HOW SHOULD SUPER BE TAXED?

The government needs to go back to the drawing board with its proposed changes to super, argues **Robert Carling**

The Turnbull government's proposed changes to superannuation taxes and rules—as announced in the May 2016 budget—will run the gauntlet of stakeholder consultation, disquiet within government ranks and Senate obstacles before they become the law of the land, and may well be amended in the process. In the longer term, the pressures that led to the government's proposals may lead to further attempts to increase taxes and other restrictions by a successor government. For these reasons, it remains relevant to review principles underlying taxation of superannuation and assess the current proposals against those principles.

The main features of superannuation taxes and contribution limits since 2007 and the government's proposed changes are summarised in the table overleaf. The arrangements that took effect in 2007 are a suitable baseline because the changes since then have been a reaction to claims of excessive generosity, especially to higher income earners, in the 2007 reforms. The critics, who became increasingly vocal as the budget deficit became a bigger problem, based their demands for change principally on the grounds that:

- no tax applied either to fund earnings or member withdrawals once a member over age 60 began draw-downs;
- the system had no 'progressive' element to mirror personal income tax, because the taxes that apply were flat percentages; and
- members were able to put in too much and accumulate a capital sum in excess of what is needed to satisfy reasonable expectations of a retirement income.

For each of these criticisms there is a rebuttal, as will become clear later in this article. However the criticisms gained public and political support, leading first in 2012 to the Labor government altering the flat tax on concessional contributions and in 2013 proposing a $100,000 limit to tax-free earnings on pension funds (which was never implemented).Then in its 2016 budget, the Turnbull government went much further by announcing far-reaching changes to taxation and contribution limits as shown in the table overleaf. These changes were primarily designed for defined contribution schemes but the government foreshadowed equivalent arrangements for defined benefit schemes.

While this article focuses on the government's proposals, Labor in opposition proposed its own version of further tax increases and more recently talked of adopting the government's more far-reaching proposals. (See Terrence O'Brien's article in this issue for a comparison of both parties' proposed changes.)

The budget imperative

The moves by both sides of politics to restrict superannuation and raise more revenue took place against the backdrop of a persistent budget deficit. Indeed, without the pressing need for action to close the deficit, it is unlikely the pressures to change the system would have gathered as much momentum or exerted as much influence on public

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Superannuation taxes and contribution limits

	2007 to 2012	Current*	Proposed*
Tax on contributions	Concessional: 15%	Concessional: 15% OR 30% if income above $300K OR 0% (through Low Income Super Contribution) if below $37K	Concessional: 15% OR 30% if income above $250K OR 0% (through Low Income Super Tax Offset) if below $37K
	Non-concessional: full marginal rate	Non-concessional: full marginal rate	Non-concessional: full marginal rate
Tax on fund earnings	Accumulation phase: 15%	Accumulation phase: 15%	Accumulation phase: 15%
	Pension phase: 0%	Pension phase: 0%	Pension: 0% for balance up to $1.6 million**
Tax on member benefits	0% over age 60	0% over age 60	0% over age 60
Contribution limits	Concessional: Initially $50K pa, then reduced	Concessional: $30K pa up to age 50; $35K above age 50	Concessional: $25K pa with limited carry-forward
	Non-concessional: $150K pa or $450K over 3 years	Non-concessional: $180K pa or $540K over 3 years	Non-concessional: $500K over lifetime, calculated from July 2007

* Shaded boxes include changes. ** Any excess above $1.6 million to be withdrawn or transferred back to accumulation account.

policy as they have. But fiscal pressures on their own are not sufficient to justify tax increases in superannuation or any other area. Governments under fiscal pressure will make whatever changes to expenditure and tax policies they think they can sustain in the parliament and the broader political contest, but the existence of fiscal pressures does not exempt their actions from scrutiny based on sound principles. Arbitrary and politically opportunistic measures which lack a sound basis in policy principles and analysis deserve to be exposed for what they are.

