SUSTAINING US ALL IN RETIREMENT:

THE CASE FOR A UNIVERSAL AGE PENSION

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Sustaining us all in retirement

The case for a universal age pension

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Summary

As Australia’s population ages, government policies that assist retirement will become even more essential. Superannuation tax concessions and the age pension are the two key government policies that assist the ageing, but they are becoming increasingly expensive. Increasing costs have prompted the Treasurer, Mr Joe Hockey to suggest the pension age be increased to 70. This suggestion is part of an austerity narrative being used by the government to justify broader spending cuts to health, education and welfare support. This paper shows super tax concessions, most of which are being claimed by people able to afford early retirements if they choose, will soon cost more than the age pension.

The age pension currently costs $39 billion and superannuation tax concessions will cost the budget around $35 billion in 2013-14. These concessions are projected to rise to $50.7 billion in 2016-17, an increase of around 12 per cent per annum. By this time superannuation tax concessions will be the single largest area of government 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 will be $74 billion in 2014 alone. With an ageing population the dual pension/superannuation system will become increasingly expensive. The government’s own projections are that the cost of super tax concessions as a share of GDP will exceed that of the age pension by 2016-17.

This paper presents an alternative model that could produce a fairer, more adequate and more sustainable retirement system. It proposes that we abolish tax concessions for superannuation and create a universal (non-means-tested) age pension. This proposed system is similar to the approach taken in New Zealand where labour force participation among older people is higher than in Australia. A subsequent paper will outline how the proposed universal age pension model could be implemented.

A universal age pension would be particularly beneficial to those groups whose superannuation balances are low, such as low income, seasonal or intermittent workers, the self-employed or those who have long periods of time out of the workforce (e.g. predominately women who care for children/ageing parents). A universal pension would create a level playing field amongst income groups and reduce the inequality in Australia’s retirement system. Superannuation could then act as a top-up for those who can afford it.

It is suggested that the single pension be lifted from 30 per cent of male total average weekly earnings to 37.5 per cent, with a consequent lift in the partnered rate. This would raise the pension rate for singles from $21,018 per annum to $26,273 per annum and the pension rate for couples from $31,689 per annum to $39,611 per annum. This system would cost $52 billion a year, almost 30 per cent less than we spend on both the pension and superannuation tax concessions.

This paper uses a 15 to 25 years phase-in period for illustrative purposes only; the precise phase-in method can be varied to suit policy objectives. The proposed transition options mean that the immediate cost of the new scheme is a lot less than the immediate revenues flowing from abolition of tax concessions. Revenues are brought forward whereas costs flow on many years down the track. This produces the interesting result that, whereas the scheme is revenue neutral in the long term, it produces a large net saving to the government in the short term. This must be of some interest to governments facing budget stringency caused by the slowing of the mining boom.

Such an increase in the pension rate would help to alleviate poverty among the aged. Additionally, government assistance by income class would become more progressive than it currently is. Whereas the present system of tax concessions for superannuation contributions...
favours high income earners the new system would more closely reflect the existing taxation rates applicable at each income level.

Although the cost of a universal age pension will rise over time, the cost of the existing combination of age pension and superannuation tax concessions will cost more. On that basis the policy proposed in this paper is more sustainable.
The cost of superannuation tax concessions

The cost of superannuation tax concessions in 2013-14 is projected to be $35.6 billion. This is projected to rise to $39.6 billion in 2014-15; $44.8 billion in 2015-16 and $50.7 billion in 2016-17.¹ These are staggering rises, of approximately 12 per cent per annum, reflecting the impact of the compounding of member balances and the phasing in of higher rates of the superannuation guarantee (SG). The SG will rise from 9 to 12 per cent over a 12-year period starting in July 2013². The current tax concession cost is slightly less than spending on the age pension at $39 billion,³ but these costs are projected to cross over in 2016-17 since the cost escalation is greater on the tax side. Figure 1 shows that the cost of super tax concessions as a share of GDP is increasing faster than the age pension.

**Figure 1: Cost as a share of GDP (%)**

Source: Australian Government (various years) Budget Paper No 1; Australian Government (2013) Mid-year economic and fiscal outlook, 2013-14; and TAI calculations and projections.

The bulk of these tax expenditures relate to two items – concessional taxation of superannuation entity earnings – $19.1 billion – and concessional taxation of employee contributions – $14.1 billion – in 2013-14. These concessions reflect the impact of taxing super at a flat rate of 15 per cent – and zero per cent for some – rather than the income tax rates applicable to members. Both items are growing strongly; the latter in relation to nominal

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¹ Treasury 2013b Budget paper No 1 and Treasury 2013a Tax Expenditure Statement 2012
² This will become 14 years under the Coalition.
³ Treasury 2013b Budget paper No 1 2013-14 Statement 6 table 9.1
wage growth and the former compounding in relation to the total sums invested in super. Such assets, currently around $1.5 trillion, are expected to reach almost $9 trillion in 2041.

The Treasury has noted criticisms of the tax expenditure (TE) concept, notably that the revenue from closing down the tax expenditure would not be nearly so great as estimated because of behavioural changes – that is, that voluntary savings outside the superannuation guarantee (now 9.25 per cent of salary) would virtually cease. Accordingly, they have provided new estimates of revenue gain (RG) which are “a way of producing tax expenditure estimates that are more comparable to budget revenue estimates”. These estimates relate to the two principal components of the super tax concessions noted above.

For concessional taxation of superannuation entity earnings the revenue gain is $14.2 billion as compared with the TE of $19.1 billion, a reduction of $4.9 billion or 25.7 per cent. For concessional taxation of employee contributions the revenue gain is $10.8 billion as opposed to the TE of $14.1 billion, a reduction of $3.4 billion or 23.8 per cent. For the total the reduction is a massive $8.3 billion or 25 per cent. Since these two TEs account for some 95 per cent of the superannuation total, the 25 per cent figure can be regarded as the appropriate discount to apply in estimating revenue gain for the whole of the TE, which reduces from $35.6 billion to $26.7 billion.

It is no coincidence that around 30 per cent of total contributions to superannuation are voluntary; that is, over and above the SG. In effect the Treasury revenue gain methodology assumes that almost all voluntary contributions would be redirected into private savings. Some of these forms of private saving, like investment properties, are relatively lightly taxed. Others, such as bank savings accounts, are taxed heavily and might be expected to yield additional tax revenue.

The revenue gain method shows little revenue from taxing fund investment income during the pension phase, as many older people pay very little income tax because of the Senior Australians’ and Pensioners Tax Offset (SAPTO). This raises the tax threshold to over $32,000 per annum for singles and $57,000 per annum for couples. A taxable non-means-tested age pension at a higher rate would substantially reduce the effective tax threshold for such people.

The Treasury methodology might therefore be regarded as producing a lower limit to the total revenue gain from eliminating tax concessions. We use the RG figure not because we agree with it but because it provides a degree of robustness in our costings, with which it is not then possible for a reasonable person to disagree.

