The great superannuation tax concession rort

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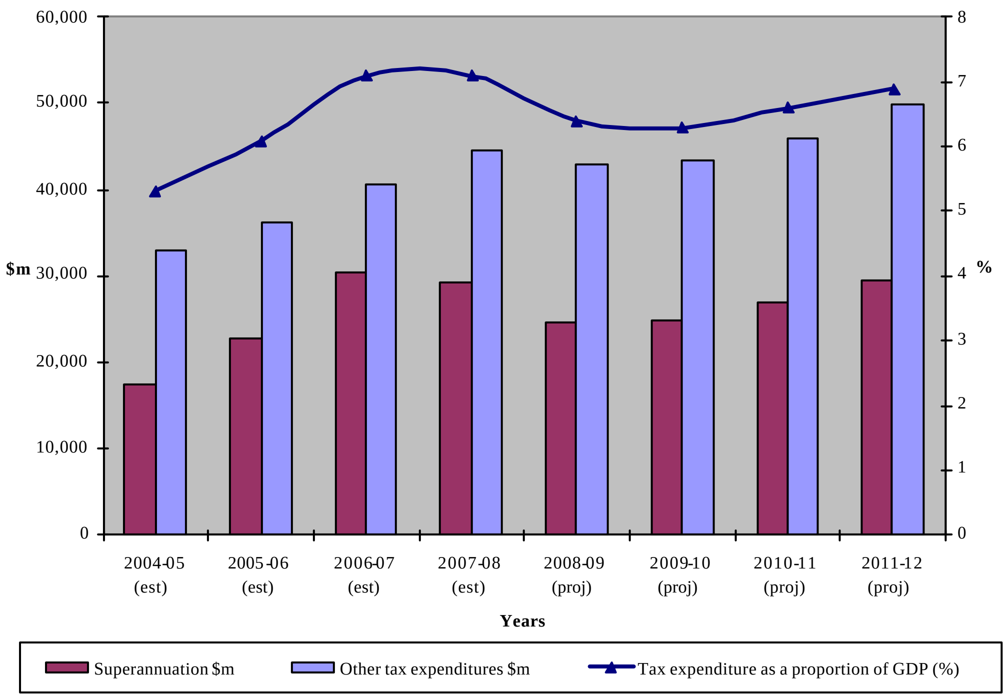
Introduction

Superannuation tax concessions will cost the budget $24.6 billion in 2008–09 (Treasury 2009), rivalling the $26.7 billion annual cost of the age pension and constituting a fifth of income tax revenue ($130 billion per annum). Tax expenditures (see Definitions, Appendix A), of which the super tax concession is by far the largest, are one of the fast-growing areas of total government spending (see Figure 1).

Figure 1 Australian government tax expenditures 2004–05 to 2011–2012



Source: Treasury 2009, Table 2.1.

Note that superannuation tax expenditures have been revised downward from those shown in Treasury 2008c, reflecting the effect of the economic crisis. Aggregate tax expenditures have been revised up, reflecting the inclusion of foregone revenue from the goods and services tax.

Measured tax expenditures are projected to rise as a proportion of GDP from 5.3 per cent in 2004–05 to 6.9 percent in 2011–12. They will fall in 2008–09, however, partly as a result of personal income tax cuts and partly as a result of lower superannuation fund earnings.

The growth in the cost of the tax concessions for superannuation will continue unless current policy settings are changed significantly. This is because the age dependency ratio (the proportion of the population aged over 65) is expected to almost double to 25 per cent over the next 40 years, while the number of people with large superannuation entitlements will also grow substantially as the superannuation guarantee system comes to full maturity.

Australian superannuation fund assets, currently over $1 trillion, are expected to reach almost $9 trillion in 2041 (Rothman and Tellis 2008). As the size of the tax concessions are related to the size of the accumulated lump sum, by virtue of the low tax rate on fund earnings, the forecast growth in superannuation assets ensures that there is a question mark over whether the current system will be sustainable.

Superannuation tax concessions have long been a bone of contention for the welfare sector, which views them as redistributing scarce resources away from low-income earners towards the secure and privileged well-off. This has created a political battleground, with the welfare groups lining up against the super industry represented most notably by ASFA. Reform options are canvassed, for example, in ACOSS 2002 and 2006 and the Brotherhood of St Laurence 2008.[1] Other welfare and consumer bodies have also argued for a fairer and more efficient system. Some of the specific reforms suggested in this paper are very similar to those of ACOSS (see Option 2b, p. 25).

Research questions and key findings

The paper begins by providing a brief history of superannuation policy in Australia and then goes on to discuss a number of the issues associated with the current taxation of superannuation. In particular, the following questions are addressed:

1. What is the incidence of the concessions?

- The paper demonstrates that the tax concessions flow overwhelmingly towards the well-off, with those earning less than $34,000 per annum receiving almost no assistance and those earning over $180,000 per annum receiving the most. Astonishingly, the top five percent of individuals account for 37 per cent of concessional contributions.

- The current concessions provide almost no benefit to low-income earners, including women working part-time, but an executive earning $300,000 per annum with a million dollar retirement account can receive $37,000 of concessions, 2.5 times the value of the age pension, for every year of their working life.

[1] For details see Freebairn and Scutella, 2008.

- Tax concessions for superannuation provide substantially greater benefits for men than women and this disparity will continue under current arrangements.

- Allowable contributions are such that high-income earners could easily retire with $5 million in assets, which would then allow them to draw down around $500,000 a year in retirement, all tax-free.

- The system has become so skewed that the annual cost of providing superannuation tax concessions to high-income earners is much greater than the cost of simply paying those same individuals the age pension. Providing tax concessions for superannuation as a mechanism to help insulate the budget from the cost of providing for an ageing population is not sensible.

2. Do the concessions provided to superannuation increase retirement income adequacy?

- While the superannuation industry has succeeded in creating concern about the adequacy of retirement incomes, current policy settings will ensure that by 2030 average Australian workers will achieve 85 per cent of their pre-retirement living standard during retirement. Even the baby boomers, who will partly miss out, will gain a substantial supplement to the age pension and almost all will achieve a 'modest but adequate' living standard.

- The paper finds that, while there is no doubt that tax concessions increase retirement incomes, the benefits of these concessions are so skewed towards the well-off that they undermine the redistributive nature of the Australian retirement income system. As a consequence, a situation has been created whereby the retirement income system will increasingly emphasise *income maintenance* after retirement rather than *income support* for retirees on low incomes. There needs to be a more appropriate balance between the two goals.

- The higher an individual's pre-retirement income, the more support the tax system provides to help boost post-retirement income. This shift in the objective of the retirement income system away from providing a safety net and towards maintaining living standards has occurred without any public debate as to whether such a radical change in direction is appropriate or whether it should be so highly taxpayer-supported.

3. How concessional are the current tax arrangements for superannuation?

- The answer to this question depends, in part, on the 'tax benchmark' used [see Definitions, Appendix A]. If comprehensive income (as used by Treasury) is the benchmark, the system is highly concessional. If an expenditure tax treatment is the benchmark, the concessions are much less but, at $4.6 billion per annum, remain substantial.

- Calls by the superannuation industry to change the methodology for measuring the size of the tax concessions are self-serving; the major effect of such a change will be to reduce the visibility of the tax concessions currently granted.
- Superannuation is the most concessionally-taxed investment in Australia, with contributions, fund earnings and payouts all receiving concessional treatment. According to Treasury, the effective marginal tax rate on superannuation savings is highly negative.
- Transition to retirement (TTR) pensions have opened up a huge rort where well-off older workers with the opportunity to receive a TTR pension while simultaneously 'salary sacrificing' into super are able to reduce their effective tax rate on earnings to a 15 per cent flat rate.

4. Do the tax concessions result in an increase in aggregate saving?

- The evidence that tax concessions stimulate additional private savings is weak. Because the concessions flow overwhelmingly to the well-off, who would save anyway, the overall effect may be to alter savings patterns without creating a net increase in savings.
- The cost of concessions is so high that any addition to private saving is likely to be more than outweighed by the loss in government saving. Particularly problematic is the provision of relatively large tax benefits to the compulsory nine per cent superannuation guarantee contributions but relatively restricted tax concessions to any voluntary additional contributions.

Having addressed these questions, the paper then explores a number of possibilities for reform.

Option 1 is to remove the most egregious of current concessions and would involve, for example, taxing the earnings of superannuation funds during the payout stage and the abolition of salary sacrifice arrangements. This option would raise $4 to $5 billion per annum and, in terms of salary sacrifice, would affect only a small minority of largely high-income earners.

Option 2a is to change both the tax on contributions and fund earnings (currently15 per cent) and the tax on fund capital gains (currently 10 per cent) to 30 per cent, comparable with the standard marginal tax rate. This would raise approximately $18 billion per annum.

Option 2b is to tax superannuation contributions at an individual's full marginal tax rate. This option would deliver greater benefits to low-income earners and significantly fewer benefits to high-income earners. Combined with the higher tax rate on fund earnings, it would raise about $21 billion per annum.

These increased revenues could be used to finance significant tax reform. For example, a large increase in the tax threshold would help to ameliorate the problems of overlap between the welfare and tax systems, which would dramatically reduce poverty traps. Yet another use would be to raise the age pension itself. The greater the weight of the pension in the retirement income system relative to superannuation tax concessions, the more redistributive the system and the greater its impact on poverty amongst the aged.

