axis on this figure shows income percentile. For example at the 99% percentile there is no age pension and total support of over \$520,000 flows from tax benefits. This is not the same as the benefit flowing to the top 1%, which would be much higher.

Separately, Mr Shepherd commented: “Compulsory super just doesn’t seem to be working”. He noted that the NCOA found that 80% of retirees would still receive a full or part pension as far out as 2050, even if the Superannuation Guarantee were to rise to 12% (It is currently frozen at 9.5%).¹⁷ In this context Shepherd included the Treasury Figure below.

¹⁶ See e.g., Mercer 2012

¹⁷ Quoted in the Australian, A Creighton 4 Sept 2014 “Audit chief Tony Shepherd wants age pension reform before super lifted”. The SG was to be lifted to 12% over time but the current government has temporarily frozen this process as a savings measure.

Figure 4: Projected proportion of eligible persons receiving an Age Pension



Source: NCOA citing Rothman, 2012.

The NCOA focussed on cutting the age pension. The main recommendation was to phase in a new indexation formula whereby the pension would be benchmarked to average weekly earnings rather than male total AWE. During the likely 15 year transition the pension would be indexed only to prices.¹⁸

In addition the NCOA recommended the pension age which is now set to rise to 67 by 2023 be set at 77 per cent of life expectancy at age 65. Under this formula, the pension age would likely reach 70 years by 2053. The 2014-15 Budget proposed “Continuing the move by the former Government to increase the age pension age to 67 by 1 July 2023, by further increasing the Age Pension age to 70 by 1 July 2035”.

The Commission recommended that the current income and asset test be scrapped in favour of a new comprehensive test that would take account of all of a pensioner’s assets using deeming, including the portion of the family home value above \$750,000 (indexed) for a couple and \$500,000 for single people. Deeming is a method of imputing a return to assets. Imputed returns are added to wage income to calculate pension entitlement; actual income from assets is disregarded. Income-poor but asset-rich home owners would have access to home equity loans (e.g., reverse mortgages) to live on.

The income test withdrawal rate would rise from 50 to 75 per cent; the deeming rate is not specified but would be “based on the returns expected from a portfolio of assets held by a prudent investor”. This implies a deeming rate around 4-5% pa, consistent with real long term returns in the superannuation system. The move to a new means test would be flagged well in advance to allow people time to adjust, the suggested year being 2027-28.

Wider use of deeming was also favoured by the Henry Report.

¹⁸ This would be the higher of the consumer price index or the pensioner and beneficiary living cost index. The recent Budget proposed indexing pensions to the CPI, rather than wages, from September 2017.

The superannuation preservation age, currently rising in stages to 58, would be set at 5 years below the pension age, becoming 62 in 2027 and 65 in 2053.

In the Commission's view the age pension should be regarded as a safety net; "those with the resources to fund their own retirement should do so."¹⁹ Eligibility for the Seniors' Health Card would be tightened, notably by including tax-free superannuation in the income test.

General comment on these reports

In relation to retirement incomes the thrust and philosophy of the 2 reports, particularly Shepherd, is residualist; that is that the age pension should be only a safety net and that private superannuation should bear the main burden of supporting the aged in retirement. However since private superannuation is heavily supported by the state through generous tax concessions the Government cannot be said to have a consistently residualist approach to retirement income policy. Rather it has an ideological attachment to self-provision despite a lot of evidence that state provision works better in the retirement income arena.

Real increases in the age pension under the previous Government have had a marked impact in reducing the proportion of the aged who are in poverty. The changed indexation arrangements proposed by Shepherd and endorsed in part by the Government (albeit with little legislative success) would markedly increase poverty among the aged.

In a recent report Ingles and Denniss²⁰ pointed out that abolishing superannuation tax concessions would raise sufficient revenue to both abolish the age pension means test and to finance a 25% increase in the age pension. The self-financing nature of this proposed 'National Superannuation' system is a measure of the huge cost inherent in the existing system.

The one specific recommendation in the Murray Report, to harmonise fund taxes in the accumulation and pay-out phases, would raise only \$3b²¹ as compared with the \$34b the super tax expenditure currently costs. However it is clear that Murray is not opposed to further changes on the tax concession side, and we support this. For example a frequent suggestion²² is that instead of a flat 15% tax on contributions made to super (which most benefits high earners who would otherwise pay tax at the 49% marginal rate²³), there should be a flat rebate for all contributors irrespective of their income.

The Murray Report correctly identifies the \$21b administrative cost as a major burden on the private superannuation system but is hesitant about acting on this, partly because the reforms initiated by the Cooper (Super System) Review are yet to fully play out. Governments have been slow to act on the high level of superannuation account fees which, at an average of 1.2%²⁴ absorb around a quarter of gross real investment returns²⁵ and reduce final accounts by a substantial proportion.²⁶ Minifie – whose report for the Grattan

¹⁹ Shepherd 2014a (NCOA) p7.1

²⁰ Ingles and Denniss 2014

²¹ Daley 2013 Grattan Institute

²² For example in the Henry Report: Henry suggests a rebate of 20% (Treasury 2010b p103).

²³ There is a surcharge of 15% on those earning over \$300,000.

²⁴ J Minifie 2014 "Super sting: how to stop Australians paying too much for superannuation" Grattan Institute April

²⁵ Murray 2014a p2-96 reports real investment returns in the order of 3.1 to 4.5 per cent over 20 years. Before fees these real returns would be 4.4-5.8%.

²⁶ The Super System Review (Cooper 2010) found that if their MySuper and SuperStream initiatives were successful in reducing fees by around 40 per cent – or 38 basis points – for the average member they would increase their superannuation balance at retirement by around \$40,000 or 7 per cent (Final

Institute clearly influenced Murray - found that the benefits of increased scale over the past decade have not found their way to members, but rather have been largely offset by higher fund expenses.²⁷ He also queried the ability of the My Super reforms to force fees down except very marginally, a view reinforced in his 2015 report.²⁸

Astonishingly, super fees and charges benefit the financial services industry by half the actual cost of paying the age pension. In 2009 Ingles and Fear proposed a government backed universal default superannuation fund as a way to dramatically lower fees for disengaged members (similar to the situation in Sweden²⁹); the Government should give serious consideration to such a proposal. Ingles 2000 had estimated that a low cost government fund could reduce the aggregate management expense ratio to around 0.4% - that is, to one third of the average cost currently prevailing. The Cooper reforms have not so far been very successful in reducing fees, as Murray notes³⁰: while this may partly be a transitional issue, the hoped for eventual reduction is not more than 0.1 percentage points.

Limiting or abolishing superannuation tax concessions

There are various proposals around to reduce or limit superannuation tax concessions. These proposals all have the common thread that the concessions are too generous, particularly to high income earners (who, on the view of the Tax Discussion Paper, would save anyway) and do little to help or incentivise savings by low income earners.

Many academics favour an EET regime³¹ for taxing retirement savings. While an EET has some nice theoretical properties, the problem is not just one of optimising the treatment of savings under the tax system but is instead one of dual or constrained optimisation, since the total return to savings is a product of the tax system and the pension means test taken together. Hence it cannot simply be assumed that EET is an optimal solution to taxing superannuation. In particular it is strange to have very concessional taxation of superannuation savings and very tight means testing, since the two systems have savings incentives which are in completely opposite directions.