Mercer disputes this cost of the tax concessions (TE), arguing that it takes no account of pension savings over the longer term, with the suggestion being that the tax concessions pay for themselves in pension savings. We refute this claim; however this issue is best dealt with when considering the incidence of tax concessions and total government support for retirement.

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4 Rothman and Tellis 2008 “Projecting the distributions of superannuation flows and assets”
5 Treasury Tax Expenditure Statement (TES) 2013
6 With the new pension rates the effective single tax threshold falls from $9,000 to $4,000 and the couple threshold from $31000 to $17,000, so there is considerable prospect of tax clawback. These effective thresholds can be calculated by subtracting the pension rate from the income levels at which tax is payable as outlined elsewhere in this paper. Indeed, we propose that with the means test abolished the tax thresholds for pensioners be aligned with the new maximum pension rates such that tax is payable from the first dollar of private income (Appendix 2); this would allow for a considerable claw-back especially at higher income levels.
7 Mercer 2012 “Tax, super and the age pension: assessing the value of total government support” February
Incidence of tax concessions

Super tax concessions are extremely regressive, as described in Ingles, Denniss and Richardson and Denniss.\(^8\) Ingles, on the basis of Treasury figures,\(^9\) found that “tax concessions flow overwhelmingly towards the well-off”. The Association of Superannuation Funds of Australia (ASFA) points out that government tightening of concessional contribution limits would by now have reduced this disparity; on its reckoning the top 20.4 per cent of wage earners receive 49 per cent of employer contributions,\(^10\) but a higher percentage of the total tax benefits. On Treasury numbers the top two deciles of income earners received 57.7 per cent of total concessions and the top decile 38.2 per cent of the total in 2009-10.\(^11\) Denniss and Richardson\(^12\) suggested that up to 61 per cent of a person’s ‘self-funded’ retirement is actually attributable to the tax concessions provided by other taxpayers. Figure 2, from Denniss, illustrates the regressivity of the tax concessions on super contributions.

Figure 2: Distribution of tax concessions on superannuation contributions 2012-13

![Figure 2: Distribution of tax concessions on superannuation contributions 2012-13](image)

The regressivity of superannuation taxes derives from their flat-rate character, with the progressive income tax scale being replaced by, in effect, a proportional (15 per cent) tax system on all contributions and investment income (with investment income in the drawdown phase being tax free). This benefits high income earners who would otherwise pay up to 47 per cent on their income. It disadvantages low income earners who would normally be free of

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\(^8\) D Ingles 2009 “The great superannuation tax concession rort” TAI Research Paper No 61, February, R Denniss and D Richardson 2012 “Can the taxpayer afford ‘self-funded’ retirement” TAI Policy Brief No 42; R Denniss 2013 “Super for some” TAI March

\(^9\) (Henry Review) “AFTS Retirement incomes consultation paper” 2009 p22 ACOSS has also published figures which deal with the tax concessions going to those on the top marginal rates in its 2012-13 Budget Priority Statement and its paper “A fairer, more efficient tax and social security system” (2011)

\(^10\) ASFA 2012 “The equity of government assistance for retirement income in Australia” Research Paper February table 2.1

\(^11\) Treasury 2012 “Distributional analysis of superannuation tax concessions”, paper for Superannuation Round Table 23 April. This paper presents Treasury analysis on the distribution of superannuation taxation concessions as presented to the Superannuation Round Table of 23 April 2012

\(^12\) Denniss and Richardson 2012 p6
tax up to the tax threshold of $18,200. The introduction of a low income rebate of $500\textsuperscript{13} plans to abolish this comparatively smaller superannuation policy, one of the few progressive elements in the system.

Knox\textsuperscript{14} and other researchers have disputed the regressivity of the tax concessions, noting that they are offset by withdrawal of age pension under the means test. In this view what matters is the progressivity of the total retirement income system and not individual elements of it. On this question Knox finds that total government assistance for retirement income is pretty much flat across income classes, with only a slight peak for higher income earners. The Treasury has come to a similar conclusion.\textsuperscript{15} Yet on the latest Treasury figures the jump in assistance at the top decile is quite marked. While total average assistance for all other income groups is around $265,000, at the 90\textsuperscript{th} percentile of male earners it jumps to $350,000; for the 95\textsuperscript{th} percentile to $425,000 and for the 99\textsuperscript{th} percentile to $515,000.\textsuperscript{16}

**Figure 3: Distribution of ”total government support” (both superannuation tax concessions and age pension)**

The Treasury does not provide similar figures for women; presumably the distribution would be similar. But we note that women would be disproportionately represented in the lower deciles for the population as a whole, and greatly under-represented at the top. Kelly et al

\textsuperscript{13} The rebate is payable at 15 per cent of contributions up to an income limit of $37,000 per annum and broadly makes superannuation tax free for low income earners.

\textsuperscript{14} Knox 2010 “The fairness and future of Australia’s retirement income system” The Australian Economic Review 43(3) pp. 302-11

\textsuperscript{15} Rothman G 2009 “Assessing the equity of Australia’s retirement income system” RIMU Treasury, July Rothman found that 2 key measures in that years’ Budget added to the equity of the retirement income system, being first the increase in the base pension (and associated increase in the means test taper) and second the reduced caps on concessional contributions.

\textsuperscript{16} Treasury 2012 “Distributional analysis of superannuation taxation concessions”. These figures are read off their graph, reproduced as Figure 3 here.
noted that women are a particularly vulnerable group in terms of superannuation because they are more likely than men to work part-time or part-year; they are more likely to have interrupted careers, and even when they work full time their earnings are lower than men's, at some 84 per cent. In 1994 women spent 17 years on average in the paid labour force compared to 39 years for men; while this gap is narrowing it would still be very large. According to Kelly et al the average female superannuation assets will still be only 70 per cent of the average male assets by 2030. Moreover women will represent two-thirds of the population in the over-85 age group, a group where superannuation assets are likely to be quite diminished.

There are some problems with the Treasury/Knox total assistance analysis. For example, assumptions must be made about a wide variety of matters including how individuals invest their lump sum and what returns they get. Knox attributes only part of the tax benefit from the low fund tax rate to individuals, on the grounds that they wouldn't pay much tax on investments outside of super. He also disregards the tax break on fund earnings during the payout phase on the grounds that the elderly don't pay much tax. Of course they don't – they have access to tax-free super. Further, the net benefits to individuals depend on how much they manipulate the system by 'double dipping', a particular issue with the current system. Double dipping refers to the ability of savers to benefit from generous tax concessions but still get the age pension, for example by using super to pay off their house mortgage – the house is not an assessable asset in the pension asset test.

The bottom line is that if the distribution of net government benefits were truly flat by income class it would be equal to the value of the full-rate age pension at each income point, with the pension being a declining proportion of the total as income rose and the total cost of pension plus tax concessions not being greater than that of a universal age pension. This is not the case – the current system costs much more, even on a revenue gain basis. This feature makes the tax-pension trade-off proposed in this paper feasible and revenue-neutral or even revenue-enhancing.

