



*"Blue Skies"*

ASFA's  
Blueprint for a  
National Retirement  
Income Policy  
June 1998

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# FOREWORD

## **Why ASFA has prepared a Retirement Income Blueprint**

Australia's retirement system has reached a crucial point. It has sound foundations in the form of a three pillar approach made up of:

- An Age Pension paid from current revenue
- Compulsory saving through occupational superannuation
- Voluntary savings, in part supported by tax concessions

These foundations, while the envy of many a country, have become corroded, if not a little shaky.

This is a major public policy issue which will impact on the living standards of individuals, the government's capacity to provide minimum services and the general economy.

It is time to restate and recommit to the objective of a retirement income strategy.

## **Problems with the Age Pension**

The continued affordability of the Age Pension, aged care and health care is becoming an increasing concern, particularly with the ageing of Australia's babyboomers. On the other hand, the effective marginal tax rate that many retirees face as the result of withdrawal of social security benefits on top of income tax is not fair and reduces the incentive to save. Individuals are not saving enough to ensure an adequate income for their retirement.

## **Making occupational superannuation better**

Occupational superannuation has achieved significant progress in terms of extent and level of coverage in the community, but many still have little or no savings in super. Those who are self-employed, who are in and out of paid work, or who are low-income earners and opt out under the Government's proposals will all too often end up with inadequate retirement income.

Savings through the Superannuation Guarantee have improved the situation considerably and will improve further with its phased increase to 9 per cent of earnings. But this is still not enough to meet the needs and expectations of Australians in retirement. Increased compulsory contributions or incentives for voluntary savings are therefore imperative.

## **Problems with voluntary savings**

The taxation and regulation of voluntary savings, particularly superannuation, has become unduly complex. There have been over 2000 changes in the last 10 years. Many ordinary Australians, and indeed many practitioners within the finance sector, have to struggle with provisions which have become

bizarre in their complexity. Governments have all too often been focussed on short term revenue needs rather than the longer term objectives and implications. This complexity and change undermines both the original public policy goals and the confidence and understanding by the public as to the value of saving for the long term.

Long term savings for retirement should be encouraged because of both individual and more general public and economic benefits generated. But there are questions about how supportive the current tax system is for voluntary savings.

Superannuation has clear tax advantages for some in the community but the extent of claimed concessions for superannuation in terms of their overall cost is nowhere near the figures put forward by the Treasury. As well, for some individuals the tax and social security systems result in significant disincentives for saving. The incentives and disincentives for private savings should be an important issue for the debate about tax reform.

These factors have led in a cumulative way to levels of private and national savings that are lower than they should be. While actions by the Commonwealth Government have led to a substantial turnaround in the level of public savings, private savings (particularly household savings) are at an all time low level. For most of the 1970s the household savings ratio was well above 10%, but in the 1990s it has slipped to below 5% and shows no signs of recovery.

### **What the Blueprint does**

The purpose of the document is to provide policy makers with a strategy for developing a coherent retirement income system and ensuring its viability into the future. It provides what we consider to be a comprehensive model for retirement income policy as it should be in the long term. The paper covers major aspects of both public and private retirement income arrangements, including the key features of the system, the scope of superannuation coverage, the amount of retirement income needed by individuals who should be covered, the desirable characteristics for a retirement benefit, and the taxation of superannuation and other retirement savings.

In some areas the current system already matches the ASFA model for the retirement income system. In other areas considerable changes will be needed to ensure that our retirement income system meets both individual and collective goals.

Transition issues will be important. The Blueprint provides some indication of how the transition to a more coherent and effective system might be achieved, but this is an area that needs further debate and elaboration. A coherent retirement income strategy is likely to require some unravelling of past arrangements.

### **How the Blueprint was developed**

The Blueprint was developed with maximum input from ASFA members so that the considerable experience of the industry was used. The document is supported and owned by the members of ASFA.

The ASFA Research Centre largely prepared the initial draft of the Blueprint, but it derived its content on many important issues from the ASFA Policy and Tax Policy Committees, and the ASFA Federal Council. Other ASFA Committees and Study Groups have also provided valuable comments and suggestions about the Blueprint.

ASFA members more generally were also involved in the process. The draft document was distributed to delegates at the 1997 ASFA Conference, with a number of the Conference sessions and speakers dealing with Blueprint issues. A summary of the draft Blueprint was placed on the ASFA Internet site, together with scope for e-mailing comments.

ASFA's Federal Council thanks all the individuals and groups that contributed their time and their ideas.

### **Future Processes**

The formulation of the ASFA Blueprint for Retirement Income Policy is, in many ways, the start rather than the finish to the reform process. We need to restore the vision for the nation's retirement income policy with the public and government. Australians need to be educated about retirement income planning and to have a sense of ownership of the system.

ASFA will also make use of future opportunities when retirement income policies are being reviewed for advancing specific aspects of the Blueprint.

In the course of these processes, ASFA will need to define the transition path for taking the retirement income system from where it is now to where we want to be. ASFA is consulting with its members and other stakeholders as to how this can best be achieved.

**Philippa Smith**  
Chief Executive Officer  
June 1998

## EXECUTIVE SUMMARY

Much has been achieved with Australia's retirement income system in the last two decades. Major steps have been taken towards ensuring that Australians have access to a decent retirement income, increasing our national savings and getting ready for the ageing of our demographic structure.

In contrast, for most of this century retirement income provision was limited to a Commonwealth Age Pension directed at poverty alleviation. This was supplemented by more generous employer schemes for a minority and substantial private savings by a very few.

Now, with a basic Age Pension legislated to move in line with community standards, compulsory superannuation coverage for

almost all employees, and preferential tax treatment for retirement savings, Australia has a truly comprehensive system which is seen as a role model by many other countries.

However, the current system does have faults. It is unduly complex and there are inconsistencies and inequities. Work patterns continue to change and retirement provisions have not kept up with this. Leakages of retirement savings prior to retirement are running at too high a level. Changes wrought by governments of various political persuasions have compromised the overall aims of retirement income policy. As well, a number of groups which consider that they have not been served well by retirement income arrangements in the past are still awaiting the resolution of their problems.

The importance of getting the retirement income debate right **soon** cannot be underestimated. The "baby boom" generation will impact on retirement income expenditure, and have simultaneous demands for increasingly sophisticated medical care as they seek longer life and a better quality of life.

EPAC projections indicate that the ratio of persons aged over 65 to persons of working age will double or more. Welfare expenditures would, in the absence of compulsory superannuation, rise from \$23 billion in 1989 to \$105 billion in 2051. Without compulsory superannuation and tax concessions for voluntary retirement savings, rates for income and other taxes would eventually have to rise by up to 20 per cent in order to provide even basic retirement incomes.

The baby boomers will not be prepared to live on the Age Pension alone. They have not been raised against a background of economic depression or war. The level of self-sacrifice they are prepared to endure has not been tested. The baby-boom generation will be a powerful political force which will demand more generous, and therefore more expensive, retirement income. How, not whether, this will be funded is the question.

As Australia enters the next millennium it will be important that Australia has in place a retirement income policy that:

- is simple and understandable
- increases national savings
- provides adequate retirement income
- is equitable
- has low administration costs
- deals with the fiscal consequences of an ageing population
- has an appropriate balance between private and public responsibilities

Those in the workforce today are making a significant contribution to retirement income. They are paying twice – first, for those who have already retired, and second,

trying to save for themselves. These contributions should be applauded, and should be matched by government commitment to a robust and sustainable set of policies which support both current and future generations.

**In undertaking this exercise ASFA is focussing on what is for the public good rather than what necessarily is good for superannuation providers.** The sector acknowledges that the way it does things will need to change. This process of change will not always be a comfortable one.

Set out below are the main elements of ASFA's proposals.

### **ASFA'S RETIREMENT INCOME POLICY BLUEPRINT**

Three Pillar Structure	<ol style="list-style-type: none"> <li>1. Safety net Age Pension (minimum of 25% of gross AWE)</li> <li>2. Compulsory superannuation (aim for 50% of gross pre-retirement earnings, up to a cap)</li> <li>3. Voluntary superannuation (maximum of 1.5 times gross AWE retirement income attracting tax concessions)</li> </ol>
Three Pillar Coverage	<ol style="list-style-type: none"> <li>1. Safety net for those who can't reach 50% of AWE on superannuation alone.</li> <li>2. All those earning taxable income to be compelled to be covered.</li> <li>3. All those who can afford to provide should be able to.</li> </ol>
Exemptions	Minimal
Benefit Structure	Primarily income streams with only modest lump sums available
Taxation	<ol style="list-style-type: none"> <li>1. Directed at benefits and paid as PAYE on income stream taken.</li> <li>2. Taxation on amounts above set limits (either income stream or lump sum) would be structured to remove benefits of compounded tax deferral.</li> </ol>

# ASFA'S RETIREMENT INCOME POLICY BLUEPRINT

## 1. THE BROAD PARAMETERS OF THE SYSTEM

What is required for retirement income can be summarised under the three pillars:

- **provision of an adequate public safety net;**
- **compulsion of self-provision** based on a set level of contributions for those in the labour force at the very least; and
- **encouragement of self-provision** (by way of superannuation or other savings preserved until retirement).