The estimated cost of superannuation tax concessions compared with an expenditure tax base is \$12b using TTE, according to the Treasury³² – this is the *minimum* that should be raised from super as no tax experts suggest that super taxation should be more concessional

Report Part One, overview and recommendations). Such a saving would reduce the \$20b aggregate admin fee by \$7b per annum. (Murray 2014a p2-101)

²⁷ Minifie 2014

²⁸ Murray 2014a p2-106 and Minifie 2015

²⁹ Murray 2014a notes that in Chile new members default to a government fund which auctions off fund management on the basis of lowest fees. Fees charged by successful bidders in Chile have fallen by 65 per cent (p2-112)

³⁰ Murray 2014a p2-111,112

³¹ Exempt contributions, Exempt earnings and Tax payouts

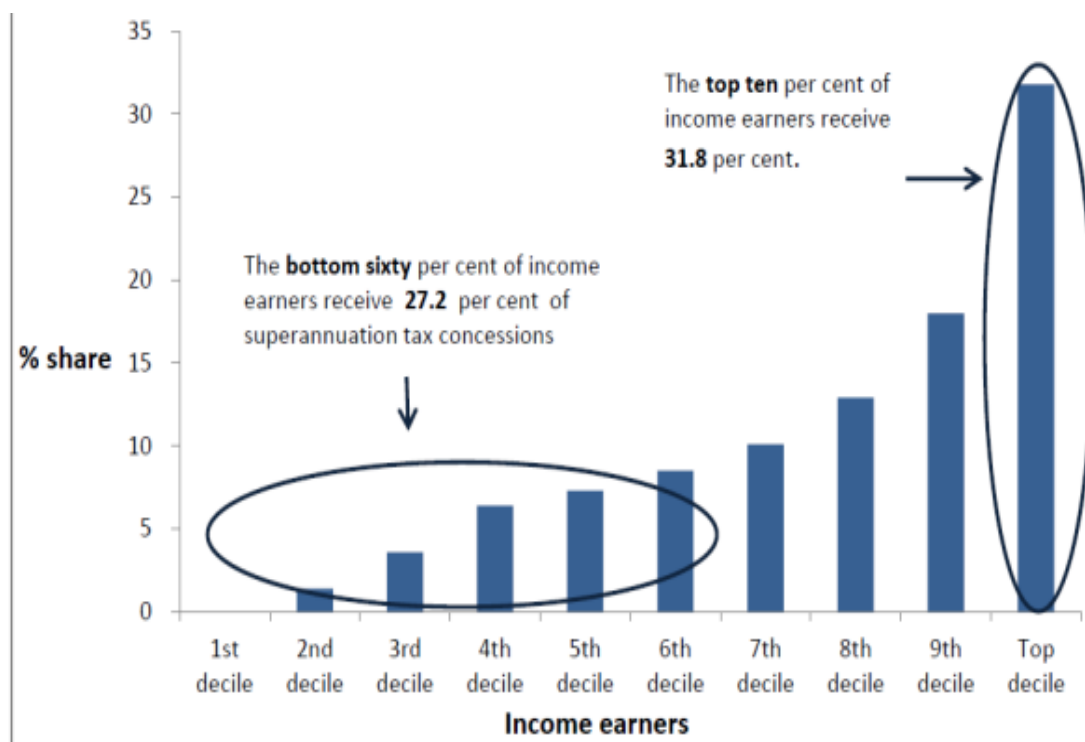
³² In the 2013 TES Appendix A, Treasury undertook an experimental estimate of the cost of the tax concessions superannuation using an expenditure tax benchmark. Using a TEE benchmark, the cost of the superannuation tax concessions fell from \$32 billion to \$11.24 billion (\$12b in 2015-16).

The Treasury notes that the use of the expenditure tax benchmark changes the current tax treatment of superannuation fund earnings from a \$16.1 billion cost to the Government to a \$5.8 billion revenue gain. According to commentators like J Sloan, this means that superannuation tax is not overall concessional. This is a misunderstanding of the Treasury analysis, which refers only to the fund earnings tax. We do not have an official figure for the cost of concessions on an EET basis. In theory the net present value of tax revenue is identical under either EET or TEE. However the timing of receipts is very different, with receipts front-loaded under TEE. There are also complications caused by the fact that the EET falls to some extent on returns above the risk-free rate (rents) but on the other hand reduces the average tax rate by virtue of providing for lifetime averaging.

than an expenditure tax. Grudnoff 2015 finds, on the basis of Natsem research, that \$18 billion a year of concessions – 60% -are going to the top 20% of income earners and 41% (\$12.2 billion) to the top 10 per cent. Little of this will flow back as reduced pension outlays. He suggests a progressive tax scale on contributions and fund earnings which would save \$10 billion pa.

In Ingles and Denniss 2014 we identified that the bulk of tax concessions flow to the well-off: Figure 5.

Figure 5: Incidence of superannuation tax concessions



Source: Treasury, 2012, Distributional analysis of superannuation taxation concessions

Murray makes the same observation. (Murray shows the share going to the top ten percent as 37 per cent.³³) Some proposals to reduce or modify superannuation tax benefits are listed below.

Henry Tax Review³⁴

- The Henry review would tax contributions to individuals at the relevant marginal rate, with a flat 20% refundable offset on contributions up to an annual cap of \$25,000, doubled for those 50 and over
- For most wage earners this keeps the effective contribution tax rate close to 15%
- Henry would halve the tax rate on all investment earnings to 7.5%, including capital gains (currently 10%) and pension phase (currently nil)
- No costing provided; however the rebate percentage could be designed to have any desired financial impact.

³³ Murray FSI 2014. The difference in the 2 estimates may stem from the fact that the Treasury figures relate to contributions and the Murray figures to total concessions

³⁴ Treasury 2010a,b,c

Grattan institute³⁵

- The Grattan Institute would remove the deductibility of contributions over \$10,000 pa, saving an estimated \$6b pa (currently up to \$35,000 can be deducted)
- Grattan would also tax fund earnings during pension phase, saving \$3b pa³⁶
- These changes produce a total saving of \$9b pa.

ACOSS and others³⁷

- ACOSS, like Henry, sought to tax contributions at the marginal rate of the individual but to provide an offset
- ACOSS, unlike Henry, would tax the fund rather than the individual; the trade-off is that accumulations are less
- Unlike Henry the offset would be at a high rate up to a low ceiling or two-tier, so would be much more progressive
- Ingles 2009a has some similar proposals as does CPD.³⁸ Grudnoff 2015 suggests a progressive schedule of contribution taxes that would save \$10 billion pa
- Most rebate proposals are meant to be revenue-neutral; however reducing the rebate percentage means that savings can be had: e.g. Ingles 2009a finds a net saving of \$3b using an 18% flat rebate up to a ceiling, or \$4b with a higher rebate but a low cap (add 50% to these savings for the current year).