Superannuation tax concessions cannot be rationalised by pointing to saved expenditure on the age pension. The sums simply do not add up. And in terms of individuals, it is notable that even when the SG is fully matured, almost two-fifths of the aged will receive a full pension and another 40 per cent a part pension. Only 22 per cent are projected to receive no pension, a slight increase on 18 per cent currently. Savings on pension spend are limited by the coverage of the SG (very low wage earners and self-employed are excluded), the generosity of the pension means test (for example, homes are excluded), and opportunities to take and run down lump sums (‘double dipping’). Age pension expenditure is therefore expected to grow from 2.7 per cent of GDP in 2014-15 to almost four per cent in 2049-50, despite much larger superannuation balances as the SG matures.

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17 Kelly S Percival R and Harding A 2002 Women and superannuation in the 21st century: poverty or plenty.
18 Kelly et al 2002 p231
19 Kelly et al 2002 p233
20 Even when the SG is fully matured the percentage of the age not receiving any pension is expected to rise only slightly: see Henry 2008. Researchers such as Mercer conclude that the system works well, implicitly because the swings and roundabouts cancel out: see e.g. Mercer 2012 “Australia among the best in Global pension index”.
22 Treasury 2010 “Intergenerational Report”
We do not have similar long-range projections for tax expenditures but, given current growth rates, they could imply a total cost for retirement income support of 10 per cent of GDP by 2050.

Kelly\(^\text{23}\) concludes that it is not unreasonable to consider the use of compulsory income streams in retirement as one way to address, inter alia, double dipping. Many other academics have called for this. But compulsion raises difficult issues. Australians are attached to their access to lump sums; half of all retirement benefits are taken in this form.\(^\text{24}\) Compulsory annuitisation raises difficult questions of equity between the long-lived (that is, the well-off) and those with shorter life expectancies. And the age pension means test can make annuities very unattractive.

The Henry tax review and the government response

Under the Henry proposals\(^\text{25}\) the flat rate tax on contributions to super would be modified. Employer contributions would be treated as income in the hands of the individual and be taxed at marginal income tax rates less a flat-rate refundable tax offset of 20 per cent. This would apply to all contributions (employer and employee) up to a maximum cap of $25,000 indexed ($50,000 for those over 50). For most taxpayers the offset, in the context of the

\(^{23}\) S Kelly 2012 “Household savings and retirement: where has all my super gone” for CPA Australia and Kelly 2013 20 years of the superannuation guarantee, Report for CPA Australia

\(^{24}\) APRA statistics indicate that in 2011-12 $35 billion was taken in lump sums and the same amount in pensions. Cited in Steketee 2013 “Unfair, inefficient and expensive: what went wrong with Australia’s superannuation system” Inside story 18 February.

personal income tax scales recommended in the Henry report, would mean that they would pay no more than 15 per cent tax on their contributions, which is the current rate.

The Henry review would also have rationalised the three different tax rates that apply to fund income, being 15 per cent for income, 10 per cent for capital gains and zero per cent for earnings in the payout (over-59) phase. These three rates would become a single 7.5 per cent.

Because the review would tax contributions to the individual rather than the fund, the net SG contribution rate would rise from 7.65 per cent to nine per cent (now 9.25 per cent). On the review’s assessment, this would have led to adequate income replacement rates implying that no further rise in the nine per cent SG rate was necessary.

Most overseas retirement income systems utilise an expenditure tax method of taxing pension savings, whereby contributions and fund earnings are exempt and end benefits are fully taxable. The shorthand for this is EET, meaning Exempt contributions, Exempt earnings, and Tax benefits. Henry was clearly attracted to this approach but constrained by the review’s terms of reference. Accordingly he sought to achieve an approximation to the expenditure tax treatment, while embedding superannuation concessions in an income tax (TTE) framework. The result can best be described as ttE, where the small Ts indicate taxation at less than full rates.

The Henry recommendations indicate that it is possible to abolish tax concessions for superannuation. To do so would require removing any rebate on super contributions and attributing fund earnings to individuals. But a number of commentators have argued that the Henry recommendations involve a great deal of administrative difficulty; they also note that the effect is to reduce peoples’ disposable income. This issue is considered further in a subsequent section of the paper (see page 17).

The previous Labor government did not adopt the Henry recommendations. Instead it moved to moderately reduce the regressivity of the super tax concessions by tightening contribution caps (now limited in general to $25,000 and $35,000) and introducing a new $500 tax rebate for low-income earners – which the present government has plans to abolished. In the lead up to the 2012-13 budget the government also announced that superannuation contributions for those earning more than $300,000 per annum would attract a tax of 30 per cent rather than the then-flat 15 per cent previously applied; this is in effect a return to the superannuation surcharge that operated for some time under the Howard government – and was justified at the time as making the superannuation system fairer.

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26 The offset would also replace the superannuation co-contributions and superannuation spouse contributions tax offset.

27 E.g. ASFA 2012 “The equity of government assistance for retirement income in Australia” Research Paper February

28 In the 1996 Budget the then treasurer, Peter Costello, stated “The measures I am announcing tonight are designed to make superannuation fairer.

“A major deficiency of the current system is that tax benefits for superannuation are overwhelmingly biased in favour of high income earners. For a person on the top tax rate, superannuation is a 33 percentage point tax concession while a person earning $20 000 receives a 5 percentage point tax concession. High income earners can take added advantage through salary sacrifice arrangements that are not available to lower income earners.

“The Government is remedying this situation.

“From tonight, a surcharge of 15 per cent will apply to future employer superannuation contributions for those whose income (including deductible superannuation contributions) is at or above $85 000 … For high income earners the superannuation contributions will still be highly concessional but are more in line with concessions to middle and low income earners.” Despite these fine words the superannuation surcharge was later unwound under the same Treasurer.
however, will impact only the top one per cent of income earners and raise very little revenue.

Fundamental suggestions for reform have come from organisations such as ACOSS, which broadly endorses Henry’s suggestions but suggests that employer contributions not be taxed in the hands of employees but rather as contributions paid to funds by the employer. ACOSS also prefers a more redistributive rebate than that proposed by Henry. ACOSS agrees with Henry that concessions on contributions should only apply to net increases in superannuation savings, eliminating the ‘churn’ that results when super benefits are paid out, and contributions paid in, for the same member.

The problem with all such suggestions, including the rebate options canvassed by Ingles, is that while they would be an improvement on the current situation, they all envisage the continuation of a hybrid super tax regime which combines both income and expenditure tax elements and lacks a clear theoretical rationale in terms of the ideal tax treatment of savings. A comprehensive income tax approach – that is, abolishing super tax concessions – makes sense; a comprehensive expenditure tax for all savings – that is, taxing all savings including superannuation as EET or TEE – might make sense; but a hybrid scheme for taxing savings is distorting and inefficient, leading to a host of well-documented problems.