Because these options are extremely redistributive, they will generate opposition from those most adversely affected. Also, super tax concessions are well-entrenched. The paper therefore canvasses two further options that are more conservative in that they redistribute the tax concessions while retaining broad taxpayer support for superannuation.

Option 3 combines Option 2b with a new rebate for *all* superannuation contributions. This could be either a 50 per cent rebate subject to a low ceiling (**Option 3a**) or a simple proportional 18 per cent rebate with a much higher ceiling **(Option 3b)**. The existing co-contribution would be abolished. Both these options would cost around $18 billion per annum and would produce net savings of about $4 billion per annum. Although both options deliver some tax assistance to the well-off, each would be a considerable improvement on the current system.

The paper concludes that the current system of tax concessions is in need of fundamental reform:

- it is too costly and the cost rises steeply with time
- the system redistributes billions of dollars to the well-off
- it distorts saving into superannuation with no guarantee that national saving is increased as a result.
- it is complex, creates arbitrary categories of favoured and non-favoured contributions and makes no economic sense.

It is time for change.

A brief history of superannuation taxation in Australia

Historically, superannuation has been lightly taxed in Australia. Prior to 1983, it was the preserve of the public sector and the privileged private sector, mainly white-collar employees. Employer contributions and fund earnings were untaxed and there was a very light tax on lump sums with five per cent of the total added to an individual's income in the relevant year. Superannuation pensions, by contrast, were almost fully taxed. Industry superannuation started to take off around this period, extended initially by incorporating it into awards and subsequently by the mandatory superannuation guarantee system.

Conceptually, superannuation can be taxed at three points:

1. contributions can be treated as income in the fund or of the individual and taxed
2. fund earnings can be taxed to the fund or the individual

3. beneficiaries can be taxed when they receive payouts from the fund.

The tax options can be summarised as:

- T = tax at full marginal rates
- t = part tax
- E = exempt.

The Treasury tax expenditure benchmark implies TTE; the super industry favours an expenditure tax benchmark being EET (or the equivalent TEE). The pre-1983 system can be characterised as tEt; tax was paid on employee and self-employed contributions and on pensions and there was a very light tax on lump-sum payouts. Fund earnings were exempt.

In 1983, the Hawke/Keating Government introduced a new tax on lump-sum payouts levied at the rate of 30 per cent, although in cases where the lump sum was received by a beneficiary aged 55 or over the first $50,000 attracted a rate of 15 per cent. The tax was 'grandfathered', that is it applied only to payments made from contributions and accumulations in respect of employment after 1 July 1983.[2] There were some concessions for contributions by the self-employed but, in general, employee contributions were not concessional. This system thus continued to be of the tEt type.

In 1988, the same government decided to bring forward superannuation tax revenue by taxing employer contributions and fund earnings, at the same time reducing the tax on lump sums below the threshold to zero and on those above the threshold to 15 per cent. Income streams continued to be taxed at personal rates but a 15 per cent tax rebate was introduced to compensate for tax paid in the accumulation stage.

The system thus became type ttt but as all three ts were at a low rate, the system as a whole was concessional compared to the Schanz-Haig-Simons comprehensive income benchmark (see Definitions, Appendix A). This can be confirmed by Treasury estimates of the superannuation tax expenditure in the relevant years, which continued to be substantial, with available concessions requiring many retirees to pay very little tax on their income streams.

In order to limit the overall concession for high-income earners, reasonable benefit limits (RBLs) were introduced from 1 July 1988. Prior to this date, a super fund was able to pay either a lump sum of seven times final average salary or a pension of 75 per cent, regardless of income level. The RBL system reduced the maximum percentages as the level of salary increased, with the pension RBL approximately double the lump-sum

[2] The tax could be reduced by spreading out the lump sum into smaller increments, known as an allocated pension.

RBL. The RBLs were later supplemented by age-based contribution limits designed to discourage excessive contributions by the self-employed.[3]

In 1992, the Superannuation Guarantee (SG) was introduced, requiring employers to contribute for their employees at a gradually increasing percentage of gross salary, which reached nine per cent in 2000.

In 1996, the superannuation surcharge introduced by the new Coalition Government was designed to bring an element of progression into the system by adding an extra 15 per cent tax to employer contributions on behalf of high-income employees. In its last year (2004–05), the income threshold at which an employee's income was considered 'high' was $99,710 and the tax applied in full when income reached $121,075. The surcharge was mainly paid by the fund on behalf of the employee with the amount deducted from accumulated benefits. Certain termination payments were also affected.

The surcharge was extremely unpopular with the industry, tax professionals and high-income earners generally, administratively very expensive and raised relatively little revenue. It was scrapped in 2005. Revenue loss was estimated to be $2.5 billion over four years; thus the surcharge had only a minor impact in reducing the quantum of super tax concessions as reflected in its relatively high threshold. It was, however, one of the few progressive elements in the entire system.

In 1998, the capital gains tax rate for super funds was reduced to 10 per cent[4] and a year later an 18 per cent tax rebate was introduced for up to $3000 of contributions made on behalf of a low-income spouse. A low income co-contribution scheme began on 1 July 2003 (see details below).

Since 2005, transition to retirement (TTR) rules have allowed people aged at least 55 and less than 74 to access part of their entitlement while still working, provided the money is used to purchase an income stream.

The Coalition Government's Simplified Superannuation reforms, announced in July 2006 and effective in 2007, changed the super tax system to ttE by scrapping taxes on payouts for those 60 and over[5] but keeping the contribution and fund tax rate at 15 per cent, well below the marginal tax rate of most individuals. The result was that the system became even more concessional.

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[3] In 2005–06, the age-based limits were reached with a contribution of $17,804 for those under 35, $52,413 for those aged 35 to 49 and $132,449 for those aged 50 to 70.

[4] In fact, the tax rate for super funds remained at 15 per cent but the funds were only required to declare two thirds of any capital gain, effectively reducing the rate to 10 per cent. Capital gains tax for individuals and trusts was halved but indexation was abolished for all taxable entities.

[5] A lump-sum tax continues to be levied on those retiring under age 55 (20 per cent) and those retiring aged 55 to 59 (15 per cent beyond a threshold of $140,000). RBLs, previously $649,000 for lump-sum benefits and $1.298 million for pensions, were scrapped. Very large lump sums can now be accumulated consistent with the $50,000/$150,000 contribution limits. The 2006 changes also scrapped the tax on pensions for those over 59, previously taxed at marginal rates less a tax offset of 15 per cent. These tax offsets, together with the senior Australians tax offset (SATO), meant that retired couples could earn more than $50,000 per annum without paying tax.

Abolishing the lump-sum tax mainly benefited the well-off whose retirement payouts exceeded the then $130,000 threshold—thus it applied only to the wealthiest 25 per cent of retirees (ACOSS 2006, p. 25). RBLs were abolished and instead the reforms imposed a $50,000 per annum limit on tax deductible contributions with a higher transitional limit ($100,000) applying to those over 49 years of age. A $150,000 per annum limit was applied to non-concessional contributions.

These reforms also reduced by half the taper on the age-pension asset test. Whatever the merits of this decision, it did reduce the scope for the asset test to 'claw back' some of the super tax concessions. If the then government was concerned about the long-term costs of an ageing population, it was not demonstrated in this package of measures.

The tax payable on superannuation benefits did not, at that time, raise much revenue. The cost of the Simplified Superannuation package was put at $2.4 billion in 2008–09 but over half of this relates to the easing of the pension asset test.[6] The reality is that relatively little revenue was collected from taxing end benefits, with many of those affected by the lump sum tax electing to take an income stream, which was taxed very concessionally.

However, projections showed that lump sum tax revenue would have grown considerably over the years (Davidson and Guest 2007). The 2007 changes, in particular, have resulted in many people coming to the view that the system has become significantly unfair and open to abuse.

The history of the taxation of superannuation in Australia is summarised in Figure 2.