Other options

- There are a range of options available to reduce either tax deductible or non-deductible contributions. Since July 2014 individuals can contribute \$30k on a deductible basis, or \$35k if over 50; these limits can be reduced (e.g., Grattan)
- Individuals can also contribute non-deductible funds up to \$180,000 pa; 3 years can be brought forward allowing a contribution of up to \$540,000 - one option is to reduce or abolish this provision.
- It is possible, under current rules, for high income earners to accumulate a \$10m super account.³⁹
- The tax rate on fund earnings could also be raised beyond the current 15%, although low income earners would be further disadvantaged. The ALP would impose a 15 per cent tax on earnings during pension phase if they exceed \$75,000 pa
- The contributions tax could be raised also (beyond 15%) but to protect low wage earners there would need to be an increase in the Low-income Super Contribution.
- There are proposals to eliminate 'churn' in super accounts, which arises when individuals both draw down their account and contribute to it on a concessional basis. For example ACOSS would reduce the annual cap on concessional contributions by \$1 for every \$1 withdrawn from a super account in the same year by a fund member, with estimated savings of \$500m in 2016-17.⁴⁰

³⁵ Daley 2013; Daley and McGannon 2014

³⁶ ACOSS 2015 put this figure at \$900m

³⁷ ACOSS 2011, 2012a,b

³⁸ Adam Stebbing and Ben Spies-Butcher 2009 Reforming Australia's hidden welfare state: Tax expenditures as welfare for the rich, Occasional Paper 25 February, Centre for Policy Development

³⁹ Some large accounts reflect rules extant some time ago but small business concession still allow large accounts to be accumulated. See the discussion in Clare R 2015 Superannuation and high account balances, ASFA April

⁴⁰ ACOSS 2015

- CSRI point to the option of applying the 30% tax on contributions from high income earners from a lower threshold than the current \$300,000 per annum.⁴¹ The Labour party proposes to reduce the threshold to \$250,000 per annum.

It is worth noting that the Labour party proposals are very minor in the context of the total cost of tax concessions. They make a \$1.4 billion dent in the \$34 billion (and rising) total. However the Government by contrast proposes to do nothing at all, under the pretext that retirees are already under the hammer due to record low interest rates and should not be further pressured.⁴² Interest rates rise and fall; this is no excuse for not making the tax system sustainable. Moreover the Government is in the process of abolishing the low-income super contribution, which finishes after 2017. This is one of the few progressive elements in the superannuation tax system.

The Ingles-Denniss proposal for flat rate National Superannuation (NS)

In Ingles and Denniss we sidestep the complexities of choosing between reform options and simply advocate that the super concessions be abolished.⁴³ To be conservative, we calculate the revenue from this change based on the Treasury's 'revenue gain' methodology rather than tax expenditures, which are some 25% higher.⁴⁴ The revenue gain figures implicitly assume that voluntary superannuation saving would cease if the concessions were abolished. While we agree with this assumption, we also note that it is highly likely that savings would take other forms, many of which would pay some tax.

The revenue saved would be used to increase the base pension rate by 25% and abolish the means test, thus introducing a form of 'National Superannuation' similar to the current New Zealand scheme. We find that most employees would be net beneficiaries from these changes, with losers being largely concentrated in the top 10-20 of income earners (who receive the lion's share of current super tax breaks). There would also be large net benefits for the economy, with the possibility of increases in labour force participation by older workers of up to a third (based on NZ participation rates). Moreover savings and spending behaviour would cease to be distorted by the means test.

Comparison with NZ provides a 'natural experiment' on impact of means testing (NZ has universal super, called NZS). Achieving NZ participation rates for older people could add \$60 billion to GDP⁴⁵ and by implication some \$20 billion to tax revenues; more than the estimated \$15b cost of means test abolition (Table 1).

Table 1: Labour force participation (%) among older workers, Australia and NZ, and numbers not in the labour force (NILF)

Age group	55-59	60-64	65-69	People NILF age 60-64
Australia men	80	60	34	409,700
NZ men	88	78	47	56,000

⁴¹ CSRI 2015 p19

⁴² Hockey interview 4 May 2015. This has not stopped the Government tightening the asset test.

⁴³ The mechanism to do this is detailed in Ingles 2009a. A key issue is whether the tax would be paid by individuals or super funds; the former is administratively much easier as the appropriate marginal rate can be easily computed, but the latter is likely to induce less taxpayer angst.

⁴⁴ Treasury 2015a

⁴⁵ Chomik and Piggott 2012a,b

Difference in % pts	8	18	14	
Aust. women	66	44	20	504,800
NZ women	77	64	34	79,900
Difference (ppts)	11	20	14	

Source: authors' calculation from OECD statistics

While the existence of the means test in Australia is not the only difference between the two countries, it must be a big factor in explaining the one-third higher workforce participation among older people in New Zealand.

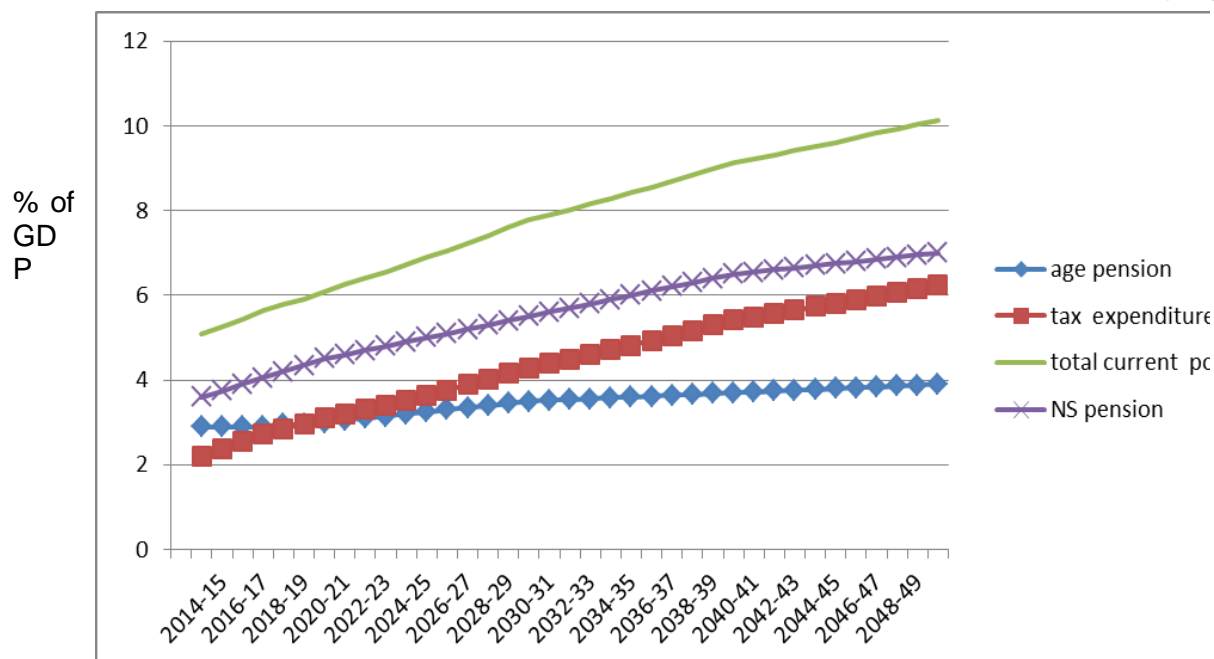
This illustrates the pension means test is not well designed. It creates very high effective tax rates on pensioners over wide ranges of private income (figure 7), and is very distorting in terms of incentives to save and work. These tax rates are so high that, on the face of it, they could be reduced and actually bring in greater revenue.⁴⁶

The proposed NS system would eliminate the need for changes to the preservation age, and make redundant proposals for compulsory annuitisation of all or part of superannuation lump sums. It makes the whole system very redistributive and very simple.

The proposed new system is much more sustainable than the current one once tax expenditures are taken into account. This is shown in Figure 6, with the vertical axis showing cost as a per cent of GDP. The top line, in green, is for current policy, and peaks at 10% of GDP. The proposed NS scheme is the purple line and this peaks at 7% of GDP (after allowing for estimated tax clawback).

⁴⁶ We are reluctant to endorse the so-called Laffer curve, but it is undeniable that total tax revenue from a particular tax is likely to be maximised by a tax rate which is less, perhaps much less, than 100%. The fact that effective tax rates for pensioners are approaching 80% is consistent with a concern that they are not revenue -or welfare –maximising.