These principles have achieved support amongst the public, major political parties and stakeholders in the sector.

Government involvement in the financing and provision of the safety net provision is both inevitable and desirable. Private provision and management of the other two pillars (subject to appropriate government supervision) is accepted both in Australia and in other countries as necessary for the control, security and maximisation of earnings rates on savings.

This “three pillars” approach has been endorsed internationally by bodies such as the World Bank (World Bank, 1994). It is the design and dimensions of each pillar, not the need for them, which should be the subject of public

discussion.

For a retirement income system to be effective its focus needs to be on retirement income. Funds should not be dissipated on fixing perceived or actual problems with the provision of housing, aged care, unemployment benefits, health costs etc. Funding of these should be the subject of separate public debate. If retirement income financing arrangements were to be used for any such additional purposes this would have to be on the basis that additional contributions were made to cover such expenses. Superannuation is not a magic pudding from which additional slices can be taken without compromising the core goals of retirement savings.

In addition to meeting these broad aims, the system should run efficiently:

- the system should be simple and understandable;
- regulations should be clear;
- administration and selling costs for retirement products should be low;
- members should be well informed and educated on retirement income issues and on their rights and responsibilities; and
- there should be effective and low cost mechanisms for resolving member problems and disputes.

## What should be the key features of the Australian system?

II First pillar - a guaranteed minimum retirement income provided by government on a means tested basis to provide for protection against poverty and a base for overall retirement income. While the exact level of such a payment will depend on community attitudes and affordability, the current level of 25 per cent of male total Average Weekly Earnings for a single retired person does not seem inappropriate at this stage.

II II Second pillar - mandated private contributions which also are privately managed. In line with community needs and expectations, the minimum goal of such mandating should be retirement income (including any payments from government) in excess of 50 per cent of gross pre-retirement earnings. A balance between needs, expectations and government responsibilities is struck by including even low income earners but capping compulsory contributions at a proportion of, say, 2.5 times AWE.

Personal and employer contributions with a total in excess of 9 per cent of earnings are required to meet the income target. Even higher contribution rates would be needed if superannuation is used for purposes in addition to retirement income.

II II II Third pillar - additional savings and retirement income beyond the mandated level should be a matter for individual decision. Retirement savings which contribute to a total retirement income stream of up to a reasonable level, say, 1.5 times AWE, should benefit from preferential taxation treatment given their benefits for individuals and the community more generally. If an individual chooses to fund a higher retirement income or takes the savings out as a lump sum, then the excess and/or lump sum elements of this should be subject to taxation which removes any benefits of preferential taxation treatment.

## Who should be covered?

Arrangements should aim to be more inclusive rather than less.

**Individual needs and capacity to contribute should be the test, not employment status.**

Rather than adding to the increasing array of allowed exceptions to the occupational link test for superannuation, in the long term any formal occupational link should be removed. The only criteria should be the receipt of taxable income by a person, for themselves and their dependants.

**No group should be excluded by design or by opting out provisions. Employees, the self-employed and those relying on business and investment income should be included in the compulsory pillar and allowed access to the voluntary pillar.**

Unless and until a group can be exempted unconditionally from later access to the Age Pension safety net, it is the responsibility of all to shoulder part of the burden of planning for future retirement income needs.

A more inclusive approach to tax advantaged retirement savings might increase levels of coverage from around 80 per cent for those employed and around 60 per cent for those employed part-time to near universal levels. This would require in particular a lifting in the coverage level of the self-employed and those who work casually or part-time. Coverage of those who are employees and who earn more

than \$450 per month is already near universal

For those not employed but aged between, say, 25 and 65 (such as spouses not in paid work, those relying on investment income and social security beneficiaries) the current level of coverage is negligible. For these groups the aim should be to achieve a significant, but not universal, level of superannuation coverage. This could be achieved by removing restrictions on contributions to superannuation, and by providing incentives for contributions on the behalf of target groups. The splitting of superannuation at time of divorce has been proposed by the Government (Costello, Williams 1998). This, along with the recent introduction of spouse accounts more generally, also would have the potential to raise the level of superannuation coverage.

## Equity

Equity has a number of dimensions, with public debate not always clear or soundly based.

Equity must be considered in the context of overall retirement incomes. Too often, superannuation and the Age Pension are considered separately. The community funds retirement income support for **both** superannuation and the Age Pension recipients, and some will benefit from one or other or partly from each.

Age and Veterans Pension expenditures are currently

approaching \$20 billion a year (1998-99 Budget Papers). **The capital value of future government pension expenditures is some hundreds of billions of dollars. Against this must be set the costs of preferential tax treatment of full or partial self-provision.**

For those middle to high income earners who can afford to provide from their own means, this is the very purpose of superannuation. Government support, subject to limits, is appropriate and equitable given the benefits that accrue to both individuals and society. Lower income earners who may receive little or no superannuation will still receive retirement income support from the community but through the Age Pension.

Equity should not necessarily be an issue if the superannuation system alone is the main source of income for those it targets. Neither should equity be an issue if some individuals are totally reliant on a government payment. In essence, the Age Pension integrates the retirement income system. The Age Pension supports those who have not received tax concessions for super and it tops up the income of those with only modest super benefits.

As will be explained later in this document, too much attention has been given in the Australian system to equity in terms of the taxation treatment of superannuation at the contributions stage. Too little attention has been given to equity in terms of the ability to make contributions or have them made on behalf of a member.

The taxation of retirement income savings through superannuation at each of the stages of contributions, earnings and benefits is unique to Australia. This tax treatment should not be sustained into the future because of its equity and efficiency drawbacks. Equity would be better served by measures designed to advantage those with low incomes, broken work patterns, and/or dependence on social security or income transfers within family units, rather than disadvantaging those who make a large contribution in any given year.

Eliminating discriminatory employment practices which lead to indirect discrimination in superannuation contributions might be a greater priority than attempting to adjust the taxation of contributions.

Equity would also be best pursued by moving to greater emphasis on the taxation of benefits, particularly benefits paid as an income stream over a significant number of retirement years.

Equity in retirement income should be delivered by the setting of appropriate tax rates on benefits. For those who ultimately receive generous benefits, they should pay higher taxes in a manner similar to the progressive income tax system on other income. Flat rates of tax on contributions and earnings generally are not compatible with equity goals.

**“Grandparenting” of accrued rights and expectations satisfies some aspects of equity criteria,**

**but introduces other anomalies between individuals of the same and different generations.** It also adds to the complexity and confusion confronting the system today. Rights and expectations should be taken into account by use transfer values and/or transitional arrangements limited to fixed time periods.

### **Increasing national savings**

A major challenge for Australia is increasing Australia's national savings (FitzGerald 1993, Budget Papers 1998-99, Smith, 1998). Compulsory superannuation contributions preserved to retirement age do this unequivocally. The institutional arrangements for the investment of superannuation funds also aid the flow of Australian savings into productive investments. Increasing the tax burden on Australian savers so as to fund reductions in other taxes paid by Australian businesses would be largely self-defeating. Broadening tax concessions for other forms of savings which are

not preserved and/or would have been made in any case do not aid national savings to anywhere near the same extent. Savings which go to productive investments such as equities and other real activities should be treated more favourably than the tax treatment of speculative financial investments.

There may also be a case for tax concessions or other government assistance to be targeted to additional savings of those with historically the poorest savings records - those on low to middle incomes, women with broken work patterns and/or expectations of depending on a spouse's savings, and social security recipients.

Further limiting access to superannuation before retirement age (preservation) and encouraging/requiring receipt of benefits as income streams over a number of years also would assist in increasing national savings. These issues are discussed further in the 1998-99 ASFA Pre-Budget Submission (ASFA 1998a).

## 2. LEVEL OF BENEFITS TO BE DELIVERED

An important benchmark for evaluating a retirement income system is the level of retirement income that is being sought and/or will actually be received. This can then be used to judge whether adequate superannuation and other savings are being undertaken. As well, this information is important in judging whether the retirement income system will achieve the aims set for it by individuals and by government.

Unfortunately, there often is confusion about the issue of what is adequate. Much discussion is based on what people want or aspire to, and not actually on what they are prepared to support through foregone consumption prior to retirement.

Assumptions about the future also are important. Retirement savings might be adequate to support retirement needs if capital is run down, but individuals might wish to maintain savings for bequest or security purposes. Staying married to someone with adequate retirement savings can also be a questionable assumption.

There are also different motives in assessing adequacy. Governments, for instance, are interested in shifting the burden from public support systems such as the Age Pension. Suppliers of various retirement savings products are often interested in selling more rather than less of such products. Individuals might want high levels of income in retirement but will not support

contribution levels and taxes needed to support them.

