Equity and retirement income provision in Australia

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Foreword

Key objectives behind the provision of government assistance for retirement income provision are to encourage savings, help ensure adequate and sustainable retirement incomes and to treat individuals equitably both in their working life and in retirement. Currently and for the foreseeable future most individuals will rely on a mixture of private savings, principally superannuation, and the government provided Age Pension for their income in retirement. Private savings provide a supplement to the Age Pension, but also have the effect of reducing the reliance on social security.

Perceptions as to adequacy, equity and fairness of these various arrangements are important if voluntary and compulsory savings through superannuation and/or the government's retirement income strategy are to have the confidence and support of the community.

This research paper primarily focuses on the issues and various dimensions of equity, although it also addresses the related issue of adequacy. It provides both a conceptual framework and a range of empirical material in order to allow judgements to be made as to the adequacy and equity of current retirement incomes and the retirement incomes projected to be achieved in the future.

While the paper is designed to stimulate debate on the issues of equity and adequacy, it also draws some important conclusions. For instance, contrary to some perceptions in the community that superannuation largely benefits higher income groups, a closer analysis reveals that:

- The bulk of the benefit of tax concessions for superannuation contributions and of the value of the Age Pension goes to those around or below average weekly earnings.
- Compared to most other nations Australia has a very compressed distribution of the incomes for the retired. While this might meet some notions of redistributive equity, most retirement incomes are clustered at just above the poverty line. Higher retirement incomes more related to pre-retirement income and expenditure would better meet equity and adequacy objectives and likely aspirations, and would be more compatible with workable incentives and confidence of future generations.

The paper provides a detailed evaluation of a range of provisions impacting on equity and adequacy of retirement income provision, and makes a number of suggestions for improvement in current arrangements.

This paper forms part of a comprehensive research program by ASFA aimed at providing a sound base for policy evaluation and review in the context of a major review of retirement income provision, in particular superannuation. ASFA welcomes feedback from readers of this paper and the support of all those interested in achieving meaningful and effective reforms and equity and adequacy in retirement income provision.

Philippa Smith
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Executive Summary

Conceptual issues

Equity has a number of dimensions in the context of retirement income, ranging from traditional tax notions of horizontal and vertical equity, to preservation of past entitlements, to lack of discrimination and equality of opportunity, to actuarial equity, to inter-generational equity. Most importantly, given that our retirement income system has a number of components, the interaction of those components is crucial in providing retirement income. It is the overall system that needs to be judged for equity, not each of its elements in isolation (pages 1 to 6).

Evaluating the equity of current retirement income arrangements depends in part on the conceptual framework adopted. Government accounting now generally adopts an accrual budgeting approach. However, the Treasury figures on tax expenditures on superannuation adopt a year by year “income tax basis” which ignores future tax receipts and government expenditures. Given the long term objectives of government, both an accrual approach and an expenditure tax base are appropriate. Compared to an expenditure tax base, superannuation is overtaxed in aggregate by some $4.6 billion, but evaluated on an income tax basis it is undertaxed (page 8).

The distribution of superannuation payments and government assistance

The bulk of the benefit of tax concessions for superannuation contributions goes to the employed at the lower end of the income distribution. Over 60% of employer contributions to superannuation accrue to the benefit of employees with incomes less than $50,000 per annum. The figure is even higher for the self employed at around 70% (pages 9 and 10).

Incomes and wealth of the retired are highly compressed and relatively low in Australia. At present, compared to other nations, a very high level of income redistribution, indeed an excessive level of redistribution, has been achieved, with a clustering of retirement incomes just above the poverty level. The bulk of eligible termination payments (ETPs) currently are below $10,000 with only 1% of such payments more than $100,000. The bulk of retirees rely almost wholly on the Age Pension for their income (page 14).

Superannuation entitlements form a major part of the financial wealth of those at the lower end of the income distribution, accounting for the majority of financial wealth for the least wealthy. However, superannuation accounts for only around 15% of the wealth of the most wealthy. For the retired without any significant private assets, the Age Pension has a capital value equivalent to private wealth of around $200,000 (page 19).

When receipt of the Age Pension is taken into account, the value of government assistance provided for retirement tends to even out across the income distribution. For a person on $40,000 per annum the tax benefit on contributions and earnings associated with compulsory superannuation is projected to be around $40,000 in today’s dollars with entitlement to $200,000 of the Age Pension on top of that ($240,000 in total). For a person on $90,000 a total tax benefit associated with compulsory superannuation of $130,000 but only limited or no access to the Age Pension (pages 21 and 22).

How Australia's retirement income system rates from an equity point of view

The retirement income and superannuation systems mostly satisfy a number of other tests for equity, including equality of opportunity, lack of discrimination, and an appropriate balance between the rights and responsibilities of different generations (pages 22 to 27).

Despite the generally favourable equity characteristics of current retirement income payments in Australia and the projected further improvements in equity, a number of aspects of the current system could be improved from the point of view of equity and adequacy:

- The Age Pension at 25% of male total average weekly earnings (MTAWE) is only just above the poverty line, and does not meet the minimum expectations of those currently in the paid labour force. While the SG will lift the private wealth and income of future retirees, at its current proposed maximum rate it is unlikely to satisfy expectations concerning adequacy (page 29).
- The Age Pension bonus for those delaying taking the Age Pension satisfies notions of actuarial fairness, but only 16,000 have registered and only 1,365 have received a bonus. Greater incentives for staying in the labour force and/or removal of barriers to working may be needed (page 30).
- Means testing the superannuation entitlements of the long term unemployed aged over 55 is discriminatory against those who have not yet retired and want to work. ASFA and others have argued for the reversal of the 1996 Budget decision introducing this (page 31).
- Age based contribution limits involve substantial compliance costs and do not allow for the flexibility in contribution patterns needed by modern social and labour market developments. If there are concerns about access to an excessive level of tax concessions then modifications could be made to the Reasonable Benefit Limits relating to final benefits received (pages 32 to 35).
- The tax surcharge on contributions by upper income earners has high compliance costs and fundamental flaws in regard to equity, particularly in its treatment of defined benefit schemes and those who have fluctuating income over their time in the labour force. Recent changes to the surcharge will spread its impact to over 600,000 employees, a substantial number of which could not be regarded as high income (pages 38 to 41).
- The "grandfathering" of the extremely tax preferred pre-1983 superannuation entitlements arguably has placed a higher priority on preservation of expectations than horizontal equity. Horizontal and vertical equity concerns are also raised by the valuation method which in effect through rollover provisions provides some of this very preferred tax treatment to superannuation accumulated after 1983 (page 15).
- The self employed are only able to claim a tax deduction of 75% of the contributions in excess of $3,000 per year. This is discriminatory relative to the treatment of contributions made on behalf of employees (page 44).
- The integration of superannuation with social security is less well developed than it might be. Different treatment of lump sums and income streams raises both equity and efficiency concerns. Different asset test treatment of different types of income

stream also arguably discriminates against higher return income stream products where the member bears the investment risk rather than the provider (pages 49 and 50).

- The current rebate for superannuation contributions made by low income earners is available to only a small proportion of employees, and is derisory in amount at no more than $100 a person with an average of $60. The replacement of that rebate with say a co-contribution of $300 for those earning less than $35,000 per annum would cost government around $975 million. Together with a matching member contribution, the retirement savings of the lower paid would be boosted by around $2 billion per annum in aggregate. An alternative 18% rebate for voluntary contributions by the lower paid would might cost government around $150 million per annum but would boost retirement savings by the lower paid by over $800 million (page 59).

Proposals for improving the equity and operation of retirement income provision

A range of commentators have called for fundamental reform of superannuation and retirement income arrangements (pages 52 to 55). Most commentators have argued for both improved equity and adequacy. A very few, such as the Australian Council of Social Service (ACOSS), however are uncomfortable with any notion of adequacy that involves income or assets in excess of a very basic level (page 52).

ASFA has called for the abolition of taxes on contributions and fund earnings, with the taxing of benefits at marginal income tax rates when received. ASFA also supports an increase in the SG from 9%. Projections indicate that for a person on $40,000 per year abolition of taxes at the fund level and raising the SG to 12% would boost superannuation savings at retirement after 30 years employment from $180,000 to $300,000. For a person on $60,000 per annum the increase would be from $270,000 to $450,000, and for a person on $90,000 per annum the increase would be from $331,000 to $670,000 (page 58). Such savings would allow retirement income to reach gross replacement rates in retirement of the order of 63%, 54% and 48% respectively, and would be more in accord with the aspirations and needs of retirees.

While the up front tax concession for superannuation would be greater if the ASFA proposal were adopted, down the track there would be offsetting savings for the government in terms of reduced Age Pension expenditures and greater income tax collections from the receipt of private incomes. The tax and social security provisions would deal with equity concerns in regard to the distribution of retirement incomes, and adequacy of retirement incomes would be improved across the income distribution (page 57).

1. Introduction

Australia's retirement income arrangements are designed to meet a number of objectives. These include achieving adequacy of income in retirement (including a minimum "safety net" level of income), providing assistance in the case of death or disability of a fund member, limiting future increases in the financing burden of the Age Pension, and increasing national savings.

These are not trivial tasks for the government or for individuals, and involve important public policy considerations. This paper in particular addresses issues relating to equity. Equity considerations arise on a number of levels. These equity considerations relate to a number of dimensions of retirement income provision. Equity can be considered in regard to the treatment of like individuals, individuals with different income levels, individuals with different labour force and life experiences, and even equity between generations of the population.

Individuals and governments may have differing perspectives on what is equitable. For individuals, superannuation contributions make up a significant proportion of their remuneration and an even greater proportion of their financial wealth. Access to employer contributions to superannuation and the level of such contributions involves important equity considerations regardless of any government involvement or assistance.

When there are government decisions impacting on the tax treatment of retirement savings or the availability of social security benefits, individual perceptions of equity become all the more intense. It is not unusual for individuals, regardless of their level of wealth or superannuation entitlements, to perceive any diminution of entitlements to be inequitable and any increase to be equitable. Equally, those without superannuation can see this as being due to inequities in superannuation coverage even if the underlying cause is another factor with widespread ramifications, such as lack of involvement in the paid workforce.

"Saving for retirement" is an increasingly important issue for the majority of Australians. In recent research commissioned by ASFA (Wirthlin Australia, October 2000) most respondents to the survey indicated that they considered superannuation as being an important area of mutual obligation. They understood that they as individuals have a responsibility to be more self reliant but expect government to help them.

For governments, the concept of opportunity cost is intense. More assistance for a particular program or person means that less is available for other programs and individuals. Important considerations are the amount of assistance provided to individuals through both the social security and taxation systems in regard to retirement income.

Decisions need to be made about the amount of assistance provided at various income levels and in various circumstances, and in regard to the balance between assistance provided for savings and that provided directly in regard to the treatment of retirement income. Governments also are concerned with any circumstances in which an individual may be facing difficulties of access or unfairness of some kind. Given the importance of superannuation in household financial assets, governments are also concerned with the equity implications of any policy change which has an impact on an actual or perceived rights and expectations.

1.1 Dimensions of equity

Equity clearly is a key issue in the debate about superannuation and retirement income reform. There is strong government and community concern that the assistance provided to retirement income should be spread fairly across society, and that there are no unfair government or private barriers to participation in the retirement income system. It would generally be accepted that retirement income reform should improve or, at the very least, not worsen the existing degree of fairness.

However, what is fair can be a matter of individual opinion, although public opinion polling can assist in discovering what common or dominant views are in regard to specific matters. It also is of assistance to consider the various aspects of equity before coming to a judgement on what is fair.

1.1.1 Horizontal equity

Horizontal equity means that people in similar positions should be treated equally. In tax terms, people with equal ability to pay should pay the same amount in tax. In social security terms, people with equal needs should receive equal assistance. This relates to both the quantum of assistance provided and to treating individuals with equivalent private means in the form of assets and/or income equally.

Developing a policy which reflects horizontal equity generally requires reference to different types of individuals or their physical, domestic or medical circumstances, for example, a single person, a married person with or without dependants, or a person with a disability or medical condition. Treating like persons alike requires a judgement to be made on who is like and who is unlike.

Both tax and social security concepts of horizontal equity need to be taken into account. Our retirement income system is made up of both government (Age Pension) and private income provision, with the latter containing both compulsory and voluntary elements. Considerations of horizontal equity apply to each of these three pillars, and to some extent to the interaction of each pillar with the others.

Currently, both tax and social security notions of horizontal equity are applied. The tax system focuses on the individual as the unit to which horizontal equity applies, while the social security system generally also takes notice of the circumstances of dependants or partners to a marriage or defacto relationship. This can lead to some apparent inconsistencies. For instance, a married couple do not have the ability to combine their Reasonable Benefit Limits for superannuation purposes, but they are required to combine their assets for the purpose of the assets test for the Age Pension.

An added complication in the case of superannuation is determining at what point is it appropriate to compare individuals. Are notions of horizontal equity satisfied by treating like individuals equally at the contributions stage, or does it also require like treatment at the stage benefits are paid?

1.1.2 Vertical equity

Vertical equity in the context of taxation requires that people should pay taxes according to their ability to pay. This usually means that those with greater ability to pay should pay a higher proportion of their income in tax than those who cannot afford to pay as much. For example, under the current income tax scales a person earning $25,000 a year pays 15.5 per cent of their income as income tax while a person earning $50,000 a year pays 22.8 per cent in income tax.

The compulsory superannuation arrangements also have arrangements relating to the lowly paid and the highly paid, despite the application of a flat percentage rate of contributions across a broad range of incomes. Those who earn over $105,200 have their compulsory superannuation requirement capped at an amount based on that wage level, while those earning less than $450 a week are not required to be covered by the Superannuation Guarantee arrangements. However, in regard to the latter threshold administrative convenience rather than equity considerations is likely to have been the dominant factor when the arrangements were put in place.

The Age Pension is means tested on the basis of separate income and assets tests. Payment is based on the test that gives the lower rate of pension. Under the income test, a single person's Age Pension the pension is reduced by 40 cents in the dollar for each dollar of income in excess of $106 per fortnight. Under the assets test, for a single homeowner the Age Pension is reduced if assets apart from the family home exceed $133,250. These various levels, current at February 2001, are adjusted over time, and differ between singles and couples, and between homeowners and non-homeowners.

Apart from the contributions surcharge applying to certain higher income individuals, most superannuation tax arrangements are flat rate. However, there are a variety of mechanisms such as age based contribution limits and reasonable benefit limits which are designed to cap the concessional tax treatment available to individuals. The existence of a tax free threshold for the receipt of lump sum benefits also introduces a degree of progressivity to the taxation of superannuation.

1.1.3 Preservation of past entitlements and expectations

or where the asset has a high value in absolute terms, equity and fairness can require past entitlements to be maintained. This is particularly the case when an individual may have made decisions based on past arrangements and/or intends in the near future to make use of their accrued benefits.

This dimension of equity is one that does not feature significantly in regard to policy changes generally made by government. However, superannuation is for most individuals the second most important financial asset after the family home. It is not surprising that any policy change that impacts on the value of that asset can arouse strong feelings within the community in regard to equitable treatment, and accordingly governments give attention to this aspect of equity.

Preservation of past entitlements can take the form of "grandfathering" where assets or the like acquired before a certain date continue to receive tax or other treatment that applied before that date. Another possible approach is a "sunset clause" where individuals can make use of past provisions or privileges only up to a future set date. After that date the new provisions uniformly apply. Sometimes such provisions are only available to individuals who have an entitlement current at the time a change is announced, with new entrants subject to the new provisions from their date of entry.

1.1.4 Equity and employment circumstances

Equity in the taxation treatment of superannuation is of little joy to an individual if they have not had the opportunity to access superannuation in the first place. Equality of opportunity can relate to requiring superannuation to be offered or provided on a uniform basis to all employees. It also can involve the outlawing of arrangements where there is no or only partial vesting of benefits.

Another important equity issue is whether superannuation should be available to all taxpayers, or whether a link to employment is required in order to make contributions or have contributions made on your behalf. Currently superannuation is primarily available for those in paid employment, but there are exceptions in the form of spouse accounts and contributions, and the proposed division of superannuation entitlements at the time of divorce or separation. The primary difficulty with any proposal to extend superannuation to those not in employment or without investment income is a lack of funds for contribution. While governments are willing to finance the Age Pension out of general taxation, there is less willingness to fund superannuation contributions out of general taxation.

1.1.5 Lack of discrimination

It now generally is taken as inequitable if an individual is unlawfully discriminated against on the basis of their gender, race, religion, marital status, age or the like. While avoidance of discrimination in retirement income on the basis of race or religion is a relatively straightforward issue in both conceptual terms and application, there are other aspects of discrimination in regard to retirement income which are not so straightforward.

