BUILDING A BETTER SUPER SYSTEM

Superannuation reform must focus on age pension savings, argues **Simon Cowan**

Both major parties took substantial superannuation reform packages to the recent federal election. Those packages, though they differed in mechanics, largely addressed the same issue: 'excessive' superannuation tax concessions being directed towards those on high incomes. Both parties proposed lowering the income cap at which additional tax is imposed on concessional contributions, both would impose tax on the wealthy in retirement mode, and both would boost low income contributions. The Coalition package went further, also capping non-concessional contributions and scrapping the transition to retirement provisions.

These measures largely reflected policy debate on superannuation, particularly from the left, for several years prior to the election. For example, during consultations on the 2015 tax white paper it was clear than many felt the transition to retirement provisions were being gamed by high income earners: although this scheme was intended to encourage retirees to continue working part time leading into retirement, the Productivity Commission found it was almost exclusively being accessed by those working full-time to minimise their tax.[1]

As almost all of the debate was over the tax revenue being lost, it is perhaps unsurprising that this was the focus of the major parties initiatives—even more so given the significant budget deficit. Nevertheless, it was an incorrect approach. In attempting to resolve the budgetary shortfall, policymakers ignored the far greater problem with the superannuation system: it is not relieving pressure on the age pension—the largest single federal government payment and the only viable reason for a compulsory superannuation system to exist in the first place.

Retirement, superannuation and savings

Before going any further it is crucial to understand what the superannuation system is, the context in which it operates, and why superannuation is different to other forms of savings.

Compulsory superannuation is one pillar of the Australian retirement system. Voluntary savings (which includes voluntary superannuation contributions) constitutes another, while the Age Pension is the third and last, though there is a very good case to consider the family home the fourth pillar.[2]

Superannuation is a compulsory deduction of 9.5% of pre-tax wages, which must be paid into a nominated superannuation fund that cannot be accessed until a certain age is reached. Generally contributions are taxed at 15%, though very low income earners and very high income earners have different rules, and there are caps on how much can be contributed each year. Earnings on money in the superannuation fund are taxed at 15% until retirement when earnings are tax free.

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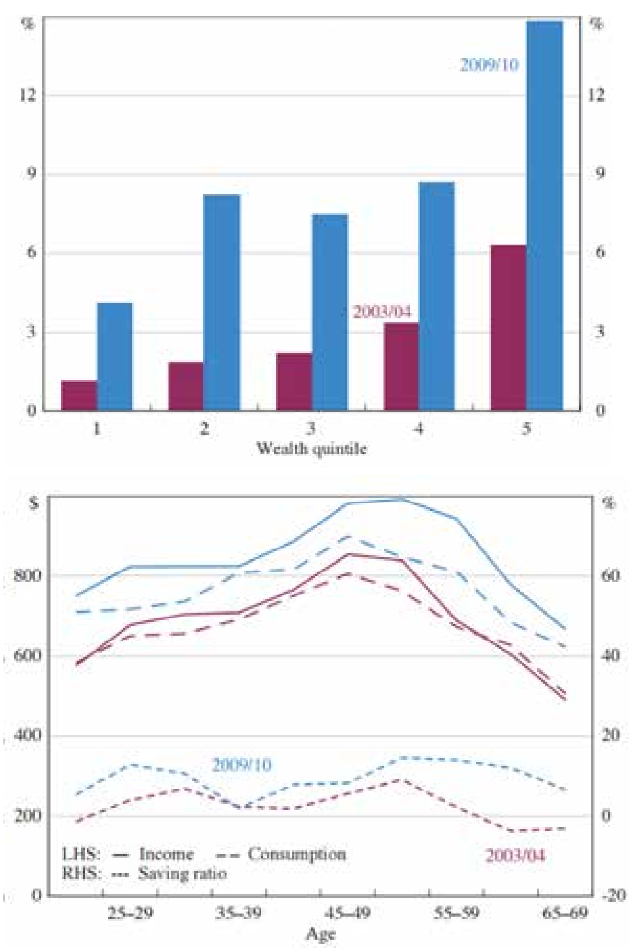
It should be immediately apparent how different superannuation is to other forms of savings. Superannuation is the only form of savings mandated by government and made from pre-tax dollars. Unlike other forms of saving, there are also differential rates of taxation based on income and age, laws governing access to the funds, and maximum limits on how much can be saved at tax advantaged rates. No other form of saving is as regulated as superannuation, nor is any other form of saving as tax advantaged as superannuation (except perhaps the family home).