Accordingly, adequacy of retirement income cannot be divorced from the question of adequacy of contribution levels. Knowing where you want to get to is of no use if the means of getting there are not considered.

Contribution rates are an important determinant of what will be achieved in terms of adequacy. However, years of contributions, average salary received, age of retirement, and sources of other funds, fund earning rates and the rate of inflation also impact on final retirement incomes. This makes the translation of an income replacement goal for retirement into an operational strategy difficult.

Another complication is that it is the combination of the Age Pension, compulsory superannuation provision, voluntary savings in both superannuation and other savings, and perhaps part-time work which determines total income in retirement. As well, some individuals want to retire early, while others will continue in full-time employment until well after usual retirement age. Tax and social security provisions also are important.

Costs of living for retirees need to be considered as well. Retirees are likely to have consumption patterns which differ from the population generally. This may

have some implications for the indexing of retirement incomes. However, more importantly if a retiree faces relatively low or no charges for medical and hospital care, pharmaceuticals, nursing care, home and community care, housing and public transport then a reasonable lifestyle might be maintained on a relatively low income.

**If substantial charges are faced in any or all of these areas or individuals are compelled to insure themselves privately against such expenses, then a higher level of income might be necessary to ensure adequacy.**

As well, to the extent that means testing for health and aged care services includes assets accumulated through superannuation and like retirement savings arrangements, a higher level of contributions will be needed to generate an assured retirement income.

There also are differences in attitude between different age groups to what is an adequate retirement income. Older people, for instance, have their views conditioned by formative years in which adversity and low incomes were relatively common. For many who have already retired the level of the Age Pension and the level of financial assets and superannuation they have accumulated govern their retirement income expectations.

For younger people, outcomes are more subject to individual control given that savings and superannuation contributions can be influenced. Very few young

people expect that they will rely upon a government pension in their old age, with the expectation of having their own significant income instead. For older people, the contrary expectation and realisation is the case.

These differences in attitudes come through clearly from Australian social research such as Zagorski, 1995 and Webster, 1997.

### **Is the Age Pension adequate?**

**At 25 per cent of average male total earnings the Age Pension bumps along just above what economic and social researchers generally regard as the poverty line in Australia.** For those in private rental accommodation the Age Pension, even with rental allowances, is not always enough to avoid what is usually perceived as poverty. The Age Pension is sufficient to sustain only a very modest lifestyle, with no major expenditures possible outside those funded by governments such as health or aged care.

Whether the current level of the Age Pension is enough is a matter that can be debated. It should be noted though that the current Government's decision to legislate the link to 25 per cent of average male total earnings was actually one of the largest items in the 1997 Budget in terms of future budgetary impact. With current constraints on the willingness or ability of governments to increase tax revenues it is unlikely that a significant increase in the Age

Pension will be possible. If governments wish in the future to increase expenditure on income support for the aged, this could involve an increase in the Age Pension. Equally it could involve an easing of the current means test so as to better reward those who have made self-provision, thus lifting incentives and average retirement incomes.

**It is the interaction between various forms of retirement income as well as the level of the Age Pension which is important, particularly as more individuals build up an entitlement to a superannuation benefit.**

However, given that there will be some who will always be totally dependent on the Age Pension, the absolute level of the Age Pension will be an important matter for consideration by government.

### **Overseas targets**

What do other countries seek to achieve in terms of replacement in retirement of working age incomes, and what are the implications for Australia?

FitzGerald, 1994 and EPAC, 1993 indicate varying target replacement rates:

- Sweden - typically around 70 per cent with almost universal coverage;
- United Kingdom - between 20 to 25 per cent and 35 per cent, and significant numbers below the poverty line;
- Israel - flat rate of around 25 per cent of average wage and up to 70 per cent under occupational

plans;

- Canada - between around 25 per cent of average earnings and 40 per cent or more for some who qualify;
- Japan - goal of around 50 per cent of gross earnings (bonuses included);
- France - 40 to 75 per cent;
- Germany - 40 to 45 per cent;
- Italy - 80 per cent;
- Netherlands - 60 per cent.

In most developed countries the minimum retirement income for an individual is around 20 to 25 per cent of AWE, and for a couple around 40 per cent. In some countries the minimum amount is at or below the poverty line. Target rates of income replacement can be as high as 70 per cent, but because only a proportion of retirees ever meet the conditions necessary to meet such targets, average retirement incomes for a single person in such countries seldom exceed 40 per cent of average weekly earnings.

While it could be argued that a low minimum income is a strong incentive for self-provision and should be adopted, **international experience suggests that a minimum income below 25 per cent of AWE is not sustainable or desirable.**

In terms of goals for income replacement, while there are some examples of replacement ratios at or in excess of 70 per cent, such rates generally are not sustainable over the longer term when significant government funding is required. This remains the case even when specially designated

taxes to finance benefits are in place. Replacement ratios in excess of 40 per cent are more common.

### **What do Australians want and deserve?**

On the basis of what the current cohort of Australian retirees has done, a goal of 25 per cent of male average total earnings might be appropriate, as most retirees are on incomes at or only slightly in excess of that level. The main exceptions are the less than 10 per cent of retirees who are on pensions from relatively generous public sector or employer defined benefit schemes, or those who have accrued significant savings during their lifetime.

However, there are strong indications that the low levels of income in retirement for the bulk of current retirees is a matter of necessity rather than choice. When asked, **Australians who are currently entering the work force typically aspire to replacement ratios of around 60 per cent, preferably with the option of this being paid from age 60 or thereabouts** (Shirlaw 1997, ARISA 1997).

This intention is reinforced by the rule of thumb adopted by many financial planners, which suggests that around 60 per cent of gross pre-retirement earnings is the appropriate goal for those putting together a savings plan for retirement.

ARISA (1997) suggest that an

appropriate target is 60 per cent of pre-retirement earnings for a single income household and 50 per cent each for a dual-income couple after 35 years of employment. They say that this would require contributions of about 15 per cent of salary (net of contributions tax) for the entire period. A significant increase in personal contributions, a reduction in contributions tax and/or an increase in the SG would be needed to achieve this.

However, through choice or necessity most working age Australians are yet to make contributions to superannuation and other savings vehicles which would be sufficient to generate retirement incomes of that order. The evidence available suggests that individuals when they are in their 40s recognise the need for increased savings and place a higher value on the level of retirement income, but often it is then too late to accumulate the savings required.

### **What have Australian governments specified as targets?**

The current Government has not publicly specified its goal for replacement incomes in retirement. However, so far as contributions are concerned it has maintained the timetable for raising the SG contribution to a maximum of 9 per cent. Taxation concessions and incentives are in place for further voluntary contributions, but there is no plan for compulsory employee contributions. The co-contribution proposed by the former

government for low and middle income earners also has been dropped. The Government also has proposed that individuals earning between \$450 and \$900 per month be allowed to opt out from having superannuation contributions made on their behalf.

The Labor Government in its statement *Security in Retirement* suggested that a replacement rate of at least 40 per cent should be aimed for. In subsequent documents, such as *Saving for our Future* (Willis 1995) projected outcomes from its proposals implied replacement rates for low income earners of 100 per cent or so of pre-retirement expenditure, equivalent after tax to around 80 per cent of pre-retirement income. For upper income earners, those on twice AWE, projected replacement rates were around 50 per cent of pre-retirement income.

It should be noted that projections of this order were dependent on the assumption of 40 years unbroken employment, and retirement at age 65 for men, and also individual contributions in addition to the compulsory SG. Each of these assumptions is questionable on the basis of trends and outcomes over the last decade.

The effects of both taxation and social security means testing need to be taken into account when calculating what level of compulsory and voluntary retirement savings are needed to generate a given level of retirement income. For instance, there would be little incentive or support for private provision if, say, a privately

provided retirement income stream of 25 per cent of AWE merely displaced the Age Pension. Under current means testing arrangements such a private income stream would produce a total retirement income (including a part Age Pension) of the order of 37 per cent of AWE.

Withdrawal rates of social security benefits in response to receipt of private income currently are in the order of 50 per cent or more of private income. ASFA research indicates that over some income ranges and circumstances withdrawal rates for government benefits can be 100 per cent or more, particularly when the effects of marginal income tax rates are taken into account.

Such effective withdrawal rates are high relative to marginal income tax rates applying to low and indeed high income earners. However, to date governments have judged that they are necessary on the grounds of limiting social security aggregate costs. In maximising both typical and overall retirement incomes, governments have to pursue some difficult assessments of the costs and benefits of adjusting base rates of payments for the Age Pension and the means test applying to individuals.

However, in the current debate on tax reform the existence of poverty traps and high effective marginal withdrawal rates have been identified as a concern, or at least so far as such rates apply to certain groups. The Government has also acted in the 1998-99 Budget to extend coverage of the Seniors Health Card to a further

220,000 self funded retirees, thereby making self provision in retirement more attractive.