For instance, superannuation and the Age Pension are for retirement income purposes, and they have age related features inherent in them. As well, given differences in life expectancy between men and women it is arguable that in some circumstances it is equitable to take gender into account. Men often pay more for life insurance cover, but less for annuities.

Similarly, both social security and superannuation arrangements take into account in some circumstances the existence and nature of dependents of an individual. In addition, while in many circumstances tax and other obligations are based on the individual, it is usual to have different social security entitlements and means testing depending on whether an individual is married or is in a de facto relationship. Given typical patterns of dependency and inter-dependency, it can be argued that such arrangements, if implemented appropriately, bring greater equity to the system rather than being a form of unjustified discrimination.

That said, it can be a fine line between unjustified discrimination and inherent characteristics of retirement income arrangements. This line may also be moving in line with changing community standards and behaviour practices. What was a reflection of social norms in the 1950s might be regarded as unjustifiable discrimination in 2001. For instance, married women were prohibited from permanent employment in the Commonwealth public service in the 1950s, but such a prohibition would not be tenable in contemporary society.

1.1.6 Actuarial equity

Where there are insurance elements within retirement income arrangements, then notions of actuarial fairness or equity may arise. Particularly where there are voluntary private insurance arrangements, the ongoing success of arrangements can depend on whether participants (both suppliers and purchasers) perceive that the rates being charged are fair. If a rate or premium is perceived as being excessive, then the individual may choose not to participate. If the rate or premium offered is lower than the actuarial risk then there is the danger of adverse selection, with high risk individuals taking opportunity of the insurance product being offered. This can place the viability of the overall scheme at risk if claims subsequently exceed the premiums that have been received.

Actuarial equity can also be a consideration when options are made available to individuals, such as delaying the take-up of benefits in return for a higher annual benefit payment. Actuarial equity would require that the benefit offered be commensurate with the cost involved in the short term for an individual.

1.1.7 Inter-generational equity

Individuals can receive differential treatment in terms of the requirement to make contributions or pay taxes and/or receive different retirement benefits depending on when they were either born, worked or retired. Changing patterns of work, taxes and retirement lead to changes in the way resources are distributed between different age groups. Along with these underlying changes there also can be changes in the rules that apply, sometimes to the detriment and sometimes to the benefit of particular generations.

Some argue that such changes can give rise to what are known as inter-generational inequity. For instance, those born prior to, say, 1950 have benefited from a welfare state, including provision of the Age Pension, where benefits received have not necessarily reflected the contributions made in the form of taxes. This can be the case on both an individual basis and in terms of the total taxes paid by the generations concerned. In contrast, more recently born generations have been expected to make greater self-provision through compulsory superannuation, taxes and other provisions such at the Higher Education Contribution Scheme (HECS).

Thomson, 1991 in “Selfish Generations?” provides a comprehensive account of such arguments in regard to taxation and government expenditures in New Zealand. Similar arguments have been raised in regard to taxation and expenditures in Australia, but most such assessments are necessarily subjective in nature regardless of how much data and other information is analysed.

1.2 Equity of overall arrangements

It is also important to note that the retirement income system has a number of components, and it is the interaction of each of these components that is important rather than strict equity in all of its dimensions being achieved within each component. As well, retirement income arrangements will necessarily be affected by inequalities in income and wealth in society more generally. If there were a desire to reduce the level of inequality in Australia, retirement income policy would play only a limited role in such an exercise. In fact the degree of inequality of income amongst those of retirement age is far less than the degree of inequality in income for individuals of workforce age. This will remain the case even with the projected increase in private superannuation benefits in the community.

2. Measuring the equity of current retirement income arrangements

Evaluation of equity of current arrangements depends in large part on the conceptual framework that is adopted. What is equitable on an expenditure tax basis is quite different to what is equitable on a conventional income tax basis. Full deductibility of superannuation contributions satisfies both horizontal and vertical equity concerns on an expenditure tax basis, but can raise some vertical equity concerns on an income tax basis if a narrow view is taken.

With a progressive income tax scale, deductions necessarily are worth more in terms of a reduction in the tax bill for persons on higher income. This does not mean that deductions from gross income are inequitable in determining taxable income. While salary sacrifice superannuation arrangements provide the greatest benefits for those on the highest tax rates (usually upper income earners), similar outcomes occur in the case of negative gearing and where any deductions are accepted as necessarily incurred in the course of earning assessable income. Where an individual has business or the like expenses, it is entirely reasonable to allow their deductibility regardless of the level of their taxable income.

Similarly, if the appropriate conceptual base for taxation is the amount of money which is spent on consumption rather than saved, then deductibility of saving in the form of superannuation is entirely appropriate. Superannuation contributions, particularly compulsory contributions, are preserved until retirement and are not available for alternative investment possibilities or for consumption. They do not form a part of current income or consumption, and it can be argued that tax deductibility is an appropriate trade-off for these contributions being locked up until retirement, which often will be many years off.

The acceptance of the theoretical and practical advantages of applying a consumption base for taxation purposes was reflected in the recent adoption in Australia of the Goods and Services Tax (GST). If an individual is not enjoying the benefits of all their income through consumption because they are saving, then they have the same standard of living as someone with the same level of consumption who is spending all their income.

Governments in Australia, including the Commonwealth government, have also moved to adopt accrual accounting. Accrual accounting seeks to take into account future obligations (and benefits) of government programs. Conceptually, adoption of accrual accounting should require the impact on future Age Pension expenditures of measures designed to boost private savings to be taken into account.

The conceptual base for evaluation tax treatment of superannuation

The Australian Treasury uses an income tax benchmark in estimating tax expenditures on superannuation and other employment termination provisions. Such a benchmark is used by some but not all OECD finance departments in evaluating tax expenditures (OECD, 1996). On this basis aggregate tax expenditures on superannuation have been estimated to be of the order of $8.8 billion (Treasury, 2001). This estimate is based on what the one-off addition to tax revenue would be in a given year if all contributions and fund earnings were included in the taxable income of taxpayers and were taxed at their marginal rates of income tax, with allowance made for the tax paid by different set of individuals receiving benefits in that same year.

The Treasury method is misleading on a number of counts. It assumes that the present value of tax concessions can be estimated by comparing the aggregate tax paid on benefits currently being received with the tax being paid on contributions and fund earnings. The Treasury methodology will generate inflated figures. In a rapidly expanding superannuation system where aggregate contributions are much higher than benefits paid in any given year because coverage has expanded and the contribution rate has increased, the Treasury method is very misleading in terms of the aggregate costs it records. This is the case even if the Treasury conceptual base is accepted.

On the other hand, the approach preferred by ASFA, several major OECD countries and a range of respected commentators such as Access Economics is to compare current tax receipts from superannuation with what they would be if superannuation was only taxed when benefits were received at normal personal income tax rates (Clare, 2000). If this conceptual base is adopted then superannuation is **overtaxed** by some $4.6 billion. The arithmetic behind this estimate is basically that currently about $6 billion a year is paid in contributions and earnings taxes by superannuation funds, and that only around $1.4 billion would be paid in income tax if benefits received this year were treated as normal taxable income of individuals. Again, because the superannuation system is expanding rapidly this approach tends to generate higher figures in regard to contributions relative to benefits in the calculation of the overtaxation.

Individuals in calculating the tax advantage of superannuation to them personally are unlikely to use the Treasury method. The Treasury method does not make sense at an individual level because it compares what tax is being paid by the minority receiving a retirement benefit in the current year with the taxation paid in respect of all contributions in the same year.

Individuals in assessing the tax advantage of superannuation need to calculate the level of contributions taxes being made now, including the surcharge, and add in an allowance for the present value of eventual taxation of benefits. When this is done, superannuation is tax advantaged for most individuals, regardless of whether contributions are made from pre- or post-tax income. Clare, 2000 has further details of estimates of tax expenditures on superannuation, and the level of tax advantage provided at various levels of income.

In essence, in order to gain a proper understanding of the tax advantage flowing to superannuation and the equity of current or proposed arrangements, you need to consider a number of matters. These include the level of contributions and the marginal tax rates for those receiving the benefit of them, the level of superannuation assets and the likely level of assets at age of retirement, and the eventual taxes paid when benefits are received. Consideration also needs to be given to the interaction between superannuation benefits received and the operation of the social security system if the overall equity of retirement provision in Australia is being considered.

Unfortunately it is difficult if not impossible to take all these factors into account in one simple assessment. A large part of the equity of superannuation is tied up with the amount of superannuation benefits finally accumulated, and the tax and social security treatment of those benefits, rather than just the tax concessions relative to some notional benchmark along the way. Estimates of benefits to be finally accumulated can be projected, but they are very much projections only. Increasingly, breaks in career paths or changes in personal circumstances can render even seemingly conservative projections very inaccurate at a very early stage.

While a precise evaluation of the equity of current superannuation arrangements would require knowing the unknowable, a reasonably comprehensive view of the equity of superannuation and retirement income provision can be developed. This involves looking at current levels of contributions and for whose benefit they are being made, and at current and prospective levels of superannuation assets for individuals across the community. Explicit recognition also needs to be given to the level of the Age Pension and the value of this for individual income and wealth.

2.1 Superannuation contributions by income level

Table 2.1 sets out ASFA Research Centre estimates of the proportion of superannuation contributions made on behalf of taxpayers in the various marginal income tax bands applying after 1 July 2000, along with an estimate of the weighted average marginal tax rate for individuals receiving the benefit of superannuation contributions. These estimates are consistent in broad terms with estimates produced by the National Centre for Social and Economic Modelling (Harding et al, 1997) and produce overall results consistent with aggregate superannuation contributions as reported by APRA, Treasury tax expenditures estimates, and contributions surcharge tax collections.

Table 2.1: Current personal income tax scale and distribution of employer contributions by income range

Taxable income range ($)	Marginal income tax rate	%of taxpayers(a)	% of wages and salaries(a)	%of employer contributions
0 - 6,000	0%	4	0.02	0
6,001 - 20,000	17%	27	11	7
20,001 - 50,000	30%	55	59	55
50,001 - 60,000	42%	3	8	10
60,001+	47%	11	22	28

(a) Based on 1997-98 ATO Taxation Statistics

As is clear from the table, superannuation contributions are not spread entirely evenly across all taxpayers or income ranges. This is because one of the basic characteristics of superannuation is that contributions are linked to employment, particularly full-time employment. Those taxpayers on very low incomes are not receiving superannuation contributions. Indeed, many of them should not be receiving any employer contributions as they will be retired or otherwise not in the paid work force. As well, while superannuation coverage is near universal for full-time employees, lower paid employees tend to receive employer contributions at no more than the compulsory level. Higher paid employees are more likely to be members of more generous corporate or public sector schemes and/or have access to salary sacrifice arrangements.

As indicated by the table, around 70% of employer contributions relate to individuals on less than the top marginal tax rate, with over 60% of contributions relating to individuals on a marginal income tax rate of 30% or less. Under 30% of contributions relate to employees earning more than $60,000.

Although not shown in the table, the number of taxpayers earning more than $60,000 rapidly drops away as taxable income increases. Only around 350,000 wage and salary earners out of the total of around 8 million have taxable incomes in excess of $70,000, with two-thirds of those earning less than $100,000. These 350,000 taxpayers account for around 14% of aggregate wages and salaries and somewhat less than 20% of employer contributions.

Table 2.2 provides information on non-employer sponsored superannuation contributions. Given that most employees are unable to make such contributions given that they receive compulsory employer contributions, this category is largely the preserve of the self employed who are the owners of unincorporated businesses. In 1997-98 around 195,000 individuals made such contributions, compared to around 7.5 million wage and salary earners benefiting from superannuation contributions.

As is clear from the table, non-employer sponsored contributions are more strongly associated with lower levels of taxable income than employer contributions. Around 70% of contributions were made by individuals with an annual income of less than $50,000, and around 10% of contributions were made by individuals who had taxable incomes so low that they were not required to pay income tax. This is likely to have something to do with the taxable and underlying incomes of many small businesses, and the role played by discretionary superannuation contributions in the tax and retirement income planning practices of proprietors of such businesses.

Table 2.2: The distribution of non-employer sponsored, tax deductible superannuation contributions by income range(a)

Taxable income range ($)	Marginal income tax rate	%of contributions
0 - 6,000	0%	8
6,001 - 20,000	17%	22
20,001 - 50,000	30%	40
50,001 - 60,000	42%	5
60,001+	47%	25

(a) Based on 1997-98 ATO Taxation Statistics

2.2 Equity of employer contributions to superannuation

Tables 2.1 and 2.2 above do not provide any evidence of any gross horizontal or vertical inequity in regard to the provision of employer contributions or otherwise tax deductible superannuation contributions. Superannuation contributions are made for nearly all full-time and many part-time employees, and their distribution across the labour force is largely in line with the distribution of wage and salary incomes. Any dispute with the distribution of superannuation contributions in Australia is largely a dispute about the distribution of wages and salaries.

Clearly, some commentators have difficulties with the distribution of salaries in Australia, with recent attention being given to executive salaries in particular. However, the distribution of earnings in Australia is not marked by international standards, and while there may have been some increase in the disparity in earnings between low and upper income earners, this has been a world wide trend (EPAC, 1995).

That said, the current structure of superannuation taxation is not without its defects from the point of view of horizontal and vertical equity. For instance, employer contributions would be tax disadvantaged and inequitable on an income tax basis and especially on a consumption tax basis for individuals with taxable incomes less than $6,000 per annum who have a zero marginal tax rate. However, there would be very few individuals with taxable income of this level who would be in employment and receiving employer contributions. Employees who earn less than $450 per month fall outside the compulsory superannuation system.

Of course, individuals who are lower income earners when employed or who have never or seldom been in paid employment tend to be the largest recipients of government social security benefits, including the Age Pension when they are retired. Low income earners may receive only a little from superannuation tax concessions, but they receive other substantial benefits instead. This is the mechanism which delivers equity for low income earners.

The contributions surcharge has introduced a number of forms of horizontal inequity (see section 3.2.3) but it also substantially removes any tax advantage flowing to upper income earners. For individuals with combined taxable income, reportable fringe benefits and surchargeable superannuation contributions exceeding a combined total of $81,493 in 2000-01, a surcharge is paid on contributions of up to 15%. The maximum rate of surcharge occurs when the total reaches $98,955. The combined effects of contributions tax, the surcharge and lump sum benefits tax are equivalent to a tax rate of 41.6% on contributions. This is lower than the top marginal tax rate of 48.5% (including the Medicare Levy) on income, but is very little different to the 43.5% rate applying to individuals with an income between $50,001 and $60,000.

There are cases where little or no tax benefit is delivered for saving for retirement through superannuation contributions. For a minority of surcharge payers the effective marginal tax rate on contributions can be 80% or more, which is far higher than the top marginal personal income tax rate. These very high marginal rates apply where there is a significant amount of contributions being made and an additional dollar of contributions will both attract the surcharge and increase the rate of surcharge applying to all contributions.

As noted earlier, there are only around 350,000 or so individuals with taxable incomes in excess of $70,000 per year who are wage and salary earners, and the surcharge impacts on 90% or more of these individuals. The inclusion of reportable fringe benefits in the income base used to determine surcharge liability has been estimated by the Treasury as likely to extend surcharge obligations to another 300,000 individuals.

While this change to the surcharge will pick up some individuals who were using salary packaging in order to avoid surcharge obligations, it is likely that as many as half of the individuals with incomes between $50,000 and $70,000 will be brought into the surcharge net. Use of an employer provided car or occupation of employer provided subsidised housing will be typical triggers for this. Some redundancy or termination payments also are assessed for surcharge purposes. This augmented surcharge regime will from July 2000 have an impact on a significant number of Australians who while not at the bottom of the income distribution are not usually regarded as high income earners.

2.3 Horizontal and vertical equity in superannuation payouts

A misconception of some commentators who claim that superannuation tax arrangements are inequitable is that “double dipping” is rife, and that many individuals receive large superannuation payouts which have been subject to minimal taxation.

The evidence available indicates that the incidence of double dipping is very limited (Kalisch, 1992). Individuals typically do not dissipate or gift their capital in order to rely on the Age Pension. Most retirees do not have enough savings to be able to make a respectable attempt at what could be called dissipation, and the incentive to do so is not big enough. The level of the Age Pension is such that where possible retirees in almost all cases will take considerable care to generate a private income in addition to the Age Pension. As well, use of a lump sum to purchase consumer durables or to undertake necessary household maintenance can be an entirely appropriate strategy at the commencement of retirement, with the amounts involved having minimal implications for Age Pension eligibility.

Other criticisms that are sometimes made are along the lines that superannuation delivers large payments for just a privileged few high income earners. However, as indicated in the following sections, most superannuation benefits are currently for a modest amount and are spread across individuals of varying income levels and even age. Projections of the level and distribution of superannuation benefits also show an increase in the average level and a diminution in the variance of superannuation benefits paid. ASFA has indicated that it would support arrangements which encouraged or required the bulk of a superannuation benefit to be taken in income stream form. Greater use of income streams would make “double dipping” even less likely.