The first question is whether the budget imperative calls for net tax increases. There is a strong case that it does not, and that the budget problem stems from excess expenditure rather than deficient revenue.[1]

That said, a case may still be made for superannuation tax increases as part of a revenue-neutral package of tax increases and reductions. This is essentially what the government put forward in the 2016 budget, with a small net increase in revenue from superannuation ($1.1 billion a year by 2019-2020) and offsetting reductions taking the form of company tax cuts and a small reduction in personal income tax.

So the question still applies: what do tax policy principles suggest for the amount of revenue the government should expect from superannuation taxes, and do current arrangements result in a shortfall (or for that matter an excess)? Through constant repetition of the assertion that current tax arrangements are resulting in a large shortfall of revenue (a 'tax expenditure' in the parlance) this idea has firmly taken root in public opinion, with a figure of $30 billion a year (and growing) often cited. But as explained below this figure is based on a counterfactual tax structure which would be inappropriate for superannuation and provides an invalid benchmark against which to assess the revenue shortfall.

How should saving be taxed?

Superannuation, for all its complexity, is a form of saving. The default tax treatment of savings under our income tax laws is that applied to a simple bank deposit held outside superannuation: the deposit is made out of fully taxed income; the interest is taxed at the individual's full marginal rate; and there is no further tax when the deposit is withdrawn. This is the benchmark against which the superannuation tax structure (and other forms of saving, such as owner-occupied housing) is compared in the Treasury's Tax Expenditure Statement, with the result that the superannuation system is said to be extremely costly to revenue.[2]

But this framing of the argument is immediately disadvantageous to superannuation, for it fails to recognise the large disincentive to saving embodied in the benchmark tax treatment. Full taxation of saving as if it were the same as any other type of income imparts a strong bias to consume income today and not save for the future, and the bias is larger in the case of long-term saving such as super.

The nature of this bias was well explained by the 2009 *Australia's Future Tax System* (Henry) Review:

> The essential reason for exempting lifetime savings or taxing them at a lower rate is that income taxation creates a bias against savings. The income taxation of savings therefore discriminates against taxpayers who save. They pay a higher lifetime tax bill than people with similar earnings who choose to save less. As savings can be thought of as deferred consumption, the longer the person saves and reinvests, the greater the implicit tax on future consumption. For a person who works today and saves, taxing savings also reduces the benefit from working.
>
> The increasing implicit tax on future consumption provides an argument to tax longer-term lifetime savings at a lower rate. An individual can undertake lifetime saving through a variety of savings vehicles, but there are asset types that are more conducive or related to lifetime savings: namely superannuation and owner-occupied housing.[3]

That said, there is no formula that tells us exactly how to correct for the bias. Many experts believe that in the superannuation context it is best corrected by exempting both contributions and fund earnings, and fully taxing withdrawals at the individual's marginal rate at the time. Indications are that this would result in little or no tax revenue over and above the current system.[4] Another approach would be to do all the taxing upfront—that is, contributions to be made out of fully taxed income and fund earnings and member withdrawals to be exempt from tax. This would result in more revenue than the current system but nothing like the $30 billion figure often plucked from Treasury's Tax Expenditure Statement as exhibit A in the case against superannuation tax concessions.

For almost 30 years Australia's super system has developed around concessional taxation at each of the three stages: contributions, fund earnings and withdrawals. Any radical move to either full taxation upfront or full taxation at withdrawal would be impractical now, except perhaps for entirely new entrants to the system. However the theoretical alternatives do provide a basis for benchmarking the current system that is better than the default income tax treatment of saving as described above.

What can be said about the current system is that there is no need for a tax at the third (pension) phase for the overall tax take to be correct. Indeed, the structure of superannuation tax is the same as that for a simple bank deposit, yet nobody says there should be a tax on withdrawals from bank deposits. Of course the tax on super is lower for most participants, and there are people who say it is too low. This is essentially a matter of judgement, but it is important to remember that at some optimum level—which is admittedly hard to estimate—the concessional taxation of super contributions and fund earnings is not an incentive to artificially boost superannuation, but a correction to avoid artificially crippling long-term saving.