**Distortions caused by tax concessions and means testing**

In theory there are two main ways to tax savings – the comprehensive income tax (TTE) approach and the cash-flow expenditure tax (EET). The touchstone of an expenditure tax is that it exempts income earned on savings. An EET regime achieves this result, assuming that tax rates are the same at the time of saving and spending. An expenditure tax of type EET and an income tax with capital income exempt (TEE) are equivalent, since the present value of tax on drawdowns is the same as the tax that would otherwise be paid on earnings. That is, there is effectively no tax on investment earnings under the EET.

Tax concessions for superannuation have been defended as creating an expenditure tax regime for long term retirement saving, which many tax experts view as the ideal tax treatment for long-term savings. Actually the Australian system goes even further than this, as the current system is actually concessional set against an expenditure tax benchmark. According to the Treasury, this concession was $4.6 billion in 2008-9. The current system achieves this result in a roundabout way using tTE (where t indicates taxation at less-than-full marginal rates); overseas it is more common to employ EET.

There are two issues with the theoretical ideal of an expenditure tax treatment. The first is that the general tax treatment of savings is much less generous and the current system diverts savings into tax-preferred forms, and also requires that it be locked up for long periods despite the fact that households might rationally wish to give priority to other investments. In economics this reflects the general problem of the ‘second best’; if the

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30 Ingles 2009

31 that is from an efficiency perspective, although it would undermine equity

32 See for example S St John “Kiwi Saver and the tax treatment of retirement savings in NZ” New Zealand Economic Papers 41 (2) 2007 p251

33 Some experts consider that the EET differs from the TEE in taxing economic rents – i.e., returns in excess of the risk-free rate

34 Henry 2008b AFTS Retirement income consultation paper, December, Box 3.1
system is distorted in one area, then removing a similar distortion in another area does not necessarily give rise to an improvement in allocative efficiency.

We can illustrate this important point. Suppose income tax has an excess burden (efficiency cost) of 20 per cent of revenue, an expenditure tax of 15 per cent and this difference is entirely due to the tax treatment of savings. Suppose we have an income tax but now tax half of all investments using EET. The weighted average efficiency cost might be thought to be 17.5 per cent. This would be wrong. Because of the distortions introduced into savings and investment decisions, the total efficiency cost of the hybrid system could well be higher than that of either tax treatment taken alone; for example, 25 per cent.

The second issue is that the tax system interacts with the pension means test to vitiate the supposed neutral treatment of retirement savings. It is pointless for tax academics to pursue a theoretically perfect tax treatment of retirement savings – the EET – if it will be comprehensively undermined by a pension means test that does the exact opposite. This point is amplified when one considers Treasury projections showing that the large bulk of retirees will continue to be impacted in one way or another by the means test.

Depending on the form in which savings are held, the pensions means test produces high and variable effective tax rates, so that the net incentive for retirement saving is only effective if the means test is circumvented. This is not, presumably, a design feature of the system.

Figure 5 and Figure 6 below indicate effective marginal tax rates\(^ {35}\) faced by single pensioners and pensioner couples; such rates can be seen to be in the order of 75 per cent over wide ranges of income. Apart from its impact on incentives to save, research by others, such as Kudrna and Woodland\(^ {36}\) confirms the likelihood of a considerable labour supply effect from the presence of the pension means test. As discussed later, this view is confirmed by comparisons with the NZ system, where the absence of any means test appears to have large impacts on workforce participation among the aged.

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35 The effective marginal tax rate (EMTR) is the amount lost in pension and tax as an additional dollar of income is earned. The EMTR for age pensioners varies according to whether the income is earned or from investments, as the former attracts the new Work Bonus. For investment income the effective EMTR threshold is lower as is the pension cut-out point so that the ‘hump’ in the graph shifts to the left.

36 G Kudrna and A Woodland 2008 “A general equilibrium analysis of the Australian means-tested age pension” October, p2-3
Figure 5: Effective marginal tax rates for single age pensioners 2012

Source: STINMOD (NATSEM modelling). The new policy referred to is the exemption of part of earned income under the Work Bonus.

Figure 6: Effective marginal tax rates for age pensioner couples 2012

Source: STINMOD (NATSEM modelling)
Retirement savings currently receive an approximate income tax treatment as a result in several conflicting policies. Superannuation tax concessions are excessively generous, even as measured against an EET. Pension means tests are quite harsh once incomes exceed the pension ‘free areas’, but don’t have an effect below the free areas or, at the margin, above the pension cut-out points. Pension means tests are also circumvented by a variety of strategies. While the overall outcome is perhaps neutral in terms of the broadly flat structure of net government assistance, this is as a result of conflicting distortions, which make nonsense of any suggestion that the system is in any way neutral or economically efficient.

**Incentives to save, double dipping and the pension means test**

For tax incentives to result in increased net savings there must be a rise in voluntary private savings greater than the cost to public savings inherent in the tax breaks. Marriot 2010 notes that “most studies conclude that tax incentives affect the allocation of household portfolios, but the effect on the amount saved is less clear … Typically research finds that only a small amount of retirement savings are ‘new’ savings and the policies are an expensive form of encouraging saving … tax incentives are successful in increasing levels of savings through the tax-preferred vehicle, but this does not necessarily result in increased levels in overall savings”.37

Partly because of doubts about the net incentive to save, costly superannuation tax concessions are accompanied by compulsory savings through the SG. But compulsory savings can be got around by compensating private behaviours prior to retirement, such as taking out loans and/or using up superannuation savings before going on the pension, and in retirement by putting saved monies into exempt forms such as owner-occupied housing or paying off debt using superannuation. Such ‘double dipping’ is facilitated by the fact that the super preservation age (the age at which superannuation can be accessed), at 55 rising to 60, is considerably lower than the pension age, which will rise in stages from 65 to 67.

While this could partly be addressed by raising the preservation age, there may be great difficulties in doing this, as many older people have legitimate reasons for retiring in advance of the pension age. At any rate, people can circumvent the preservation threshold by borrowing monies and paying them back out of superannuation savings once they reach the preservation age. Kelly provides convincing evidence that this is occurring already, with rising rates of debt among older people.38 He finds that:

> People approaching 65 have sharply increased their debt levels. Their average mortgage balance and other property debt has more than doubled since 2002 and credit card debt is up 70 per cent. … At best, all [the SG] has achieved is to make some savings compulsory instead of voluntary and quarantine these savings until retirement age. Overall these enforced savings … have been largely offset by similar if not larger private borrowings.39

In a later paper Kelly notes that “all of the money that has been accumulated in superannuation by Australians ($1,674 billion in March 2012) has been matched by a similar amount of debt being taken on ($1,627 billion). He concludes that: “It is now twenty years after the SG was introduced, and superannuation savings minus household debt effectively equals zero”.40 But Kelly also cites academic studies that suggest that the extent to which compulsory superannuation is offset by declines in other savings is much less than

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38 S Kelly 2012 “Household savings and retirement: where has all my super gone” for CPA Australia.
39 Kelly 2012 p2
40 Kelly 2013 p27
100 per cent; in one study the offset is 30 per cent.\textsuperscript{41} Either way, nobody disputes that there is some offset, and that it is potentially large.