2.3.1 The current distribution of eligible termination payments (ETPs) and retirement benefits

Criticism of the equity of superannuation tax arrangements and retirement income more generally is sometimes based on incorrect assumptions about the nature and level of superannuation benefit payments both now and in the future. Attention is at times given to generous public sector superannuation schemes, but many of these are closed to new members and in any event pay their benefits mostly in pension form. Typically, the bulk of pension benefits received from largely unfunded schemes such as the Commonwealth Superannuation Scheme are fully included in the taxable income of the recipients, and the generous nature of the schemes comes from the generous benefit levels funded from consolidated revenue rather than any tax concessions. Some State public sector schemes pay lump sums and/or pensions which have more favourable tax treatment.

Currently most superannuation benefits received in lump sum form, which is the case for the vast bulk of persons in the private sector, are of modest size. As shown in Table 2.3, in 1995 around 85% of lump sums received were less than $100,000, with over 70% of lump sums less than $60,000. With the maturity of the compulsory superannuation system these averages will increase, but it will be a number of decades before a significant proportion of benefits will exceed $100,000 in terms of today's dollars.

Certainly some individuals have problems with Reasonable Benefit Limits applying to their superannuation payout and other employer termination payments, but ATO and industry figures suggest that this group is unlikely to be more than 1,500 in number every year. Around about 650 people a year pay tax on excess benefits, but others are likely to have put in place strategies to deal with their potential excess benefits. This compares to the one million or so taxpayers in the age group where superannuation benefits are customarily or required to be taken.

Table 2.3: Value and incidence of superannuation lump sums received in the previous two years by persons aged 45-74 who had ceased work, 1995

Range value of lump sum	Males (%)	Females (%)	All persons (%)
Under $5,000	19	47	30
$5,000-$20,000	19	22	20
$20,000-$60,000	23	19	21
$60,000-$100,000	16	6	12
$100,000-$200,000	15	5	11
Over $200,000	8	1	5
Total	100	100	100

Source: ABS, *Superannuation Australia, November 1995*, Cat No 6319.0

As noted in the following section, superannuation payouts are expected to increase significantly with the maturity of the compulsory superannuation system. While the level of superannuation payments currently received by retirees (or projected to be received) is not a cause for concern on horizontal or vertical equity grounds, there are some aspects of the current tax treatment of eligible termination payments made by superannuation funds and by employers that give rise to some concerns. A number of these concerns relate to tax provisions which are transitional but long standing in operation, or which will decline in importance as preservation requirements apply to a larger proportion of superannuation entitlements.

Official Australian Taxation Office statistics (ATO, 2000) indicate that in 1997-98 around 410,000 individuals received an eligible termination payment (ETP). Around two-thirds of these recipients were aged less than 55, and were not retired or permanently disabled. Around $2.5 billion was received by around 130,000 individuals who retired or became disabled.

ETPs paid at retirement were on average larger in amount than payments made on termination of employment. As a result, while there were more recipients of such payments, the aggregate amount was similar. Around $2.5 billion in benefits were paid on termination or change of employment, rather than being preserved to retirement. The average for such payments was $9,500 or so, but there was considerable variation in amount. The bulk of recipients received payments of less than $5,000, but there were less than one per cent of recipients who received payments of over $100,000.

The total value of termination payment tax rebates was around $1.4 billion in 1997-98 (ATO, 2000). This figure is the difference in the amount of tax actually paid in regard to termination payments and what would have been paid if normal marginal income tax rates applied. For individuals receiving modest payments on change of employment the average value of the rebate, which equates to the value of the concessional tax treatment of the ETP, was less than $1,000. For individuals with taxable income in excess of $100,000 (including the termination payment itself), the average rebate was over $18,000 and for individuals with taxable income in excess of $200,000 the value of the rebate on average was in excess of $40,000. There were only 25,000 individuals with income over $100,000 receiving the benefit of this rebate, and only 4,500 recipients with taxable income over $200,000.

ETPs received before age 55 generally attract tax at a rate of 20% on the entire amount if from a taxed source, and at a rate of 30% if from an untaxed source. Given that the contributions and earnings supporting such payments from a taxed source were taxed at 15% at the fund level, these rates of tax are not highly concessional. However, the ability of individuals to receive such payments and receive the benefits of concessional taxation does give rise to both horizontal and vertical equity concerns. Such benefits, particularly when for a modest amount, are treated by individuals as part of their general income and are used often for consumption purposes. Applying a lower rate of tax gives rise to treating individuals with similar levels of income in a different way.

The availability of ETPs prior to retirement is an issue that has been addressed by the government. Tighter preservation arrangements are leading to a declining but still significant number of such recipients. For instance in 1994-95 there were around 360,000 such recipients, but this had fallen to nearly 260,000 by 1997-98. The Treasury has forecast that by 2007 the proportion of superannuation assets not preserved will have fallen to 10%, compared to around 65% in 1995 (Rothman, 1997).

Tax treatment of lump sums attributed to pre-1983 employment

Another cause of possible concern in regard to horizontal and vertical equity in the system is the receipt of ETPs of which only 5% forms part of assessable income. These ETPs relate to benefits attributable, in a fairly generous way, to employment prior to 1983. These very concessionally treated ETPs are received across a wide range of age groups and income levels, with ATO data indicating that some recipients are of an age which is incompatible with pre-1983 employment. (Apart from possible errors in claims by taxpayers, death benefits to non-dependants can give rise to 5% assessable payments, and pre-1983 service can also be "inherited" in some circumstances (ARISA, 2000)). However, the bulk of recipients are aged over 45.

Despite the fact that 1983 is now a long time ago, the transitional tax treatment continues to affect around one-third of ETPs. While the number of 5% assessable recipients has declined from 182,000 in 1994-95 to 143,000 in 1997-98, the aggregate amount of such payments remained constant at $2.7 billion. Average benefits for this category tend to be higher than other ETPs, with payments of at least $10,000 common. At the upper end of the income scale, 5% assessable ETPs in excess of $100,000 were reported by at least several thousand taxpayers in 1997-98.

The growing average value of 5% assessable ETPs may reflect the personal circumstances of recent retirees, but it most likely has more to do with the very generous arrangements for treating pre-1983 entitlements. Rolling over pre-1983 benefits into a fund containing only benefits accrued after that date has the effect of increasing the aggregate amount of a retirement benefit subject to concessional treatment.

As will be discussed later, the transitional treatment of pre-1983 benefits is equitable in the sense that past entitlements and expectations are preserved. However, the inclusion of only 5% of certain benefits received in taxable income regardless of the amount does raise horizontal equity concerns relative to other benefits received. This is especially the case given that the amount of concession provided can depend on whether a benefit is rolled over and combined with other benefits. It also raises vertical equity concerns, in that the tax treatment is very concessional, has no upper cap on the amounts to which it applies, and applies an extremely limited progressivity of tax rates given that only 5% of such amounts is included in normal taxable income.

2.3.2 The projected distribution of superannuation benefits

According to projections prepared by the Retirement Income Modelling Group of the Treasury, average age retirement payouts are expected to increase (in today's dollars) from the current level of around $62,000 per person rising to $77,000 in June 2005, to $97,000 in June 2010 to $135,000 in June 2020 (Kemp, 2000). These averages reflect both the experiences of those who had superannuation coverage prior to the introduction of compulsory superannuation in the early part of the 1990s, and those whose only superannuation comes from the compulsory arrangements. Salary growth, better vesting and strong investment earnings have helped those in the older schemes, whereas the SG system has delivered substantial benefits to those who previously were not covered by superannuation.

The bulk of the payments on this Treasury scenario will not be subject to further taxation at the benefits stage, because the first $100,000 or so of superannuation benefits are not taxed when the recipient is aged 55 and over. However, receipt of such payments actually improves both horizontal and vertical equity.

Projections of superannuation lump sums and retirement income for specific case studies based on individual circumstances have been prepared by the ASFA Research Centre using methodology broadly consistent with that used by the Commonwealth Treasury (ASFA, 1999). These indicate that for a person currently earning $40,000 per annum (around average weekly earnings), 30 years of superannuation contributions at 9% of salary will generate a lump sum in today's dollars of around $180,000. A lump sum of this order would permit the purchase of an income stream indexed to the CPI which would increase retirement income from the level of the Age Pension ($10,000 per annum) to around $19,000 per annum.

An income of this level is not high in absolute terms and indeed does not meet minimum community expectations as to adequacy (Wirthlin, 2000). Nor is it excessive in relation to the pre-retirement income concerned. Contrary to criticisms that are sometimes made by welfare lobby groups, it does not give rise to horizontal equity concerns in regard to the relative position of those in the workforce making contributions and those receiving subsequent benefits. Horizontal equity is served by generating retirement incomes which bear some relationship to pre-retirement earnings. Vertical equity is also served by providing the greatest proportional income replacement for those on the lowest pre-retirement incomes.

The reason for this is that the interaction of the tax and social security provisions bring about a significant degree of vertical equity in the provision of retirement incomes. As shown by Table 2.4, the replacement rate of retirement income falls markedly with increased levels of pre-retirement income. Put more simply, the system delivers the greatest relative benefits in terms of replacement income to the lower paid. Questions remain as to the overall "adequacy" achieved.

Table 2.4: Average outcomes, Super Guarantee 9%

	30 years contributions		*40 years contributions*	
Final Average Salary	% of gross pre-retirement	% of net pre-retirement	% of gross pre-retirement	% of net pre-retirement
$20,000	70%	79%	82%	90%
$40,000	45%	55%	58%	70%
$60,000	37%	48%	50%	62%

Source: ASFA, 1999.

As the table shows, with 9% Super Guarantee and no additional contributions an individual on one-half AWE would end up with 70% of his or her final gross salary ($14,000 per annum), which provides about 80% of their pre-retirement disposable income. With a fully complying income stream product, the bulk of the income would be provided by the Age Pension.

By contrast, those on average or higher incomes achieve much lower outcomes relative to pre-retirement income, with the flat rate nature of the Age Pension a significant factor in this outcome. Under the current means test, the individual still may receive most or all the Age Pension in the first year of retirement because only a small component of a complying income stream linked to the CPI is assessed as income under the means test in the early years of the income stream. However, not surprisingly, the Age Pension represents proportionately less of the income stream than it did for the low income earner.

2.3.3 The income distribution of retirees

If anything, the Australian retirement income system has resulted in a pattern of income distribution for the aged which is tightly compressed. Compared to most other nations a very high level of income redistribution has been achieved, with a clustering of numerous individuals with retirement incomes at a level just above the poverty level. Relatively few individuals have retirement incomes that are much higher.

Table 2.5 indicates that in Australia, compared to other major developed countries, those at the upper income end of the income distribution of retirees are not that far ahead of the poorest retirees. For instance, in Australia the income of retired couples who have an income in excess of that received by 90% of retirees is 2.5 times that of couples at the low end of the income distribution. In Canada and the USA the ratio is around 5 and 7, indicating a much wider spread of retirement incomes in those countries. This is likely to be a combination of the poorest of the retirees in those countries being worse off than the poorest retirees in Australia, and the richest of their retirees being better off in relative terms compared to those in Australia.

Table 2.6 provides information on where retirees fit in the overall income distribution. In Australia nearly 50% of retirees have incomes which put them in the poorest 30% of the income distribution, with only 7% of retirees managing to have incomes which put them in the top half of the overall income distribution of the community. In comparison, in most other developed countries there are fewer retirees in the bottom 30% of the income distribution and more in the top half of the income distribution. While some clustering of incomes at the lower end of the income distribution is to be expected amongst those who have retired from paid employment, this clustering is much more severe in Australia than in most other developed countries.

Other countries are more successful in delivering retirement incomes which are more closely linked to what individuals received prior to retirement. In Australia at this time most retirees are relatively poor compared to the rest of the community. However, it needs to be acknowledged that the near universal availability of at least the Age Pension, and relatively high levels of home ownership by international standards, is responsible for keeping the vast bulk of the retired above the poverty line in Australia. In a number of other countries the relatively low base level of government social security payments for the aged in combination with a higher level of private rental by the aged can lead to significant proportions of the aged with incomes below the poverty line for their household type.

On the face of it, the concessional arrangements which have applied to the taxation of superannuation benefits, including the highly concessional arrangements that applied prior to 1983, have not resulted in any marked departure from vertical equity in regard to retirement incomes. It could in fact be argued that there is an undue compression of incomes around a low level that is inadequate in terms of the needs and expectations of retirees. An increase in the number of retired people with higher incomes would improve both outcomes in terms of adequacy and the equity of the system. Both the effects of compulsory superannuation and more sensible taxation treatment of contributions to funds and of fund earnings would help contribute to increasing the adequacy of retirement incomes and improving equity both within the retired and between the retired and those still in the paid labour force.

Table 2.5: Inequality among pensioners – ratio of the 90th to the 10th percentiles of pensioner incomes

Age	60-64	65-69	70-74	75+	All 60+
Australia					
Couples	2.5	2.8	2.2	2.5	2.5
Single Men	1.8	2.6	1.8	2.9	2.4
Single Women	2.6	2	2	1.7	1.9
Canada					
Couples	4.9	2.8	2.8	2.6	2.8
Single Men	4.7	3.2	2.8	2.5	3
Single Women	3.9	2.7	2.3	2	2.4
UK					
Couples	3.6	3.6	3	3	3.3
Single Men	3.5	3.5	2.7	2.9	3.1
Single Women	3.2	2.9	2.7	2.8	2.8
USA					
Couples	7.1	5.3	4.6	5.7	5.1
Single Men	9.4	6.5	5	4.9	5.5
Single Women	>10	5.7	4.5	4.5	5

Source: Johnson, 1999.

Table 2.6: Proportion of pensioners in three parts of the overall income distribution of the community

	% in poorest 30%	% in middle 40%	% in richest 50%
Australia	48	44	7
Canada	49	37	15
France	28	43	30
Germany	36	44	20
Italy	28	46	27
Netherlands	32	51	18
UK	38	46	15
US	41	40	18

Source: Johnson, 1999.

2.3.4 Superannuation and total wealth

Concessional tax treatment of superannuation along with compulsory contributions has the capacity to reduce inequality in wealth and retirement incomes. As shown by the following tables, superannuation forms a large part of the financial wealth of the lower wealth and income groups. For the 30% of households with the most wealth, superannuation forms 20% or less of household wealth. Reducing the concessionality of superannuation would have little impact on the overall wealth of such households, particularly given that assets formerly in superannuation would move to other concessionally taxed investments.

However, for the middle to lower wealth deciles, superannuation can form 60% or more of total wealth (Table 2.7). This percentage can be expected to increase as the compulsory superannuation system matures. Those without housing equity, usually the young and/or those at the lower end of the income distribution, very often have no savings apart from superannuation. Removing taxes from superannuation contributions and earnings would have the potential to reduce wealth inequality as it would have its greatest relative impact at the lower ends of the wealth distribution. For the lowest part of the wealth distribution, developments in the real level of the Age Pension will continue to be the most important influences on income and living standards.

In effect, entitlement to the Age Pension or the Veterans Pension forms the greatest part of the "wealth" of the majority of the retired. At current market rates, the cost of purchasing an annuity at retirement equivalent to the Age Pension is of the order of $250,000 for a female, and around $180,000 for a male. Inclusion of this form of "wealth" results in a much more even distribution of wealth being recorded.

Rice, 1998 has estimated that the present value of the Age Pension, rent relief and the Veterans Pension was $172 billion in 1997. This compares to assets in superannuation at that time of $333 billion and total wealth of $1,500 billion (Table 2.8).