Figure 6: Current Policy vs proposed flat-rate National Superannuation - costs over time



Source: author's modelling based on extrapolation of current TE growth rates (which are assumed to gradually decrease) and Intergenerational Report 2015

Current pension rates are just over \$22,000 per annum for singles and \$33,000 per annum for couples. The proposed new rates would be over \$27,000 per annum and \$41,000 per annum if the new system were fully phased in at this time.⁴⁷ These rates exceed the SPRC's 'modest but adequate' standards (in 2013, \$23,877 and \$35,222 pa post-retirement⁴⁸).

These rates could be expected to virtually abolish poverty among the aged, even on the OECD's standardised poverty lines.⁴⁹

There would be a marked redistribution from high to low income earners and from men to women, especially those with broken labour force histories. Time spent caring would be less penalised than it now is.⁵⁰

It should be noted that under a universal pension the net benefits to higher income earners would be reduced by up to half because part of the benefit – which is taxable – is clawed back in the income tax system. This would make the overall system progressive, in marked contrast to the current system which in aggregate is regressive (figure 2).

Tax claw-back is enhanced if the tax system more fully taxes asset income including that from owner-occupied housing. We discuss options for this in the companion tax paper.

In a recent Submission on the FSI Report, the CSRI⁵¹ has argued that the ideal tax system for superannuation is the consumption tax (EET⁵²), which is more or less the thinking

⁴⁷ In fact we suggest that such a system be phased in over a lengthy period.

⁴⁸ Social Policy Research Centre, University of NSW

⁴⁹ The NZ RPRC 2009 shows very low rates of poverty among the aged in NZ

⁵⁰ These lines are based on a percentage of median income, equivalised for family size. The Henderson lines often used in Australia assume quite low costs for the aged and can thus give a distorted picture.

underlying the Henry report⁵³. However it does not make a great deal of sense to single out a particular ‘pot’ of savings as being more worthy of concessionality than, for example, bank account savings. There are strong arguments for neutral treatment of all savings in the income tax system. If expenditure tax treatment is favoured, then the appropriate response is to move the income tax to an expenditure base or to ramp up taxes like the GST. A hybrid treatment of savings under the income tax system leads to all sorts of inefficiencies.

The CSRI also suggest that “the idea that superannuation should be taxed in the same way as other non-housing savings on a full marginal tax rate is inappropriate given the objective of facilitating the smoothing of lifetime incomes”. However we note that very considerable smoothing is achieved through the mechanism of a free-of-means-test age pension (one pays taxes while working, and receives benefits while retired), and suggest that it is wrong to consider only the tax system in this context. We also note that our proposed system achieves a very defensible pattern of earnings replacement rates in retirement and a progressive schedule of total Government support to retirees by income class.⁵⁴

Other options

There are a lot of options short of the NS proposal which go a long way towards a fairer system. It is possible to combine a less onerous pension means test with reduced tax concessions – e.g., with a taper of 25% most *effective tax rates* (ETRs) become reasonable and work incentives would increase. Taper reductions are so potent that they have the potential to be almost self-financing, so long as the reductions were believed to be permanent. This is because the current effective tax rates for age pensioners discourage self-provision, and to a marked extent (Figure 7). This figure shows that once a pensioner’s wage income exceeds \$250 per week, their effective tax rate jumps to 50 per cent and then to 70-80 per cent over a very wide range of income between \$400 and \$1350 a week.

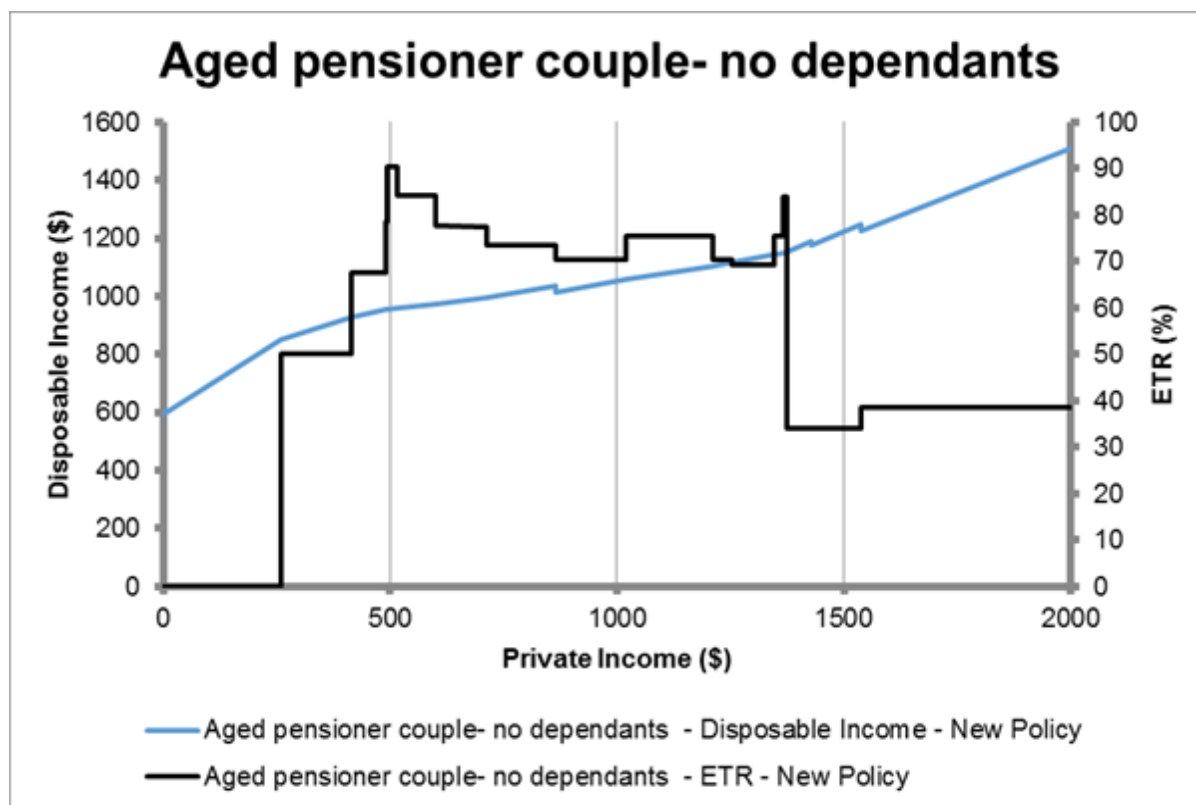
⁵¹ CSRI 2015 (Committee for sustainable retirement incomes)

⁵² Exempt contributions, Exempt fund earnings, and Tax withdrawals at full marginal rates. This is a cash-flow form of expenditure tax; its economic property is that it does not tax the economic yield on savings.

⁵³ The Henry Report was of the view that long-term savings are disadvantaged under the income tax’s ‘double taxation’ of savings. Their proposed super tax system can be viewed as a sort of ‘back door’ EET and would have similar costs.