On retirement, super lump sums can be used to pay down borrowings, so hoped-for savings in age pension expenditure do not materialise. Kelly found that households whose inhabitants were aged 50-54 and were not retired had a debt-to-superannuation ratio of 91 per cent, and even those aged 60-64 had a ratio of 42 per cent.\textsuperscript{42} Kelly argues that the government “is effectively funding a $30 billion per annum tax concession that will do little if anything to relieve pressure on the cost of providing the age pension to retirees and the impact on the public purse”.\textsuperscript{43}

Toohey notes that, according to the Budget papers, “lifting compulsory contributions to 12 per cent of salaries will add a tiny 0.4 per cent to national savings by 2035”.\textsuperscript{44} Steketee, in the same vein, suggests that: “The same ministers who scour every nook and cranny to find savings are throwing money at superannuation tax concessions with dubious benefits”.\textsuperscript{45} Toohey calls compulsory superannuation “a policy in search of evidence”.\textsuperscript{46}

\textbf{The policy option – abolish the tax concessions and the means test}

There is a very simple way of ensuring that the incidence of total government assistance is progressive by income class: abolish the super tax concessions and abolish the pension means test. Since the pension is taxable, the income tax will claw back part of the universal pension from the well off. The sums involved – $26.7 billion in savings even on the Treasury’s conservative revenue gain calculation compared with the $13 billion cost of means test abolition\textsuperscript{47} – indicate that this option would produce a $13.7 billion saving to revenue, leaving a surplus which could be used to raise the base pension rate.

There would be additional savings because the universal age pension would be taxable; this means that net government assistance would actually decline by income class instead of rising as it now does.\textsuperscript{48} For the highest income decile the net assistance would be approximately half that of the lowest, reflective of the effective 47 per cent top income tax rate.\textsuperscript{49} Many would regard such a pattern of assistance as quite defensible in a public policy sense.

\textsuperscript{41} Kelly 2013 p20
\textsuperscript{42} Kelly 2012 p4
\textsuperscript{43} Kelly 2012 p203
\textsuperscript{47} It is difficult to find an up-to-date figure for this cost. Clare 2008 suggests that it would be “a net cost well in excess of $6.5 billion a year” (p11), but this figure is not sourced. Dunsford and Wickham 2009 computed a cost of $10.6 billion in 2006-07 or one per cent of GDP. Rothman 1998 projected a 2010-11 cost of .75 per cent of GDP. Dunsford and Wickham computed a cost of $10.6 billion in 2006-07 or one per cent of GDP. My costing is as follows: since 18 per cent of the elderly receive no pension, the minimum gross cost is 20 per cent of current spending – i.e. $7.8 billion. There are additional costs from part pensioners which we here estimate at $5.2 billion; hence $13 billion in total or .85 per cent of GDP. Most pensioners – two thirds – receive the full rate. The cost is rising slowly as the SG matures and pensioners have greater assets, which why our figure is slightly higher than Rothman’s.
\textsuperscript{48} Henry suggested that pensions should become tax free, which might make sense if there is a means test but not otherwise. Making the pension taxable reduces the net assistance to higher income earners and creates a measure of horizontal equity vis-à-vis those of workforce age. The NZ pension is fully taxable and, in fact, some tax is paid by NZS pensioners with no other income.
\textsuperscript{49} That rate is actually 45 per cent, but the Medicare levy, now 1.5 per cent, will rise to two per cent to bring the total to 47 per cent.
The logic of this policy is that the existing age pension means test discourages retirement savings and superannuation tax concessions encourage them. The net impact of these countervailing incentives balance each other out, but the process creates distortions in saving and investment behaviour including people converting their lump sums into housing, which of course makes housing less affordable in general. The two current policies are in conflict, not harmony. This argument has been made in the past and by a number of researchers. Ross, for example, concluded that “fundamentally we have two complex systems (age pension/social security and superannuation) which have conflicting effects – the means test ... discourages saving for retirement, while the superannuation system is designed to encourage it.”

Thirty years ago Ingles et al, in one of the earliest comprehensive attempts to cost tax concessions for occupational superannuation, noted that the “presence of an income test is likely to work counter to the savings incentives promoted by the tax concessions”. They went on to say that: “An alternative approach would involve reducing or eliminating the tax concessions themselves. This might be done in combination with easing or abolishing the income test on age pensions”.

This was in a context where the means test for those aged over 75 had been abolished in 1973 and for those aged 70-74 in 1975. Since those days there has been a general move back towards increased targeting of the age pension, with the reintroduction of income tests and subsequent imposition of an assets test and deeming. There is now a general antipathy towards ‘middle class welfare’, though such antipathy does not appear to extend to welfare provided through the tax system. Stanton and Herscovitch suggest that: “If cutting so-called ‘middle class’ – and indeed, ‘upper-class’ – welfare is an important policy aim, restoring tax on superannuation for people 60 and over should be a priority”.

The system would be similar to New Zealand superannuation

Interestingly, the tax/means test trade-off proposed would have the effect of moving us very close to the New Zealand system, which pays a universal NZ superannuation pension to all those aged 65 and over who are residentially qualified, set at a net 66 per cent of the net national average wage for a couple and 37 per cent for a single person living alone. Originally there were no mandatory contributions to superannuation or retirement income tax concessions; a referendum to impose a mandatory tier was overwhelmingly rejected. Subsequently the Kiwi Saver scheme was introduced in 2007 to encourage voluntary contributions with auto-enrolment but also an opt-out facility; this was accompanied by a modest kick-start of $1,000 and a small tax subsidy for the first $1,040 of contributions.

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50 See Ingles 2001 and references therein and also Knox 1995.
51 Ross J 1997 “The gap between objectives and policy outcomes in Australian retirement incomes” paper for eighth Annual Colloquium of Superannuation Researchers’ University of New South Wales
52 Ingles Jackson Podger and Raymond 1982, “Taxation expenditures” p25. The then-income test on age pensions was later modified to again become a means test.
53 Ingles et al 1982 p26
54 Stanton and Herscovitch 2013 “Social policy and programs: from principles to design” (p21)
55 The gross rates of NZ super are $20,804 (single, lives alone) and $31,450 couple as at 1 April 2012. These payments are taxable and the net rates are $18,143 and $27,914 respectively. The NZ dollar is 16 per cent less than the $A, so these amounts can be reduced in that proportion for comparative purposes. However NZ wages are also lower.
The NZ Retirement Policy and Research Centre (RPRC) argues that:

*New Zealand superannuation is one of the simplest, most generous Tier 1 pension systems in the world. A 2006 New Zealand Government Report found that the over 65s have among the lowest levels of ‘hardship’ of all the social groups measured. Now, a 2008 OECD report has shown that New Zealand is one of three OECD countries with the lowest levels of poverty among those of retirement age. New Zealand superannuation and relatively high rates of home ownership are the main reasons for this.*

While NZ has low rates of aged poverty, it also has relatively low rates of income replacement among middle and upper income groups (income replacement rates or IRRs compare income in retirement to income while working and express this as a ratio). This of course is an inevitable consequence of a flat-rate superannuation pension allied with relatively low levels of occupational superannuation coverage and associated modest tax incentives.