Since the tax on withdrawals was removed for those over 60 in 2007, it has been accepted by both major parties that no such tax should be reintroduced, budget problems notwithstanding. However, this has not stopped Labor from wanting to reintroduce a tax on pension fund earnings above a certain threshold or the Coalition from proposing to cap the pension balance eligible for the tax exemption on earnings. Although this is not the same thing as a tax on withdrawals in the hands of the member, its effect is the same—that is, although the pension itself is not taxed, the tax on earnings reduces the capacity of the fund to pay a pension. For this reason, any tax on a pension-paying fund, or on the pension itself, is properly regarded as a third-stage tax in the three-stage contribution/accumulation/draw-down structure.

Any government is free to accept the principle of zero taxation in the third stage but restrict its application to pension funds of a certain size. However, any such restriction is essentially arbitrary and those unaffected by it at this time should be alert to the possibility that a future government will tighten the restriction—again arbitrarily.

Equity

Perceptions of inequity in current arrangements are a strong driving force behind the proposed changes. Although equity (or 'fairness') has many dimensions, the one receiving most attention has been the flatness of superannuation tax, or lack of 'progressivity', resulting in higher income earners appearing to benefit disproportionately from tax concessions. The proposed changes will address these concerns by steepening the progressivity in contributions tax and introducing what is in effect a new progressive element to the fund earnings tax.

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Whether this will ever satisfy the critics remains to be seen. As Hayek pointed out, once progressivity is introduced to a tax, there is no objective limit to how far it can be taken.[5] Subjectivity rules. It is quite likely that even if the government's changes are implemented as proposed, the critics will be calling for more progressivity before long.

As a counter, consider these points. There is more to 'fairness' than taking more tax from the rich. The concept of 'fairness' also encompasses a fair return on effort and sacrifice through saving and foregoing consumption, and government honouring undertakings which formed the basis of peoples' past commitment to superannuation. Savers have counted on government commitments to tax concessions in calculating when and how much to save, and in which mix of financial instruments, to meet their preferred retirement standard of living.

A suitably broad understanding of fairness would also embrace the tax/transfer system as a whole and take a lifetime view. As the Gillard government's 2013 Super Charter Group observed:

> While it is broadly accepted that a fair tax system would feature a progressive tax rate structure, it does not necessarily follow that every tax or tax expenditure should be progressive. Typically, Australia has relied on the progressive rate structure of the personal income tax system, combined with means testing of income support payments to deliver distributional fairness.[6]

Analysis of the distribution of the personal income tax burden and the distribution of superannuation tax concessions is instructive. The superannuation concessions are skewed towards the higher income deciles, which is hardly surprising given that richer people are in a position to save more and especially to lock those savings away for 40 or more years in superannuation. But the personal income tax burden, which reflects any benefits from deductions for superannuation, is even more skewed towards higher incomes. Comparing the two distributions, as Figures 1 and 2 opposite do, we can say that the richest 20% pay a greater share of income tax than they receive in superannuation concessions, by about 5 percentage points. More generally, the Australian tax/transfer system in its entirety is highly redistributive.[7]

This analysis is based on a snapshot at one point in time, but retirement saving and retirement income are a lifetime project. The distribution of taxable incomes and superannuation tax concessions in any given year is a poor indicator of lifetime tax effects. The most informative analysis of distributional effects must embrace tax benefits relative to income over a lifetime, and also the distribution of public age pension payments, which currently run at $45 billion a year. Workers not in a position to benefit much from superannuation tax concessions at one point in their lives (such as the young) are likely to at another point. While people who remain on a lifetime of low income may benefit little from tax concessions, they do benefit from the age pension. When this lifetime dimension is added, and age pension payments are brought into the picture, the distribution of benefits is much smoother. Work by the Association of Superannuation Funds of Australia suggests that across all personal income tax brackets lifetime benefits do not vary much from an average of $300,000.[8]