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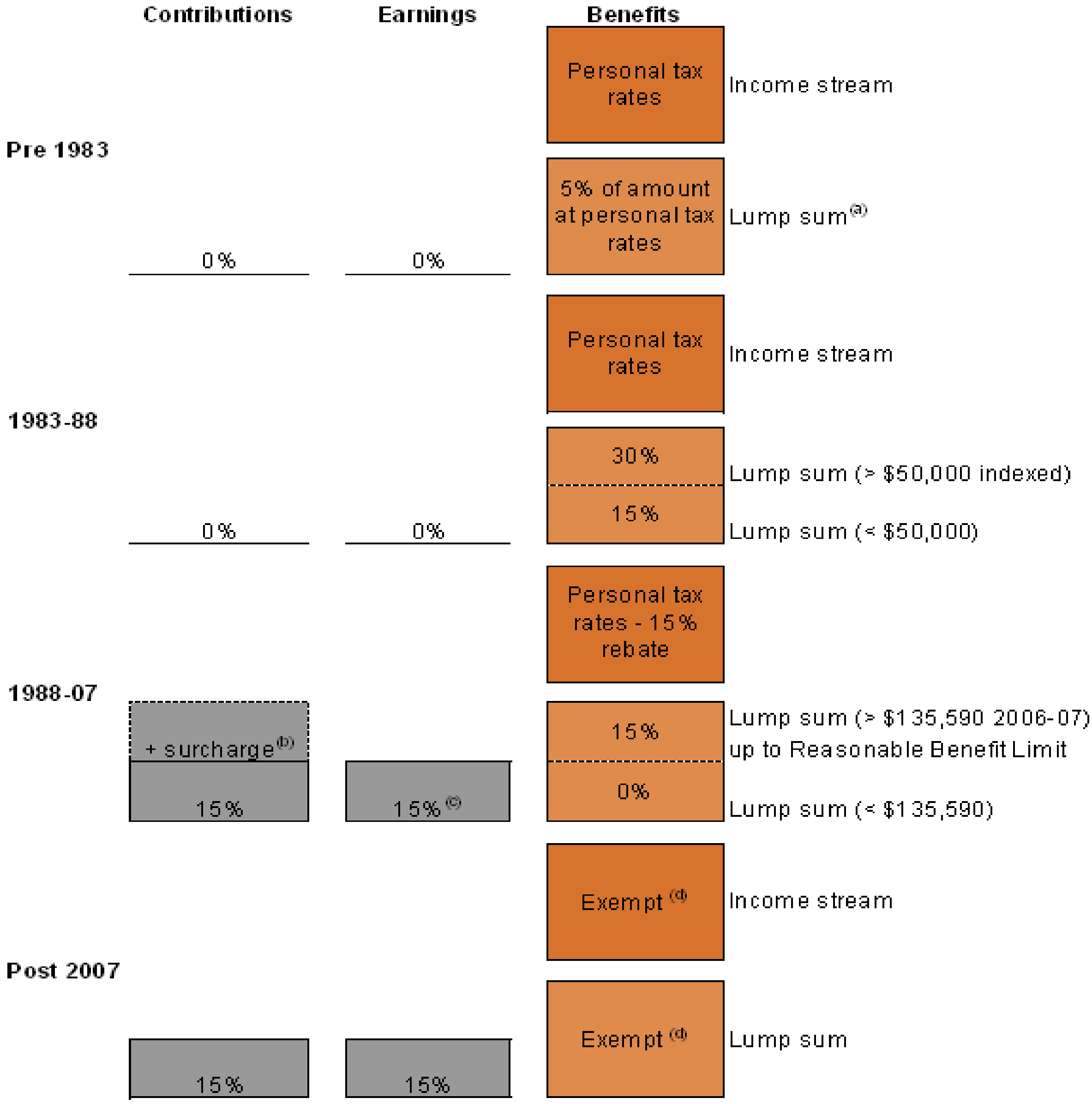
[6] See Clare 2009 p. 25.

Figure 2 History of the taxation of superannuation



Source: Treasury 2008b, Appendix B, Chart B.1.

Notes:

a) This resulted in an effective tax rate no greater than three per cent depending on the individual's personal tax rate.

b) The surcharge applied between the 1997–98 and 2004–05 income years.

c) Earnings on income stream assets were exempt. Capital gains are taxed at an effective rate of 10 per cent.

d) Different rates apply to people who take their benefits before age 60 years and payments from funds that have not paid tax on their contributions and earnings.

Current superannuation tax concessions in Australia

Contributions

Contributions to a super fund made by an employer on behalf of an employee, including those under salary sacrifice arrangements, are not included in the employee's personal income and are taxed at a flat rate of 15 per cent in the fund instead of at the employee's marginal income tax rate. There is a $50,000 per annum (indexed) ceiling on this concession (temporarily $100,000 if the employee is aged over 49).

Those who are not on a wage, including the self-employed, can claim a tax deduction for their personal contributions. These are taxed at 15 per cent in the fund subject to the indexed annual limit of $50,000. Personal contributions by employees are made from after-tax income and hence these are fully taxed before being paid into the fund, although they may attract a 150 per cent co-contribution from the Commonwealth Government of up to $1500 per annum if personal income is less than $60,342. Such contributions are not taxed in the hands of the super fund. An annual limit of $150,000 (indexed) applies to non-deductible contributions.

The concession for contributions made by low-income employees and the self-employed is known as the co-contribution scheme. Under this scheme, post-tax contributions are matched at $1.50 for every dollar up to a maximum contribution of $1000, phasing out as incomes exceed $30,342 and ceasing entirely when incomes exceed $60,342.

There is a low take-up of this benefit, with only 20 per cent of those potentially eligible using it (Treasury 2008a, p. 245). The cost is $1.2 billion per annum.[7] It has been suggested that the co-contribution is mainly taken up by the better-off section of the target population, including those with low personal income but well-off spouses or parents (Borowski 2008, p.7). There is also an 18 per cent concession for contributions made for a low-income spouse, costing only $8 million per annum.

The effect of this system is that there are at least three different tax regimes applying to superannuation contributions:

- employer contributions, along with salary sacrifice and self-employed contributions, are taxed only in the hands of the fund at 15 per cent
- employee contributions are fully taxed as income but may benefit from some co-contribution
- low-income spouse contributions are fully taxed but receive an 18 per cent rebate.[8]

[7] The co-contribution is treated as a non-concessional contribution for tax purposes and thus no fund tax applies. This adds $300 million to the cost of the tax expenditure of $900 million. To be eligible, an individual must be under age 71 and must be ineligible to claim a tax deduction for their personal contributions.

[8] There are also inconsistencies in contribution rules. An individual can make contributions up to age 65 without having to work but must work (a bit) to make contributions after 65 years. The SG is paid up to age 70 years. After turning 70, an individual is not paid SG but can utilise salary sacrifice up to age 75.

Earnings in the fund—accumulations

In addition to the 15 per cent contributions tax, the earnings of super funds are taxed at a 15 per cent flat rate. Capital gains are taxed at 10 per cent if the asset has been held for 12 months.[9] Earnings in the fund are not taxed when an individual's account begins to be paid out as an income stream.

Payments to beneficiaries

Superannuation benefits derived from previously taxed contributions and accumulations are exempt from tax when paid to beneficiaries aged 60 or more, while such benefits paid before age 60 are taxed at concessional rates. Where the benefit is paid from a fund that did not pay tax on its contributions and earnings, such as many government sector funds,[10] tax is paid on the benefit but at a lesser rate after age 60 (a 10 per cent rebate applies).

Benefits that can be traced back to contributions made from after-tax income or capital are also tax-free to recipients.

This is a much simplified version of the rules. For more details see Treasury 2006, 2008a, p. 25 or the Australian Taxation Office website.

The cost of superannuation tax concessions

Although both employer contributions and fund earnings are currently taxed, the applicable rate of 15 per cent is much lower than most members' marginal rate, which for the majority of wage earners is 31.5 per cent. In addition, earnings by the fund are not taxed when the individual begins to receive an income stream. As noted above, benefits for those aged 60 or over are tax-free if the benefit is from a taxed source and are otherwise taxed concessionally. Superannuation pensions from untaxed sources should theoretically be taxed at full marginal rates; in fact a special rebate applies.

There is controversy over the true cost and extent of the superannuation concessions and various models are used to develop costings.

In calculating the value of superannuation concessions, the Treasury benchmark is the Schanz-Haig-Simons comprehensive income base where contributions and fund earnings are taxed as income at the employee's marginal rate (TTE), contributing an extra $11.5 billion and $12.2 billion respectively (Treasury 2009). The capital gains discount for funds costs $.6 billion and the low income co-contribution $1.2 billion.[11] With other adjustments, this totals $24.2 billion in 2008–09.

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[9] When the capital gains regime was changed in 2000, the one third reduction in the capital gains of super funds subject to taxation was 'designed to be a broad offset for the loss of indexation but has been set on the generous side' (Treasury 1999, p. 78).

[10] In the past many government sector schemes were unfunded or only partly funded.

[11] The capital gains discount was $1.4 billion in 2007–08. The low income contribution estimate is from Treasury 2008c. It does not appear to be included in Treasury 2009.

Organisations like the Association of Superannuation Funds of Australia (ASFA) and many academics regard the cash flow expenditure tax benchmark as more relevant. An expenditure tax base is extremely kind to capital accumulation because the tax rate on savings is effectively nil. This model considers that only payments, either as lump sums or pensions, should be taxed at the relevant marginal rate and all contributions and fund earnings should be tax-free (EET).

The problem with this approach is that if the expenditure tax is accepted as the appropriate way to tax savings, it should logically apply to all savings and not just to superannuation.[12] While we continue to use the income base as the basic approach to capital income taxation, departing from it in one specific area does not appear to make a lot of sense and distorts savings decisions.

This conclusion is reinforced by the observation that we already tax expenditure in both pre-paid and post-paid forms through the payroll tax and the GST systems respectively and the government has the ability to shift in the direction of expenditure taxation by increasing the weight of these taxes in the overall mix. Since it has ruled out the option of heavier reliance on the GST in the Henry Review's terms of reference, there is an implicit presumption that the current mix of income and expenditure bases is appropriate.

An alternative to the cash flow expenditure tax benchmark, which has a similar present value, is the pre-paid expenditure tax based on direct taxation of labour income with an exemption for saving. Treasury estimates that tax expenditure according to this benchmark (TEE) was $4.6 billion in 2007–08 (2008b, Box 3.1). The cost under a post-paid expenditure tax benchmark (EET) is not estimated but is expected to be less (more revenue flows in later years under the post-paid alternative).[13] The TEE approach is seen by Freebairn and Scutella (2008) as having some advantages, notably that it equates superannuation tax with the tax treatment of owner-occupied housing.[14] On balance, however, they appear to favour the EET approach (2008, p. 4).

This use by Treasury of the TEE expenditure tax benchmark for costing superannuation concessions represents a small victory for the superannuation industry, which has been lobbying against the comprehensive income benchmark. The effect, if the TEE benchmark were to become widely adopted, would be to conceal the true cost of the tax preferences for superannuation and reduce pressure to reform the system. But it also suggests that, at the very minimum, tax expenditures on super should be reduced by $4.6 billion. No-one suggests there should be a more lenient treatment than the expenditure tax benchmark.