⁵⁴ In marked contrast to the current system

Figure 7: Effective tax rates (ETRs) for age pensioners, wage income \$ per week



Source: Natsem⁵⁵ unpublished modelling for TAI, 2014. The black line showing the effective tax rate needs to be read against the right axis, showing ETRs up to and exceeding 80 per cent. 'New policy' includes the impact of the Work Bonus. The Work Bonus increases the amount an eligible pensioner can earn from employment before it affects their pension rate. The first \$250 of fortnightly employment income is not assessed and is not counted under the pension income test.⁵⁶

Easing the means test taper results in very high income cut-out levels where pension eligibility ceases; this cut-out is already around \$1350 a week for a couple and the 25% taper would almost double this.⁵⁷ This is unavoidable if ETRs are to be lowered. Shepherd's proposals to increase the means test taper from 50% to 75% reduces cut-out levels but will reduce incentives to work and save and result in pensioners running down their assets to avoid the full brunt of the means test⁵⁸, which would likely have effective tax rates approaching 100% at some income levels. A moderate taper rate also preserves the current

⁵⁵ National Centre for Social and Economic Modelling, University of Canberra

⁵⁶ The Work Bonus operates in addition to the pension income test free area. For single pensioners, the pension income test free area is \$160 a fortnight and for couples combined, it is \$284 a fortnight. For example, this means a single pensioner over Age Pension age with no other private income could earn up to \$410 a fortnight from employment and still receive the maximum rate of pension.

⁵⁷ It would however make sense to abolish the work bonus if the taper were halved. There seems little reason to discriminate against capital income in the means test while subsidising it in the superannuation tax system.

⁵⁸ In theory a high initial taper rate can sometimes be the least distorting policy so long as most pensioners have incomes which put them above the cut-out points. I doubt that this would be the effect of the Shepherd proposal. Policy in Australia over many decades has been to gradually ease tapers and means test so that most people are at least eligible for a part pension. The logical conclusion to this stream of development is a linear income tax applied to pensioners so that withdrawal rates are modest and uniform over a wide range of private income. This result is achieved by the sort of categorical Guaranteed Minimum Income discussed in Ingles 2010.

situation whereby *income replacement rates* at retirement are relatively high for low income earners and then reduce gradually with higher private income.⁵⁹

The critical issue in all these reform proposals is the schedule of total support for retirement by income class. The Shepherd proposals, like the Government's asset test, carve into assistance for the middle class while leaving assistance for the well-off untouched. The Ingles/Denniss proposal has an assistance schedule which gradually declines with income class, so that the richest 10 percent receive half the net assistance of the poorest. Their assistance is halved by virtue of tax clawback; the tax proposals set out in the companion tax issues paper seek to make this clawback more comprehensive.

ACOSS has recently proposed that the pension asset test be tightened (as an alternative to reducing rate indexation) by reducing the asset test free areas to \$100,000 for singles and \$150,000 for couples and increasing the taper rate from \$1.50 per fortnight per \$1,000 to \$2 per \$1,000 for assets above the free areas. Suggested savings are around \$1.4b per annum. ACOSS also suggest that super tax concessions be wound back as described earlier. The Government has jumped on the first part of their suggestion but not at all the second.

The Government has now announced changes to asset test taper rates which deliver benefits at the low end but which are quite draconian at the top end. The assets free areas are to rise from \$202,000 to \$250,000 for single home owners and from \$286,500 to \$375,000 for couple home owners.⁶⁰ Pensioners who do not own their own home benefit from an increase in their threshold to \$200,000 more than homeowner pensioners. However the asset test taper doubles, from \$1.50 per fortnight per \$1,000 to \$3 per \$1,000. The effect is to reduce the asset cut-out point where pension ceases; for example a home-owner couple will see their pension cease at assets of \$823,000 compared to over \$1.1 million currently.

On a superficial view these seem like reasonable changes, saving an estimated \$2.4 billion over the 3-year Budget forecast. Many economists have welcomed the changes. However economists in general have little understanding of the tax-transfer system. When we look at the changes in detail, they don't make for sensible policy.

The pension means test is conceptually a demogrant (universal payment) plus a special income tax (with a 50% tax rate up to the cut out point) plus an annual wealth tax (AWT) operating as an alternative minimum tax.⁶¹ Under current rules the wealth tax rate computes to be 3.9% on wealth above the threshold. Restoring the old taper of \$3 per fortnight per \$1,000 (\$78 a year) implies a wealth tax rate of 7.8%. These are very high rates in a context where, with real returns of 4-5% on many investments, the AWT confiscates the whole of the real return (the implicit tax rate is over 160 per cent) so that savings are very heavily taxed; indeed the situation could arise where there is little point for the individual in such savings. A home-owner couple with \$823,000 in savings would not have a higher living standard than one with \$375,000; indeed, it will be lower.

For the conservative investor the situation is even worse, as risk free rates from e.g. term deposits are only slightly higher than the rate of inflation and the cost of an indexed annuity is

⁵⁹ Income replacement rates are the ratio of retirement income to income in the final years of work. They are usually calculated using disposable (after tax and benefit) income.

⁶⁰ <http://scottmorrison.dss.gov.au/media-releases/fairer-access-to-a-more-sustainable-pension>

⁶¹ The alternative minimum tax – AMT - is used in the US to make sure the rich pay at least some tax, and is assessed on a more comprehensive base than the normal income tax. Taxpayers are liable for whichever tax gives the higher liability. Under the pension means test pensioners are assessed under whichever test gives the lower rate of payment.

such that a \$1m lump sum will only buy the married rate of pension - a return of 3.3% in real terms.⁶² On these figures we should be easing the asset test, not tightening it.

The tighter means test promotes risky behaviour. Someone with an asset around the new cut-out might consider walking into a casino and putting all bar \$375,000 on the black. If they lose, they are still better off on the full pension. If they win they become truly self-funded. Similar risks might be taken on the stock market.

Super tax concessions can offset the disincentive to save inherent in the pension mean test but once pension age is achieved, there is an incentive to run down savings or convert them into untaxed forms by e.g., paying off housing loans. A system based on offsetting distortions is highly inefficient. Why incentivise savings through super tax breaks and then penalise them under the means test?

In Denniss and Swann 2014 there is a proposal for widening of the pension loans scheme, which is secured against housing equity, and which would allow the aged of any income to maintain or even increase their standard of living - including in the context of a widening of the pension asset test to include part of the value of the family home.⁶³ This combination of base broadening and rate reduction is usually a good option in tax/pension reform.

In terms of the rate structure, the highest priority is to lift rent assistance. While we have shown that pension rates are higher than the Henderson poverty line for aged people, the gap is smallest for those renting privately.⁶⁴ Many low income renters below age pension age live in poverty.

Deeming as an alternative to the asset test

In the welfare system Henry and Shepherd have both argued that the separate asset test should be replaced by a general regime of deeming, which would return us to the 'merged means test' which operated up to the 1970s.⁶⁵ Deeming is currently applied only to a restricted range of financial assets such as bank accounts.

The pension asset test is really a form of annual wealth tax utilising the alternative minimum tax (AMT) approach. Deeming is a better option. Under pension deeming actual income from an asset is disregarded; only deemed income – which is equivalent to potential income – is included.

Under the old 'merged means test', assets were deemed to yield 10% per annum and actual income from assets was disregarded. Ten per cent was the assumed yield on an annuity purchased at age 65. Currently an indexed annuity at that age would yield around a third of that, and even a 'growth' investment strategy will yield only 4-6% so a much lower deeming

⁶² <http://thenewdaily.com.au/money/2015/04/20/super-shock-million-will-get-pension/>

⁶³ One advantage of this approach is that it would allow the asset test thresholds for home-owners to be aligned with those for non-homeowners, producing a simpler and more sensible overall outcome. Currently the thresholds are \$433,000 for non-homeowner couples and \$286,500 for home owners. See <http://www.humanservices.gov.au/customer/enablers/assets/>

⁶⁴ Richardson and Dennis 2014 p20 Table 7 shows that pension payments are substantially above the poverty line for home-owners but barely above for renters. These calculations must be used cautiously as the Henderson lines embody relatively low costs for the aged, whereas lines such as the OECD's standardised lines based on median income show much higher costs.