While this is a potential criticism of the NZ system, the strength of the criticism depends on a basic philosophical question: that is, should we be concerned with poverty among the aged or with deprivation relative to one’s previous standard of living? It is not entirely clear that government policy should prioritise the latter rather than the former, especially if you take the view that individuals can make their own decisions about their desired level of retirement savings. For example it is not entirely clear why providing a worker on $200,000 a year with an IRR of 70-80 per cent should be a taxpayer’s problem. Be that as it may, we envisage that the SG tier would continue under our proposed scheme and hence in Australia adequacy of income replacement rates would not appear to be an issue.

Susan St John has argued: “Voluntary, unsubsidised private savings together with a universal state pension, New Zealand Superannuation, appeared to be a well-supported, cost effective, adequate and highly equitable approach to retirement income policies.” And while the issue of sustainability has been a live one in NZ, the approach adopted has been to partially fund NZ super using a sovereign wealth fund, the NZSF, established in 2001. Sustainability will always be an issue with retirement in the context of an ageing population, but a system like NZ super is more sustainable than the Australian combination of means tested pension and super tax concessions, with the costs of the latter spiralling ever upward.

NZ has retreated from the policy of no super tax concessions with the advent of KiwiSaver. St John notes:

*By effectively abandoning the framework of comprehensive income tax, New Zealand has returned to the complexities, inefficiencies and inequities of a hybrid approach for taxing returns to capital thought to be so damaging in the 1980s both in New Zealand and in many other OECD countries...*  

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56 Pension Briefing 2009-1, Retirement Policy and Research Centre, University of Auckland. The OECD uses a standardised poverty line based on 50 per cent of median earnings for a couple and the NZ super pension is comfortably above that. The alternative OECD poverty line is based on 60 per cent of median earnings; on this measure NZ has a high rate of aged poverty (34 per cent), indicating that there is substantial clustering of incomes among the aged at or just above the NZ pension base rates. This reflects the (previously) very low incidence of occupational superannuation coverage in NZ.

57 Prior to KiwiSaver occupational superannuation coverage in NZ was only 13.4 per cent and pension savings, relative to GDP, were one-fourteenth those in Australia (Marriott 2010 p208).

58 S St John “Kiwi Saver and the tax treatment of retirement savings in NZ” New Zealand Economic Papers 41 (2) 2007 p251

59 St John 2007 p252
Subsequent policy change has reduced these concessions markedly however. Dale et al surveyed the four years of KiwiSaver’s evolution. In that time, the fundamental questions around KiwiSaver’s purpose have not been resolved. Is it to enhance an individual’s ability to consume in retirement; to reduce the pressures on the economy of an ageing population; or to solve the national saving problem? “When the purposes are unclear, the scheme may be vulnerable to the industry determining the design of the scheme to meet its own objectives.”

New Zealand is concerned about its relatively low levels of occupational superannuation coverage and household savings; it has a household savings rate that is “consistently one of the lowest in OECD countries” and low financial asset holdings. It also has concerns about income replacement rates at middle and higher incomes. These concerns would not be relevant in the Australian context given that the SG would continue and there would also be the possibility of a new tax concession targeted on voluntary savings (Appendix 1). This would safeguard the ‘three pillars’ approach which Australian super experts are very attached to.

**How would the tax concessions be abolished?**

The Henry Review has indicated one mechanism by which tax concessions on contributions could be abolished, by taxing them to the individual at their marginal tax rate (albeit with a tax rebate). To abolish the concessions on fund investment income would necessarily involve attributing such income to individuals. One possibility, analogous to Henry, is to tax such income as if it were an individual’s income. Another possibility, which we prefer, is to tax the fund both in respect of contributions and earnings. There would need to be a mechanism to notify the fund of the individual’s marginal tax rate so that tax could be withheld at the appropriate rate. This avoids reducing the disposable income of employees at the time of the scheme’s inception.

Administratively it is easier to tax the member, as the fund can notify him or her of contributions received and investment income attributed. Another possibility, therefore, is for the fund to withhold tax at, say, 35 per cent and for the member to receive a corresponding tax credit while paying any deficit. Yet another approach, canvassed in Ingles 2009, is that the fund issue an income statement to members each year; this would add to other taxable income in assessing tax, and tax attributable to super would be advised by the ATO to the fund who would pay it on behalf of the member.

The downside of taxing at the fund level is that eventual accumulations in superannuation will be reduced. This is an inevitable trade-off from having an increased government role in the provision of retirement incomes, but also makes the retirement income distribution more equitable. We do not advocate increasing the SG still further to offset this effect, as compulsory savings reduce living standards at times in the life cycle when needs may be relatively high compared to the retirement years.

There will inevitably be some complexity in fully abolishing tax concessions, and the transition to the new scheme will involve administrative costs at the outset. We do not envisage that the ongoing administrative costs would be prohibitive and indeed there will be substantial administrative savings in the pension system and in private superannuation given

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62 Among OECD countries NZ ranks well at 9th for low income earners due to NZS but at 5th lowest for average earners and 3rd lowest for double average earnings. See Marriot 2010 p200
63 See Henry 2009 “AFTS The retirement income system: Report on strategic issues”
64 Ingles 2009 p25 fn 36.
that the current administrative cost of the latter is $18.6 billion rising at over 10 per cent per annum. The New Zealand experience is that administration is quite manageable once the new systems are in place; there is also a mechanism to tax defined benefit schemes\(^{65}\).

**Transition to the new scheme (NS)**

The transition to the proposed scheme is an important issue. Transition and implementation is briefly considered in this paper and will be more fully outlined in a subsequent paper. It should not be phased in overnight, as the principal beneficiaries are the well-off among the aged, who have already benefitted from superannuation tax concessions over their working life. An extreme option is that the scheme be phased in over 45 years so that those now entering the workforce would face a consistent situation where they didn't benefit from tax concessions and would expect, in return, to receive a full NS pension at age 67.

Such a long phase-in has disadvantages, however. In particular, it is a long time to wait to reap the advantages of NS in terms of saving and investment neutrality and workforce participation (as discussed above). In addition, those now aged over 60 will be immediate losers from the taxation on their fund investment income. For these reasons we consider a phasing in period much less than 45 years; perhaps 15 to 25 years. This means that those retiring just at the beginning of the phasing in period would gain access to almost the full NS pension by the end of their retirement, given life expectancies for men of 19 years at age 65 (and 22 years for women).