Other government measures also impact on eventual outcomes. For instance, the current Government has replaced the proposed government co-contribution with a much less valuable rebate on contributions, reducing directly and indirectly the amount contributed by low and middle income earners to superannuation.

Careers also are starting later and finishing earlier, with ASFA commissioned research (Cornish, 1997) indicating that many early retirements are induced through labour market or health developments outside the control of individuals.

While the current Government has not formally specified a target for retirement income beyond its proposals for the adjustment of the Age Pension, through the operation of the incomes test, some Age Pension is payable up to nearly 58 percent of AWE for an individual. Limits on what is "reasonable" and expected for retirement income have therefore arguably already been set around the mark of 50 to 60 percent of AWE.

Projections using the AMP model of retirement income (Doyle, 1997) suggest that SG contributions of 9 per cent, which is the main compulsory element of the current Government's policies, would result in a replacement rate of 28 per cent after 30 years and 43 per cent replacement rate after 40 years.

For a person on about AWE, this implies a total replacement rate of both super and Age Pension after 30 years contributions of around 40 per cent.

Additional saving by individuals in the form of a 3 per cent personal contribution to a balanced superannuation fund would lift the gross replacement rate by 9 percentage points in gross terms, or around 4 or 5 percentage points when the impact on the Age Pension is taken into account.

If a SG contribution of 9 per cent and a personal contribution of 3 per cent is taken as the Government's preferred outcome, this is consistent with a replacement rate of around 45 per cent for 30 years' contributions and over 50 per cent for 40 years' contributions.

## **What ASFA is proposing**

Retirement income provisions should aim at achieving much more than poverty alleviation or the achievement of a minimum benchmark income for all individuals. The guaranteed minimum by government for a single retired person of a retirement income of 25 per cent of male total average weekly earnings provides a base level of income which just meets the objective of alleviating poverty.

**In conjunction with this should be private retirement income arrangements which on the basis of reasonable assumptions about lifetime working patterns**

**and other earnings will deliver a total retirement income in gross, pre-tax terms for a single person in excess of 50 per cent of Average Weekly Earnings.** A level of 70 per cent would be more in line with the hopes and expectations of many in the population, but this may be difficult for the bulk of the population to achieve.

**In terms of the level of employer contributions required to generate retirement incomes of the order of these targets, ASFA considers that 9 per cent of earnings will not be sufficient in most cases. Additional**

**employer or employee contributions and/or government contributions and/or more favourable tax treatment will be needed if community expectations about incomes in retirement are to be met.**

If the framework for compulsory superannuation coverage were used for funding other needs such as aged care or medical expenses, then an increase in the contribution rate would be required, as otherwise the level of retirement incomes that could be generated would in most cases be inadequate.

### 3. WHO SHOULD BE COVERED?

In setting the level of retirement income aimed for generally in the community, some groups are currently not included in the superannuation system.

Therefore, for these people we are implicitly only aiming for the 25 per cent of AWE. However, it is unlikely that these groups will be happy with this income level, and, arguably, by not personally building retirement savings they are not contributing towards minimising future burdens.

There are a number of dimensions to the concept of coverage. The first is whether an individual is allowed to contribute to superannuation, the second is whether they are compelled to, and the third is whether encouragement in the form of a tax concession or subsidy is provided by the government.

Currently in the main only those in the labour force or who have had a past connection with the labour force are allowed to contribute to superannuation or have contributions made on their behalf. However, a number of exceptions have developed, including contributions made on behalf of a low income spouse (Costello 1997). Superannuation assets are also taken into account in property settlements at the time of divorce. The Government is proposing that the distribution of superannuation at the time of marriage breakdown be further formalised, including where appropriate the creation of new spouse superannuation accounts.

**In ASFA's view, the link with occupation for superannuation tax concessions and obligations should be removed. The implication of this view is that those who are subject to the tax system should be required to put something aside, guaranteed, for their future.** On this view, no group should be excluded by design or by opting out provisions, with employees, the self-employed and those relying on business and investment income all included in the compulsory second pillar and allowed access to the voluntary third pillar. Appropriate provision for spouses both in terms of contributions and distribution of assets at time of divorce also is appropriate.

For example, the self-employed are currently exempt from the Superannuation Guarantee provisions in regard to their own employment. They are permitted but not compelled to make superannuation contributions, and capital gains tax relief is available in some circumstances for owners of small businesses who rollover into a superannuation fund the proceeds of the sale of their business.

However, problems arise with assuming that the self-employed will independently fund their retirement. Some may have businesses with virtually nothing to sell (eg a tradesperson) or they may unfortunately find themselves seeking to retire in a recession when the market for even a saleable business is depressed.

Even the level of bankruptcies is proof that not all will be able to rely on their businesses to fund retirement.

It is recognised as essential for there to be separation between a business and a superannuation fund to reduce the reliance of the latter on the former and this is the objective that should also be put into place for the self-employed. Superannuation rules should be such to ensure that the self-employed have the independence in retirement that they enjoyed in their working lives.

For those who are reliant on government payments or on the income earned by a spouse the case for compulsion is not as strong. However, such individuals should not be excluded from the superannuation system.

Unless and until a group can be exempted unconditionally from later access to the Age Pension, it is the responsibility of all to plan for their future retirement income needs to the best of their ability. Those with employment income and/or investment or business income should be expected to make significant self-provision.

**A more inclusive approach to tax advantaged retirement savings might increase levels of coverage from around 80 per cent for those employed and around 60 per cent for those employed part-time to near universal levels.** This would require in particular a lifting in the coverage level of the self-employed and those who work casually or part-time.

For those not employed but aged between, say, 25 and 65 (such as spouses, those relying on investment income and social security beneficiaries) where current coverage is negligible, the aim should be to achieve a significant level of private superannuation coverage. This could be achieved by removing restrictions on contributions to superannuation by or for those not in employment, and by providing incentives to be made on the behalf of target groups. The splitting of superannuation entitlements at the time of divorce also would have the potential to raise the level of superannuation coverage.

## 4. WHAT SHOULD BE THE CHARACTERISTICS OF A RETIREMENT BENEFIT?

ASFA considers that a number of characteristics should be attached to retirement benefits which receive the benefit of concessional tax treatment or other assistance from government. These include:

- **being in the form of an income stream rather than a lump sum** (apart from a modest sum to meet immediate or urgent expenses);
- **providing reasonable protection against the financial consequences of longevity** through being available for a period not dissimilar to life expectancy;
- **providing protection for dependants** through appropriate reversionary benefits; and
- **involve a drawing down of capital rather than being a form of estate planning.**

Translation of these general goals into detailed provisions will necessarily be a substantial task for both regulators and the sector. However, there are indications that both social security and taxation provisions are being reviewed by the relevant authorities with a view to making income streams more attractive to retirees. Another important goal will be to ensure that various types of income streams are consistently treated by tax and social security provisions.

The superannuation industry also will need to review its practices and products. The move from defined benefits to accumulation schemes has led to the sector concentrating on the collection and investment management of contributions through the accumulation stage. Less attention has been given to how retirement income products are provided and marketed to those who take a benefit from accumulation funds. However, this is beginning to change as more individuals build up substantial balances in accumulation funds and seek a seamless transition from accumulation to a retirement income stream.

## 5. THE TAX TREATMENT OF SUPERANNUATION AND OTHER RETIREMENT SAVINGS

Taxation considerations loom large in both the design and practice of superannuation and retirement savings. The three main reasons individuals want to use superannuation rather than other forms of saving for retirement are usually tax, tax and tax. Equally the three main reasons that the system is complicated and the public have difficulty in comprehending superannuation are tax, tax and tax.

As shown in Figure 1 the current system is now bizarre in its complexity. The mythical visitor from Mars would not be able to understand either the substance or the rationale of many of the provisions. Most Australians do not.

Getting the taxation treatment of superannuation “right” is crucial for achieving desired retirement savings and retirement income objectives, and for achieving an efficient and equitable superannuation system.

Governments also need to get the treatment of superannuation right in the construction of an efficient and equitable overall taxation base. Contributions made to superannuation, earnings on those contributions and benefits paid to members and their dependants are large both individually and in aggregate. In fact they are so large they are treated as an important part of the tax base for government.

The advantages for fund members of the importance of superannuation savings both individually and collectively are that governments generally are unwilling to significantly disturb expectations of members, and will continue with the concessional tax treatment of this form of savings.

The disadvantages for the sector and for members are that because members’ access to benefits is generally postponed for years or decades governments can, mistakenly, treat superannuation funds as a “magic pudding” from which slices can be taken to fill up any short term hole in the Commonwealth Budget.

### **Why should there be specific tax arrangements for saving for retirement?**

There are both practical and conceptual reasons for these specific tax arrangements. Among the practical reasons are that few if any other forms of saving involve contributions from both individuals and employers, with savings held on trust and generally preserved until retirement. In some cases contributions are notional, and an employee might only receive an eventual benefit in limited and defined circumstances. Benefits also can be taken in a variety of circumstances and forms with potential implications for taxation treatment. On a practical level superannuation contributions and benefits are not equivalent to

deposits and withdrawals from, say, a bank account. Superannuation is treated differently because it is different.