⁶⁵ Deeming was used extensively in the social security means test up to the early 1970s, but the deeming rate was a very high 10% pa. It was suggested as a solution to tax reform by Fleming and Little 1974 and D Dixon 1985 and endorsed by Prof. J Head in Head and Krever 1997. It has been utilised in the Netherlands and canvassed by tax reformers in NZ in the form of the 'risk-free return' method meant to get around the issue that NZ does not have a comprehensive tax on capital gains.

rate around 5-6% could be justified. Deeming rates can be set to achieve the savings sought by ACOSS and the Government with much less unfairness. The also distort decisions less, as deeming utilises a much wider effective base than the asset test. This is why comparable savings are achievable with an effective marginal wealth tax rate of 3 per cent (under 6 per cent deeming and a 50 per cent means test taper).

The Shepherd proposals widening the use of deeming are consistent with those of the Henry Report and are broadly sensible. At the moment pensioners are assessed under both the income test and the asset test, and whichever test gives the lower rate is applied. This allows considerable scope for sophisticated pension planning. Deeming, by contrast, allows a pensioner to have either modest income or modest assets, but not both. Deeming fully integrates the pension AWT with the pension income test, so it doesn't unfairly advantage those who maximise their entitlements under both tests simultaneously as the current system allows. But the suggestion to include part of the family home – above a threshold - in the asset test, while sensible, appears not to be politically acceptable.⁶⁶

Ideally in the pension system housing wealth would be fully included in the asset test, with deemed income to include all or part of housing wealth.⁶⁷ There would need to be rises in base rates to partly compensate pensioner home owners; these rate rises would allow separate rent assistance schemes at both federal and state level to be abolished. At the moment such schemes are necessary to partly compensate renters for their being comprehensively discriminated against in the tax and social security systems. Separate asset thresholds for home-owners and non-home-owners would disappear.

Because such a policy would be very redistributive it would need to be phased in over a long period to avoid disruption. Asset prices would be impacted, particularly for housing. A pensioner loans scheme⁶⁸ also makes a lot of sense if housing is included in the asset definition.

If wealth were taxed widely under an annual wealth tax and integrated with the income tax we could abolish separate social security means tests and claw-back pensions and allowances by a simple system of income tax surcharges. This option is canvassed in Ingles 2001. At the moment the income tax base is so full of holes that this option is not sustainable. While improvements to the tax base are canvassed in a companion paper I note that radical action on the tax side is currently unlikely, so support a return to deeming in the pension system as an alternative to the current asset test. This would save money while avoiding the undesirable side effects of tighter means and asset tapers, described earlier.

Administrative costs of private superannuation

Murray rightly saw the \$21 billion a year administrative costs in the private super system as a major concern. As Ingles and Fear pointed out in 2009, administrative costs are capable of reducing final accumulations by up to a third.⁶⁹ At the time, administrative costs were 1.35% of assets (also known as funds under management, or FUM); currently they are just under 1.2%. This reduction in costs is attributable to economies of scale as large funds are shown

⁶⁶ The Social Services Minister, Morrison, has ruled it out.

⁶⁷ We suggest that smaller amounts of housing wealth be initially excluded from the tax base. The changes suggested here are radical transformations which would need to be effected over a considerable period of time. The AWT in any case is based on the net value of wealth including housing; in the case of housing that is the gross value of the property less mortgage loans outstanding.

⁶⁸ Denniss and Swann 2014

⁶⁹ Ingles and Fear 2009 The case for a universal default superannuation fund, TAI Policy Brief No 3 September, Figure 1

to have lower costs than small ones, and funds under management have grown considerable in the past 6 years at around 10-12% a year. But costs, as Murray points out, have not fallen as far or as fast as economies of scale would indicate.⁷⁰

1.2% does not sound like a lot but it is a large impost – a quarter - when the expected gross real return from superannuation savings is in the order of 4-5 per cent. In aggregate it reduces final payouts by 20-25% or by more than \$250,000 – 27% - for a 25 year-old.⁷¹ Moreover the aggregate cost of administering superannuation is now \$20b per annum⁷² – half the cost of the age pension, and \$1300 a year for every fund member. This is a huge free kick for the financial services industry. In addition international experience has shown that private super can be administered for much lower costs under an appropriately designed system, with expense ratios as low as 0.4% theoretically available (Ingles 2000).⁷³ Minifie also suggests that “Australian funds charge fees that are three times the median OECD rate, on average”.⁷⁴

Minifie comments that large increases in funds under management were meant to lower fees by reaping economies of scale, however “The scale dividend has been fully absorbed by cost increases”⁷⁵ and the Australian system is very costly relative to its very large size as a proportion of GDP. Nor have the efficiencies that were forecast to flow from the Cooper Review as yet played out; there is some doubt whether this will ever happen and in any case the purported total cost saving, at 0.1% of FUM, is still small.⁷⁶ MySuper products continue to have fees in the range 0.6 to 1.4% of FUM and aggregate fees are, if anything, rising.⁷⁷

High fees are not reflective of high returns; study after study has shown that fees reduce net returns; they don't reflect good management skills. Minifie comments: “on average, high-fee funds do not generate higher gross returns and so generate much lower returns after fees than low fee funds”.⁷⁸

Studies also show that most active managers will be beaten by a simple strategy of indexation which can have costs as low as 0.2-0.3%.⁷⁹ Over any long time period, 90% of active managers will underperform the index. This is inherent in the nature of financial markets; all investors in aggregate cannot out-perform the index, and net returns will be

⁷⁰ See the discussion on this in Minifie 2014 p6

⁷¹ Minifie 2014 p8 and fig 4

⁷² Minifie 2014 p1

⁷³ D Ingles 2000 Reducing administrative costs in the Australian superannuation system, Discussion Paper No 77, ANU, p10

⁷⁴ Minifie 2014 p1

⁷⁵ Minifie 2014 p6-7 and Figures 2, 3

⁷⁶ See the discussion in Murray 2014b p107 and Minifie 2014 p19-21, as well as Minifie 2015 p40-45. The Stronger Super reforms being phased in from 2012 until 2017 – which flow from the Cooper Review - are intended to simplify default products and reduce administrative costs. MySuper comprises a uniform set of products intended for people who do not actively choose their fund. Every new default super account has to be in a MySuper product, and existing default investments must be transferred to a MySuper account by July 2017. SuperStream is a package of administrative reforms, including the wide use of tax file numbers, to reduce costs.

⁷⁷ Minifie 2014 p22-23

⁷⁸ Minifie 2014 p7

⁷⁹ For example STW, an exchange-traded fund tracking the ASX200, has a management expense ratio of 0.286%. A large super fund could employ a DIY indexation strategy with an even lower cost ratio. Its only transactions would involve buying and selling a few companies each quarter to match rebalancing in the S&P ASX200 index. The only decisions for such a fund would be asset allocation decisions; such as the proportion of assets invested overseas, in property and so on. In each case there is an available exchange traded fund, although for some of these the expense ratio can be higher than for the ASX200 funds.

reduced by the amount of management fees.⁸⁰ Administrative costs are an ongoing scandal which is robbing superannuation savers of a good part of their savings.