The present value of government pensions was based on market rates for annuities at that time, and assumed that average earnings would outstrip pensions by 2% per annum. On the basis of current annuity rates and assuming that Age Pensions will continue to be indexed to Average Weekly Ordinary Time Earnings (AWOTE), the current present value of Age and Veterans Pensions is in excess of $200 billion

Table 2.7 Superannuation as part of total wealth by wealth percentiles

	1986			1993		
Wealth Percentile	**Super**	**Total Wealth ($,000)**	**%**	**Super**	**Total Wealth ($,000)**	**%**
1-10	0	0		0	-1	0
11-20	0	0		0	1	0
21-30	1	3	33	6	8	75
31-40	10	22	45	17	26	65
41-50	12	57	21	23	62	37
51-60	13	89	15	24	103	23
61-70	15	118	13	28	144	19
71-80	25	159	16	38	195	19
81-90	44	234	19	59	278	21
91-100	69	545	13	88	643	14
Total	**19**	**122**	**16**	**28**	**146**	**19**

Source: Baekgaard, 1998

Table 2.8 Components of net wealth ($b)

	Interest bearing securities	equities	super & life office	other financial assets	dwellings	motor vehicles	consumer durables	other non financial assets	Total
1990	36.3	55.2	164.4	43.3	644.8	29.3	55.7	62.7	1091.7
1991	37.1	50.6	178.3	51.3	675.6	29.8	57.4	56.4	1136.5
1992	41.6	63.8	203.1	33.1	668.9	30.3	58.8	54.4	1154.0
1993	46.2	86.7	218.2	26.1	699.8	32	59.6	57.6	1226.2
1994	58.6	109.8	238.4	33.8	733.1	32.5	62	59.9	1328.1
1995	53.1	105.9	253.4	41.9	761	34.8	63.7	59.2	1373.0
1996	47.1	107	282.5	41.9	773.8	36.3	66.2	61.7	1416.5
1997	42.9	125.8	332.5	55.9	804.8	35.4	68.7	62.5	1528.5

Source: Bacon, 1998

Table 2.9 Percentage of net wealth in major asset classes

	Interest bearing securities	equities	super & life office	other financial assets	dwellings	motor vehicles	consumer durables	other non financial assets	Total
1990	3.3	5.1	15.1	4.0	59.1	2.7	5.1	5.7	100
1991	3.3	4.5	15.7	4.5	59.4	2.6	5.1	5.0	100
1992	3.6	5.5	17.6	2.9	58.0	2.6	5.1	4.7	100
1993	3.8	7.1	17.8	2.1	57.1	2.6	4.9	4.7	100
1994	4.4	8.3	18.0	2.5	55.2	2.4	4.7	4.5	100
1995	3.9	7.7	18.5	3.1	55.4	2.5	4.6	4.3	100
1996	3.3	7.6	19.9	3.0	54.6	2.6	4.7	4.4	100
1997	2.0	8.2	21.8	3.7	52.7	2.3	4.5	4.1	100

Source: Bacon, 1998

2.3.5 The distribution of tax benefits and government retirement income assistance by income level

There are considerable difficulties in estimating the level of tax assistance provided to superannuation at different income levels. Apart from the basic conceptual issue of whether the appropriate taxation point is when benefits are paid or when contributions and earnings are credited to an account, establishing how much tax is paid on super can only be determined in retrospect. The total tax bill will depend on the amount of superannuation eventually accumulated and on the form in which a benefit is taken. Until a benefit is taken any estimate of the amount of taxation can at best be a very approximate projection. High or indeed low contributions or income in any one year cannot be taken as characterising the circumstances of an individual as contributions, income and eventual financial circumstances can change markedly from year to year.

Table 2.10 below sets out the tax break accruing to superannuation prior to the benefit stage, at least on the assumption of a comprehensive income tax base. Not surprisingly the larger tax benefits accrue to the individuals with the most contributions and on the highest marginal tax rates.

As well, consistent with the findings of other analysts, such as Rothman, 2000, the larger part of the tax benefit during the accumulation phase is in regard to earnings. This is because earnings form the largest part of eventual benefits, at least after a number of years, and because the difference in tax rates for investment earnings received within a superannuation fund is relatively great. In regard to the latter, an individual on the top marginal rate may face an effective tax rate of 34% on income from a balanced portfolio. This is lower than the standard marginal rate because of the impact of imputation credits and capital gains.

Table 2.10: Tax breaks for 30 years of super contributions and fund earnings(a)

			Contributions		*Earnings*	
Final Average Salary	Lump sum benefit	Tax benefit on contributions and earnings	After personal tax equivalent	Tax break	After personal tax equivalent	Tax break
$40,000	$180,000	$38,616	$46,985	$9,815	$94,400	$28,800
$60,000(b)	$270,000	$107,585	$58,715	$26,468	$101,700	$83,117
$90,000(c)	$330,955	$129,874	$80,720	$25,000	$120,363	$104,874

(a) Current dollar values based on contributions at the SG rate of 9%, fund earnings of 8% nominal, wages growth of 3.75% nominal and effective tax rate on earnings of 6.5%. No allowance is made for tax paid on benefits.
(b) Assumed 42% personal tax rate applies to wages income and effective rate of 27% applies to a balanced portfolio held personally.
(c) Assumed surcharge applies at the full 15% rate and an effective tax rate of 34.6% applies to a balanced portfolio held personally.

There can be a substantial claw back of these tax breaks on contributions and investment earnings, particularly if a benefit is taken in lump sum form. For instance, a lump sum of

$331,000 attracts lump sum tax of around $38,000 if taken at age 55 or later, and more if taken earlier. This is substantially more than the $11,900 payable on a $180,000 benefit and the $27,900 payable on a $270,000 benefit. As well, the holding of financial assets in excess of $266,750 disqualifies single homeowner from the receipt of the Age Pension. (A higher threshold applies to non-homeowners, and a joint test applies to couples). The Age Pension has a capital value in excess of $200,000, so this more than offsets the value of any tax break received.

If a benefit is taken as an income stream, the analysis becomes a little more complicated. An income stream will have implications for both personal taxation obligations and Age Pension entitlement. Some forms of income stream would rule out eligibility for the Age Pension, and would give rise to a significant level of income tax obligations. If taken as an asset test exempt lifetime annuity, then even for relatively large benefits there is only a limited reduction in the Age Pension received in the early years of receipt of such an income stream and only a relatively modest income tax liability during the life of the income stream.

If there were concerns that the level of tax concessions made available to lower income earners is too low relative to higher income earners, this does not mean that the tax concession available to higher income earners should be cut back. A more constructive response to such concerns would be to boost the assistance to low income earners. This could be achieved by way of a government co-contribution, tax rebate or the like. Such a mechanism could be targeted at the bulk of wage and salary earners that fall within the $20,000 to $50,000 income band who face a 30 per cent marginal income tax rate.

2.4 Equity of superannuation in terms of preserving past entitlements and expectations

Superannuation arrangements in terms of both prudential regulation and taxation provisions are scrupulous in preserving past entitlements and expectations. Provisions of the Superannuation Industry Supervision (SIS) Act along with general provisions of trust law prevent an individual being deprived of any past entitlement. If an employer sponsor wishes to close down a fund and transfer an employee to a new fund, then that fund has to provide at least equivalent benefits and/or the consent of each and every member needs to be obtained.

“Grandfathering”, that is, the preservation of entitlements accrued at a given date, is common in regard to superannuation taxation. A prominent example is the treatment of pre- and post 1983 entitlements. Through splitting pre- and post-1983 periods of employment taxation provisions are such that past entitlements are at the very least maintained and in many cases grow. There is also a requirement for funds to split pre 1 July 1999 benefits into preserved and non-preserved components.

In other areas, particularly in regard to the operations of funds, practices in place at a certain date frequently can continue even though other funds may be prohibited from undertaking such activities. In some cases a “sunset clause” is applied, which allows a fund a year or even years to change their practices in order to comply with new requirements. This both preserves past entitlements and facilitates ordered and more easy transitions.

At the individual level, those close to retirement are not subject to certain changes or are given the benefit of generous transitional provisions. For instance, the preservation age for receipt of superannuation benefits is being increased from age 55 to 60, but this will not start to take effect until 2015. Similarly, the increase in the age at which females can receive the Age Pension is being phased in over an extensive period.

If anything, the pursuit of equity in preserving past expectations has dominated over horizontal and vertical equity in more conventional terms.

2.5 Equality of opportunity in accessing superannuation

The superannuation system is widely, but not universally, accessible. It is available in effect in one form or another to nearly all Australian residents engaged in paid employment. In fact it is compulsory for employees provided they earn more than $450 in a calendar month. The self employed and those earning under that $450 a month threshold can choose to contribute, and may in certain circumstances receive the benefit of tax concessions. It is also open to individuals to make contributions on behalf of their spouse or de-facto spouse. Foreshadowed changes to the Family Law Act and to SIS also will open the possibility of accounts being established for a former or separated spouse as part of a negotiated or imposed financial settlement.

The main concerns in regard to equality of opportunity in accessing superannuation are in regard to the exclusion of those who are not in paid employment. ASFA has argued that the employment nexus for superannuation has already broken down, and that it would be desirable to open up access to the superannuation system to anyone in receipt of taxable income.

Whether individuals with no taxable income who are on social security benefits should be involved in or have access to the superannuation system is a more debatable point. An important part of the equity grounds for superannuation is that it allows for incomes in retirement that are in some way commensurate with pre-retirement income. For those of working age who are on social security, reliance on the social security system in retirement can be regarded as both the expected and reasonable outcome.

2.6 Discrimination and superannuation funds

Superannuation funds rate very well in terms of lack of discrimination in regard to fund members. Superannuation is universally available to those in employment, and with most funds there also is automatic acceptance for insurance coverage up to certain levels for life insurance and disability insurance. For a significant number of individuals, ancillary insurance cover or benefit design provided through superannuation is the only form of coverage for the financial consequences of death or disability for the member or their family that may be available, at least at an affordable price.

Superannuation funds also do not discrimination on the basis of sex. Research commissioned by ASFA (Ferris, 1997) has found no evidence of sex discrimination in pension funds in Australia. Funds generally provide equal pensions for each sex and use unisex commutation factors to convert pension benefits to lump sums, despite differences in life expectancy between the sexes. There are differences between the rates charged for each sex for annuities, and according to age as well, but this is justifiable on the basis of clear actuarial and statistical data in regard to life expectancy. While females receive lower annuity payments for a given capital sum they equally have the benefit of lower life insurance premiums. In both cases life expectancy is a reasonable factor to take into account.

However, one area where superannuation funds are required to discriminate is in regard to the treatment of same sex partners where a member dies. Both taxation and SIS provisions treat same sex partners differently to a spouse or de facto spouse. Superannuation funds necessarily have to comply with those provisions, although some funds may be easier to convince that there is evidence of financial dependence by same sex partners, thereby reducing the impact of the legal provisions in relation to dependency and beneficiaries. This is an issue that has been the subject of considerable public debate, and is one for government to deal with rather than a matter for the discretion of superannuation funds.

2.6.1 Indirect discrimination and women

What women get out of super has a lot to do with what they put into it or have contributed on their behalf. Differences in involvement in the paid work force have a lot to do with differences in superannuation coverage and benefit levels. Around 40 per cent of women currently work part time, compared to around 10 per cent of men. Average weekly earnings of women around $450 per week, compared to around $700 for men.

Differences in labour force participation mean that more men than women have superannuation. As at December 1996 there were 9.4 million superannuation accounts held by males, compared to 6.6 million for females (ISC, 1997). As at June 1994 Treasury has estimated that the average superannuation entitlement for women was around $17,000 compared to $42,000 for men. The proportion of all superannuation assets held by women was 23 per cent.

Separately derived estimates prepared by the National Centre for Social and Economic Modelling (NATSEM, 1999) suggest that for persons then aged 35 to 49 years, the average superannuation balance for males was $46,300 and for females it was $15,600. This indicates a higher disparity in average superannuation balances, which in part would reflect the absence of compulsory or award superannuation for most of the working life of women of in that age group.

For current retirees, only a small proportion of women rely substantially on their own superannuation entitlements. The vast bulk of currently retired women rely on government social security payments and/or another person's income, typically a spouse if the spouse is still living. Incomes in retirement for two-thirds of retired women are at or little more than the Age Pension.

As women and men increasingly have similar career patterns, superannuation entitlements will become more similar to those of men on average. The experience of our daughters in the paid work force will be markedly different from the experience of our mothers.

Treasury RIM Group projections show catching up in the future, with a projected real average balance for women of $77,000 in the year 2019, and $121,000 for men. The proportion of super assets held by women is projected to rise to 33 per cent in that year.

While women make up around 40 per cent of super fund membership, they account for around 10 to 15 per cent of total trustees. Less than 5 per cent of employer nominated trustees are female, in part reflecting the composition of the management groups from which trustees are drawn.

Spouse contributions to super have some potential for married women to have superannuation entitlements in their own right rather than dependence on a spouse. **However, a government co-contribution for low income earners might have been a far better alternative for most women**. The spouse rebate is likely to be used mainly by relatively high and single income families. In 1997-98 16,475 taxpayers claimed an average $430 rebate for spouse contributions, implying aggregate spouse contributions attracting a rebate of about $45 million in total. In contrast, around 450,000 taxpayers claimed the more general Dependant Spouse Rebate.

2.6.2 Superannuation and divorce

In the past the Family Court has only had a limited capacity to redistribute superannuation assets between a divorcing couple compared to its powers in regard to other assets. Where a superannuation benefit has or is being paid, the Court is able to deal with this directly. However, in other cases the superannuation entitlement generally is a trust based contingent interest. This is difficult for the Court to deal with under current legislative provisions. The Court, and parties to a marriage in private settlements, usually seeks some information on relative account balances, and then when splitting other assets makes adjustment for this.

Legislation and regulations currently before the Parliament are designed to widen the powers of the Family Court to actually split current balances or to flag the division of a superannuation benefit once it becomes payable. The legislation also proposes better and more consistent reporting to the parties to a marriage of the superannuation entitlement of their partner.

Once in operation, which is likely to be at least 12 months away, the legislation has the potential to increase the degree of equity in the treatment of the division of assets of divorced or separated couples. However, superannuation will not be a pot of gold for most divorcing couples. The distribution of superannuation entitlements remains skewed. Older persons in the workforce, particularly men, have the most. Those not long in the workforce or with broken work patterns have the least. The Superannuation Guarantee-based superannuation contributions are yet to reach the maximum contribution rate, and even when they do it will take low income earners some decades to reach substantial superannuation balances. That said, for many low income earners superannuation will still be the largest financial asset outside equity in the family home.

Data on super balances of divorcing parties are scant. One survey was the 1984 survey Economic Consequences of Marital Breakdown (McDonald, 1986). It showed that while the 10 per cent of couples divorcing with the most wealth had an average of $40,000 in super, the lowest 10% had negligible super. The median figure for super was $3,500, which was then less than the average value of household furniture owned by the divorcing couple and about the same as the value of the family car.

A 1997 survey by the Australian Institute of Family Studies (Dewar et al, 1999) indicated that of the sample of couples divorcing, about 80% of couples had at least one spouse with superannuation. Around 75% of men had super and around 35% of women. Reporting and valuation problems lead to a level of uncertainty and/or inaccuracy in these results. However, the survey results suggest that, for the couples surveyed, the median value of superannuation held by men was around $25,000, while for women the median was around $5,500. Some men, and very few women, had balances considerably in excess of these figures. On average, superannuation represented about 25% of total assets of couples.

Other estimates are available on super balances, but these are not strictly related to divorcing couples. Estimates of superannuation balances have been made for Australian households according to income level for the year 1993 (Baekgaard, 1998). In the first five income deciles (the lower half of the income distribution) superannuation balances were estimated to be, on average, $23,000 or less. At low income levels they were, on average, only a few thousand dollars. For the top 10 per cent of households ranked by income the average was around $88,000 and for the second highest decile it was $59,000.

With the increased participation of women in the paid workforce, later age for first marriage, and the introduction of the Superannuation Guarantee in 1992 both husbands and wives are more likely to have some or significant superannuation savings in the future. The average superannuation balance currently is about $54,000 and is expected to double by 2020. Those divorcing are younger on average than all those with super, with accordingly lower average balance. However, their average super balances can be expected to show strong growth as well.

Although women are still more likely to have less savings because of pay inequity and broken work patterns, large disparities are also expected to decrease in future as younger women build up super entitlements in their own right.

2.7 Inter-generational equity

Consideration of inter-generational equity involves evaluating and comparing the benefits and burdens incurred by an individual born in a particular year with the benefits and burdens of those born in another year. Generally such analysis relates to birth cohorts covering a number of years in which individuals are born. While designation of specific years to fall within a given generation will always be a somewhat arbitrary exercise, there are often defining events. These can be external events, such as the end of World War II, or policy related events such as introduction of Medicare, the Superannuation Guarantee or the Higher Education Contribution Scheme Sometimes generations can be identified by marked changes in demography, such as birth rates. The "babyboomers" who make up the post-War generation can be identified by both their identifying demography and external defining events.

However, circumstances can and do differ markedly between individuals who form part of particular generations, and our society is made up of individuals rather than generational bargaining groups. In addition, individuals are generally part of families and other groupings that cover a number of generations. An individual may value highly benefits being received by his or her parents, rather than seeing this as an inter-generational imbalance. Many would argue that there is a responsibility to share both the benefits and costs of current community income and expenditures, rather than trying to run some sort of account for each generation.

As indicated by the Table 2.11, over the decades there are marked developments in needs, capacities and expectations. Those born in the 1940s and principally employed during the 1960s and 1970s should not necessarily be expected to live in some sort of time warp related to those periods. That said, major shifts in policy that advantage or disadvantaged a particular generation can give rise to equity considerations.