The current rate of the single pension is 30 per cent of MTAWE\(^{66}\), and the proposed new rate is 37.5 per cent. One phasing-in suggestion is that the 50 per cent means test taper be reduced over ten years in five per cent increments. At the end of this period the pension would rise in real terms by five per cent per year; after five years it reaches the maximum rise of 25 per cent. This gives a total phase-in of 15 years but front-ends the means test taper reduction so as to have the maximum impact on work incentives.

A different and longer phasing in suggestion is that the NS pension be immediately payable to all those 65 and over at a partial rate of 1.5 per cent of MTAWE, rising in equal steps over 25 years until it reaches 37.5 per cent.\(^{67}\) The age pension would then continue as a means-tested supplement to the NS pension. Note that after 20 years the NS pension equals the age pension which therefore disappears at this time, with the last five years of the phase-in being the period when the base rate of assistance rises relative to current policy.

Obviously the precise phase-in method can be varied to suit policy objectives. It could be much faster than 15 or 25 years, for example. More priority could be given to increasing the base rate and less to phasing out the means test. We use 15 to 25 years for illustrative purposes only, as we have no strong view about the ideal phase-in period.

The proposed transition options mean that the immediate cost of the NS scheme is a lot less than the immediate revenues flowing from abolition of tax concessions. Revenues are brought forward whereas costs flow on many years down the track. This produces the interesting result that, whereas the scheme is revenue neutral in the long term, it produces a large net saving to the government in the short term. Under the 25-year phase-in we expect

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\(^{65}\) There would be advantage in consulting with the NZ Treasury to devise a practical tax regime, as it has managed to address all these administrative issues.

\(^{66}\) The base rate is indexed to 27.7 per cent of male total average weekly earnings (MTAWE) and the married rate to 41.76 per cent. Pension supplements bring the single rate to 30 per cent.

\(^{67}\) We here assume that the single rate and married rate would move in unison. Another option is that there be a new structure incorporating a living alone allowance. A decision to introduce a NS scheme would be an appropriate time to re-evaluate this option.
to reap $26.2 billion per annum from the tax changes (using the Treasury estimate of revenue gain) as compared to the initial cost of four per cent of that, i.e. $1.05 billion, producing a net saving of $25.2 billion. Over 25 years the saving adds to over $312 billion in real terms. This must be of some interest to governments facing budget stringency caused by the slowing of the mining boom. Even if the phase-in period were as little as five years, the aggregate benefit to the budget would be $50 billion, with other phase-in periods given a proportionately smaller or larger gain.

Apart from repairing the budget, these monies could be used to fund part of future pension spending, as is done in New Zealand. $312 billion invested at four per cent real return would provide $12.5 billion per annum. An alternative use of such surpluses would be to improve national infrastructure. The exact use of these monies is less important than the general idea that, in bringing revenue forward, we should use it to maintain generational equity by paying down deficits or building surpluses in a fund, or building assets.

The New Zealand super pension is taxable and the tax threshold is lower than the base rate, so the net payment in the NZ scheme is less than the gross payment. For Australia we suggest a continuation of the current situation whereby pensioners do not pay tax if they only receive the base pension, since to pay a higher pension and then tax it results in a lot of churn and increases the apparent size of the program (and indeed of the government sector). Instead, age-based rebates would operate to prevent any NS pension being taxable. These rebates would commence to phase out at income levels equal to the NS rates, meaning that all private income would be taxable. This would result in a considerable clawback of NS pension from middle and higher income earners.

**Overall impact of the scheme**

Current pension rates are $21,018 per annum for singles and $31,689 per annum for couples. The proposed new rates would be $26,273 per annum and $39,611 per annum if the new system were fully phased in now. These rates could be expected to virtually abolish poverty among the aged. In the mid-2000s, Australia and New Zealand had similar levels of 'social spending for elderly people' but a large disparity in elderly poverty rates, reflective of the fact that NZS is set at rates higher than the OECD’s poverty line based on half median income. While the situation in Australia has improved since that time, a 25 per cent rise in age pensions could be expected to have a much more dramatic impact. These

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68 This is based on a simple extrapolation of the current situation. In fact there would be population and wage changes over time so the projection is quite conservative.

69 This is the return target for the Future Fund set up to partially fund Commonwealth pensions.

70 In the current situation the pension is taxable but special rebates act to prevent aged taxpayers being liable for tax on either the pension or a large slab of initial income. Arguably this situation is too generous and tax should be payable on any income above the pension. But such a tax would interact with the means test to produce very high emtrs over some income ranges – as indeed it already does. Obviously this wouldn’t be an issue with a universal pension. In effect the tax system would act as a form of means test albeit that the maximum loss of pension would be half and means testing through the tax system is less rigorous that through the pension system with its special rules defining income (including deeming rules and the asset test).

71 Obviously the actual rates will be much higher in 25 years as the pension is indexed to earnings.

72 RPRC University of Auckland 2009-1 Pension Briefing “International comparison of poverty amongst the elderly” 2009 p4. The OECD found elderly poverty was 26.9 per cent for Australia vs. 1.5 per cent for NZ. There are of course huge problems in making truly representative international comparisons of poverty rates.

73 The single pension was raised in 2009 following the Pensions Review. The outstanding adequacy issue, in terms of poverty, mainly relates to the level of assistance for those in private rental accommodation. The Henry Review suggested that this be fixed, but the Government has not acted on this.
levels would be more than consistent with the Westpac/ASFA estimates of an income providing a ‘modest’ lifestyle in retirement.\(^{74}\)

There would also be a considerable redistribution from men to women. The RPRC has noted that: “Whereas in most countries older women have markedly disadvantaged relative living standards, the same is generally not true for older men and women in New Zealand”.\(^{75}\) Cameron has documented the much lower superannuation balances of women compared to men, partly due to the gender pay gap and partly due to periods out of the workforce for caring. She notes that “superannuation effectively takes the income inequalities that exist during people’s working lives and magnifies them in retirement”.\(^{76}\) The upshot is that average superannuation payouts for women are 57 per cent of those for men, and a significant proportion of women have no superannuation (38.5 per cent versus 31.6 per cent for males).\(^ {77}\) Improving the base pension while de-emphasising private superannuation unambiguously benefits women.