**More fundamentally, there are public policy reasons for superannuation receiving what should be termed as strategic treatment.**

First, **the elderly need superannuation** because they cannot or no longer wish to work.

Second, **tax favoured self provision in retirement is seen as an essential component in how we cope with an ageing society**. There is both popular and policy analyst recognition of the changing demographic profile of Australia (the baby boomers moving through to retirement) (EPAC 1994, National Commission of Audit 1996). There is both public and government concern with the emerging costs of retirement income and aged care. Governments are concerned about whether future Age Pension payments can be delivered, and individuals are concerned whether they will be able to rely on government for them.

Third, **survey and other evidence clearly shows that individuals do not want to retire on 25% of AWE** (which is the full Age Pension). Tax preferred saving in the form of superannuation is a relatively efficient way of increasing retirement incomes while limiting costs to government.

Fourth, **tax concessions are part of the glue that holds together community acceptance of**

**compulsory saving for retirement, compulsory preservation of voluntary contributions and means testing of the Age Pension**. If super were taxed the same, say, as bank accounts the combined effect of taxes and means testing of benefits would be punitive, not neutral. Taxes paid at each stage and social security payments received have to be taken into account in an overall approach.

The test for any government tax or other subsidy for private savings is whether it leads to increased private savings and decreased government expenditures over time. This is the case in general for superannuation. In contrast, tax breaks for, say, transaction type bank accounts will not achieve such goals.

### **Public policy and taxation of retirement savings**

The mere fact that savings are for retirement should not mean that they automatically qualify for strategic tax deferral or other special arrangements. The public policy reasons for concessional tax treatment of retirement savings are that such savings reduce the burden on future governments for retirement income provision and lead to better retirement incomes for Australians (ASFA 1998b).

For savings to be given special treatment they need to be actually used for retirement income purposes. The mere fact that an amount is saved and not consumed by an individual for either a long or short period does not amount to

justification for concessional tax treatment. Reducing the amount of tax payable by an individual, or maximising the amount an individual can provide by way of a bequest at the time of their death are not public policy grounds for encouraging savings.

This then suggests that **any tax benefits should be conditional on the savings being preserved until retirement age and retirement from the work force is achieved, and that the savings be converted in large part to an income stream.** While not all of the retirement savings should be required to be consumed over an individual's lifetime, equally tax concessions should not attach to what are essentially estate planning arrangements.

**There are circumstances in which access to a lump sum would be consistent with retirement income provision.** For instance, it might be desirable for a relatively modest capital sum to be available on favourable taxation terms at the time of retirement to cover capital costs of new domestic appliances, a car or paying off a home loan. As well, if the level of retirement savings is very modest it may be impractical or inefficient to use such a sum to purchase an income stream. There may also be circumstances where access to a lump sum is justified on the grounds of hardship of an individual. However, these examples should be exceptions rather than the rule. The primary emphasis should be on an income stream taken in retirement.  
**Any element of the savings taken**

**other than as a prescribed lump sum or as an income stream would be subject to tax arrangements which had the aim of taxing the savings as though they had been accumulated under ordinary arrangements relating to wages and savings.** Depending on levels of payments and other factors, this could involve a tax rate which exceeds the top marginal rate applying to ordinary income.

**Public policy does not require unlimited concessional treatment of retirement savings.** While it should be open to individuals to achieve as high a level of retirement income they wish to arrange, the benefits of strategic tax deferral should not be provided above a specified level. This level should take into account the objectives of providing an adequate level of retirement income, containing future Age Pension costs and encouraging increased national savings.

### **Conceptual approaches to taxing superannuation**

There are three main tax bases in the taxation literature and in use throughout the world: nominal income base, the real income tax base and the consumption or expenditure tax base.

The nominal income tax base applies the individual's marginal tax rate to all income from both work and investment, but allows expenses that are incurred in the earning of the individual income to be tax deductible. An example of

the nominal income tax base is the tax system currently used in Australia to calculate individuals' tax liabilities for wage and salary, investment and other like income.

If the nominal income tax base were applied fully to superannuation, then on at least one interpretation, employer contributions should be tax deductible to the employer, but taxable to the employee at his or her marginal tax rate given that the superannuation contribution is an addition to the individual's net wealth and eventual command over resources. Any returns on the superannuation investment also would be taxed at the member's marginal tax rate. However, any dissaving, ie when the member receives her/his benefit, should be tax free.

The nominal income tax approach is not generally used for retirement savings schemes, with New Zealand a notable exception. In regard to the latter, one interpretation is that New Zealand has a retirement income system problem rather than a solution. That country is experiencing increasing and unaffordable costs associated with their public retirement income system, and inadequate private provision.

The real income tax base is similar to the nominal income tax base except it takes into account the effect of inflation on the taxable sum. An example of the application of such an approach is the current Capital Gains Tax system in Australia. If a real income tax base were applied to superannuation it would

be the same as allowing the nominal tax base to superannuation, but any inflation, especially in the investment returns, would be removed from the taxable sum.

A consumption or expenditure tax base involves the levying of tax when goods or services are purchased and/or when funds are paid by an employer or withdrawn from a savings instrument. While the precise collection method can vary, the overall aim is to tax consumption, not savings.

If a consumption or expenditure tax base were applied to superannuation, the result would be that employer and employee superannuation contributions would be tax free to the employee. The return on the investment would also be tax free, but when the member received her/his benefit, this benefit would be taxed at the member's full marginal tax rate. The consumption and expenditure tax base encourages saving, because reducing taxes on saving increases the after tax rate of return on savings. It also reduces the cost of the eventual consumption funded from savings and thus makes saving for the goal of a better retirement income a relatively attractive option.

Table 1: Tax Treatment Of Retirement Benefits

<i>Country</i>	<i>Contributions</i>	<i>Investment/Income</i>	<i>Benefits</i>
Australia	T	T	T
Canada	E	E	T
Chile	E	E	T
Denmark	E	T	T
Ireland	E	E	T
Netherlands	E	E	T
New Zealand	T	T	E
Singapore	E	E	E
United Kingdom	E	T	T
United States	E	E	T

Notes: E: Exempt subject to regulations and limits. T: Taxed

The current Government has indicated its preference for moving to greater reliance on indirect taxes and less reliance on direct taxes such as income taxes. Taxing superannuation contributions at the marginal rate of tax applying to the taxpayer's other income could be seen as being inconsistent with such a preference.

Taxing superannuation benefits at the full marginal rate of the taxpayer also would encourage individuals to take superannuation benefits as an income stream over their retirement lifetime. Rather than paying tax at the marginal rate applicable for a large income, tax would be paid at the marginal rate appropriate for the consumption level of each year of their retirement.

Most other countries explicitly or implicitly tax retirement benefits on an expenditure tax basis, with contributions deductible and benefits fully taxable. Table 1 indicates in summary form the tax treatment of retirement savings in a

number of other major countries, and Attachment A provides further details .

### **Equity, taxation and superannuation**

Achieving equity in the taxation of superannuation is no simple matter. **Taxing contributions at different marginal rates is a particularly poor way of achieving equity given that high contributions in a year can reflect a variety of factors which have little to do with the economic circumstances of an individual within either a given year or over their lifetime.**

High contributions might merely be a catch-up for a person in lieu of contributions missed earlier in their career because of differences in employer practices or because of career breaks. While the latter have been very common for women, particularly those who have children, it also is increasingly common for men due to restructuring of work places and

greater assumption of family care responsibilities.

In the absence of full vesting, contributions, particularly notional contributions made on behalf of an individual to a defined benefit scheme, can be a very poor indicator of the increase in the individual's net worth from involvement in superannuation. If an individual leaves employment and/or a superannuation scheme and receives a resignation or termination benefit much lower than what would be a retirement benefit based on their pro-rata service, then taxing contributions at marginal rates would be unjust. This has been one of the many equity problems associated with the Government's recent move to tax notional superannuation contributions to defined benefit schemes which are made on behalf of upper income earners.

**Superannuation experts (such as Professor David Knox) agree that the most equitable way of taxing super is at the benefits stage.** Equity is facilitated if superannuation is required to be taken as an income stream rather than as a lump sum. This has the advantage of smoothing the benefits received from superannuation over a number of tax years, avoiding the problems of taxing one-off receipts at marginal rates.

In the absence of such an approach, attempts at achieving greater equity in the taxation of superannuation are likely to be no more than "band-aids" for problems with the system which create as many equity problems as they

solve. There has to be a better way than the income and total contribution linked tax surcharge on contributions, age-based contribution limits and the Reasonable Benefits Limits amongst other controls.

More general measures are likely to aid equity than these current tinkering with the system. Despite the operations of the SG, some contributors are more equal than others with higher contributions made on their behalf in both absolute and percentage terms. Eliminating discriminatory employment practices which lead to indirect discrimination in superannuation contributions might be a greater priority than attempting to adjust the taxation of contributions.