Yet in many ways superannuation is a poor savings vehicle. The ratio of savings to consumption rises and falls over the life cycle: at the beginning of an individual's career savings rates are low, they rise in their late twenties and early thirties when saving for a home and children, fall around the age when households have young kids and then rise sharply until retirement.[3] Saving rates also vary by income and wealth: those with higher incomes and greater wealth save more while those with lower incomes save less and consume more.[4]

Figure 1: Savings ratios by wealth and age quintile



Source: Richard Finlay and Fiona Price, *Household Savings in Australia.*[5]

Therefore setting the superannuation guarantee at a constant rate, with an annual cap, doesn't match how households would choose to save and consume. Older households, high income households and those with broken work patterns may be prevented from saving more within the concessional superannuation system. While this is problematic, a greater problem is that low income households and families with young children are forced to save income they would otherwise use to boost their living standards.

There are several reasons why this matters. First, as women are far more likely to have broken work patterns than men, women tend to have much lower superannuation balances than men.[6] Thus the existing rules effectively disadvantage women.

Second, household savings may be directed away from other equally important preferences. Those in their twenties and early thirties may rationally choose to save more to buy a home and less for their retirement but are prevented by government from doing so.[7] A Reserve Bank estimate in 2004 found that almost 40 cents in every dollar of superannuation saved is actually offset by a reduction in other forms of savings.[8] A subsequent RBA estimate in 2007 found a lower effect at between 10 and 30 cents in the dollar.[9] Recent factors, such as the continuing economic uncertainty post the global financial crisis and flat income growth, may also impact this offset.

Third, the government provides substantial income support to groups forced to save income they would otherwise consume. A family of four with a single income earner on $75,000 a year pays $7,125 a year into superannuation but receives around $7,500 a year in family tax benefits alone.[10] The cost of these benefits, together with childcare payments and even some income support payments, amounts to potentially tens of billions of dollars. This cost should really be included with estimates of the total cost of the superannuation system but is never assessed as such.

Government interest in superannuation

There is a great deal of debate over the true cost of superannuation tax concessions and the proper benchmark to measure them against. Treasury provides three potential figures for the cost of concessional taxation of employer contributions and fund earnings. The most recent tax expenditure statement estimates that for 2015-2016 revenue forgone from concessional taxation of superannuation was $29.8 billion, while an alternative figure that estimates the revenue that could be gained by changing concessional taxation (which reflects potential behaviour changes) was $28.2 billion.[11] The third estimate of $12.9 billion for 2015-2016 was assessed in 2013 against an expenditure tax benchmark where contributions are taxed at marginal rates, but earnings and benefits are exempt from tax.[12]

While the exact cost is important—and disputable—for these purposes it is enough to note that the revenue forgone, and spending incurred on benefits that might otherwise not be needed, is well in excess of ten billion dollars a year.

As noted above, superannuation is singled out as a particular form of savings: it costs tens of billions of dollars a year, participation is mandated by government, and it is subject to reams of government regulation. The reasons why superannuation is singled out are important: if superannuation tax concessions are merely a model for the efficient taxation of savings, why are other forms of savings taxed so inefficiently? Understanding the reason for superannuation tax concessions takes us a long way to understanding the purpose (and flaws) of the system.

Government may have a legitimate role in boosting the living standards of society in retirement by encouraging saving. This rationale is poor, and if this role extends to essentially confiscating 10% of a person's pre-tax salary for 40 years it is also horribly paternalistic. Beyond this, why specify superannuation as the necessary savings vehicle? Superannuation is inflexible, and in some cases harmful given there are valid reasons for saving different amounts based on personal circumstances, income and age.

Other rationales equally fall away, such as claims that superannuation represents an increase in wages that would otherwise be paid. Paul Keating, who introduced compulsory superannuation in 1992, admitted that the costs were not borne by employers, instead coming from lower wages.[13] In effect superannuation offsets higher wages, meaning that the government forces people to accept lower living standards now in the hope of obtaining higher living standards in retirement.

Some have argued that government needs to compensate investors for locking away their money for an extended period of time.[14] This is a curious argument. It is true that financial institutions must offer higher rates of return in order to entice investors to lock away investments for longer; for example, the rate of interest on term deposit accounts exceeds that of at-call savings accounts. If the interest rate was the same on those accounts why lock your money away? However, there is no reason for this logic to extend to government. Government does not offer differential tax rates on other forms of saving based on term: the tax rate on term deposits and at-call accounts is exactly the same.

If superannuation is also needed to rectify under-saving either the age pension is an ineffective solution or it is an inefficient one.

Nor does government need to attract investors with beneficial rates, because superannuation is compulsory—which raises the additional point that this rationale does not even attempt to explain why superannuation is compulsory in the first place. If superannuation was not compulsory then superannuation funds would need to compete with other forms of savings by offering attractive rates of return, a fact that perhaps explains why current returns are not higher.