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[12] This is indeed an option likely to be considered by the Henry Review.

[13] The cash-flow or post-paid expenditure tax employs EET, with tax payable at the individual's marginal rate. Alternatively, a similar effect can be realised with TEE; although the timing of tax receipts is different, the net present value is similar (this is known as the 'tax pre-paid' form of expenditure tax). The two taxes are not precise equivalents since the TEE advantages lucky or clever savers able to get a better return than the average, and marginal tax rates may not be the same at the time of earning and at the time of benefit receipt.

[14] In the comprehensive income benchmark, the tax treatment of owner-occupied housing is concessional because imputed rental income, that is the value of the flow of services from the asset, is not taxable.

Another argument is based on the observation that the current system uses both income and expenditure tax concepts to tax capital income and is actually a hybrid of the two. From this perspective it is not clear, *a priori*, in which direction reform should head although it is probable that a more consistent application of either concept would enhance economic efficiency. Although an expenditure tax has been promoted as a means of taxing capital income more evenly, it is not the only means. Treasury draws on a study by Banks and Diamond to suggest that 'more recent literature has cast doubt on the premise that expenditure taxes are necessarily superior to income taxes' (2008a, p. 216).

A further issue is that the cost of the concessions is distorted by inflation. The tax expenditure concept used by Treasury assumes full taxation of nominal income but it is arguable that this results in an over-estimation of fund income and hence of revenue forgone.[15] Against this, the measure of capital gains used in the Treasury concept is a realisation measure whereas an accrual measure is conceptually more appropriate. Under modest rates of inflation, these two adjustments broadly cancel out.[16]

Behavioural changes, which reduce the potential revenue to be recouped as a result of removing the concessions, also need to be considered. For example, voluntary contributions to superannuation would likely fall. These potential losses in revenue would be ameliorated by the compulsory nature of the SG.

The 2006 Warburton and Hendy report to Treasury, which compared international tax regimes with that in Australia, was unable to reach clear conclusions as to the relative weight of tax systems on retirement savings. Drawing on two other studies, they indicate that 'the Australian retirement savings regime, like those of other countries, is concessional compared to the taxation treatment of other savings'.

However their two source papers came to contradictory conclusions about the effective tax rates on private pension savings. 'Whitehouse (1999) indicates that the concession offered … is the third highest in the OECD-10. In contrast, Yoo and de Serres (2004) indicate that Australia has the second-highest effective tax rate applying to private pension savings out of the OECD-10. This contradiction cannot be reconciled because of methodological issues with both papers' (Warburton and Hendy 2006, p. 225). Both these studies are now out-of-date as concessions increased in the 2007 reforms.[17]

[15] Total superannuation assets are around $1.1 trillion and the long-term average nominal yield about seven per cent or $80 billion per annum after administrative costs. About $20 billion of this is attributable to the impact of inflation, making the real yield about 4.5 per cent per annum.

[16] In theory, increments in the value of an investment should be taxed each year as they accrue. In practice, most capital gains tax regimes employ a realisation basis where gains are measured when the asset is disposed of. This gives an advantage to long-term holders of assets. Assume the nominal return on superannuation savings is seven per cent per annum and the real return is 4.5 per cent. Of the seven per cent, assume four per cent is declared income and three per cent capital gain. Assuming 15 per cent of capital gain is realised each year, the nominal tax rate required to approximate a real 30 per cent tax rate is also around 30 per cent.

[17] These cost $2.4 billion over three years. Clare (2009) states that the changes to the asset test for the age pension, which halved the imputation rate, accounted for over half of these costs.

The effect of tax concessions on aggregate savings

Superannuation tax concessions obviously do not affect contributions mandated under Australia's SG system, which are set at nine per cent of gross salary.[18] However, a faster rate of compounding, as permitted by tax concessions, would increase the assets that are accumulated by those subject to the SG and also provide an incentive to contribute above the SG rate. The average extra contribution across all employees is 3.5 per cent, bringing the aggregate contribution rate to 12.5 per cent.

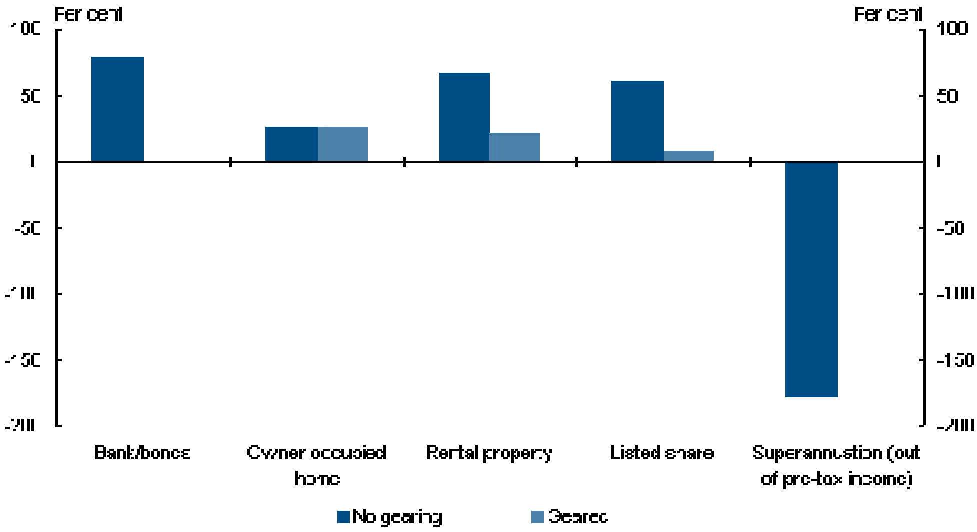
Treasury notes that 'The empirical literature on the effectiveness of tax-preferred retirement savings plans in encouraging savings is mixed, with researchers finding effects ranging from significant impact on savings to no effect … If the concession results mainly in switching savings from one vehicle to another there may be no increase in overall household saving. *Indeed national savings may decrease if the value of additional savings is less then the cost of the concession to governments'* [italics added] (Treasury 2008a, p. 243).

Treasury also notes the OECD's conclusion that the success of the policy in encouraging new savings depends on the level of take-up by moderate income households. Higher-income households are more likely to respond to superannuation tax concessions by simply shifting their savings from other investment vehicles into superannuation with no actual increase in the rate of savings. This is a concern because, as outlined below, the incidence of tax expenditure on superannuation is highly regressive and, as a consequence, there is reason to believe that the concessions are relatively ineffective in increasing aggregate household savings. This conclusion is further reinforced by the compulsory nature of much of the superannuation savings in Australia.

Tax concessions for certain preferred types of saving such as superannuation divert savings into the favoured categories. Treasury calculations suggest that the effective marginal tax rates on superannuation savings are substantial and negative; taking inflation into account, the real tax rate on superannuation savings is negative 180 per cent compared to a real rate on bank deposits or bonds of almost 80 per cent.

[18] The SG does not apply to those earning less than $450 per month, to employees under age 18 and working less than 30 hours per week or to those over 70.

Figure 3 Real EMTRs by asset type and financing arrangement



Source: Treasury 2008a, Chart 8.4

Assumptions:

- Calculated for an individual taxpayer on a 46.5 per cent marginal tax rate; assets held for seven years; inflation of 2.5 per cent; six per cent nominal return. Gearing is 70 per cent, not applicable to bank/bonds and superannuation. Tax on debt providers is disregarded.
- For property, 70 per cent of the return is attributable to capital gains and 30 per cent to rent. A three per cent conveyancing duty is assumed on the acquisition value and annual rates are applied at 0.6 per cent of the value. Land tax applies to rental property at the same rate as annual rates.
- The 'listed share' is a company holding an asset taxed on an accruals basis. The company retains 50 per cent of its profits each year. There is no duty on the purchase or sale of the listed share and accrued franking credits are assumed to be fully valued by the market.
- For superannuation, the taxpayer makes a one-off contribution at the beginning of the period out of pre-tax income and is eligible for a tax-free payout at the end of seven years.

This disparity disadvantages the unsophisticated or badly-advised saver. There would appear to be strong arguments for making the overall taxation of savings more neutral by reducing both the concessionality of superannuation savings and the tax on some un-geared investments, for example through indexation of the tax base (but this is very complex).

It is sometimes suggested that superannuation savings are long-term in nature and therefore warrant special treatment. However, it is nearly impossible to say that some savings are short-term and others long-term. Is someone saving for a house deposit making a short-term commitment? Moreover, whether short- or long-term, *all* savings, not just superannuation savings, contribute to the aggregate savings rate, which is probably an appropriate focus for policy concern.

Theoretically, the aim of policy should be to equalize real effective tax rates on all asset types and financing arrangements and allow people to allocate funds to different investments in accordance with their own priorities, uninfluenced by tax. If aggregate saving is a concern, the best responses are either to raise the level of the SG, to increase government savings or else to lower the general tax burden on investments. It is difficult to make a convincing case for creating particular tax-favoured forms of investments.