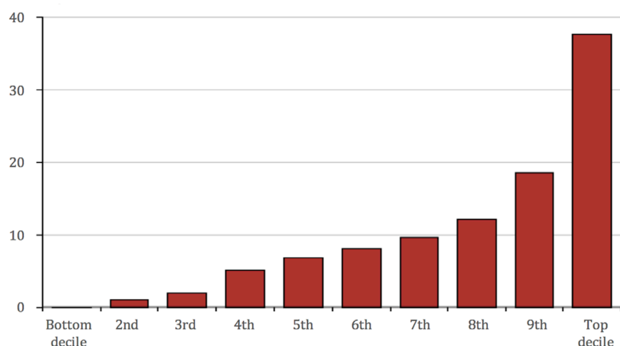
Access limits

Ideally all forms of household saving would be concessionally taxed in recognition of the anti-saving distortion implicit in taxation at full

marginal rates. Indeed, the 2009 Henry Tax Review recommended a broad discount to incomes from saving to make taxation of different forms of saving more even. However, as long as that is not the case, or superannuation is more lightly taxed than other forms of saving, there will need to be limits on contributions and/or balances to manage the revenue consequences. There have long been limits, which since 2007 have taken the form of limits on both concessional (pre-tax) and non-concessional (after-tax) contributions.

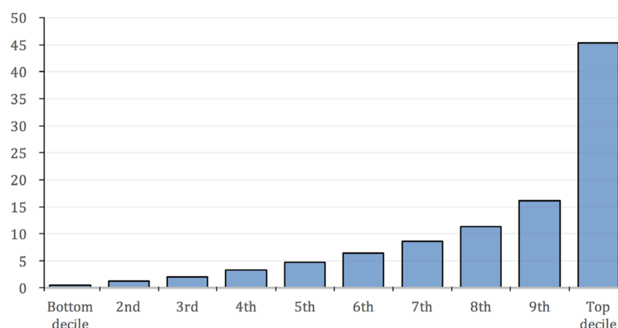
While proposing to tighten these limits the government has provided no reasoned case as to why the existing limits are inadequate, apart from vague appeals to 'fairness' and 'sustainability'. Indeed, the tightening of limits announced in the 2016 budget taken as a whole can only be described as draconian—particularly the reduction in non-concessional contributions from $540,000 *over three years* to $500,000 *over a lifetime*, and the balance cap of $1.6 million on a retirement fund free of the 15% earnings tax, whereas up to now there has been no such cap. (The 'retrospectivity' of these changes and the case for grandfathering are the subject of Terrence O'Brien's article in this issue.)

Figure 1: Percentage of total value of super tax concessions utilised by each decile, sorted by 2011-2012 taxable incomes



Source: *Financial System Inquiry: Final Report* (The Australian Government the Treasury, November 2014), p. 138.
Note: The value of the tax concessions are benchmarked against a comprehensive income tax and thus are subject to the criticisms above.

Figure 2: Net tax paid by taxable income decile, % of total, 2013-2014



Source: Australian Taxation Office, *Taxation Statistics 2013-14* (Commonwealth of Australia, 2016)..

While access limits can be justified in principle, their levels need to be actuarially based and allow flexibility in the mix and timing of individuals' concessional and non-concessional contributions, as different people will need to rely more heavily on one or the other depending on lifetime circumstances. The government claims that $1.6 million is sufficient to fund a superannuation pension four times the public age pension,[9] but this has been contested by others. For example, Ron Bewley estimates that a sum of $3.2 million would be needed to meet this standard for retirement at age 60.[10]

Also, the lifetime limit on non-concessional contributions appears far too low to accommodate those who need to rely heavily on this type of contribution to set up an adequate retirement fund. It seems also to have been forgotten by the government that non-concessional contributions are just that—they are made out of after-tax income. The only 'concession' is that the income from them is taxed at 15%.

All indications are that the government should go back to the drawing board to redefine the limits on contributions and balances in pension funds.

Simplicity

Simplicity is an important criterion in its own right. It is often overlooked that simplification was one of the objectives of the 2007 changes, which streamlined the contributions structure and limits, eliminated cumbersome reasonable benefit limits, and removed the necessity for beneficiaries over age 60 to distinguish between the sources of funds for superannuation payouts according to their original tax treatment. Elimination of tax on superannuation payouts to those over 60 cost little in revenue but achieved simplification.