Future retirees will have been better educated than earlier cohorts or retirees, or at least have had higher participation rates in higher education. They will have experienced higher living standards during their working years compared to earlier age cohorts in terms of wages and real income, and will expect higher standards of living in retirement than their parents or grandparents. What were luxuries as recently as the 1970s have already become common, and will be perceived as necessities when the babyboomer demographic bulge hits retirement.

Table 2.11: Markers of needs, economic capacity, and expectations of living standards

	1970s	1990s	2000	2020
Living longer				
Life Expectancy at birth – males	68.2	74.5	75.6	82
Life Expectancy at birth – females	75	80.4	81.3	86.5
Life Expectancy at age 65 – males		16.1	17	20
Life Expectancy at age 65 – females		19.8	20	23
Working for less years				
Expected years in employment – **males**	42	38	36	35
Expected years in employment - **females**	20	27	28	30
Participation rate for persons aged over 55 years	30	25	24	22
Participation rate for males	82.5	73.9	72.8	
Participation rate for females	40.6	51.7	53.9	
Percentage of workforce aged persons receiving social security payments	4.5	12.5	18.6	20
Higher education participation rate	6	13.7	18	20
Unemployment rate	2.5	10.4	6.8	
Higher incomes				
Average weekly earnings – males	$106	$636	$769	$1,143
Average weekly earnings – females	$69	$501	$514	$764
Real disposable income (index value)	100	143	185	274

Higher expectations				
Motor vehicles per 1000 persons	403	558	644	700
Percentage of owner occupied housing	66	67	70	70
Telephone connections per person	0.23	0.52		
Mobile phones per person			0.26	0.67
% of households with – colour TV	49	99	99	99
videorecorder	0.1	80	87	99
Microwave	0	62	83	95
Computer			47	90
Internet			22	80

3. Equity elements in the current system

3.1 Age and Veterans Pensions

The Age Pension is a non-contributory flat-rate entitlement to which persons continuously resident in Australia for at least 10 years become eligible when they attain the qualifying age, subject to income and assets tests. To qualify men must be 65 years or older, with the minimum qualifying age for women being gradually increased from 60 to 65 by January 2014. Similar payments to the Age Pension are available to war veterans, but are available five years earlier.

The Age Pension is adjusted every six months in line with movements in the Consumer Price Index, and is also required by legislation to be no less that 25% of Male Total Average Weekly Earnings. The combined rate for an aged couple is 1.6 times the single rate.

As at 20 September 2000 the basic pension rate was $394.10 a fortnight for a single person and $328.90 a fortnight for each member of a couple. Both income and asset test apply to entitlement to the age pension, with a single person receiving no age pension if their income exceeds $1,105.75 per fortnight or if they have greater than $266,750 in assets for a single homeowner. Higher limits apply to couples and non-homeowners, and the Age Pension begins to be phased out at lower income and asset levels in all these cases.

Australia is unusual amongst developed nations in having a flat rate, means tested age pension. It could be argued that this meets vertical equity concerns, in that higher income individuals receive less or no government assistance in the form of the age pension and as such the system is highly redistributive.

However, at a maximum standard rate of 25% of average weekly earnings, the Age Pension is only just above the poverty line as commonly calculated in Australia. Adjustments to the Age Pension in recent years have increased its level in absolute terms, but similar adjustments have also been made to the poverty lines calculated for various household types. The Age Pension does not meet even the minimum expectations of retirement income of those currently in the paid labour force. As such it requires considerable supplementation through compulsory and voluntary private savings in order to provide an adequate retirement income. Accordingly, the Age Pension has an important equity role in providing a safety net, rather than providing a retirement income that meets horizontal or vertical equity concerns in its own right.

3.1.1 Characteristics of the Age Pension population

Around 67% of the population over Age Pension age receive the Age Pension, with payments from the Department of Veterans' Affairs going to another 13% of that population. Women comprise 62% of the recipients, reflecting their greater longevity and lower assets and incomes on average. Around 50% of age pensioners are paid the partnered rate (FACS, 2000).

For persons aged over 65 government pension payments currently are the principal source of income for around 75% of the group, with this percentage declining marginally in recent years. For around 25% of those receiving a government pension, the government pension contributed less than 50% of total income, and it contributed less than 20 per cent of income for only 17.6% of the group.

Around 95% of age pensioners have private income, but the average amount is only between $2,000 and $3,000. Given that the means tests include a free area where recipients can earn income or own assets without affecting their pension payment, some 67% of age pensioners receive a full Age Pension. While the proportion receiving a part pension has increased slightly over the last few years, it is not much different to the proportion applying in the early 1990s. Currently the bulk of Australians aged over 65 do not have much in the way of income or assets (apart from their own home).

In 1999-2000 for those receiving a part rate pension the average reduction due to the means tests was around $95 per fortnight, or just over 25% of the standard rate pension. Around 85% of partnered age pensioners and around 50% of single age pensioners own their own home (single age pensioners tend to be poorer, older and/or in nursing homes or hostels).

Projections, such as those in EPAC, 1994, of the number of Age Pension recipients and the level of pension they are likely to receive indicate that in the decades ahead the vast bulk of persons of Age Pension age are likely to continue to receive the Age Pension. However, it is likely that the proportion of recipients receiving a full Age Pension will fall, with a commensurate rise in the proportion receiving a part pension. One scenario has the number of part pensioners rising from around one-third of recipients to around two-thirds. The reason for this is largely the projected increase in superannuation benefits associated with the operation of the compulsory superannuation system.

3.1.2 The Age Pension bonus

One provision that has been introduced is a bonus payable by the government when an individual delays taking payment of the age pension and meets a number of criteria.

However, given the fairly restrictive conditions that apply to this bonus the take-up to date has been limited, even lower than expected by the Government. In some cases potential retirees may not have appreciated the availability of the bonus, while in other cases its availability is known but a judgement is made on the benefits available relative to the obligations imposed. As at 30 June 2000, some 16,000 people had registered for the scheme and over the year to 30 June 2000 only 1,365 people received a pension bonus (FACS, 2000). This compares to nearly 2.1 million people receiving the Age Pension or a similar payment from the Department of Veterans' Affairs.

Nevertheless, this provision has potential to assist in the achievement of horizontal equity given that it makes an allowance for differences in behaviour between individuals. It also is one of the few elements in the social security system that has an element of actuarial equity within it. Unlike many other countries, social security entitlements are generally universal, flat rate benefits that are not affected by an individual's past pattern of employment or payment of taxes, or when a benefit is taken. The ten year qualifying period for receiving the Age Pension relates to residency, not the period over which income tax or contributions are received.

3.1.3 Means testing of the long term unemployed aged over 55

While a bonus is provided for individuals who delay their exit from the paid labour force, individuals who lose their job prior to Age Pension age but after they turn 55 are subject to relatively severe means testing in regard to any superannuation balance they may have. The 1996 Budget imposed an obligation on individuals who have received unemployment benefits or Disability Support Pension for at least 39 weeks to include any superannuation account balances in the assets counted for means test purposes. Superannuation assets also impact on the income test through a deemed rate of return for financial assets, but the asset test normally takes primacy. The asset test for receipt of unemployment benefits is relatively strict, being much stricter than the asset test applying to recipients of the Age and other pensions.

This measure offends vertical equity concerns in that it has a relatively harsh impact on the those already disadvantaged by unemployment. It also offends horizontal equity concerns in that it applies a more comprehensive means test to the unemployed aged over 55 compared to those aged under 55. Even it were accepted that the long term unemployed aged over 55 are effectively retired given the poor chance of them gaining another job, the measure offends horizontal equity in that the means test applied is far harsher than that applying to recipients of the Age Pension.

ASFA on a number of occasions has raised its concerns in regard to this measure. The House of Representatives Standing Committee on Employment, Education and Workplace Relations in its report of August 2000 also has recommended that the Government re-consider this decision, and if necessary set a ceiling on the amount of superannuation assets that are able to be excluded from the means test.

Points for discussion

Should the Age Pension continue to be flat rate?

Is the current level of the Age Pension adequate?

Should there be more incentives or bonuses for getting off or not taking up the Age Pension?

Do means testing arrangements for complying annuities lead to individuals sacrificing potential higher private income in order to obtain the pension?

Are the current eligibility age for men and the increasing eligibility age for women appropriate?

3.2 Superannuation

The equity of current superannuation arrangements is influenced largely but not exclusively by its tax treatment. Unfortunately the tax treatment of superannuation is of a level of complexity that is such that the degree of equity in its treatment is difficult to evaluate. This is not just a local perception or one of the sector itself. The World Bank (World Bank, 1994) has described the Australian tax treatment of superannuation in the following terms:

> The tax treatment is complex: contributions, earnings, and benefits are partially taxed and partially deductible, the result of a pragmatic attempt to reduce tax expenditures, especially those benefiting higher-income individuals, while encouraging compliance. Employer contributions are tax deductible up to specific limits that increase with the worker's age. Fund earnings are taxed but at a low rate. Benefits taken beyond a specified floor are taxed but a lower rate if the benefit is taken as an annuity rather than a lump sum.

If one were designing a tax regime and equity arrangements for superannuation from scratch it would be unlikely if not bizarre to have arrangements which resemble those currently in place. Many of the provisions are unique to Australia, with a number of them unique for the very good reason that no-one in their right mind would want to replicate them. However, it is not possible to start with a clean page, especially given that there are over 20 million existing superannuation accounts and over $488 billion in assets. The fact that the Commonwealth Government receives around $6 billion a year in tax on contributions and fund earnings also is a constraint given that most reform proposals would lead to a postponement in the receipt of revenue.

The complexity of the system, the importance of accrued benefits and expectations in the financial wealth of individuals, and the dependence of governments on tax revenue from superannuation make for a challenging reform process. Like the Irish joke about getting directions, this is not a good spot to start from if you want to find your way to the destination of an equitable and efficient superannuation system.

That said, some of the provisions are more deserving of early abolition or modification than others.

3.2.1 Age based contribution limits

Limits on the extent to which employers can claim tax deductions for superannuation contributions made on behalf of their employees have been in place for a long time as part of the pragmatic attempt to limit tax expenditures benefiting high-income individuals as described by the World Bank. However, these provisions have gone through a number of transitions, and some would dispute that the provision is meeting its aims.

History of limits

Prior to 1988 the statutory limit on tax deductible employer contributions was the greater of $400 or 5 per cent of the employee's salary, although the Commissioner of Taxation had a discretion to allow a greater deduction if he considered it reasonable. From 1988-89 to 1993-94 there was no direct limit on the amount of deductions for employers, but a fund was limited to accepting amounts which were sufficient for the fund to provide benefits which were within the reasonable benefits limit. With the rise of schemes sponsored by a number of employers and with the portability of fund balances, such a limitation became increasingly irrelevant. Whether it was needed is another matter.

However, rather than abolish limits on contributions an alternative approach to limiting deductible contributions was developed. From 1 July 1994 to 30 June 1996 the maximum deductible employer contributions was either a set contribution limit based upon the age of each relevant employee or a standard contribution based upon the number of employees when the employer had 10 or more filled employee positions.

Some employers used the standard contributions method to support a pattern of widely diverging contributions across their labour force which bore little relationship to the age of the employees. The government apparently considered this to be unacceptable. Following the 1996 Budget, only the age based contribution option was available. These limits are indexed in line with Average Weekly Ordinary Time Earnings (AWOTE). By 2000-2001 the maximum deductible contribution for members aged under 35 had reached $11,388, for those 35 to 49 it had reached $31,631 and for those age 50 and over it had reached $78,445.

Rationale for the limits

Essentially the rationale for such limits is to limit the amount of savings that receive concessional taxation treatment, particularly contributions made on behalf of those who are relatively young. Apparently there was government concern that the Reasonable Benefit Limits on final benefits received were not effective in capping concessional tax treatment available for some individuals.

As detailed in Clare, 2000 and Rothman, 2000, a major part of the concessional treatment of superannuation relates to the long term compounding of earnings within a superannuation fund. The earlier and larger the contributions the greater the effect. This appears to be the rationale for limiting contributions on an age basis, particularly those made for individuals who are relatively young. However, why age based limits are needed when there is an overall limit on final benefits (the RBL) is less clear. A benign explanation of the government's motives is that the aged based limits help prevent individuals from inadvertently breaching their RBL. On the other hand there are some indications that the government considered that some individuals were getting around the RBL system and that further controls were needed to bolster the capping of tax preferred benefits.

The age based limits are not necessarily incompatible with the RBL system. However, while the pattern of age based limits is compatible with career paths of continuous employment in more or less the same type of work, the limits can impose severe restrictions on those who bloom early or late. The limit for those aged under 35 is not supportive for individuals who seek high paid employment early in their life and then withdraw from the labour force for family or other reasons. It is also contrary to other messages being delivered about the virtues of saving for retirement, and in particular to start early. Whether limiting the access to superannuation of those aged under 35 is a valid public policy concern, and whether the compliance burden of the age-based limits is justified by any public benefits, is less than clear.

Limitations and defects of the age based limits

It would be fair to say the limits have a number of arbitrary elements. For instance, the limit on deductible contributions for those aged under 35 is relatively low. While the limit is sufficient to allow contributions to be made consistent with Superannuation Guarantee obligations up to the maximum earnings base for SG purposes, there is relatively little leeway.

The maximum SG obligation at 9% will take up around 85 per cent of the deductible contribution limit for those aged under 35. Employers need to be careful about the timing of contributions in regard to their more highly paid employees. Contributions made after the close of a financial year but before 28 July could end up being in effect non deductible contributions as the spillover into the following financial year could exceed the amount of contributions allowed in that financial year. As well, a number of more generous corporate and public sector schemes involve employer contribution rates in excess of 10% or even 15% of salary, and the contribution limit can be a problem for high flyers aged under 35.

For those who are older there is considerably more flexibility. An annual deductible contribution of more than $78,000 for those aged over 50 is far greater than required by the SG legislation or by the normal contribution rates of standard employer sponsored schemes. Only a very small number of individuals would have a remuneration package to support, or inclination to have, employer contributions of such an amount made on their behalf. The main advantage of such a relatively high annual amount is that it allows individuals to catch up with salary sacrifice contributions in cases where only relatively modest contributions were made at an earlier age.

As well, the maximum deductible limit for those aged over 55 is very near the lower threshold of the surcharge, and individuals receiving any wage or other income along with the benefit of superannuation contributions near the limit would be subject to the full 30% surcharge.

Age based contribution limits have a number of technical and design limitations. For instance, the limits have little or no effect apart from a demonstration effect when the employer is not a taxable entity. This is the case for a significant number of employees of Commonwealth and State government entities, not-for-profit employers and overseas entities. They limits also apply to each employer of an individual, so if an employee has multiple jobs within a year or more than one employer they can have deductible contributions which are a multiple of the standard limits. In addition, the limits have no application when a defined benefit fund is on a contributions holiday.

While the limits can be relatively generous or have no impact at all for some individuals, for others they can be relatively harsh. The limits are based on annual contributions rather than the amount and duration of savings or the eventual level of benefits at retirement. That they are a very blunt equity instrument is highlighted by the major differences in allowable deductions brought about by an increase in age from 34 to 35 and from age 49 to 50.

In regard to this last point, depending on the age at which contributions are made and their amount, compliance with the age based limits will not necessarily mean that the Reasonable Benefits Limits on final benefits will be satisfied. This is particularly the case where benefits are taken as a lump sum rather than attracting the higher pension RBL. The age based limits are compatible with the RBLs in only a very general sense given the broadness of the age bands and the major differences in the limit for each age group. A very large number of sets of age bands and limits would be just as compatible with RBLs on benefits as is the current system of age based limits.

It could be argued that the limits are unduly restrictive under age 35, relatively generous over age 50, and that the transition between the various age limits is too sharp. It is not clear why it is permitted to catch-up when aged over 50, but it is not permitted to make adequate provision for retirement early in a working career. Given family and other responsibilities it could be argued that either pattern of work and saving for retirement should both be permitted and encouraged. The more fundamental question is why both age based contribution limits and Reasonable Benefit Limits are needed.

Points for discussion

Do age based contribution limits serve any useful purpose given that Reasonable Benefit Limits applying to ultimate benefits?

Are the limits too restrictive given developments in patterns of labour force participation?

What would be needed to convince Treasury that aged based limits are not necessary?

3.2.2 Reasonable Benefits Limits

Restrictions on the total benefits that can be received from a superannuation fund without loss of concessionary tax treatment have been a long established feature of the superannuation system. The basic rationale appears to be along the lines that only a certain amount of benefits are needed to fund a reasonable standard of living in retirement, and benefits above that level should be taxed in such a way that no concession is delivered. However, the mechanism and upper limit has varied over time as both the concept of what is reasonable and what is administratively feasible has changed.