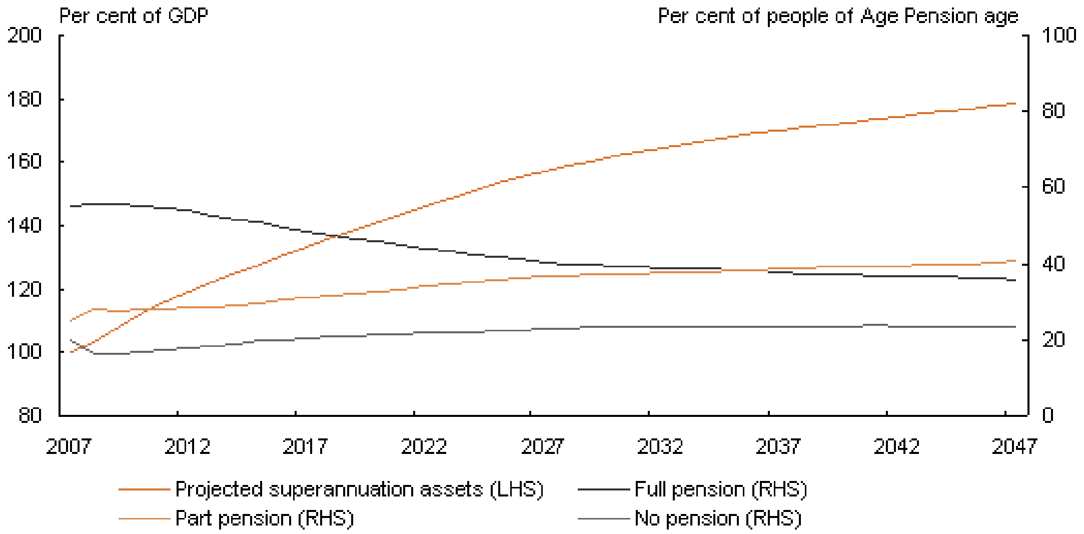
The OECD comments above suggest that tax concessions for superannuation in Australia are very likely to cost more in government savings than they are to boost private savings. There is also the paradox that, in general, we subsidise compulsory savings more than we do additional member contributions.[19]

The effect of tax concessions on demand for the age pension

Super tax concessions do not efficiently reduce budgetary pressures arising from the ageing of the population. Even when the SG scheme matures, projections show that the bulk of the aged, almost 80 per cent, will continue to receive a full or part age pension. Rothman suggests that this 'shows that for a typical worker earning around AWOTE,[20] retirement income is made up about equally from private sources and from the age pension' (2007, p.17). Figure 4 reveals that, even when the SG is fully mature, almost 40 per cent of the aged will receive a full pension and another 40 per cent a part pension (up from 30 per cent currently). Only 22 per cent will receive no pension, a slight rise from the current 18 per cent.

The increased incidence of part pensions is probably a healthy sign, reflecting the impact of superannuation in topping up a modest age pension. But the point is that superannuation tax expenditures are never recouped. Reflecting this, age pension expenditure is expected to grow from 2.5 per cent of GDP in 2006–07 to 4.4 per cent in 2046–47 (Treasury 2008b, p. 2).

Figure 4 Superannuation and age pension coverage



Source: Treasury 2008b, Chart 6.1

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[19] A conclusion mitigated at low incomes by the presence of the co-contributions and at high incomes by the opportunity for salary sacrifice.

[20] Average weekly ordinary time earnings.

Adequacy of retirement incomes

There is no possibility of recouping tax concessions through pension savings either. The cost of the tax concessions is far higher than the potential savings from abolishing the age pension means test, calculated at $6.5 billion.[21]

Superannuation tax concessions, together with private savings and the SG, contribute towards the adequacy of retirement incomes. Rothman and Bingham (2004) concluded that most baby boomers, due to a combination of the SG and the age pension, are likely to achieve retirement spending power equivalent to at least the 'modest but adequate' budget standard developed by the Social Policy Research Centre (SPRC) at the University of New South Wales.

For a single person, this standard is about $18,500 per annum, around a third higher than the age pension of $14,615 per annum. Adequacy is projected to rise as the SG matures, reaching full maturity about 2030. This conclusion, which is consistent with that of Morrison and Kelly (2008)[22] and Treasury (2000b), would not be much affected by any of the policy options discussed in this paper as they mainly affect higher-income earners with retirement incomes well above the 'modest but adequate' standard.[23]

Adequacy can also be measured by replacement rates, comparing income or consumption pre- and post-retirement. When the SG matures, Australian replacement rates will be broadly consistent with, and may well be higher than, OECD averages. The current OECD average replacement rate for a single earner on the average wage is 84 per cent; reforms to lower the cost of ageing will result in the average replacement rate falling to 70 per cent by 2040 (Treasury 2008b, p. 4).

Rothman (2007) takes into account the 2007 changes and estimates that, for the representative fifth decile of employment income, the replacement rate is currently a modest 52 per cent;[24] it will rise strongly to reach 60 per cent by 2010, 70 per cent by 2015 and 85 per cent by 2030. For the population as a whole, the estimated replacement rate in 2030 will be no less than 95 per cent.

Significantly, if we rank the population by income deciles (tenths) with 1 being the lowest and 10 the highest, we find that projected replacement rates over deciles 2 to 8 rise with income (Rothman 2007, p. 12). For example, they will reach 90 per cent for the high-income Decile 8 compared with 85 per cent for Decile 5 and 80 per cent for the low-income Decile 2.

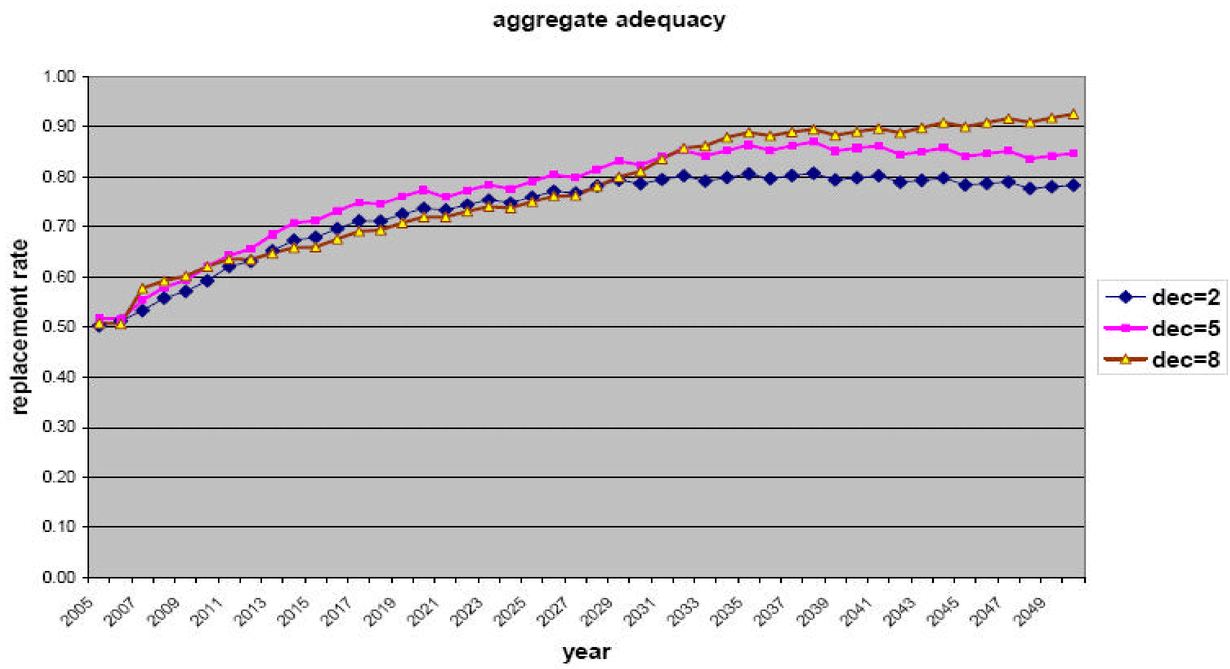
[21] Cited in Clare 2009, p. 4.

[22] This NATSEM paper looks at the whole picture of retirement living standards, not just gross income from super and pensions. It builds on work originally done by Anthony King.

[23] The SPRC standards have been updated by the Westpac-ASFA retirement standards. For a discussion, see Clare 2009, p. 19.

[24] Calculation of replacement rates is fraught with difficulty; for example, are we comparing income or consumption? For a discussion, see the references in the text.

Figure 5 Potential aggregate replacement ratios for selected deciles



Source: Rothman 2007, p. 12.

Morrison and Kelly of NATSEM (2008) calculate lower replacement rates than Rothman does and find a pattern of replacement rates declining with higher earnings. Part of the difference results from Rothman's inclusion of savings outside of superannuation and voluntary contributions. This is illustrated clearly in Treasury 2008b where Table 1.1 shows replacement rates declining as income rises whereas Table 2.3 shows that the inclusion of savings outside the SG dramatically raises replacement rates to levels consistent with Rothman's 2007 projections.[25]

Morrison and Kelly note that the 2007 changes will increase living standards in retirement compared with the old rules. 'However there is little if any improvement for low income earners. Middle (average) income earners see modest improvements while the biggest improvements are enjoyed by high income earners' (2008, p. iv).

The failure of Treasury's projected replacement rates to fall as incomes rise indicates that the regressive impact of the superannuation system and its associated tax benefits overwhelm the progressive effect of the means-tested age pension system. This is a remarkable finding. It clearly illustrates the movement of the Australian retirement income system away from a target of *income security* and towards a target of *income maintenance*. But there has never been any real public debate about the relative merits of these alternatives.