Where benefits are taken as an income stream and have not been subject to tax whilst accumulating, it becomes much easier to introduce equity measures. **In fact taxing contributions and earnings along the way can have the effect of increasing inequities as the benefits to low and middle income earners from the compound growth of earnings are diminished.**

Taxation arrangements also are only part of the overall framework for achieving equity in retirement income provision. As noted earlier in this paper, the community funds retirement income support for **both** superannuation and the Age Pension recipients, and some will benefit from one or other or partly from each. Tax provisions relating to superannuation certainly

significantly assist individuals who are saving for retirement. However, social security payments to the aged are even larger with annual payments currently approaching \$20 billion, and an unfunded future liability for payments to current Age Pension recipients of some hundreds of billions of dollars.

### **Is the current tax treatment of superannuation concessional?**

The Tax Expenditure Statement prepared each year by the Treasury claims that the revenue that the government forgoes as a result of what are described as tax concessions for superannuation currently exceeds \$6 billion. Their estimates for future years are even larger.

The major components of the superannuation tax concessions set out in the Tax Expenditure Statement in 1995-96 were a claimed under-taxation of employer contributions, \$3 billion, under-taxation of fund earnings, \$2 billion, and under-taxation of unfunded lump sums, \$1 billion. Whilst these figures are impressive in their size they are also excessive and do not actually reflect the overall effect of superannuation on taxation receipts.

The Tax Expenditure estimates equal the revenue which would have been collected if superannuation contributions and income had been taxed at the full marginal rate of every member,

less the tax revenue actually collected.

**One of the major problems of the Tax Expenditure estimates is that the estimate is an immediate measure, and does not take any of the long-term effects of the Retirement Income Policy into account.** For instance, future balances and the associated tax base would be much smaller if higher taxation applied along the way.

Other problems with the Tax Expenditure Statement estimates for superannuation tax concessions include:

- The calculations do not include the trade-off between short-term costs and long-term benefits. In the early years the growth in the coverage of superannuation will increase the cost to taxpayers in terms of foregone revenue. However, in the future superannuation will bring rewards for government, including a decrease in Age Pension expenditures.
- No allowance is made for any increase in tax revenues as superannuation payouts increase in size. Tax is deferred, not eliminated.
- In the benchmark it is assumed that the behaviour of individuals in terms of savings and consumption decisions would not change if the tax arrangements were changed. In effect it is assumed that people would continue to place what they had been putting into

superannuation into normally taxed investment such as bank accounts. In fact, without tax concessions for the superannuation the bulk of discretionary superannuation savings that were previously made would go into concessionally taxed investments, or be used for immediate consumption.

- High returns associated with long term managed savings in the form of superannuation are seen by the Treasury as increasing the cost of the tax concessions rather than reducing future claims on the government for retirement income support through the Age Pension.

The ASFA Research Centre has prepared estimates of the cost of tax concessions that more realistically represent the short term costs to government of the current taxation treatment of superannuation.

Attachment B provides an estimate for 1994-95 of the extent of tax concessions for superannuation based on a benchmark of taxation being payable when benefits are paid. **It puts the immediate costs to revenue from the superannuation tax concessions at around \$1.4 billion, rather than the Treasury's estimate of \$5.8 billion for the same year.** On the basis of the ASFA Research Centre methodology, much of the cost of the tax concession is the under-taxation of pre-1983 lump sums rather than under-taxation of current contributions as the Treasury claims.

**Adoption of a taxation of benefits benchmark is, arguably, a more realistic benchmark than that currently used by Treasury, as individuals do not gain any access to the value of their superannuation until a benefit payment is made.** It is the standard taxation approach adopted in other countries, with New Zealand about the only exception.

Superannuation provides a superior return to most alternative investments under the existing regime in Australia, but further incentives for saving would come from a move to taxation being applied only at the benefits stage. Taxing at the benefit stage would also avoid a number of inequities and anomalies in the current system which can discourage individuals from saving for retirement through superannuation.

### **Taxes on super - what is a sensible upper limit?**

Theoretically, taxes on super should at least be no more than taxes on alternative investments. Arguably, they should be considerably less because of the restrictions that come with super such as preservation until retirement age and because private super entitlements lead to less Age Pension entitlement. One very relevant factor is the impact of any additional tax on overall national savings and the mix between private and public savings. All other things being equal (such as increased taxes

improving the Budget bottom line and not being used for increased public expenditures) an increase in taxes on superannuation would lead to increased public savings. But offsetting this would be an equivalent decrease in private savings (given that superannuation entitlements are reduced by the tax).

Another question relates to how concessional the tax treatment of superannuation is. Worked examples tend to show that it is not highly concessional for those on low marginal tax rates, or who will be subject to the superannuation contributions tax surcharge. Rather than removing the concessional treatment for those in the middle income bracket, equity would be best addressed by moving to taxation of benefits, not contributions.

It also is not highly concessional compared to some other forms of investment which receive tax breaks or benefit from negative gearing. For many people super is taxed concessional compared to having money in a bank account or similar, but it is generally accepted that taxation of the full nominal amount of interest received from bank accounts is relatively harsh, particularly if inflation rates are high.

**Higher taxes on super might generate short term revenue for government, but are not a good long term investment for governments or individuals.**

Higher taxes now mean low retirement benefit balances in the future, higher Age Pension liabilities and higher taxes than

they would otherwise be. The benefits to both individuals and governments from the high earnings rates of superannuation funds will be lost in part.

Individuals will suffer because they will end up with low retirement benefits and higher future taxes. Governments will end up with a higher Pensions bill. Accordingly, any proposal to increase taxes on super should be accompanied by an estimate of the impact of the measure on the future Age Pension liabilities accruing to government.

Overall national savings would suffer if individuals saved less as a result of less favourable tax treatment of super. Government revenue will also be less than expected if savings flow into concessional areas such as owner occupied housing and/or geared property or share investment.

This is a factor which business should keep in mind when it is considering its preferences for a shift in the balance of taxes. Some elements of the business community apparently consider superannuation funds as a “magic pudding” from which additional slices of taxation can be taken to fund reductions in, or elimination of specific taxes on business such as payroll tax.

However, such an approach would be very short-sighted on the part of business and/or government. Higher taxes on superannuation contributions or earnings would mean that fewer funds would be available to invest in Australian businesses. Superannuation funds

are not sitting idly as banknotes in a vault. They are invested inter alia in Australian companies and property. Superannuation funds have over \$100 billion in Australian equities, and nearly \$20 billion in Australian property. Taxing superannuation more would mean less capital would be available for Australian businesses.

### **What are the real savings and tax problems?**

What would strike an outside commentator, or indeed a dispassionate Australian observer, is that there are many areas of the Australian tax system that need reform. However, few if any commentators would see applying further layers to the taxation of superannuation as a priority compared to making more fundamental reforms. Expediency in the form of grabs for greater revenue appears to have triumphed over sound principle.

#### **ASFA considers that the principles that should apply to taxation reform should be:**

- **equity**
- **simplicity**
- **efficiency**
- **need to support saving and investment**
- **both government expenditures and revenues need to be sustainable over the long term.**

ASFA's more detailed views on taxation reform are set out in its February 1998 submission to the Government on taxation reform

(ASFA 1998b).

A major factor in the consideration of tax reform proposals should be promotion of increased savings and productive investment.

Due to the tax advantages of negative gearing of property and the non-taxation of the value of housing for owner occupiers, investment in residential property has been greater than it should have been. Holdings of dwelling assets are now 40 per cent higher than private sector holdings of business assets, whereas just 20 years ago more wealth was held in business assets than dwellings.

The relative tax and spending roles of the Commonwealth and the States also demand attention. The limitations on the States' taxation base has led to an array of inefficient and inequitable duties and charges on financial and other transactions.

In regard to savings, the real problems are getting a greater level of national savings in aggregate and getting individual savings to accrue to significant levels so that they can deliver real benefits to individuals and reduce calls on public expenditures. Supposedly levelling the playing field so that more funds are left loitering in low return bank accounts does nothing towards achieving either of these aims. **Individuals need a mixture of education, inducement and compulsion to save more.** Strengthening each of these components will achieve much more in terms of individual and national savings compared to

policies of supporting consumption now, reducing tax advantages for super, and removing compulsion in regard to low income earners and others.

## **What ASFA is proposing for the taxation of superannuation and savings**

**ASFA supports a gradual transition to a system based solely on the taxation of benefits as income streams because it would be fairer and more equitable, more efficient, less costly to administer and more supportive of saving for retirement.**

Attachment C sets out in tabular form the current taxation treatment of superannuation and ASFA's preferred model for the long term.

The recognition of the inefficiencies and bias against savings associated with income taxes has been a powerful force in recent moves to reconsider whether and on what terms should a general consumption tax be introduced in Australia. These same arguments heighten the need for reform of the taxation of superannuation and imply less reliance on contributions and earnings taxes and greater emphasis on the taxation of final benefits.