History

Before 1990 the mechanism worked through the conditions which a fund needed to satisfy to be exempt from tax. The Income Tax Assessment Act provided that for the income of a private sector fund to be exempt from tax it needed to provide benefits that were reasonable. The Taxation Office decided on the level of benefits that were reasonable, with this communicated by way of a series of tax rulings. For instance, Taxation Ruling IT 2201 issued in 1985 established a reasonable benefit limit of 7 times a member's taxable earnings averaged over the last three years of employment for lump sums, with 75% of final average salary (FAS) for pensions paid by a fund.

With the introduction of fund taxation in 1988 this taxation carrot for adopting reasonable benefit practices lost some of its nutritional value, but there still were considerable advantages in being a complying superannuation fund for taxation purposes. However, there were a number of reasons for adopting a new approach to establishing RBLs.

One problem under the previous arrangements was that public sector funds were never able to be taxed and therefore did not need to comply with the ATO rulings. The more fundamental challenge was the rise in importance of defined contribution schemes, with the added complication of multiple fund memberships and portability of member balances. Funds did not necessarily know what the final average salary of the member was given that the nexus between a specific employer sponsor and the administration of a fund had been broken in many cases. In any event, an individual fund limiting benefits to some multiple of salary would not necessarily limit the total superannuation benefits available to an individual from other funds.

Accordingly, after 1 July 1991 RBLs have been subject to centralised reporting and enforcement on an individual basis through the application of tax at the highest personal marginal rate to payments in excess of an individual's RBL. Payers of eligible termination payments and of superannuation pensions and annuities were required to notify the then Insurance and Superannuation Commission in regard to payments made before 1 July 1994. Since 1 July 1994 the Australian Taxation Office has had responsibility for administration of the RBL arrangements.

Along with the shift in administering authority, the system since 1994 has been based on absolute limits rather than being determined by a function of salary levels. For 2000-01 the lump sum reasonable benefit limit is $506,092, while the limit of $1,012,181 applies where at least 50% of the total benefit received by a person is taken in the form of a complying pension or annuity. Both amounts are indexed each year in line with movement in average weekly ordinary time earnings (AWOTE).

These fixed limits are more generous for persons on lower incomes compared to the previous regime based on a multiple of final average salary. However, for an individual on a final average salary of greater than $72,500 they are less generous in case of a lump sum. The pension RBL is vaguely consistent with a pension of 75% of a final average salary of around $70,000, but the equivalence depends on the characteristics of the pension taken and the age at which it starts, and on pension and annuity rates. The fact that the new limits involved a financial detriment for some individuals led to transitional RBLs based on past entitlements being made available in defined circumstances.

Impact of the limits

The current RBL rules satisfy some **vertical equity goals** by providing a cap on the benefits taken. As noted earlier in the paper, currently only between 600 and 1,500 individuals each year appear to exceed the limits. However, more individuals may have taken action to avoid their RBL problem, and it is likely that the number of individuals approaching or exceeding their RBL will rise through a conjunction of rising superannuation coverage, higher contribution rates and healthy investment earnings of funds.

In broad terms the RBL limits cap concessional tax treatment for superannuation entitlements for individuals earning up to around twice average weekly earnings, assuming that contributions are made at 9% of salary for close to 40 years. Individuals on higher salaries but making contributions for less than 40 years, or on lower salaries and making higher percentage contributions, also are able to comply under the RBLs. However, for individuals making contributions for less than a full standard working career, the aged based contribution limits may take precedence and prevent the accumulation of benefits that would exceed the RBL limits.

A lump sum of around $1 million could be used to purchase a lifetime, indexed annuity at retirement of around $50,000 a year. A lump sum of $500,000 before benefit tax would generate a somewhat lower income, perhaps no more than $30,000 a year even if invested in high yield areas, but the capital would be preserved.

The picture in regard to **horizontal equity** is even less clear than the vertical equity implications. The difference between lump sum and pension RBLs could be regarded as having adverse horizontal equity implications, as individuals with similar levels of assets are treated differently. However, the difference in the RBLs is more related to providing an incentive to take an income stream than any equity concerns. As well, allowing a larger amount of benefits to be taken in pension form can actually improve equity given the interaction of private pension payments with the operation of means testing of the Age Pension. An apparent divergence in horizontal equity in RBLs can help make up for equity deficiencies in the means testing of capital sums received by individuals where the lump sum is dissipated or disposed of.

The existence of "grandfathered" arrangements such as the transitional RBLs is also a departure from horizontal equity, but could be seen as being equitable through maintaining past entitlements and expectations concerning entitlements.

In terms of an overall assessment of equity, while not perfect the RBL arrangements appear to work reasonably well. There appears to be fairly general acceptance of the RBL system as a method for supporting equity within the taxation of superannuation. While the RBL limits are somewhat arbitrary, they do restrict the degree to which the rich can access the benefit of superannuation tax concessions.

The RBLs are linked to benefits received rather than to contributions in a single year, so they can take into account the superannuation outcome achieved by an individual over their entire career. The selection of any particular lump sum or pension RBL is necessarily a somewhat arbitrary exercise, with the levels chosen in 1994 having no particular intrinsic value. However, adjusting the limits by use of an indexation factor (movements in AWOTE) has avoided the limits becoming even more arbitrary, as they have been adjusted in line with community income standards. The different treatment of lump sums and income streams could be regarded as offending notions of horizontal equity, but there appears to be general acceptance of the provision of an incentive to take a complying income stream.

The RBL system despite its various shortcomings is a major component of the design elements in the taxation of superannuation that support vertical equity. However, in terms of its impact on equity it acts only as a cap on the amount of benefits received which have had concessional tax treatment. The current RBL system has no progressive elements within it, and, other than allowing a very generous upper limit for those on average or low salaries, does not assist lower income earners. Many low income earners will not have the capacity to make contributions that will lead to an accumulated superannuation balance anywhere near the RBL amounts, nor will they have available any substantial level of tax incentives given their marginal tax rate. Other elements within the retirement income system are needed to bring about vertical equity.

Points for discussion

Are the current RBLs for lump sums and pension benefits set at the right levels?

What is the appropriate tax treatment for benefits exceeding the applicable RBL?

Should the pension RBL be twice the level for a benefit paid as a lump sum?

Should the RBL system be modified so as to remove any disincentive for an individual to seek and achieve above average returns on their superannuation savings?

3.2.3 The surcharge

History and nature of the surcharge

The surcharge is payable if a member's "adjusted taxable income" for a financial year is greater than the surcharge threshold for that year, or in some circumstances if the ATO does not know what the taxable income of the member is. A member's adjusted taxable income is the sum of the member's taxable income less any amounts that are eligible termination payments from a superannuation fund or are certain lump sum payments tied to redundancy, early retirement or invalidity, plus any reportable fringe benefits, plus the member's "surchargeable contributions" for the year.

Some termination payments also are subject to the surcharge. A further complication is that there also are a range of transitional provisions which apply to payments received in respect of pre-1996 employment or in the five year period from August 1996.

The equity of the surcharge is open to debate. The proponents of the surcharge, namely the government, its advisers and hardly anyone else, argue that it is an important equity measure in the superannuation system. Others argue that the surcharge is a naked grab for additional tax revenue dressed up as an equity measure. Given some of its features, including the now abandoned advance instalment arrangements, the latter explanation may be the closest to the mark. The adoption of the surcharge proposal by the government relatively late in the 1996 budget cycle in circumstances where there was pressure to raise substantial new revenue also is supportive of the argument that pragmatism rather than principle was involved.

The surcharge is a peculiarly Australian innovation. Most other nations do not tax contributions to superannuation and pension funds at all, let alone link the contributions tax rate to a concept of total reportable income. However, many regard the surcharge as about as desirable as the introduction of the cane toad, rather than rivalling the merits of Australian inventions such as the rotary clothesline or the petrol powered lawn mower.

The surcharge is levied on certain superannuation contributions, and in some cases benefits, received after 20 August 1996. Generally, the intention is that only high income earners are affected, but a surcharge liability can arise from a failure to quote a Tax File Number of a low income person in regard to contributions made to a superannuation fund. As well, the concept of adjusted taxable income which underlies the administration of the surcharge includes superannuation contributions, reportable fringe benefits, and a variety of lump sum or irregular items of income. This can include certain redundancy or termination payments received by individuals, and so the surcharge can impact on some of the most vulnerable persons in the labour force (or more accurately, the most vulnerable of those recently separated from the labour force).

For the income year 2000-2001, the lower threshold for the surcharge is $81,493 and the upper limit is $98,955 at which the full surcharge rate of 15% is payable on surchargeable contributions. The 15% rate phases in over the $17,500 or so band between these limits. The limits are indexed each year in line with movements in AWOTE.

To date, information on full year tax collections from the surcharge has not been available. Collections have been affected by delays in assessments being issued and other special factors. At the time of its introduction the surcharge was expected to raise between $450 and $500 million a year from around 365,000 individuals, and collections so far are consistent with this. With the inclusion of reportable fringe benefits in the calculation of adjusted taxable income, the number of individuals affected by the surcharge is expected to rise to around 600,000 with associated tax revenue in excess of $600 million per annum.

Given the convoluted way the surcharge operates, it has relatively high compliance costs for funds and even individuals, particularly those who take a retirement benefit and or rollover a benefit. The initial implementation costs for superannuation funds have been estimated as being in the order of $200 million, and there also are significant ongoing costs. While some funds allocate these costs to members liable to the surcharge, in general all fund members bear some of the incidence of the increased administration costs, with lower superannuation benefits and retirement incomes the ultimate result.

These high costs highlight the administrative deficiencies of a measure which links the obligations of superannuation funds to the detailed circumstances of each of the fund's members. If the equity outcomes delivered were significant then these high costs might be justified. However, the evidence available indicates that the surcharge has a number of major problems in regard to horizontal and vertical equity.

Equity implications

On the face of it, the surcharge appears to have some vertical equity elements, as those with higher incomes in effect pay a larger amount of tax. However, the surcharge offends a number of horizontal equity principles.

One major problem is that the surcharge relates to contributions made in a particular income year, rather than the total amount of contributions made over the lifetime of an individual. This has an adverse horizontal equity impact when an individual is attempting to catch up late in their working life for the effects of low income and low or no superannuation contributions early in their career.

As well, members of defined benefit funds are subject to potential arbitrary treatment as a result of the operation of the surcharge. With a defined benefit fund, while it is possible using actuarial methods to allocate the cost of the scheme across various categories of members, such an allocation will not necessarily reflect the eventual value of the contributions for an individual member.

For instance, many defined benefit schemes offer generous benefits to those who retire with 30 or more year's service. However, for those who voluntarily resign to take up employment elsewhere the resignation benefit may only be a fraction of the retirement benefit. As well, while minimum vesting standards apply, resignation benefits in defined benefit schemes also may be only a proportion of what would have been the benefit if Superannuation Guarantee contributions were made to an accumulation fund with a modest earnings rate.

While on average the surcharge liabilities of defined benefit fund members should be in line with the benefits received by the overall membership of the fund, in many cases the surcharge liability will be either more or less than what would be justified by the benefits eventually received. In more concrete terms, those resigning voluntarily generally will pay more surcharge relative to the superannuation benefits they receive than an individual who retires after many years' service.

It is entirely feasible for a person resigning to have surcharge liabilities in excess of 15% of the benefit received. In the case of unfunded defined benefit schemes, typically generous public sector schemes, special provisions cap the surcharge liability at 15% of the benefit paid. However, for other defined benefit schemes no such cap applies. On the other hand, some benefit recipients will end up with a surcharge liability that is less than 15% of the relevant benefits received. Horizontal equity is achieved only on average for various groups, rather than on an individual basis.

The inclusion of reportable fringe benefits in “adjusted taxable income” and irregular items of income can also offend notions of horizontal equity. For instance, individuals such as teachers or policemen who receive accommodation as part of their conditions of employment can end up with reportable fringe benefits and a total adjusted taxable income that is out of keeping with their actual economic position.

Irregular receipt of capital gains also has the potential to lead to surcharge liabilities for individuals who, when viewed over the working life, cannot be regarded as high income earners.

Accordingly, while many individuals who bear the incidence of the surcharge could reasonably be regarded as being high income, others who pay the surcharge in one or more years are drawn more from the battlers of our society. There are inherent difficulties in attempting to apply vertical equity principles at the contributions stage. Vertical equity considerations can be much more effectively applied at the time benefits are paid.

Points for discussion

Does the surcharge play any useful equity role or is it just a revenue raising device for government?

Are there any more effective measures for limiting the amount of tax concessions for superannuation available to the more highly paid?

If the surcharge is to continue, are there alternative administration methods which would involve lower administrative costs?

3.2.4 Tax free threshold for lump sums

History

The tax free threshold for lump sums has a long and somewhat complicated history. It was first introduced in 1983 when eligible termination payment (ETP) taxation arrangements were put into effect. Previously, only 5% of superannuation and various termination payments were included in assessable income, regardless of the age at which they were received. After 1 July 1983 the full amount of any benefits accruing after that date was included subject to a maximum marginal rate of 30%. As well, in order to encourage the preservation of benefits until retirement, the tax rate on the first $50,000 of the post-June 1983 component was reduced to 15% provided the recipient had obtained the age of 55.

The threshold amount for the higher rate of taxation was increased to $55,000 in 1985-86 and to $60,000 in 1988-89. The year 1988 also saw major changes to the taxation of superannuation funds and of superannuation and other termination payments. A 15% tax was introduced on all contributions other than undeducted contributions, and the tax on the post-1983 component was reduced from 30% to 15%. Logically, the rate on the first $60,000 was reduced to zero.

This complicated history suggests a number of possible roles for the threshold in terms of both horizontal and vertical equity, and in regard to maintaining past entitlements. However, it is not clear what role each factor has had. History and transition provisions appear to have been as important as principle.

The current benefit tax structure had its immediate heritage in adjustments designed to maintain the relative position of individuals following the 1988 changes to the taxation of superannuation. Accordingly it can be regarded at least in part as a measure designed to provide horizontal equity and/or to maintain the value of past entitlements.

The threshold and equity

The tax free threshold provides a level of vertical equity. It also should be noted that the tax free threshold is one of the few superannuation tax provisions which generally receives little or no adverse comment. For a substantial number of low income individuals who have accrued very modest superannuation entitlements, the existence of the threshold is essential in order to provide a measure of equity in terms of the total taxation of contributions, earnings and benefits. It assists with retirement income adequacy for low income employees and those who receive superannuation contributions for only a short period. A lump sum benefit (rather than a pension or other income stream) is also likely to be the only viable form of benefit when a relatively modest sum is involved.

However, while at least on one interpretation the threshold is designed to deliver a concession to lower income earners, the threshold is available to all recipients of lump sums. This does not necessarily mean that the provision offends notions of vertical equity. The combination of the threshold and a flat rate of tax on benefits in excess of the threshold (up until the Reasonable Benefit Limit) means that average rate of tax on lump sums progressively rises with an increase in the lump sum amount. The degree of progressivity is limited, however, by the maximum tax rate being 15% of benefits.

The threshold also goes someway to providing vertical equity for low income earners who were subject to the 15% tax on contributions on the way in. Individuals earning less than $20,000 a year are on a 17% or less marginal tax rate, and it would be unfair in terms of vertical equity if they paid tax on their superannuation contributions of more than their marginal income tax rate. Some such individuals would have years in which their taxable income is more than $20,000, but flat rates of tax and even the threshold do not cope well with low income earners. For some low income earners no tax on contributions, fund earnings or benefits might be the appropriate outcome. There is an argument that the only way to deal well with the taxation of the superannuation of low income earners is to tax once only when benefits are taken.

Points for discussion

Is the tax free threshold set at an appropriate level? Should it be available to all recipients of lump sums?

Would a system of higher marginal rates on receipt of higher benefits negate the need for a threshold, or lead to a different threshold?

Should an income stream be mandated or encouraged once the tax free threshold is reached?

3.2.5 Capped rate on marginal tax applying to lump sums

For taxpayers aged under 55 years at the time a lump sum is paid, a maximum rate applies to that part of a lump sum attributable post-1983 service. No threshold applies, and the rate applying to lump sums sourced from contributions which were taxable when received by the fund is a maximum of 20%. Lump sums paid from untaxed sources have a rate of 30% applied, which is lower by two percentage points than the effect of a 15% tax on the way into the fund and a 20% tax on the way out.

The equity grounds for provisions of this nature are not clear. The flat, capped rate does not contribute to vertical equity. Applying a capped marginal tax rate to the receipt of lump sums not being used for retirement income or related purposes could not be said to promote horizontal equity with the receipt of other forms of income by persons aged under 55. History could be the explanation, with the arrangements originally introduced as a replacement for a tax regime in which only 5% of superannuation lump sums formed part of the taxable income of individuals. A flat rate also does away with the problem of a one-off lump sum lifting an individual into a higher tax bracket.