Clare, Director of Research at ASFA, argues that the retirement income system in Australia has moved from a poverty alleviation focus to 'one where the emphasis is on

[25] This should not surprise—Rothman is one of Treasury's senior modellers.

achieving a modest or comfortable standard of living in retirement' (2009 p. 6). But according to Treasury analysis it has gone much further than this. That is not to dispute the ASFA argument that most of those *currently* about to retire have fairly modest entitlements (Clare 2009, p. 5–6).

It is clearly a moot point as to whether public policy should strive to achieve high replacement rates at all income levels or merely an adequate basic income. Probably most people would accept that there is a role for an income maintenance element in the system but it is less pressing with higher incomes. At the very least, these projections suggest that we may have gone too far in the direction of promoting the income maintenance objective through tax concessions. Reform options canvassed in this paper attempt to swing the pendulum at least a little in the other direction.

Incidence of super tax concessions

Super tax concessions flow overwhelmingly, and to an extraordinary extent, to the well-off. They apply to those earning incomes at and beyond the 30 per cent marginal tax rate threshold ($34,000 per annum and over) and particularly to those earning incomes attracting the higher marginal tax rates of 41.5 per cent ($80,000 per annum) and 46.5 per cent ($180,000 per annum). By contrast, almost no net benefits flow to people earning below $34,000 per annum except where such people are able to take up the co-contribution or in the pension phase when fund earnings are exempted. Treasury (2008a) estimates that 1.2 million individuals receive no benefit from their concessional superannuation contributions tax rate and a further 1.2 million only a 1.5 per cent benefit, equivalent to the Medicare levy.

Because women tend to earn less than men and more often work part-time, they are substantially disadvantaged by comparison. This is exacerbated by their tendency to take time out of the workforce caring for children.

Treasury notes that: 'The proportion of concessions that flow to individuals on higher personal tax rates has been increasing in recent years … For 2005–06, it is estimated that 5 per cent of individuals accounted for over 37 per cent of concessional superannuation contributions' (2008b, p. 4). Treasury does not provide a comparable figure for the fund earnings concessions benefit but it would be of a similar order.

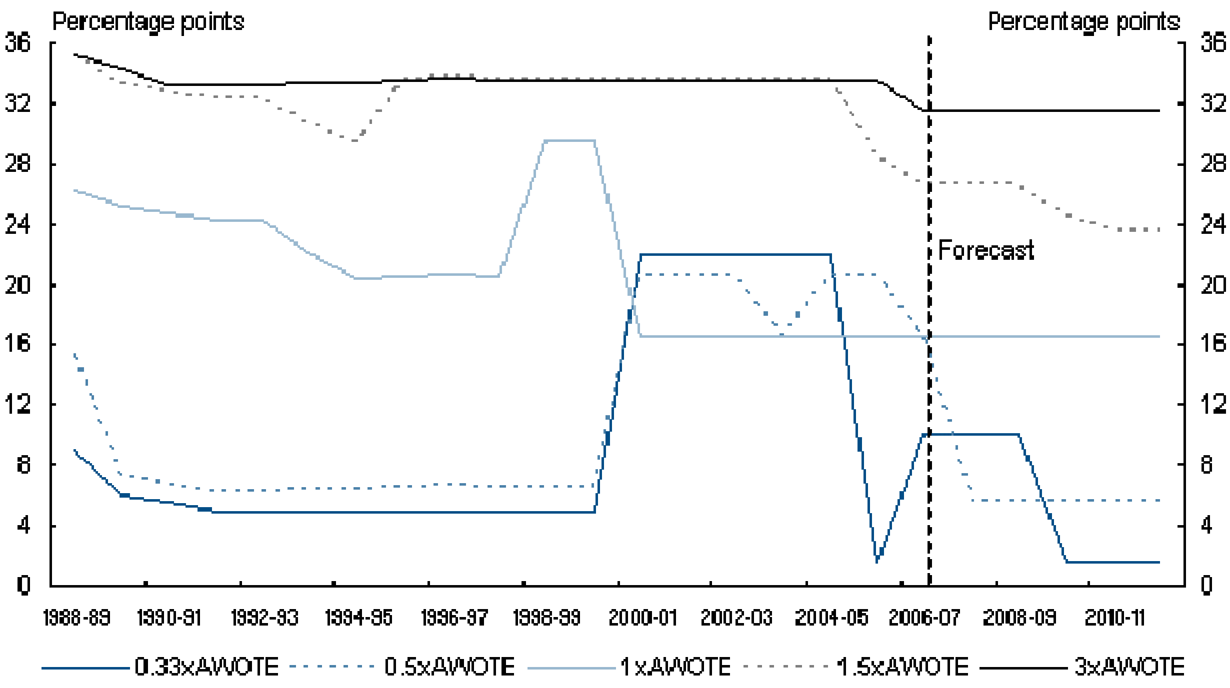
For a 50-year-old on $300,000 per annum and a marginal tax rate of 46.5 per cent, for example, the concessions on a maximum contribution of $100,000 are $31,500 per annum. If the person is aged less than 50, the maximum contribution is $50,000 and the concession is $15,750. If the lump sum is $1 million, at a return of seven per cent the fund earnings concession is another $22,050, a total of $53,550/$37,250 per annum. By contrast, the maximum age pension for an individual is $14,615 per annum.

The value of the concessions to low-income earners subject to social security means tests might be understated in these calculations. For such people, effective marginal tax rates can be very high and the value of the tax concession correspondingly increases. Account also needs to be taken of the co-contribution.

There are generous limits to these concessions. The old RBLs, designed to cap the benefits to the well-off, were abolished in 2007. Concessional contributions are limited during the accumulation phase, with an annual cap of $50,000 indexed to AWOTE.[26] Non-concessional contributions are limited to $150,000 per annum. Lump sums and associated payouts are without limit. Over a working life contributing at $50,000 per annum (admittedly an extreme example), a person could quite feasibly accumulate $5 million in superannuation and much more if use were to be made of the non-concessional contribution limits.[27]

Treasury has documented the progression of effective marginal concessions on superannuation contributions over the decade to 2011 in their discussion paper, *Architecture of Australia's tax and transfer system*, (2008a, p. 245). Figure 6 shows that the concession on high incomes of three times AWOTE has been fairly steady at around 32 percentage points whereas for all lower incomes it has declined and, in the case of those on one-third AWOTE, has fallen to 1.5 per cent (there is no Medicare levy on their contributions).

Figure 6 Effective marginal concession on superannuation contributions



Source: Treasury 2008a, Chart 7.13.

[26] For those over 50 the annual cap is $100,000 until 2011.

[27] Employer contributions in excess of the caps are subject to extra tax which is imposed on the employee.

The table below shows projections of average nominal superannuation assets by income decile.

Table 1 Projections of average nominal superannuation assets by income decile

Decile	2010–11, $1000		2040–41	
	Women	Men	Women	Men
2	48	70	83	120
5	65	101	161	234
8	116	193	348	478
10	258	459	739	936

Source: Rothman and Tellis (2008, p. 22).

The importance of this projection is that the low tax on fund earnings (especially capital gains) benefits higher income earners disproportionately, with the concession rising not only with the size of the accumulated benefit but also with the size of the marginal tax rate applicable. High net-worth individuals also benefit from longer life expectancies.

Kelly (2003) suggests that wealth inequality will rise substantially over the next 20 to 30 years as a result of the ageing of the population. By 2030, almost half of all wealth will be held by retirees, a trend which will obviously be exacerbated by the regressive nature of the tax expenditures related to superannuation.

Superannuation is the most popular item in salary sacrifice arrangements with 520,000 employees taking advantage of the facility. The average amount sacrificed is $180 per week (Treasury 2008a, p.18). This is overwhelmingly an arrangement for high-income employees. As described below, there is also a tax dodge involved in taking a largely untaxed transition to retirement (TTR) pension before final retirement while salary sacrificing into super at the same time in order to reduce the effective tax rate on total income. How this could be a socially useful arrangement is a mystery.

Some obvious rorts

Combined with the 2007 changes, TTR pensions have opened up a rort with people taking a low or zero-taxed TTR pension and simultaneously salary sacrificing into super in order to drastically reduce their taxable income. The extent of the savings available is documented in Table 2, which shows a reduction in net tax of $4,725 per annum on a $50,000 per annum salary and of $11,150 per annum on a $100,000 per annum salary, assuming a 50 per cent salary sacrifice. Borowski notes: ‘TTR … was originally intended for those who wanted to reduce their working hours but maintain their spending capacity. Since the 2006 Budget changes, however, “it has morphed … for the over-60s [worker] into a full-blown tax arbitrage opportunity”’ (2008, p. 9).

Table 2 Transition to retirement strategy—tax impact

	Salary	
	$50,000 **$**	**$100,000** **$**
Without transition to retirement		
Income tax and Medicare	8,850	27,500
Net income	41,150	72,500
With transition to retirement		
Salary sacrifice	25,000	50,000
Superannuation income	16,525	31,350
Income tax and Medicare on remaining $25,000/$50,000	375	8,850
Tax on super contributions	3,750	7,500
Net income	41,150	72,500
Reduction in total tax	4,725	11,150

Source: Treasury 2008b, Table 3.2.

Note: Tax scales for 2008–09 are used. The individual is assumed to have no income other than salary and is aged 60 to 64 years. The examples are constructed to achieve the same after-tax income; that is, the tax saving is applied to achieve higher superannuation balances. To receive a TTR pension of the amounts shown, the individual must have a superannuation balance of at least 10 times the pension.