Some of this simplification has been lost due to changes since 2007 and more of it is at risk from

the further changes now proposed. Adoption in 2012 of a two-tier (15% and 30%) rate structure for concessional contributions introduced a new complication. Single rate taxes on concessional contributions and fund earnings are the simplest for super funds to administer because it means they need no information about the tax status of members.

The proposed cap on pension funds will impose a new compliance burden on fund administrators, as there is currently no cap on individuals' superannuation balances. When individuals hold multiple accounts the pension components will need to be aggregated to ensure compliance with the cap. Defined benefit pensions will need to be actuarially converted to a lump sum equivalent for inclusion in the cap. The cap will also lead members with existing pension balances above $1.6 million to maintain separate accumulation and pension accounts whether or not they already do so.

The proposed lifetime cap on non-concessional contributions will require record keeping and aggregation across multiple accounts over many years. Against that, members will no longer need to comply with annual caps.

There will no doubt be unintended consequences to be identified and addressed in the process of consultation and legislative drafting.

The existing system is by no means simple, but the government's proposals will exacerbate complexity. It is not clear that this cost has been properly accounted for and is worth bearing in order to meet other objectives.

Conclusion

Since 2007 the superannuation tax regime has been based on the principle of concessional taxation of contributions and fund earnings, with no further tax taken once members begin to withdraw benefits from their fund. This concessional approach is justified by reference to tax policy principles, even if the exact architecture is not ideal.

However, the degree of concessionality has been eroded by past and proposed increases in contributions tax for higher income earners, and the scope for current and future participants to benefit from concessions has been severely curbed through past and proposed tightening of caps on contributions and the scope of tax-free pension fund earnings. These changes have been made in response to budget pressures and community pressures for greater 'fairness' in superannuation tax.

Fairness is a subjective concept, but what can be said objectively is that the overall tax/transfer system is highly redistributive without any further reshaping of superannuation taxes to mirror the progressive personal income tax. Moreover, there are significant simplification benefits in flat superannuation taxes. The recent and proposed changes are introducing new complexities to the system.

Balancing the budget is an important objective but in itself does not override the principle of concessionality for superannuation. Revenue constraints will always require limits on access to concessionality, but the tightening of access proposed by the government is draconian and little justification has been provided for the details. The government needs to go back to the drawing board, review its proposals, and produce a green paper for consultation, including the actuarial basis for revised proposals.

Endnotes

1 Michael Potter, *The Case Against Tax Increases in Australia: The Growing Burden,* Research Report 15 (Sydney: The Centre for Independent Studies, 2016).

2 Treasury, *Tax Expenditure Statement 2015* (The Australian Government the Treasury, 2016).

3 Ken Henry et al, *Australia's Future Tax System: Report to the Treasurer, December 2009, Part Two, Detailed Analysis, Volume 1* (Commonwealth of Australia, 2010), p. 12.

4 *Australia's Future Tax System Review, Retirement Income Consultation Paper, December 2008* (Commonwealth of Australia, 2008), p. 23.

5 Friedrich A. Hayek, *The Constitution of Liberty* (Chicago: University of Chicago Press, 1960).

6 Superannuation Charter Group, *A Super Charter: Fewer Changes, Better Outcomes,* Report to the Treasurer by the Charter Group (The Australian Government the Treasury, 2013), pp. 25-26.

7 Peter Whiteford, 'The Australian Tax-Transfer System: Architecture and Outcomes', *Economic Record* 86:275 (December 2010), pp. 528-544.

8 Ross Clare, *Mythbusting Superannuation Tax Concessions* (Sydney: ASFA Research and Resource Centre, August 2015), www.superannuation.asn.au

9 Budget 2016-2017, 'Budget Speech' (Commonwealth of Australia, 2016), http://www.budget.gov.au/2016-17/content/speech/html/speech.htm

10 Ron Bewley, *So How Much Should the Superannuation Cap Be?* (Woodhall Investment Research, 8 June 2016), www.woodhall.com.au