Why has competition not driven down fees? Simply, the free market does not produce good outcomes in the superannuation arena. Funds do not compete primarily on fees but on other features such as investment choice which mainly serve to confuse members. Members are disengaged and content to ride along with default arrangements, however poor these may sometimes be. “About half of account holders do not know the fees they pay... Less than a third of people choose their own fund”.⁸¹

The Grattan Institute’s 2014 report on fees⁸² proposed that government run a competitive tender to select funds to operate the default funds used by most workers. Similarly the Murray report recommended a competitive mechanism to select default products unless a review held by 2020 shows the sector has become much more efficient. That is a long time to wait.

Minifie 2015 suggests that administrative costs are \$4 billion higher than they need be (due to multiple accounts and insufficient mergers), and investment fees \$2 billion – or more - higher. That suggests a \$6 billion saving on the \$16 billion fees currently levied by larger funds, or close to \$1,000 per person⁸³ (self-managed super costs another \$5 billion, but this sector is relatively cheap to run as it accounts for one-third of total super assets).

Ingles 2000 proposed a radical option to lower fees: a Government run fund which would centralise super administration but contract out both the administration and also the fund management. There are overseas precedents for such a scheme, which could reduce fees by two-thirds.

Ingles and Fear proposed another solution to high fees: The Government would mandate a Universal Default Fund (UDF) which would provide a safety net to the current awards-based system of defaults, and to which all other employees could have access. The fund would employ passive management (indexation). They also suggested capping all super fees at 1% with capacity to opt-out.

Minifie’s survey of overseas fees and systems leads to a few main conclusions. Among these, “running a government default fund, or centralising the collection of funds and the maintenance of accounts, can significantly reduce costs.” Funds using this approach in the US, UK and Sweden have costs of 0.4% of FUM or below. “Second, making firms compete on fees for the right to manage default funds also achieves low fees”.⁸⁴ Variants of this model are used in Chile, NZ and Mexico, and in Chile – where low fees are the main criterion – costs in the default fund are comparable to the first model.

The Ingles and Fear approach of allowing widespread access to the UDF assumes people would make an active decision about what fund to join; experience shows that they do not do this (this is why competition has had so little impact on lowering fees in the past). Under Minifie’s proposal, the Government would select a small number of default funds every few years using a tender based on the lowest fee. Unless they opt out, all new entrants would pay into these funds. Moreover existing account holders would be able to elect into one of

⁸⁰ Ingles and Fear 2009 p12, Minifie 2014 Appendix 2

⁸¹ Minifie 2014 p13

⁸² Minifie 2014

⁸³ Minifie 2015 p2

⁸⁴ Minifie 2014 p24

these low-fee funds every year at tax time. Minifie argues that aggregate costs could be more than halved under this proposal.⁸⁵

These are far-reaching proposals and potentially quite disruptive. They would be fiercely resisted by the industry. While they would work, there is a question over their political feasibility.

I believe that the best and most politically feasible solution is simply to revisit the Ingles and Fear fall-back approach of capping fees as a percentage of FUM. The initial cap would be at the current average expense ratio of 1.2% with a lower cap of say 1% to apply to MySuper products. These capped fees would reduce over time – say 7 years - towards a target of say 0.4%. This would put immediate pressure on high cost funds, and put other funds on notice that they either need to get efficient or get out - e.g., through greater use of passive management and/or amalgamation with larger funds. Members could opt into higher cost funds if they wished – few would do this. I really cannot see any downside to a simple regulated approach along these lines and the final outcome would be assured.

Decumulation phase.

The Murray Report (2014a) identified an inconsistent approach to policy for the retirement income system. On the one hand policy in the accumulation phase assumes that people don't act rationally and under-provide for retirement. On the other hand policy in the decumulation phase is almost completely laissez-faire, with people able to spend lump sums how they wish and in practice, often making poor or uninformed choices. "If superannuation streams are not transformed into retirement income streams effectively, taxpayers ultimately carry significant risk in the form of higher Age Pension costs".⁸⁶ This concern is heightened by reference to life expectancies which are continuing to rise and are now over 20 years on reaching pension age.

Most retirees take lump sums (around half of total benefits, often used to retire debt) or account-based pensions (94 per cent of the remaining pension assets are in these), with most people drawing down the minimum amount. At age 65 this is 5 per cent per annum. Drawdowns at minimum rates reduce the risk of outliving your assets but tend to leave very large bequests.

By contrast very few people take up annuities, which provide a guaranteed income stream – either for a fixed term or for life - in exchange for an upfront payment or a series of smaller payments. Indexed annuities are more costly but protect against inflation.

The dominance of account-based pensions is because of their flexibility (which allows both lump sum withdrawals and bequests), the low implicit returns from annuities (whose underlying assets tend to be conservatively invested) and the "fact that individuals can rely on the Age Pension to help manage longevity risk".⁸⁷ In consequence the Government bears much of Australia's longevity risk, in contrast to other countries where annuities are a much higher proportion of retirement incomes. Murray's observation was that "the retirement phase of superannuation is underdeveloped and does not meet the risk management needs of many retirees... Individuals are justifiably concerned about outliving their savings". In consequence they enjoy a lower standard of living than that theoretically available, and leave

⁸⁵ Minifie 2014 p30

⁸⁶ Murray 2014a p4-3, 4-4

⁸⁷ Murray 2014a p4-7

large bequests. Hence, “the lack of effective [longevity] risk management... is a major weakness of Australia’s retirement income system”.⁸⁸

Another weakness is so-called ‘double dipping’. People enjoy access to generous tax concessions and then use their lump sums, not to generate income but to retire debt. In addition a third of superannuation assets are withdrawn by the time an individual reaches the eligibility age for age pension.⁸⁹ Hence spending on the age pension is not much reduced by the very large super tax concessions as Figure 3 showed. Murray notes that “Australia is the only developed country with mandatory saving to not have a decumulation structure”.⁹⁰

The Super System Review recommended that default MySuper products should incorporate an income stream product. However the previous Government decided that such products would initially cover only the accumulation phase.⁹¹

In its final Report, the Murray Inquiry called for a default income stream option to be a standard part of accumulation schemes. Evidence shows that members tend to cleave to default pension options when they are offered.⁹² Murray also wished to remove regulatory and tax impediments to offering pensions.

We are supportive of offering a default pension option. However we note that our proposal for a NZ-style National Superannuation system completely sidesteps the problem of decumulation by providing a basic, adequate pension for everyone and leaves it to individuals to then decide what level of longevity insurance they should seek. It also removes any issue of ‘double dipping’ as the amount of government support received becomes independent of decisions about how to use retirement lump sums.

There are interesting options in overseas systems for the decumulation phase. The UK in particular has shown interest in ‘collective pensions’.⁹³ Such schemes are common in Denmark, Holland, the US and Canada. They allow those in a pension scheme to contribute into a shared ‘pot’ which keeps their finances invested longer, and offers an income in retirement directly from this pot – cutting out the annuity process altogether. By keeping costs down and allowing investment in growth assets, collective schemes offer a far higher income in retirement than individual defined contribution schemes. Some modelling puts income in retirement a third higher. However there is a risk that in some years, income could drop. But these drops - 7% on average on three occasions since 1930 - are relative to a 33-39% higher income.⁹⁴ Modelling shows that in all cases the loss was subsequently recouped.

There are very strong arguments for keeping some of retirees’ savings in growth assets, given the very long life expectancies which people now have at retirement. Collective pensions are a good way of maintaining such exposure.