Even without utilising the TTR strategy, it seems absurd that someone approaching retirement and in a position to defer income for a few years can use superannuation salary sacrifice to dramatically lower their average tax rate. This is not an option available to the average working family.

Abuse of the TTR rules is not the only rort. Under the new rules an older parent can be given a sum of money by an adult child to contribute to a super fund. This sum and its earnings can be withdrawn at a later stage completely tax-free and returned to the adult child. 'Such tax avoidance is obviously "offensive from a policy perspective" …' (Borowski 2008, p. 99).

The 2006 reforms eliminating tax on end benefits are estimated to add an additional one per cent of GDP to the cost of population ageing, already projected to reach six per cent of GDP in 40 years (Davidson and Guest 2007, p. 5). Modelling by Davidson and Guest shows that a counter policy, namely taxing all superannuation benefits at 15 per cent, would have clawed back sufficient revenue to substantially offset the fiscal cost of population ageing (p.13). This indicates, perhaps, the cost of an opportunity foregone.

Fixing the problems

The Terms of Reference for the Henry Review indicate that tax-free payments for retirees 60 and over are to be preserved. However, this may not be the obstacle to reform it first appears to be. Indeed, the 2007 changes have made it easier to sort out the mess as there are now only two tax points, contributions and fund earnings. Benefits are to remain for the most part exempt, pointing reform efforts towards some variant of the comprehensive income tax benchmark taxing contributions and fund earnings but not benefits.

It would obviously be desirable to remove some of the present anomalies in the tax regime for superannuation. The most outstanding of these is the difference in tax treatment afforded employer, employee and self-employed contributions, which encourages artificial arrangements and is horizontally inequitable because the self-employed and those in a position to salary sacrifice receive much greater benefits than other employees. [28]

Possible broad approaches are as follows.

Option 1

Option 1 simply addresses some obvious anomalies, preferably in a manner that tends to reduce rather than raise assistance.

- One obvious step is to remove the tax exemption on fund earnings during the payout phase after the age of 55. This would save around $3 billion per annum.[29]

- A further option is to raise the fund capital gains tax rate from 10 per cent to 15 per cent,[30] saving a further $.6 billion.[31] The complication with these options is that they will impact on some retired people with incomes below the tax threshold, although many such people in fact face an effective marginal tax rate of 40 per cent due to the pension means test.

- Another obvious step is to disallow salary sacrificing into superannuation. This would save about $1 billion per annum.[32] Deductible contributions by non-waged people should be limited to nine per cent of taxable income, putting them on a par with employees and saving another $1 billion.

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[28] Salary sacrifice is not a right but rather a discretionary employment benefit. Moreover, only those with discretionary income are in a position to make these extra savings.

[29] It is here assumed that about a quarter to one-third of fund assets are in the payout phase.

[30] This would be achieved by the fund declaring the full extent of the capital gain instead of two thirds as is currently the case.

[31] It makes little economic sense to tax capital gains at a lower rate than other income as it distorts investments into forms yielding such gains. Also, capital gains enjoy the benefit of tax deferral, an advantage that increases the longer an asset is held.

[32] Five hundred and twenty thousand contributors times $180 per week times .20 average marginal tax rate increase = $1 billion.

- The co-contribution scheme could be reformed because a 150 per cent rebate makes no economic sense.[33] If the rebate were limited to, say, 40 or 50 per cent, the threshold could be approximately doubled to $60,000 (phasing out by $90,000), and the maximum subsidised contribution raised to $3000, thus giving many more people an incentive to contribute outside of compulsory superannuation.

The overall saving from Option 1 is about $5 billion per annum, assuming that any change to the co-contribution scheme is revenue neutral.

Option 2

Option 2 radically reduces the quantum of tax assistance. If there is concern about the adequacy of retirement incomes, one offset could be to raise the age pension. This would result in a retirement income system that is much more egalitarian but it has the downside of drastically reducing incentives for superannuation savings beyond the level of the SG. As discussed earlier, it is not clear how much effect these incentives have on the aggregate level of retirement saving. Nor is it clear that tax encouragement for high-income earners to achieve high replacement rates is a policy priority.

Option 2a

Under Option 2, an obvious step is to raise the 15 per cent tax rate on employer contributions and fund income. This could rise as high as the standard marginal income tax rate of 30 per cent. As for Option 1, the capital gains concession would be abolished. This '30:30' approach is a simple solution and would raise around $18 to $19 billion per annum (Option 2a). For most people, who pay a marginal tax rate of 30 per cent, this option would make the effective tax rate on concessional and non-concessional contributions the same.[34] Existing lump-sum taxes for those under 60 could be abolished.

Salary sacrificing would be allowed but it would provide little net benefit except to high-income taxpayers earning over $80,000 per annum. The co-contribution would be reformed along the lines of Option 1.

The downside of this option is that it disadvantages low-income earners (those earning less than the $34,000 per annum with a 30 per cent marginal tax rate threshold) and continues to advantage high-income earners (those earning over $80,000 per annum with marginal tax rates higher than 30 per cent).

[33] The issue here is the optimal tax rate on capital income. An expenditure tax treatment probably provides a lower bound on this tax rate, implying an effective tax rate of zero but not a subsidy. One problem is that the co-contribution is the sole progressive element in the entire system and the proposal waters this down a little. But the low take-up of the existing co-contribution shows that it is not an effective policy.

[34] Or almost the same, taking into account the 1.5 per cent Medicare levy.

Option 2b

A more refined solution is to tax contributions at the marginal rate of the employee. One approach is to reinstate the high-income superannuation surcharge in a much expanded form. A better option (2b) is simply to add employer contributions to the individual's taxable income in a given year. Fund contributions tax would be abolished as would be tax deductions for the self-employed and non-employees. PAYG withholding tax could be based on grossed-up wages (that is, wages inclusive of superannuation contributions made by the employer).

This option reduces tax payable up front in the fund but increases tax on the employee. It would be politically easier to implement if it were accompanied by a matching program of income tax cuts so that the aggregate tax burden did not increase. The alternative is to deduct tax from the monies the employer forwards to the fund. This would reduce super contributions, but so does the existing 15 per cent tax on contributions.[35]

Much greater difficulty applies to taxing fund income at the individual's marginal tax rate. For this, the 30 per cent linear tax might be the best approach.[36] Full marginal rate taxation of contributions raises $11.5 billion and the 30 per cent fund earnings tax another $9 billion (with capital gains fully taxed), a total of around $21 billion per annum.

If superannuation tax were to become less concessional, the issue would arise as to whether the SG would continue to be adequate. It might be deemed necessary to phase in a higher rate than nine per cent as contribution and fund income tax rates are increased. Note, however, that the above proposal reduces the tax paid by the fund while increasing that paid by the employee. Hence, contributions are effectively raised.

A further issue involves the reduced incentive to keep money in superannuation beyond the compulsory preservation age (all withdrawals would remain tax-free). For those paying less than the 30 per cent marginal tax rate, there is an actual disincentive. Low-income retirees would be well-advised to put their savings into other vehicles, such as managed funds, and draw them down as required. But since the result is to tax an individual's investment income at the appropriate marginal rate, this might not be considered a disadvantage. The greatest risk is that ill-informed savers will make poor investment choices; when their monies are confined within superannuation they tend, by default, to sensibly utilise a mixture of growth and other investments. Therefore, there might need to be new rules allowing super funds to offer non-superannuation balanced investment accounts.[37]

[35] This effect could be offset if any new tax rebate (see Option 3) were made payable to the fund. Net contributions from low- and middle-income earners would then increase.

[36] This is akin to the 'schedular' taxation of capital income used in some Nordic countries. It would be difficult but not impossible to tax fund income at full marginal rates. The fund would issue a taxable earnings statement to individual members at the end of each financial year; members would calculate their tax on a grossed-up basis; tax so calculated would be advised to the fund, which would then pay the tax on behalf of each member.

[37] Balanced accounts are those with a mixture of growth and capital-preserved assets. Such accounts would pay no tax but their earnings would be taxable to the individual.

Option 3

Option 3 preserves something like the current quantum of assistance but redistributes it from the wealthy towards those less well-off. The new allocation of assistance could be more egalitarian, for example with a ceiling like the co-contribution or merely proportional. The latter would still be a great improvement on the regressivity of the current system and would continue to provide a major incentive for saving through superannuation. This option would combine Option 2b with a new tax rebate for all super contributions from both employers and employees.

Option 3a

In the most egalitarian version, the new tax rebate would be subject to a low fixed ceiling. It would make sense to abolish the existing co-contribution in this scenario as it fulfils essentially the same purpose. A 50 cents in the dollar tax rebate would be paid up to a ceiling of about $2000 per annum,[38] costing around $17 billion per annum and raising $4 billion net in conjunction with Option 2b. (Additional savings would come from abolishing the spouse contribution rebate and the co-contribution.) Unlike the existing co-contribution, the rebate would not be confined to 20 per cent of the target population but would benefit SG and non-compulsory contributions alike.

Option 3a is similar to the approach of ACOSS (2002, 2006) and Disney (2007). These proposals combine the higher contributions tax with a new rebate subject to a ceiling. The ACOSS proposal is for a two-tier rebate (2006, p. 25); for example, 100 per cent for those earning up to 0.5 per cent of AWE plus 30 per cent for additional contributions up to 12 per cent of AWE.