Some have claimed that superannuation is an attempt to rectify systemic under-saving for retirement.[15] While there is a question as to whether this phenomenon is real, more importantly a policy solution already exists for that problem, the age pension.[16] If superannuation is also needed to rectify under-saving either the age pension is an ineffective solution or it is an inefficient one: it is either inadequate or too expensive. We can dismiss inadequacy of the pension as a motivation for two reasons: first, evidence suggests the pension is not inadequate and second, inadequacy of the pension would in fact create a strong incentive to *over*-save for retirement and avoid poverty in old age.[17]

Therefore, the only legitimate motivation for government to mandate and preference superannuation to such an extent is to minimise the cost of the age pension. The existence of a government income support payment for those over 65 effectively shifts the cost of retirement onto the government, allowing retirees to under-save (or hold their net worth in non-productive ways such as owner-occupied housing). An adequate age pension is a significant disincentive to saving for retirement and a substantial cost to government, two factors which might warrant government intervention.

However the scale of that intervention must be in line with the increased cost of the age pension. If the superannuation system costs more than the age pension in its entirety, it is arguable that Australia would be better off abolishing superannuation (while cutting the family benefits made necessary by compulsory superannuation) and using the proceeds to meet additional age pension costs and reduce the tax burden on other forms of savings. In passing it should be noted that abolishing superannuation would neither justify making the age pension universal, nor stop people saving for retirement.

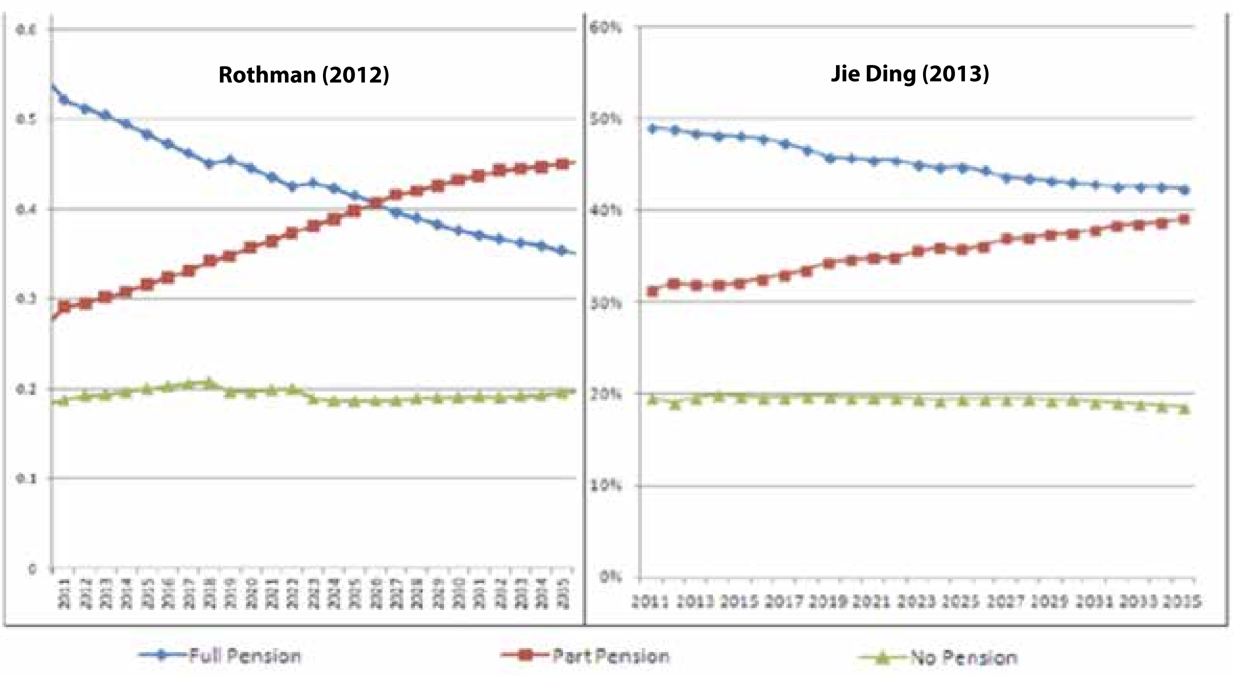
Impact of superannuation on age pension

The failure of the superannuation system is laid bare when considered in light of this objective. Treasury estimates cited in the 2009 Harmer Review of the Age Pension suggest that the maturation of the superannuation system will reduce pension expenditure by just 6%.[18]