Increasingly restrictive preservation requirements will mean that the amount of superannuation benefits taken as a lump sum before the age 55 will decline in the future. Eventually no such benefits, other than benefits taken because of disability or in an income stream form, will be payable.

Points for discussion

Should tax rates for ETPs be flat rate or some other structure which takes into account their one-off nature?

Should any concessional treatment be provided for receipt of ETPs prior to retirement age for reasons other than death, hardship or disability?

3.2.6 Death and invalidity benefits

Invalidity payments made on or after 1 July 1994 are exempt from tax. This could be seen as involving both horizontal and vertical equity considerations as those suffering from invalidity are different from other taxpayers and have a reduced capacity to pay tax.

However, some invalidity benefit recipients could have investment income that puts them into a high income tax bracket and which raises some concerns about consistency of treatment of various types of income. On the other hand, being unable to achieve an income from personal exertion is a significant concern on equity grounds. The requirement to have two qualified medical practitioners certify that the disability is likely to result in the taxpayer being unable to ever to be employed is a capacity for which they are reasonably qualified severely restricts the availability of these concessionally taxed payments.

Death benefits paid to a dependent are also free from tax provided they are within the deceased's Reasonable Benefit Limit. Exempting payments to widows and orphans aged under 18 meets equity concerns in a popular sense, if not in a technical sense as well. It would be a courageous government that sought to impose a tax on benefits received by widows and orphans given that they previously have not been taxed.

However, more contentious is the treatment of death benefits to individuals who are not a spouse, child under 18, or financially dependent on the deceased. Same sex partners who were not financially dependent on the deceased person can only benefit through the payment of a death benefit to the estate of the deceased following payment of benefit taxes at the usual rates. Whether this offends in terms of being discriminatory is a matter of current debate. ASFA's long standing position is that same sex partners should be treated like other de facto partners and not be required to establish they were financially dependent.

There also are anti-detriment provisions which allow a rebate of tax to be paid to a superannuation fund in order to restore a death benefit to the level that would have been achieved had there not been the tax on the contributions and earnings of superannuation funds. This has its origins in preserving past entitlements, but given that it applies more generally there are also horizontal equity considerations that presumably lie behind this provision.

Points for discussion

Are current tax arrangements for the taxation of death and disability benefits appropriate?

Should same sex partners receive the same concessional tax treatment as married or de facto partners?

3.2.7 Tax deductions and rebates for contributors

The self employed, defined as those who attract no or only a small amount of employer support for superannuation, are able to make tax deductible personal contributions in certain circumstances. The allowable amount of deductible contributions is all of the first $3,000 plus 75% of the contributions in excess of that amount up to the usual aged based limits. Contributions of $3,000 equate at the current SG rate to a salary of only $37,500, so the limit of full deductibility is relatively tight. It is sometimes argued that the self employed have more flexibility in adjusting their contributions so tighter conditions are appropriate on equity grounds. That said, the rationale for the level and rate of the deduction is not clear given that all employer contributions are deductible provided they are consistent with the age based contribution limits where applicable.

In 1997-98 around 196,000 individuals claimed $920 million in deductions for superannuation contributions by the self employed. The total contributions are likely to have been over the $1 billion mark given only a partial deduction is available. A substantial amount of the contributions were by individuals with low taxable incomes, although this may have more to do with the tax planning activities of the self employed and small businesses than with the attractiveness of super for the lower paid. Around 85,000 self employed individuals with taxable incomes of less than $20,000 per annum claimed deductions for superannuation totalling $280 million.

The average deduction claimed varies with income level. For those with taxable income of less than $20,000 the average deduction is around $3,000, rising to around $5,000 for those on $40,000 per annum. At the $100,000 mark the average deduction reached around $13,000.

Members with employer support above the defined threshold are not entitled to any taxation concessions for contributions unless their annual income is below $31,000. For incomes below $27,000 there is a maximum rebate of $100 based on maximum rebateable contributions of $1,000. Phasing out arrangements apply between $27,000 and $31,000. In 1997-98 about 280,000 individuals with taxable income claimed the rebate, with an average rebate of $60. A lucky handful with income over $31,000 also received the benefit of the rebate according to the ATO statistics, but they may have been dealt with later by way of audit.

The provision could not be said to be have major vertical equity implications given that it is available to relatively few taxpayers and is severely limited in amount. The failure to index the upper thresholds also means that declining numbers of individuals will be eligible for the rebate, and of those that are only a small proportion will have the capacity or inclination to make contributions.

Points for discussion

How can coverage be better extended to the self employed and those outside full time employment?

Should full deductibility be allowed for contributions made by those without employer support?

Is enough assistance being provided to low income individuals making personal contributions?

3.2.7 Tax rebates for spouse contributions

From 1 July 1997 a taxpayer is entitled to an 18% rebate for contributions up to $3,000 a year which are made for the benefit of his or her spouse. The contributing partner is entitled to an annual tax rebate of $540 if the non-earning partner receives assessable income less than $10,800 per year. The rebate cuts out an income level for the spouse of $13,800. None of these amounts are indexed.

For some couples the ability to make contributions on behalf of a spouse who has no connection with the paid workforce is more important than the rebate offered.

In 1997-98 less than 16,000 individuals claimed the rebate, with the total rebates obtained amounting to around $6.5 million. This implies spouse contributions of at least $35 million, with some further contributions which did not attract the rebate. The aggregate amount of rebate is much lower than the cost to revenue estimates prepared when the measure was announced.

The cost to revenue will also be lower as the result of recent audit activity by the ATO. Around 10% of taxpayers claiming the rebate have had their claim reduced or disallowed, often on the basis of the assessable income declared by their spouse. Many taxpayers appear to have based their claim on the taxable income of their spouse, rather than their assessable income. The latter is generally higher because it is calculated before any deductions are taken into account. Apart from the issue of whether instructions in TaxPack were misleading on this point, it is an issue whether the best basis for applying horizontal and vertical equity provisions is taxable or assessable income.

Taxable income forms the basis of assessment for income tax payments, but a number of provisions relating to superannuation rebates are related to assessable income. These latter provisions could be regarded as treating individuals with a higher level of rental property or other deductions more harshly than those without such deductions.

Taxpayers across the range made contributions for their spouse, with around 1,000 contributors with taxable incomes of less than $20,000, and three contributors with taxable incomes of over $1m. However, the majority of contributors were drawn from the $40,000 to $100,000 range. This is not unexpected in terms of the demographics of persons with spouses who are likely to make contributions.

That 1,700 or so taxpayers with taxable income less than $20,000 per annum made contributions is more surprising. Similarly, one wonders about the 400 contributors with income over $200,000. ETPs, final salary payments and retirement income planning appear to impact at the top and bottom ends of the taxable income scale of those making spouse contributions.

Points for discussion

Is the level of the rebate sufficient for its objective of encouraging spouse contributions?

Could assistance be better provided through a co-contribution provided by government for low income individuals, including spouses?

Do the proposed Family Law provisions allowing the splitting of super balances reduce the need for a rebate for spouse contributions?

Should the income test for the spouse be based on taxable income rather than the more restrictive and complex notion of assessable income?

3.2.8 Tax deductions and rebates for certain annuities and pensions

An annuity is an income stream purchased from a life insurance company, while a pension is an income stream paid by a superannuation fund. As noted in section 2, annuities and pensions play an important role in providing retirement income. Their interaction with the tax and social security systems can be complex. It is important that this interaction at the very least not discourage the taking of an annuity or pension. Whether further encouragement should be provided for pensions and annuities given the income protection they provide, and the fact that they have the potential to reduce double dipping, is another matter.

The deductible amount

Annuities and pensions differ in fundamental ways from most other investments, so special provisions are required in regard to their treatment for social security and taxation purposes. Generally, a component of private sector pensions and annuities purchased at least in part with an after tax superannuation benefit or other tax paid savings is a return of capital. The financial product design builds into the income stream payable both an investment return and a return of part of the purchase price. However, when a pension is payable as part of the benefit design of a public or private sector scheme, there is no real capital sum involved. Equally, when an income stream is purchased with a rolled over account balance on which no benefit tax has been paid, no allowance necessarily is made for return of capital. In these latter cases both actuarial and taxation principles suggest that all or most of the pension received be treated as income of the recipient.

Accordingly, taxation law allows individuals to claim a deduction for only that part of a pension or annuity which is attributable to the return of capital. This is an important element of horizontal equity as otherwise pensions and annuities would be treated less favourably than direct investments in equities or interest bearing bank accounts or debt instruments.

The Income Tax Assessment Act sets out the formulae for calculating these deductible amounts. In 1997-98 around 190,000 taxpayers claimed a tax deduction for the purchase price of a pension or annuity, with around 90,000 of these taxpayers with taxable income under $25,000. Over $1 billion in deductions in total were claimed. Around 40 per cent of those claiming the deduction had taxable incomes below $20,000 a year. Over 4,000 taxpayers had taxable incomes over $100,000, but this would be likely to reflect the receipt of an ETP which then results in a part-year annuity payment. The average deduction is around the $6,000 mark for most income ranges under the $100,000 mark, but jumps to two or three times that at high levels of taxable income.

As noted above, the availability of the deduction is largely justified on horizontal equity grounds. As well, it is received largely by individuals in retirement with relatively low incomes.

The 15% tax rebate for certain income streams

Another provision which is more difficult to classify in terms of equity is the availability of tax rebates for certain pension and annuity payments received by individuals. Horizontal equity considerations play some role, but history and the maintenance of comparative levels of tax advantage or disadvantage have also been important.

Prior to 1 July 1983 only 5% of the amount received as a lump sum payment on termination of employment was taxed. In contrast all of a pension or annuity payment (apart from the deductible amount reflecting the return of capital) was assessable. Pension provision was assisted though by the income of superannuation funds being tax exempt, boosting the earnings which supported the payment of pensions and annuities. Because lump sums received such favourable tax treatment, and the more generous schemes provided only pension benefits, it was rare to see substantial deductible amounts in regard to pensions.

In July 1983 this relativity was altered by increasing the taxation of lump sums, with a maximum rate of 30% and a rate of 15% for the first $50,000 of lump sum benefits. The tax treatment of pensions was largely left alone. However, effective from 1 July 1988 the tax on the post-1983 component of lump sums was reduced from 30% to 15% and from 15% to zero, with a tax on contributions (other than undeducted contributions) and earnings at the fund level.

The balance between lump sums and pensions/annuities was disturbed by this reduction in tax. Hence the government introduced a 15% rebate to apply to the post-1983 portion of a pension or annuity, and exempted the income earned on assets set aside by a fund to pay pensions from taxation at the fund level. In regard to the latter, exempting fund earnings was necessary in order to maintain the relativity with lump sums and to avoid the double taxation of investment earnings taken in the form of a pension. It would be wrong, for instance, to tax bank account interest at the bank level at a flat rate, and again at full marginal rates when the interest was received by an individual.

The rationale for rebate had its roots in maintaining tax relativities, but the strength of that argument tends to decline as pre-1988 tax arrangements increasingly become merely part of history. The rationale and arithmetic are also strongest when a straight superannuation fund pension totally funded out of post-1988 contributions is involved, with no deductible amount for the purchase price of the pension. However, even in this case the benchmark for determining whether the rebate is concessional or merely an allowance for the taxation of contributions is not clear.

Whatever the rationale, the rebate is important in encouraging the take-up of pensions and annuities. This both assists in maintaining more adequate retirement incomes and in better integration between superannuation and social security benefits.

Tax data for 1997-98 indicate average rebates for those receiving annuities and pensions of $1,900 for the 210,000 recipients. There was a spread in the taxable incomes of annuity purchasers, with over 30,000 annuity holders having taxable incomes of over $40,000. That said, apart from the horizontal equity and preservation of past relativities considerations, the rebate assists mainly those on relatively low incomes and hence can be regarded as meeting vertical equity concerns.

Points for discussion

What is the rationale for the 15% rebate? Is it to maintain relativities with other forms of benefit or is it justified because it encourages the taking of income streams?

Should access to the rebate be linked to income in any way, or should a higher rebate be provided for those on low incomes?

Would there be any justification for a 15% rebate if contributions and fund earnings were exempt from tax?

3.2.9 Integration of superannuation with social security

The means test provisions applying to the provision of social security necessarily impact on the integration between superannuation and social security and on the equity of both superannuation and social security.

Where a superannuation benefit has been taken as a lump sum, the means test provisions are reasonably straightforward in that there will be both a capital amount and receipt of income relating to that capital amount which can be readily identified for means test purposes. However, as forthcoming research commissioned by ASFA (Ageing Agendas, 2001) indicates, the treatment of various income stream products purchased either for cash or by rollover of superannuation monies is complex.

Some of these complexities are hard to avoid given that an element of many retirement income streams reflects a return of capital. It would be unfair on horizontal equity grounds to tax recipients of such payments more harshly than individuals who make use of investments with a clearer split between income and return of capital.

A number of means test provisions also encourage the taking of an income stream through providing concessions for pensions and annuities meeting certain minimum standards. These standards are designed to promote the taking of lifetime or long term income stream products which offer little or no access to the underlying capital. However, it can be difficult to identify which provisions provide an incentive to take an income stream and which merely make appropriate allowance for the return of capital to the annuity or private pension recipient.

A horizontal equity issue is the different treatment given under the asset test to different types of income stream products. The most generous treatment is given to products which generate an income stream for the rest of the individual's life and where the payment each year is guaranteed in quantum and meets a number of other criteria. In order to meet these criteria the supplier of the income product in effect has to bear the investment risk and provide what in effect is insurance cover in relation to the financial consequences of longevity.

As a result, the rate of return underlying these complying income stream products is much lower than products where the recipient bears all or part of the investment risk, and implicit charges for the life insurance element impact on the perceived attractiveness of such products. Without the preferential means test treatment, these complying income stream products would have great difficulty in achieving any significant market share.

The bias in the means test for the Age Pension against products based on growth assets has been raised by certain providers with the government on a number of occasions. The government has been reluctant to broaden the class of income stream products exempt from the asset test, perhaps because of concerns about estate planning and/or "double dipping". Future research by ASFA will be examining this issue in more detail.

Points for discussion

How can the interaction between the superannuation system and the social security system be improved?

Should the asset test vary with different types of income stream?

What product development changes would be desirable to encourage greater uptake of income stream products and less reliance on social security?

Would the interaction between the two systems be aided by superannuation only being taxed at the benefit stage (with no taxes on contributions or earnings)?

4. Criticisms of the equity of current retirement income arrangements

4.1 ASFA's views

Taxing contributions is a particularly poor way of achieving equity given that high contributions in a particular year may not reflect the economic circumstances of an individual within either a given year or over their lifetime. The anomalies related to this are apparent when the surcharge is applied to contributions on top of the standard 15% tax on employer contributions and other deductible contributions.

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 is unjust. This has been one of the many equity problems associated with the Government's move to tax notional superannuation contributions to defined benefit schemes.

The most equitable way of taxing super is at the benefits stage. Equity also is facilitated if superannuation is 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 an approach based on taxing benefits only, attempts at achieving greater equity in the taxation of superannuation are likely to be "band-aids" for problems within the system which create a number of new equity problems. 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.

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. Implicit in this are assumptions as to the adequacy of the safety net, mutual obligation and achieving self reliance. 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.

4.2 ACOSS views

ACOSS argues that existing saving incentives are excessively biased in favour of saving for retirement, in favour of superannuation savings, and in favour of high income taxpayers. The perception of ACOSS is that unless they are very carefully designed and targeted, tax incentives for saving are likely to be regressive, as high income earners have a greater capacity to save and take advantage of the concession (ACOSS, 1998 and 2000).

ACOSS argues that reform of the system should give priority to reducing these claimed biases and to supporting savings vehicles that are flexible and accessible to meet a range of needs of low income Australians. ACOSS puts priority on individuals being able to draw on savings during their working lives when they are in need, rather than having long term savings available only in retirement. ACOSS either has not considered or has disregarded the fact that the income distribution of retirees is very condensed at near the poverty level for many currently retired. In a number of ways ACOSS appears uncomfortable with any notion of adequacy which involves income or assets in excess of a very basic level and/or regards this as outside their brief.

In ACOSS's view, public subsidies are needed in a compulsory superannuation scheme, but their main role should be to compensate for the loss of disposable income experienced by wage earners, particularly low income earners. A somewhat complicated proposal for rebates is put forward by ACOSS, but in essence it would involve a 100% rebate for annual contributions for the first $400 of contributions and a 20% rebate for additional contributions up to 14% of AWOTE, which is approximately $5,500. The caps on contributions would be lower in the initial years the arrangements were in place and would also be lower if the superannuation guarantee does not ultimately reach 12% of earnings. In the view of ACOSS a retirement income, including the age pension, of 40% of AWOTE should be sufficient for individuals (ACOSS, 2000).