Option 3b

The problem with Option 3a is that for those whose compulsory contributions exceed $4000 per annum, that is those with incomes higher than $45,000 per annum, there is no marginal incentive to make additional contributions towards superannuation. A way around this is to move to a simple proportional system whereby an individual's total contribution (employer plus employee) would attract a tax rebate of, say, 18 per cent of the total contributed up to $9000 per annum (Option 3b).[39] This would also cost roughly $18 billion[40] and save a net $3 billion in combination with Option 2b.

Compared to the current system, this brings the tax concession forward to where it is most visible while reducing the long-term cost escalation built into the system by virtue

[38] The existing maximum co-contribution is $1500. In costing the proposed rebate, the assumption is that there are 10 million contributors and a maximum cost of $20 billion, were they all to take up the maximum. This is discounted to reflect the fact that some of these contributors will not take up the maximum.

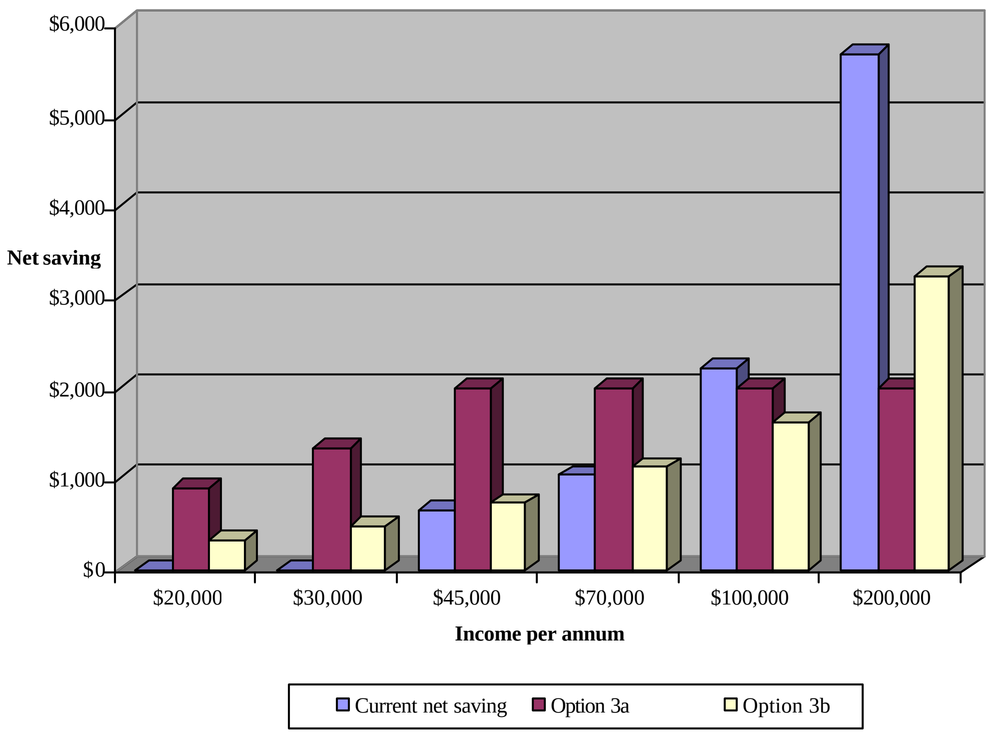
[39] Eighteen per cent of the existing concessional contribution limit of $50,000 is $9000.

[40] Total contributions to super are about $100 billion per annum (based on Rothman and Tellis (2008) who estimate $79 billion of contributions in 2005–06). An 18 per cent rebate thus costs $18 billion, assuming no behavioural change. For contributors on the 30 per cent marginal tax rate, the current system is equivalent to a rebate of 16.5 per cent. For those on the top marginal rate it is equivalent to 31.5 per cent.

of the low tax rates on fund earnings. It evens out the disparate treatment of different forms of contributions.

Figure 7 shows the incidence of the current system and the effect of options 3a and 3b, assuming that only compulsory contributions are made. The figure does not take into account the higher tax on fund earnings. It can be seen that both options raise net assistance for low-income earners and reduce that for high-income earners. Although the proportional rebate is regressive, it is nonetheless redistributive from high-income to low-income earners when compared with the current system.

Figure 7: Existing tax breaks for SG contributions only, and effect of options 3a and 3b ($pa)



Conclusion

It makes sense to reduce superannuation-related tax expenditures, which would never stand scrutiny as ordinary expenditure programs because of their extraordinary regressivity, but administrative issues make it difficult to implement the full Schanz-Haig-Simons approach. It would also be politically difficult to implement, notwithstanding that the revenues raised could be used very advantageously.

The paper canvasses three broad options for change.

Option 1 is for piecemeal reform: remove the exemption for fund earnings during the pension phase, remove the capital gains concession, disallow salary sacrificing into superannuation and reduce deductibility limits for non-wage contributors. There could also be a no net-cost reform of the co-contribution to make it less distorting and more widely available. These steps could raise about $5 billion per annum.

The second broad option (2a) is to increase taxes on contributions and fund earnings to around 30 per cent. This raises $18 to $19 billion but is rather a sledgehammer approach as it fails to account for the differing marginal tax rates of low-income and high-income contributors.

Hence a preferred approach, Option 2b, is to tax all contributions, including employer contributions, as income to the employee. The deductions available to the self-employed would be abolished. The tax rate on fund earnings could also be increased to 30 per cent and the capital gains concession abolished. This option would raise in the order of $21 billion per annum.

The problem with Option 2 is that it undermines what many see as a legitimate employee benefit and removes much of the marginal incentive to contribute to superannuation. Although it would finance considerable tax reform, it is politically difficult. Hence a third option is to combine Option 2b with a new tax rebate for superannuation contributions, which would apply equally to employer and employee contributions. Other rebates would be abolished. The rebate could either be subject to a low ceiling or at a proportional rate with a much higher ceiling.

We propose either a 50 per cent rebate subject to a $2000 ceiling (Option 3a) or a simple proportionate rebate of around 18 per cent of total contributions with a ceiling of $9000 (Option 3b). Option 3a is the most redistributive option but even the 18 per cent uniform rebate would remove some of the regressivity of the current system by giving the tax benefit a simple linear relationship to income. The effect of either option would be to create a much simpler and fairer system, raise some monies for tax reform, and reduce the long-term cost of population ageing.

Appendix A: Definitions

Age dependency ratio (65)	The ratio of people over 65 to the number of employed persons
AWE	Average weekly earnings
AWOTE	Average weekly ordinary time earnings
EMTR	Effective marginal tax rate
Expenditure tax benchmark	Considers the appropriate point for taxation to be when superannuation benefits are received and spent. The two types of expenditure tax benchmarks are: a pre-paid expenditure tax based on direct taxation of labour income with an exemption for saving (TEE); and a post-paid expenditure tax based on the taxation of cash flows from investments (EET).
Income tax benchmark	The standard taxation arrangements applying to personal and business income, in which savings are made from after-tax income and earnings from savings are taxed at full marginal tax rates based on the income of individuals in any one financial year. See also Schanz-Haig-Simons income definition, below.
NATSEM	National Centre for Social and Economic Modelling
OECD	The Organisation for Economic Co-Operation and Development
PAYG	Pay As You Go withholding taxation, formerly group tax
Pre-paid tax expenditure tax benchmark	Under the pre-paid expenditure tax benchmark, the value of the concession is the difference between the tax paid if the superannuation contribution were taxed as income at the individual's personal tax rate (plus the Medicare levy) and the tax paid in the fund, less the tax paid on earnings in the fund. Benefits are tax exempt under this benchmark, which is consistent with the tax exemption of superannuation benefits in Australia's retirement income system.
Post-paid tax expenditure tax benchmark	Under the post-paid expenditure tax benchmark, both contributions and earnings would be tax-exempt but benefits would be fully taxable when paid. The tax concession under this benchmark is expected to be less than under the pre-paid expenditure tax benchmark, as tax receipts flow earlier under the latter. However the present value of the two benchmarks is equal, assuming that marginal tax rates are similar when income is earned and when it is consumed.
Replacement rate	The percentage of pre-retirement income or consumption that an individual is able to maintain in retirement.
Salary sacrifice	Where an employee elects to have part (or all) of their salary paid into a superannuation fund. The salary is then taxed not at the employee's marginal rate but at the standard 15 per cent rate levied on fund contributions.

Schanz-Haig-Simons definition of income	The tax base for the income tax benchmark is based on the Schanz-Haig-Simons definition of income. An entity’s income is defined as the increase in the entity’s economic wealth (stock of assets) between two points in time, plus the entity’s consumption in that period. Consumption includes all expenditures except those incurred in earning or producing income.
SG	Superannuation Guarantee
SPRC	Social Policy Research Centre
Tax concessions	Tax concessions occur when certain taxpayers, activities or assets are granted more favourable tax treatment than that applicable to taxpayers generally. The term ‘tax concessions’ is used interchangeably with ‘tax expenditures’ as they have similar policy and fiscal impacts.
Tax expenditures	Generally, the cost to the revenue of tax concessions. Australia uses the revenue forgone approach to measure tax expenditures. This approach measures the difference in tax paid by taxpayers who receive a particular concession relative to similar taxpayers who do not receive the concession. It compares the current or prospective treatment to the 'benchmark' treatment, assuming taxpayer behaviour is unchanged. Two guiding principles in setting the benchmark are that a standard tax treatment should apply across similar taxpayers or transactions and that the benchmark may incorporate structural elements of the tax system, such as the progressive personal income tax rate structure and the nominal income tax approach. The estimated tax expenditures would differ considerably if measured against a real income tax benchmark or an expenditure tax benchmark.

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