While the precise level set for obtaining special tax treatment is a matter for judgement, ASFA suggests that the level could be set at accumulated savings which would generate an income stream

in retirement of 1.5 times average weekly earnings. AWE is currently around \$35,000 per annum, so this would imply tax concessions being available in current dollar terms for retirement income streams of the order of \$53,000 per annum. This would cover the great bulk of the population, but at the same time limit the access to concessional tax treatment of very high income earners and asset holders not in need of government assistance for retirement income provision.

Any retirement savings in excess of the amount needed to generate an income stream of 1.5 times average weekly earnings would be subject to taxation designed to bring about an outcome similar to that which would have applied had those excess savings been generated and accumulated outside the retirement income system (ie a "clawback" of the accumulated tax deferral).

As well as the "clawback" of the tax deferral for high levels of benefits, equity would be advanced by the interaction of income streams with the progressive income tax system. Those receiving lower benefits would be taxed less along with all other low income Australians.

If the Government considers that there are sound public policy reasons for other tax advantaged savings instruments to be established to support long term savings, ASFA considers that they should meet the criteria of:

- adding to both private and national savings rather than being just a transfer from

government to the savings or consumption of those who are already saving;

- being preserved until retirement or for a lengthy period;
- not being able to be accessed for short-term consumption purposes; and
- not being an alternative to government funding of services best undertaken by government.

ASFA considers that superannuation funds should not be excluded from any such products provided that the criteria can be met by funds. It should be product type, not provider type which should influence tax and other regulatory arrangements.

Consistent with these principles ASFA notes that:

- the savings rebate and spouse contributions rebate recently introduced by the Government have very worthy goals, but it might be possible to refine those rebates so as to better encourage additional savings.
- it is important that savings which go to productive investments such as investment in equities and real activities be treated at least as favourably if not more favourably than speculative financial investments.

### **Transitional treatment**

A shift in the balance between direct and indirect taxes would have implications for the taxation of

superannuation benefits. For instance, the introduction of a consumption tax would raise the question of how self funded retirees who accumulated their assets under the current and previous tax regimes should be treated. Subjecting expenditure by such persons in retirement to a full rate of consumption tax would lead to at least triple taxation of such expenditure given that it was taxed at each of the stages of contributions, earnings and benefits. One remedy for this would be for government to grant a tax rebate to self funded retirees that was designed to compensate, at least in part, for this triple taxation.

It is quite possible though that persons with substantial benefits in retirement now have either accumulated them under a tax free regime (pre 1988) or have the benefit of recognition of a substantial taxfree portion (pre 1983 element) and it is arguable how much further assistance they should receive. Persons who do not have these factors in their retirement income would not be likely to have substantial benefits and are probably therefore caught up in the consideration to be given to all low income and social security recipients.

Another more specific transitional question is how the various elements of superannuation savings which were contributed or accumulated at various times in the past should be treated. The current taxation system treats various elements differently, and requires complex records to be maintained. **Another approach would be to assign transfer**

**values to any rights that have accrued to individuals in the taxation system and to have relatively uniform treatment of individuals when benefits are finally taken as an income stream.**

Obviously these are areas which will need detailed consideration. As noted in the foreword to this document, **the formulation of this Blueprint for Retirement Income Policy is in many ways the start rather than the finish to the reform process.** We need to restore the credibility of the

nation's retirement income policy with the public. Australians need to be educated about retirement income planning and to have a sense of ownership of the system.

**ASFA will also make use of future opportunities when retirement income policies are being reviewed for advancing specific aspects of the Blueprint.**

Some of these opportunities will be the result of direct action by ASFA to engage policymakers in a process of reform and refinement of the system.

## **Attachment A: Tax treatment of retirement savings in selected countries**

### **United Kingdom**

#### *Contributions*

- Employers' National Insurance contributions are tax deductible.
- Employees' National Insurance contributions are not tax deductible.
- Employers' and employees' contributions to approved pension plans are tax deductible.

#### *Pensions*

- State incapacity and pension benefits are taxable as earned income to the recipient. Most other benefits are not taxable under current legislation.
- Private pensions are taxable as earned income.
- At retirement, part of an approved pension may be commuted tax free into cash.

#### *Tax Rates*

- The lower income tax rate of 20% is payable on the first £3,900 (A\$8,405) of annual taxable income, and the standard rate of 24% is payable on income between £3,900 (A\$8,405) and £25,500 (A\$54,957). For all income in excess of £25,500 (A\$54,957), there is a single higher tax rate of 40%. These rates and income bands apply from April 1996.

### **United States of America**

#### *Contributions*

- Employees' Social Security contributions are not tax deductible, but pre-tax elective contributions to 401(k) plans are deductible to a limit of US\$9,500 (A\$12,488) for 1996.
- In 1996, higher income persons must pay federal income tax on 85% of their Social Security benefits. Welfare type benefits under government-sponsored plans are tax free.

#### *Pensions*

- Generally, retirement income funded by the employer and amounts contributed by the employee to a 401(k) plan are taxable to the employee at the time payments are received..

### *Tax Rates*

- There are five federal rates of income tax - 15%, 28%, 31%, 36% and 39.6% - which are assessed according to the taxpayer's filing status and income level.
- Many state and local governments also impose income tax with rates generally ranging from 0% to 12%.

## **France**

### *Contributions*

- Employee and employer contributions to Social Security are tax deductible.
- Employee and employer contributions to mandatory plans and compulsory employer-sponsored retirement, death, disability and medical plans are tax deductible within certain limits.
- Contributions in excess of the limits are treated as salary and taxed accordingly.

### *Pensions*

- Retirement and disability pensions from group plans (State, ARRCO, AGIRC or private) are normally taxed as income after deduction of allowances similar to those applied to salary.
- Pension benefits from individual plans are normally partially taxed on a fixed scale, based on the pensioner's age.

### *Tax Rates*

- There are seven bands of income for personal tax purposes. The highest rate of tax is 56.8% on annual taxable income over FF282,730 (A\$64,260) (for an individual).

## **Chile**

### *Contributions*

- Employee contributions for the provision of mandatory and voluntary retirement are tax deductible.
- Employer contributions in respect of benefits which complement Social Security (life, health, pensions, etc.) are deductible for the employer and not considered taxable income for the employee.

### *Pensions*

- Pensions, regardless of source, are subject to tax.

### *Tax Rates*

- The tax rates are progressive and vary from 5% to 45%. The 45% rate applies to employees with monthly salaries exceeding Ch\$2,635,600 (\$A8,934 ).

## **New Zealand**

### *Contributions*

- Employee superannuation contributions are not tax deductible. Employer superannuation contributions are tax deductible without limit but are subject to a 33% withholding tax.

### *Investment Earnings*

- The investment earnings of superannuation schemes are also taxed at 33%.

### *Pensions*

- All State pensions are subject to personal income tax.
- Lump sum redundancy or retirement benefits (but not those from superannuation schemes) paid by an employer are subject to personal income tax. The fringe benefit tax rate on other benefits is 49%.
- All superannuation scheme benefits (including pensions) are tax free. Fifty percent of pension payments are subject to the tax surcharge on New Zealand Superannuation.

### *Tax Rates*

- The top marginal personal income tax rate is 33%, applicable to income over NZ\$30,875 (A\$28,035). The company tax rate is also 33%.

## Attachment B: Tax Expenditures on Superannuation

Table B1 estimates tax expenditures on superannuation in 1994-95 (the latest year for which taxation data is publicly available) based on the appropriate taxation point being when benefits are received, in contrast to collection as contributions and earnings are made. The figures for under-taxation of pre-1983 lump sums and under-taxation of post-1983 lump sums in the cost section of the table are derived by applying an average marginal rate to the total of lump sums received, and removing from this the taxation actually applied to those benefits. The offset figure, tax on fund contributions and earnings, represents the current fund contribution and earnings taxes that are applied to superannuation contributions and superannuation fund investment earnings.

There is a significant difference between the Net Tax Expenditure on this tax of benefits basis (\$1,390m) and the Net Tax Expenditure as currently calculated by Treasury (\$5,770m). This result occurred in part because the system is currently growing rapidly with new contributions and earnings, in excess of benefits being paid-out and thus taxed. However, in a steady state system each approach would give a more similar result.