In their view, the RBL limits which allow a retirement income stream of twice average earnings are too high. The non-taxation of transfers of superannuation assets to beneficiaries of a retiree after his or her death is also seen to be a concern.

4.3 Views of the Institute of Actuaries Australia (IAA)

The IAA has put forward a number of proposals over the last decade. While the basic thrust has been similar, the emphasis on different aspects of equity has varied.

In July 1996 proposals put to Senate Select Committee on Superannuation (IAA, 1996), the IAA focussed on the equity implications of means testing the age pension and the availability of superannuation benefits in lump sum form. While acknowledging that equity is a matter of opinion, the Institute proposed that equity be improved by removing the Social Security means tests on the age pension and offsetting the effects of this on government revenue by increasing the taxes payable by middle and higher income earners on superannuation benefits and on income received after becoming an age pensioner.

While claiming that the proposal should be described as a package which includes a taxable age pension not subject to a means test rather than for a universal age pension, the lack of political and public support for the proposal apparently led to adoption of other proposals by the IAA. At the 1998 ASFA National Conference another proposal was put forward in the form of a discussion paper. Both the contributions tax and the surcharge were considered to be inequitable, and it was further suggested that all contributions, whether from the self-employed, employer or the member, should receive a deduction or rebate.

According to the IAA, benefits taken in either lump sum or income stream form should be taxed at marginal rates, and any "grandfathered" amounts should be given a value and a tax rate based on what tax would have been payable on the transition date had the member retired then. The value of the benefit as that date would be adjusted by an indexation factor (similar to the current practice of using AWOTE to index various thresholds), with that amount when received taxed at the calculated amount. Any benefit in excess of the indexed accrued component would be taxed under the new system. This would improve equity by linking the tax rates in the superannuation system to the marginal personal income tax system. However, an exception to this in the IAA model was the taxing of fund earnings at a standard rate of 15%. When received by an individual, the proposal would apparently tax these earnings at standard marginal income tax rates as well.

4.4 Views of the Australian Retirement Income Streams Association (ARISA)

In a discussion paper (ARISA, 1997), a number of criticisms of the equity of the current system were made by ARISA. These related chiefly to the availability of lump sums and subsequent double dipping with social security, and intergenerational inequity with future generations expected to finance the retirement income needs of those currently employed. ARISA also considers that there is a lack of tax incentives to invest in retirement income streams, gaps in the coverage of compulsory superannuation, and poor integration between the tax and social security systems.

ARISA suggested that the compulsory employer contribution be increased from 9%, a compulsory member contribution be introduced, that there be a minimum compulsory contribution for the self employed, and that the Reasonable Benefit Limit be abolished. They also argued that tax incentives be introduced to encourage additional voluntary savings (particularly for those aged over 45 years) with associated adjustments to the existing deductible contribution rules, and that the current employment test applying to superannuation contributions be abolished. As part of their proposals a tax rebate of 18% would apply in regard to contributions, capped at $500 for those aged under 45 and $1,000 for those aged over. Tighter maximum annual deductible contribution limits would apply to those aged over 35 compared to what currently applies.

While a number of options were suggested, the basic thrust of the equity measures in regard to their first option dealing with benefits was to have a small lump sum (up to AWOTE) available tax free, with an income stream with a purchase price of up to six times AWOTE tax free. Any amount taken as a lump sum in excess of those amounts subject to heavier taxation.

Other options presented had similar or greater levels of complexity, with their general theme being that income streams should be compulsory to a significant degree and/or encouraged by tax and social security incentives.

4.5 Views of prominent commentators and analysts

A number of superannuation experts and analysts have over the last few years made criticisms of the equity of current superannuation and retirement income arrangements and have made suggestions of reform. Some of these suggestions have received media attention, and others have had less publicity but in some cases have influenced the position of various industry bodies.

4.5.1 Views of Dr Vince FitzGerald

In his seminal report on national savings (FitzGerald, 1993), Dr FitzGerald suggested that taxing superannuation savings on an expenditure tax basis, that is, when benefits are received, would be most appropriate. In FitzGerald, 1999 he strengthened his support for that position, but suggested that a second best policy would be to levy some tax at the contributions stage, say at the lowest non-zero marginal rate and to treat this as withholding tax against the ultimate liability when the benefit is paid out. Ordinary income tax would then apply, but with some average to allow for a lump sum being paid. He has also given general support to arrangements which would avoid the need for grandfathering by payment of tax liabilities on still accruing benefits as at the transition date. This tax liability could be paid in whole or by instalments.

4.5.2 Views of Geoff Carmody and Access Economics

In Access Economics, 1996 it was proposed that tax on contributions to funds and fund earnings be abolished, along with the surcharge. It was also recommended that non-deductible or partially deductible contributions be allowed full deductibility for tax purposes, and that income tax at full marginal rates be applied to all superannuation benefits whether lump sum or income stream. These reforms would apply prospectively.

In the view of Access Economics, the adoption of such proposals would make superannuation taxation both simpler and fairer. Complications between defined benefit and accumulation schemes also would not arise because tax liability is determined at the time of payout.

4.5.3 Views of David Knox

David Knox has been a long standing commentator on superannuation policy matters, first as a Professor of Actuarial Studies at the University of Melbourne, and more recently as a partner of PricewaterhouseCoopers. He has also made a substantial contribution to the development of the position of the Institute of Actuaries.

While the exact detail of his preferred outcome has varied over the years (for instance, see Knox, 1987 and Knox, 1998), the basic thrust of his position is to reduce or eliminate the standard tax on deductible contributions, abolish the surcharge, hold or increase the current tax rate on fund investment income, and increase the tax on post 1983 lump sum benefits to either a higher flat rate or the member's marginal income tax rate. He also had advocated at times the adoption of transitional provisions which would involve the payment of tax on accrued pre-1983 benefits in order to ease the impact on tax revenues and to simplify ongoing record keeping for funds and individuals.

5. ASFA proposals for improving the equity of superannuation and retirement income

ASFA has long supported 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. "Blue Skies", ASFA's Blueprint for a National Retirement Income Policy (ASFA, 1998) sets out the reasons for adopting such an approach along with an outline of taxation and other arrangements that would be consistent with such an approach.

More recently, ASFA has proposed a "downpayment" for reaching the ultimate goal of tax on benefits only. This had its genesis in research into public opinions which showed very strong support to the proposal that "government require employees to contribute an extra 1% of salary to super if in turn the government matched this by abolishing the current 15% taxes on your contributions".

In more concrete terms, adoption of the ASFA proposal would:

- Help to simplify the tax arrangements for super by reducing the number of steps involved. This would simplify both the taxation compliance of funds and the accounting arrangements for individual member accounts.
- Improve adequacy by increasing member contributions by one percentage point of salary.
- Lift individual retirement savings on average by around a further two percentage points of salary as a result of the removal of the contributions tax (Superannuation Guarantee contributions currently account for around 75% of total employer contributions, so removal of a 15% tax on contributions would be equivalent to a 20% or so increase in the SG from 9% to 11%).
- Lift compulsory saving through superannuation to the equivalent of 12% of an employee's salary by way of the combined effect of removal of contributions taxes and introduction of compulsory member contributions.
- Benefit all who are receiving tax deductible contributions, not just employees covered by the SG.
- Add to national savings without adding to the wages bill or to inflationary pressures.

For an individual on AWE a 2% government contribution would boost that individual's savings by around $800 per year. This is equivalent to receiving a $20 a week pay rise, but it would involve no costs to employers and would have no inflationary consequences. In terms of retirement savings, the combined impact of removing the contributions tax and introducing a 1% member contribution would be to generate an additional lump sum of $55,500 or an indexed income stream of $2,700 over the individual's entire retirement.

5.1 Equity implications of making all contributions to superannuation tax deductible

The ASFA “Blue Skies” document proposed that employee contributions be deductible to the contributor and that employer contributions be fully deductible to the employer and not form part of the income of the employee for taxation purposes. For the self employed and employees who are self supporting it also was proposed that all contributions be deductible to the contributor. In this framework there would be no age-based contribution limits as preservation requirements and the capping of tax advantaged benefits through an RBL or like mechanism to a specified level would stop any contributions in excess of what would be needed to fund a comfortable lifestyle in retirement.

As noted earlier, on an income base for taxation purposes, allowing full deductibility delivers the most tax advantage to those who make the highest contributions and/or are on the highest marginal personal income tax rate. However, the more appropriate base for considering long term savings such as superannuation is an expenditure tax base. Using this latter conceptual base, the arguments are essentially reversed. Allowing full deductibility brings neutrality in tax treatment of contributions. Taxing contributions at full marginal tax rates would be a departure from horizontal equity.

It is also important to note that tax treatment at the time contributions are made is only part of the story. Equity under the ASFA proposals is dealt with in a fundamental way when benefits are paid. The combination of progressive marginal tax rates and the means testing arrangements for the Age Pension would mean that upper income earners with substantial accrued superannuation benefits would be subject to highly progressive effective marginal tax rates (EMTRs). These EMTRs would be a powerful redistributive force, particularly given the proposed requirement or encouragement to take benefits in income stream form, and would largely remove any opportunities in the retirement system for taking a private benefit and then “double dipping” from the public Age Pension once the private assets were dissipated.

By way of example, removal of the taxes on contributions and earnings would lead to the accumulated superannuation savings after 30 years for a person on $90,000 per year and an SG rate of 9% increasing from $331,000 to $504,000 in today’s dollars (Table 5.1).

Table 5.1: Projected superannuation savings after 30 years(a)

Final Average Salary	Current projected amount	SG at 9%, no tax on contributions or earnings	SG at 12%, no tax on contributions or earnings	SG at 15%, no tax on contribution s or earnings
$40,000	$180,000	$230,000	$300,000	$375,000
$60,000(b)	$270,000	$345,000	$450,000	$560,000
$90,000(c)	$331,000	$504,000	$670,000	$840,000

(a) Current dollar values based on fund earnings of 8% nominal, wages growth of 3.75% nominal and effective tax rate on fund earnings of 6.5%. No allowance is made for tax paid on benefits.

While the up-front tax concession for superannuation would be greater under the ASFA proposal, down the track there would be offsetting savings for the government in terms of reduced Age Pension expenditures and greater income tax collections from the receipt of private annuities. It would also generate greater levels of adequacy of retirement income across the income range.

The ASFA proposal would be far more effective in containing future Age Pension expenditures because future private retirement incomes would be higher. As well, because benefits would be largely taken in income stream form and only be taxed on receipt, future superannuation benefits would involve less return of capital being assessed for tax and social security purposes. In essence the ASFA proposal would involve the government giving up taxes on contributions and fund earnings in order to generate higher benefits in the future which would then be taxed on receipt as income and would be taken into account for social security means testing purposes.

In addition, the ASFA proposed limit on the maximum amount of benefits attracting concessional taxation treatment (see section 5.3) would also assist in bringing about vertical equity.

As indicated earlier in this paper, the contributions surcharge has very doubtful vertical equity impact. As well, its abolition would not lead to a reduction in vertical equity given that the tax advantage for superannuation benefits would be removed for benefits in excess of a reasonable level.

5.2 Equity implications of the low income and spouse rebates

In the ASFA “Blue Skies” document, it was suggested that the low income rebate could be abolished given that equity would be dealt with at the benefits stage. It was also suggested that it might be possible to refine the spouse contributions rebate so as to better encourage additional savings.

While full deductibility of contributions and taxation of benefits at marginal tax rates can be seen as dealing with vertical equity concerns, low income and a lack of capacity to make contributions could be seen as involving issues of equity in terms of equality of opportunity. Accordingly, there could be a case for including a rebate or government contribution even in circumstances where all contributions are tax deductible. This would also assist in making superannuation contributions tax attractive for individuals on low income and relatively low marginal tax rates.

Making such a rebate available for individuals with incomes up to, say, 80% of AWOTE would go some way to dealing with concerns about inequality of opportunity to make superannuation contributions. A rebate of, say, 18% capped in amount at $540 as is the spouse contribution rebate could be seen as being far more effective than the current very limited rebate arrangements for low income earners.

There are around 2.5 million wage and salary earners with income between $15,000 and $30,000 per annum, with a further 750,000 with income between $30,000 and $35,000. The cost to government of a contribution or rebate would be linked to these numbers, the quantum of the contribution and the take up rate.

For instance, if an average $300 government contribution or payment were made available to these 3.25 million low income earners, the aggregate cost would be $975 million. If this payment required a matching member contribution, then in effect the superannuation contributions of low income workers would be boosted by around $2 billion a year. Over time this would have a significant impact on superannuation savings and adequacy of income in retirement of the lower paid.

On the other hand, if a rebate was paid in regard to voluntary contributions by the lower paid, the take up rate would be much lower than 100%. For instance, if 500,000 individuals made average voluntary contributions of around $1,700, then at an 18% rebate rate the average rebate would be $300. The aggregate cost to the government would be $150 million, and superannuation contributions would be boosted in aggregate by around $830 million. For an individual on $30,000 per annum a $1,700 voluntary contribution would amount to a 70% increase in contributions compared to the SG alone.

5.3 Limiting the concessional treatment of superannuation

While the precise level of benefits which should attract special tax treatment is a matter for judgement, ASFA has suggested that the level could be set at accumulated savings which would generate an income stream in retirement of 1.5 times average weekly ordinary time earnings. AWOTE is currently around $40,000 per annum, so this would imply tax concessions being available in current dollar terms for retirement income streams of the order of $60,000 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. An income stream of $60,000 is, depending on the age at which it commences and other characteristics of the annuity, more or less consistent with the current pension Reasonable Benefit Limit.

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).

The clawback factor would need to be seen as related to the degree of tax advantage that is delivered by deferral of taxation until a benefit is taken. The current penalty tax rate applying to excess benefits is effectively 15% fund taxation plus 48.5% tax at the personal income tax level. The intention in the ASFA proposal is to largely or wholly remove the benefit of any tax concession for benefits in excess of the specified amount. However, care would be needed in order to avoid any such penalty tax regime encouraging very conservative contribution strategies to superannuation by middle and upper income earners.

In summary, the combination of a rebate for contributions at the low income end of the income distribution spectrum, the interaction of the social security means test and superannuation benefits for middle income earners, and an excess benefits tax for upper income earners could be seen as substantially addressing any vertical equity concerns.

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.

5.4 Treatment of death and disability benefits

benefits. These currently receive favourable taxation treatment when received in lump sum form, which is their customary form given standard insurance and benefit design practices.

A matter for debate is whether lump sums should continue to be available in these cases. While uniformity of treatment would suggest that all benefits should be taken as an income stream or be subject to a high marginal tax rate if taken as a lump sum in excess of some specified amount, there could be difficulties in imposing a new tax on widows and orphans. As well, many insured benefits are relatively small, and may not exceed the lump sum threshold that ASFA is proposing.

5.5 Transitional arrangements

A 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. For example, records of pre-1983 superannuation entitlements have to be maintained, along with pre- and post 1988 service and contributions.

One approach that was suggested in "Blue Skies" would be to assign transfer values to any rights that have accrued to individuals in the taxation system. For instance, on the transfer date the value of the concessional treatment of pre-1983 entitlements could be given a dollar value relative to one or more marginal tax rates. This value could then be used as a tax offset when a final benefit is taken at a later stage when standard tax rates are applied. In the case of post-1988 contributions a credit would need to be given for contributions and earnings taxes that had been applied. This credit could be provided at the time a benefit was taken, or could be given over time as an income stream was drawn down, similar to the current 15% tax rebate for certain income streams.

Another approach which has been suggested from time to time is to determine a transfer value at a given date and for the fund to pay tax on the basis of 5% assessable, etc. The amount net of tax could then be included along with any undeducted member contributions which are to be carried forward in the system.

Another approach would be to apply a "sunset clause". The advantage of this over grandfathering is that while it does not disturb the expectations of the soon to be retired, it has a cut off date for its operation. Under grandfathering, tax provisions not available to new entrants to the labour force can continue to have an impact for many decades with very weak equity justification. For instance, it is now some 17 years since the only 5% assessable arrangements were replaced by concessional taxation of eligible termination payments (ETPs). The bulk of most retirees' superannuation payments are now attributable to post-1983 contributions. In another 10 years' time most retirees will have only a relatively small proportion of their total years of employment and contributions attributable to pre-1983 employment.

Any individual aged less that 45 is unlikely to have any significant amount of pre-1983 service. Removing any entitlement to 5% assessable treatment of retirement benefits would not involve any significant disturbance of retirement expectations. For those aged over 45 a possible sunset clause might be ten years. This would not disturb the expectations of the soon to be retired, and after a further ten years the proportion of the retirement benefits of any individual retiring which could be related to pre-1983 service would be small.

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