The proposed changes would rebalance the existing system away from a defined contribution plans and associated reliance on the individual, towards a defined benefit model.\(^ {78}\) This consequence has a number of desirable attributes, as individuals often make bad decisions about their savings. As Dunsford and Wickham note, tax free lump sums on retirement are “given to people who largely have no experience in handling such amounts” ... “and their financial advisers compound the uncertainty by recommending unstable investments that require regular review of mix and income drawdown, and reducing the benefits by levying fees for their obscure advice”.\(^ {79}\)

**Conclusion**

The 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 quite unlike the current system which incentivises such savings through the tax system and penalises them through the means test. It provides a consistent vision of the tax system based on comprehensive income principles and a consistent treatment of savings inside and outside of superannuation.\(^ {80}\)

It resolves the issue of the preservation age, which is less important in a non-means tested system. 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. It has a marked

\(^{74}\) Clare 2008 The age pension, superannuation and Australian retirement incomes’ ASFA Research and resource centre p5

\(^{75}\) RPRC 2009 p2

\(^{76}\) 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 p19

\(^{77}\) Cameron 2013 p9

\(^{78}\) Bateman argues that defined contribution schemes place much of the risk and responsibility associated with retirement income provision on individual savers. Bateman 2009 “Retirement income provision in Australia – outstanding design issues in a mature system” p2

\(^{79}\) G Dunsford and D Wickham 2009 “New ideas for age pension reform – discussion paper” Journal of superannuation management vol 3 no 2 p13

\(^{80}\) Although owner-occupied housing continues to be very concessional and geared investments yielding capital gains slightly less so.
impact on the aggregate cost of administering occupational superannuation. It substantially reduces investment and other risk for superannuation savers. One of the strongest impacts of the proposal is its impact on the income distribution in retirement and its associated gender inequity. The current system severely disadvantages women, along with others who have broken work histories.

For those who believe the main idea is too radical, there are a range of options which involve a tax/means test trade off. For example, we could tax contributions more and use the funds to reduce the taper on the pension means test; this cuts effective marginal tax rates for pensioners and hopefully increases mature age workforce participation. Our preference is for the full package because it ticks so many boxes in moving towards a rational retirement income system. It is, quite simply, a good idea whose time has come.
Appendix 1: What should be the tax treatment of voluntary superannuation saving?

Under the proposed scheme compulsory contributions to superannuation would receive no concessional treatment. This is logical; with compulsion, the question of incentive does not arise. Some would argue that if workers are compelled to contribute to super, they should at least get some tax benefit to compensate them for having their money locked away for so many years. The answer is that they get the benefit of having a full top-up to the age pension without loss due to means testing, and in consequence are not on average worse off from the policy change. And low- to middle-income earners are better off because of the highly redistributive nature of the proposals.

There is, however, a possible case for some tax advantages for voluntary superannuation saving, as such saving would be unlikely to occur in the absence of tax advantages. People would simply invest outside of super. Voluntary saving is regarded as the ‘third leg’ of the current retirement income mix, and many experts see it as an important part of the whole.

It may seem perverse to introduce a new tax subsidy for voluntary saving at the same time as we are striving to get rid of existing TEs. This may be, but any such new tax treatment would have some logic in terms of the structure of the system and could be used to introduce rational retirement tax treatment. For example, many experts regard the EET expenditure tax system as the ideal for taxing retirement savings, under which only end benefits are taxed, and at full marginal rates.

Bateman and Kingston have come up with a clever idea to rationalise the current tax treatment of superannuation.\(^81\) Under their proposal workers would be given a choice of two types of super account, one taxed under current arrangements and the other only at retirement and at the marginal rate of the retiree – that is, as EET. Under this proposal, these monies would be used only for the purchase of lifetime annuities: “They would kick-start the market for longevity insurance and ease the cost to taxpayers of population ageing”.\(^82\)

Ironically the Bateman and Kingston proposal wouldn’t work well under the existing system as current tax treatment is already more concessional than EET and annuities are disliked. In other words the option would not be taken up. The EET tax regime proposed makes more sense in the context of a means-test-free pension as the means test does not act to undermine the supposed neutrality of the tax system. Nor would there be any need for compulsory annuitisation, as there is no issue of double dipping and the adequacy of the base pension means we are less concerned about how retirees use their superannuation entitlements. Compulsory annuitisation is a difficult policy in the Australian context because of the public’s attachment to lump sums (half of all benefits are taken in this form) and because it redistributes towards those with longer life expectancies – i.e. the wealthy.

The EET proposal also has the virtue of providing for some lifetime income averaging, something that tax experts regard as a good thing.\(^83\) If an employee is promoted late in life he or she can pour money into an EET account and effectively average that income over his or her retirement years, and this is regarded as fair as it puts the employee on the same tax footing as someone who earns a consistently high salary throughout his or her career.

On the face of it an EET with deduction limits similar to those now prevailing would cost approximately $8.5 billion per annum. This is the difference between the $34.7 billion TE

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\(^{81}\) Bateman and Kingston 2010 “Tax and super – unfinished business” CPS Discussion paper 02/10, UNSW

\(^{82}\) Bateman and Kingston 2010 p4

\(^{83}\) See Vickrey 1947 Agenda for Progressive Taxation
calculated by Treasury and the $26.2 billion revenue gain (RG). Since the difference mainly relates to the withdrawal of voluntary contributions, inducing them back into superannuation has the same cost.

But since we have used the RG figure in our costings, we can infer that the new EET for voluntary contributions will have no new net cost. It would only have an $8.5 billion net cost if we used the TE figure. The intuition for this strange result is as follows. The RG figure assumes that voluntary savings would virtually cease, and that monies previously invested in super would be invested in forms that yielded on average very little tax revenue. When these monies are induced back into super by our new concessions they therefore don’t result in a diminution of revenue outside of super. Hence, no net cost.

Of course, this is an approximation. Our new EET is somewhat less concessional than the current regime, so voluntary contributions might fall back to some extent. And there would be higher tax on end benefits, so the timing of tax receipts would shift towards the future. On balance it could be anticipated that the revenue effects would be minimal, and if there was a net cost due to timing effects there is scope to, for example, adjust contribution limits.

An alternative non-concessional approach to income averaging is available through an ETT tax regime. This has the same net present value to the government as a conventional income tax (TTE) but tax is initially exempt, allowing monies to be put aside at a time of life when marginal tax rates are high and then paid when monies are withdrawn during retirement, allowing a form of income averaging. An ETT regime shifts tax revenues backwards but has no real net cost in present value terms except to the extent that marginal tax rates are lower when revenues are collected. But since such averaging is consistent with the comprehensive income tax ideal it should not be expected to show up as a cost in the tax expenditure statement.

It might seem strange that both the EET and the ETT should show up as having no net cost, and indeed it is a paradox as the former gives rise to a TE $8.5 billion greater than the latter. The paradox is resolved when we see that it arises from using a TE concept that applies in a perfect world. A deviation from the comprehensive income ideal can be measured if that ideal applies elsewhere; when it does not apply then such deviations become very hard to cost.

Both the EET and the ETT require that residual monies in the voluntary super account at the time of death be taxed as ordinary income using some averaging method – for example, by spreading the amount over the last five years of life and applying the marginal tax rates that result. Governments are reluctant to tax appropriately in this area – witness the current treatment of capital gains on death84 - because of not wishing to appear to levy a bequest tax. That is why EET is normally associated with life annuities whose value extinguishes on death, and this might be one reason to favour the Bateman and Kingston approach.

84 Ingles 2009b “Tax equity: reforming capital gains tax in Australia” TAI Technical brief No 1 April
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