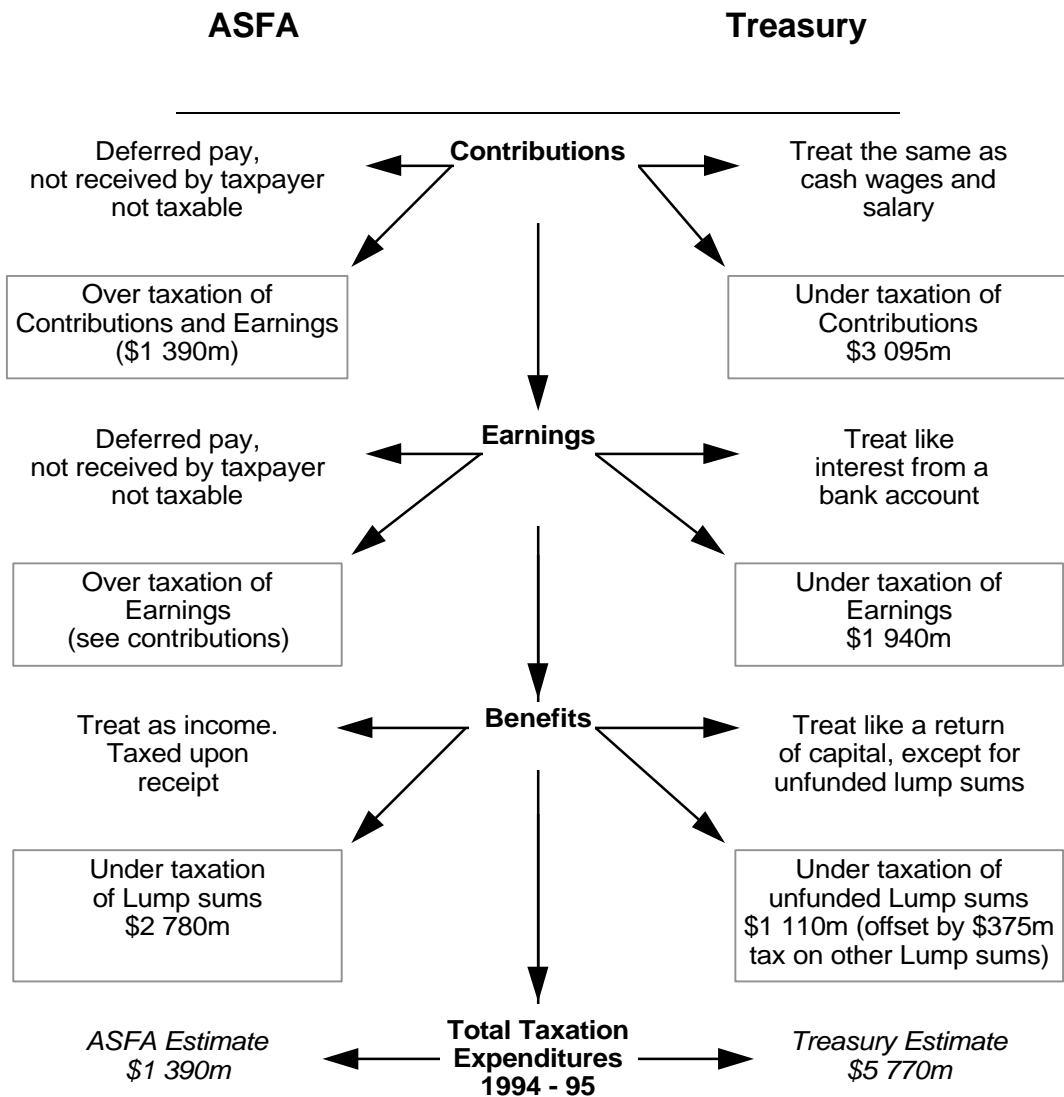
Figure B1 gives further detail in the differences between the Treasury and ASFA approaches.

*Table B1:*

Costs:	
Under-taxation of pre 1983 Lump Sums	\$1,275m
Under-taxation of post 1983 Lump Sums	\$ 395m
Under-taxation of Unfunded Lump Sums	<u>\$1,110m</u>
Total Costs:	<u>\$2,780m</u>
Less Offsets:	
Tax on Funds' Contributions and Earnings	<u>\$1,390m</u>
Total Offsets:	<u>\$1,390m</u>
Net Tax Expenditure	\$1,390m

**Figure B1**

## Conceptual Approaches to Tax Expenditure Estimates



# Attachment C

## Current tax treatment of superannuation

Contributions	Superannuation Funds' Income	Benefits
<ul style="list-style-type: none"> <li>Employee Contribution                             <ul style="list-style-type: none"> <li>- paid out of taxed income</li> <li>- not deductible to contributor</li> </ul> </li> </ul>	<p><b>Contributions</b></p> <ul style="list-style-type: none"> <li>- taxable at 15% to superannuation fund, except for undeducted contributions which are tax-free.</li> </ul>	<p><b>Lump Sums</b></p> <ul style="list-style-type: none"> <li>pre 1/7/83 component - 5% of lump sum is included in assessable income.</li> </ul>
<ul style="list-style-type: none"> <li>Employer Contributions                             <ul style="list-style-type: none"> <li>- paid out of pre-taxed income</li> <li>- deductible to contributors up to a defined age limit</li> </ul> </li> </ul>	<p><b>Earnings on investment income</b></p> <ul style="list-style-type: none"> <li>- taxable at 15% to superannuation fund</li> </ul>	<ul style="list-style-type: none"> <li>post 1/7/83 component (below RBL) -                             <ul style="list-style-type: none"> <li>up to 55 years old                                     <ul style="list-style-type: none"> <li>- taxed source - taxed 20% + medicare levy</li> <li>- untaxed source - taxed at 30% + medicare levy</li> </ul> </li> <li>55 and over                                     <ul style="list-style-type: none"> <li>- taxed source - \$0 to threshold - 0%   <ul style="list-style-type: none"> <li>- over threshold - 15% + medicare levy</li> </ul> </li> <li>- untaxed source - \$0 to threshold - 15% + medicare levy   <ul style="list-style-type: none"> <li>- over threshold - 30% + medicare levy</li> </ul> </li> </ul> </li> </ul> </li> </ul>
<ul style="list-style-type: none"> <li>Self-employed / Self-Supporting Contribution                             <ul style="list-style-type: none"> <li>- deductible to contributor for the first \$3,000 plus 75% of any contribution over and above the initial \$3,000, up to the age limit.</li> </ul> </li> </ul>		
<ul style="list-style-type: none"> <li>Surcharge                             <ul style="list-style-type: none"> <li>- If member's income + superannuation contribution is greater than \$73,220, there is a surcharge on the contribution starting at 0.001%, with a 0.001% on every extra dollar, levelling out at 15%, for amounts \$88,910 and over.</li> </ul> </li> </ul>		
<ul style="list-style-type: none"> <li>Low Income rebate                             <ul style="list-style-type: none"> <li>- 10% of personal contribution up to \$1,000 if Assessable income of \$27,000 or less. Maximum rebatable contributions are reduced by 25c for every dollar by which a member's assessable income exceeds \$27,000.</li> </ul> </li> </ul>		<ul style="list-style-type: none"> <li>Reasonable Benefits Limits (RBLs)                             <ul style="list-style-type: none"> <li>maximum amount that a person is entitled to receive on a concessional basis.</li> <li>- \$454,718 - for a lump-sum</li> <li>- \$909,435 - where at least 50% of the total benefit is taken in the form of a pension or annuity.</li> </ul> </li> </ul>

<b>Contributions</b>	<b>Superannuation Funds' Income</b>	<b>Benefits</b>
<ul style="list-style-type: none"> <li>• Employee Contribution               <ul style="list-style-type: none"> <li>- deductible to contributor</li> </ul> </li> </ul>	<p><b>Contributions</b></p> <ul style="list-style-type: none"> <li>- not taxable in the hands of the fund.</li> </ul>	<p><b>Lump Sums</b></p> <ul style="list-style-type: none"> <li>• pre 1/7/83 component - given transfer value, subject to normal tax provisions</li> <li>• all other lump sums above a specified modest level taxed at a marginal rate designed to bring equivalence in tax treatment to employee remuneration and savings outside the retirement savings system.</li> </ul>
<ul style="list-style-type: none"> <li>• Employer Contributions               <ul style="list-style-type: none"> <li>- paid out of pre-taxed income</li> <li>- no age-based contribution limits</li> </ul> </li> </ul>	<p><b>Earnings on investment income</b></p> <ul style="list-style-type: none"> <li>- not taxable</li> </ul>	<ul style="list-style-type: none"> <li>• retirement income streams up to 1.5 times average weekly earnings taxed at marginal income tax rates.</li> <li>• component of income stream above 1.5 times AWE taxed at higher rate which would be the same rate applying to lump sums in excess of the specified maximum.</li> </ul>
<ul style="list-style-type: none"> <li>• Self-employed / Self-Supporting Contribution               <ul style="list-style-type: none"> <li>- deductible to contributor</li> <li>- no age-based contribution limits</li> </ul> </li> </ul>		
<ul style="list-style-type: none"> <li>• Surcharge               <ul style="list-style-type: none"> <li>- equity matters dealt with at benefits stage</li> </ul> </li> </ul>		
<ul style="list-style-type: none"> <li>• Low Income rebate               <ul style="list-style-type: none"> <li>- equity dealt with at benefits stage.</li> </ul> </li> </ul>		<p>All income streams (pensions, annuities etc) taxed at marginal rate with no superannuation specific rebates.</p>

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