There is some irony in considerations of national superannuation and collective pensions. In 1973 the Whitlam government commissioned an Inquiry into National Superannuation. The

⁸⁸ Murray 2014a p4-8, 4-9

⁸⁹ Murray 2014a 4-14,15

⁹⁰ This is a citation – see Murray 2014 4-18 fn 42

⁹¹ Murray 2014a 4-23

⁹² Murray 2014a chart 8.5 p4-22

⁹³ UK Dept. of Work and Pensions 2013 ‘Reshaping workforce pensions for future generations’ Cm8710, November. The Henry Report alluded briefly to such schemes in the context of the pension phase, but opposed mandatory annuitisation, partly because it would discriminate against those with poor life expectancies. The UK literature points out that there are ways around this issue.

⁹⁴ D Pitt-Watson 2013 “Collective pension in the UK ii”, Research and Action Centre, November

Hancock Inquiry⁹⁵ reported in 1976 and 1977 and concluded that an earnings-related NS scheme was feasible and could be largely funded with a 5% contribution from payroll. However by the time of their final Report the government had changed and the Fraser Government decided that 5% was too high an impost.⁹⁶ Ironically we now have a 9.5% levy – the superannuation guarantee – but none of the advantages that could have been reaped from national superannuation such as low administrative costs and assured retirement incomes.

Intergenerational equity

A number of recent research reports have pointed to a growing issue of intergenerational equity. For example Daley and Wood suggest that “Today’s generation of young Australians may have lower standards of living than their parents at a similar age. Over the past decade, older households captured most of the growth in Australia’s wealth [in large part due to big increases in housing wealth]... Governments are also spending much more on older households for pension and services, particularly health”.⁹⁷ Although wealth will ultimately be passed on through inheritances, they are typically received later in life and benefit those who are already wealthy.

“Targeting the age pension, reducing superannuation tax concessions and shifting towards asset taxes could reduce the transfers between today’s younger taxpayers and older retirees.” Reducing government structural debt is also important.⁹⁸

However the Grattan Institute Report does not explicitly address issues of **intragenerational fairness**, while noting that “Large and increasing differences in income and wealth among people of a similar age raise important policy issues”.⁹⁹ There is a risk that policies meant to redress intergenerational fairness, such as cutting pensions, will at the same time reduce intragenerational fairness and increase poverty. In the view of the Australia Institute, policies should be designed to increase fairness in both dimensions.

According to the OECD the government’s proposed cut to pension indexation was likely to be unsustainable over the long term. “Pay-out from the Age Pension ranks as one of the most modest first-tier pensions in the OECD...[under the government’s plans] the pension’s value will drift down in relation to average incomes, and at some point may cross socially acceptable limits of adequacy... constant change to pension indexation is not optimal”.¹⁰⁰

Australia’s aged pension replaces only 60 per cent of half Australia’s average wage, which is low by OECD standards¹⁰¹. The OECD supports better targeting of superannuation tax concessions, noting that “making superannuation income tax-free has meant that sizeable

⁹⁵ K Hancock (Chair) National Superannuation Committee of Inquiry, Final Report Parts 1 (1976) and 2 (1977)

⁹⁶ In fact the incidence of the levy, like the SG, would ultimately be on employees through lower wages. However without an agreement such as the prices and incomes Accord, the adjustment path would have been difficult. There was also the view, to which I was party, that 5% would not fully fund the scheme outside the projection period, thus visiting on Australia some of the difficulties which have resulted from under-funded pay-as-you-go national pension schemes overseas. In 1975 there was some prospect of a free of means test universal pension (the means test had been removed for those aged over 70 and the assets test abolished) and a very underdeveloped private superannuation sector. Had I known the system we would end up with, I would not have been opposed to NS in 1977.

⁹⁷ Daley and Wood 2014 p2 See also Tapper et al 2014

⁹⁸ Daley and Wood 2014 p9

⁹⁹ Daley and Wood 2014 p9

¹⁰⁰ OECD 2014 Economic Survey: Australia, December

¹⁰¹ OECD 2014 Economic Survey: Australia, December

sums of public money [of about 2% of GDP] are implicitly being spent in a way that largely benefits middle and upper income earners".¹⁰²

Tapper et al suggest that welfare policies have favoured the elderly at the expense of the young and elderly households today are on average well-off by comparison with younger households"¹⁰³, with equivalent net incomes only slightly lower than for non-aged households and much higher average levels of wealth.

There are good arguments for including wealth more consistently in the tax base. However the arguments for higher wealth taxes on the pensioner population – by means testing housing for example – need to be considered in the context of the generally inconsistent treatment of assets in the income tax system. In the view of the Institute there are strong arguments for reforming the taxation of housing more generally. The exemptions of imputed rent from the tax base, and the exclusion of capital gains from owner-occupied housing, are massive tax expenditures which together cost the revenue around \$35b per annum. Reform on these fronts would automatically impact on wealthy pensioners since part – up to half - of their pension is clawed back through the income tax, and would continue to be clawed back under our National Superannuation proposal. Some taxation of housing is also achieved by the AWT proposed in the companion paper provided that housing is not carved out of the AWT base.

Conclusion

Reforms suggested by Shepherd and endorsed in part in the Government's 2014 Budget punish age pensioners and do so unnecessarily, as substantial revenues can be found on the tax side and undermining pension indexation would affect the systems' ability to prevent poverty amongst the aged.

Murray is more on the right track in seeking to bring down fees but his preferred changes, like those of the Cooper Report before him, are not sufficient. We propose a very direct approach to reducing fees, by regulation.

Both Shepherd and Murray are right to be concerned about the incidence and utility of superannuation tax concessions.

Our proposed NS/tax trade-off solves most of the really difficult issues in the current retirement income system. It addresses the unaffordability of the current system.

It directly confronts the issue of retirement income adequacy and aged poverty by substantially raising base rates. It confronts the issue of high effective marginal tax rates for pensioners with direct adverse impacts on incentives to work and save.

It fixes the inequity of superannuation tax concessions. It provides a coherent set of incentives for retirement savings. It resolves the issue of the preservation age, which is less important in a non-means tested system as it removes any opportunity for 'double dipping'.

It resolves the issue of compulsory annuitisation in the negative, as there is no public policy reason to compel annuitisation when base benefits are adequate and no pension savings flow from annuitisation. However we are not opposed to Murray's suggestions for default annuitisation, but suggest that this be done utilising the 'collective pension' concept used overseas.

¹⁰² OECD 2014 Economic Survey: Australia, December p83

¹⁰³ Tapper Fenna and Phillimore 2014 p5

Short of NS, there are lots of options to reduce the cost of tax concessions which could be allied with pension taper changes to maintain incentives to save and improve incentives to work.

If means test easing is financed by reducing super tax concessions the net incentive to save for retirement is not altered but the system ceases to discriminate against savings made outside of superannuation.

We would support the Shepherd Report in seeking to include some measure of housing wealth in the pension means test. However an alternative is to reform the taxation of housing more generally; well-off pensioners would be affected by this as up to half of the value of their pension can be clawed back through the income tax, suitably reformed. This could be achieved with an annual wealth tax, an approach we canvass in a companion paper.

List of abbreviations

ACOSS Australian council of social service

AMT alternative minimum tax

ASFA Association of superannuation funds of Australia

AWT annual wealth tax

CPD Centre for policy development

ETR effective tax rate

FSI Financial system Inquiry (Murray, Chair)

FUM funds under management

GDP gross domestic product

NATSEM National centre for social and economic modelling

NCOA National Commission of audit (Shepherd, Chair)

NILF not in the labour force

NS national superannuation

OECD Organisation for economic co-operation and development

SG superannuation guarantee – currently 9.5% of pay

SMSF self-managed superannuation fund

SPRC Social policy research centre

TAI the Australia Institute

TE tax expenditure

TES tax expenditure statement (Treasury)

UDF universal default fund

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