The 2015 Intergenerational Report notes that 'the proportion of retirees receiving any pension is not projected to decline'.[19] As Figure 2 below shows, the primary impact of superannuation is to move people from a full pension to a part pension, and even then estimates vary of the effectiveness of superannuation in moving people onto the part pension.[20]

While these estimates do not take into account the changes to superannuation in the 2015 budget, which are expected to reduce pension eligibility over time, nor do they take into account

Figure 2: Proportion of retirees receiving full, part and no pension over time



Source: Jie Ding, *Superannuation Policies and Behavioural Effects: How Much Age Pension?*[21]

the trend for discretionary increases in age pension spending over time which may expand the eligible cohort. There have been three discretionary increases in the last 20 years: one to compensate pensioners for the introduction of the GST, a similar increase upon the introduction of the carbon tax (which was retained despite the abolition of the tax), and another in 2009 in response to the Harmer Review. Both in respect of the GST and the carbon tax, pensioners were over-compensated for potential impacts.

Indeed, though the percentage of retirees receiving an age pension fell as a result of the reintroduction of the assets component of the means test in the 1980s, thus far little evidence can be seen of the impact of 20 years of compulsory superannuation on the percentage of retirees receiving the age pension.

In part this is actually an issue with the design of the age pension, rather than superannuation, arising out of the massive expansion in pension eligibility criteria over the years. The assets test cut-off has increased from just under 12 times the full rate of the pension in 1911 to nearly 35 times the full rate of the pension today despite a sevenfold increase in that full rate.[23]

Yet superannuation is specifically designed to generate an income stream in retirement and, as such, should enable the government to tighten the means test. Instead superannuation is deemed to receive an artificially low rate of return, which effectively further expands eligibility.[24]

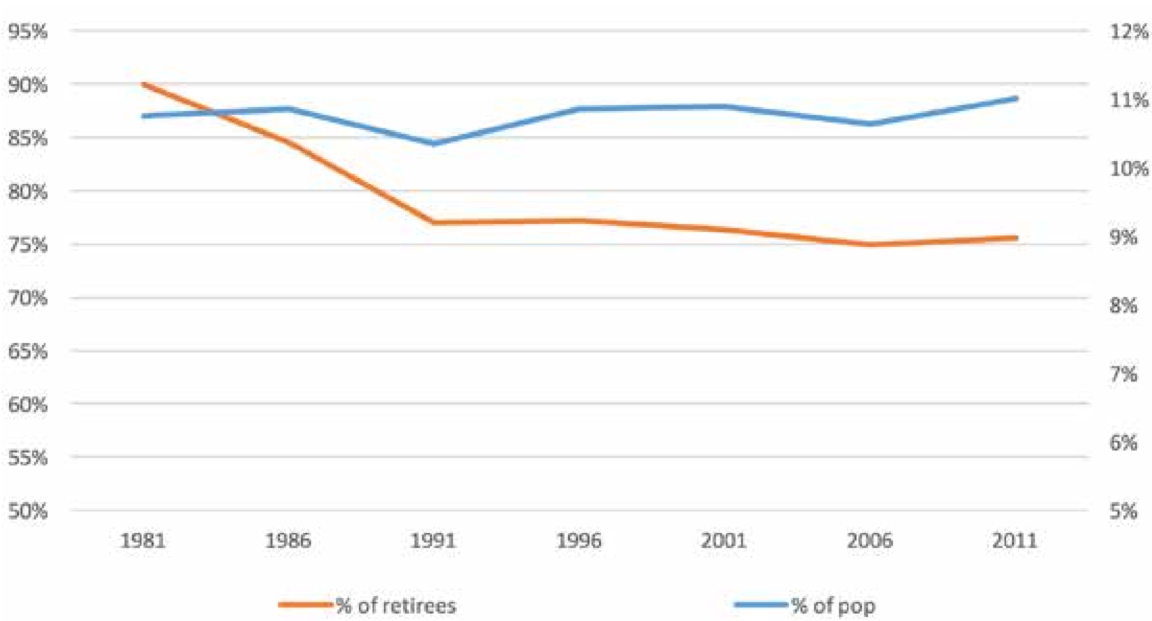
Given the relatively miniscule impact on the cost of the age pension that the multi-trillion dollar superannuation industry generates, it is hard to argue that the benefit to the taxpayer exceeds the tens of billions of dollars a year the system costs.

While the weight of decades of compulsory superannuation and trillions of dollars of investment may make abolition of superannuation an impossible proposition, at a minimum the incentives and benefits of the superannuation system should be redirected primarily at reducing the cost of the age pension.

How to construct a better superannuation system

In the first instance this means a shift away from focusing on income earned by contributors towards a focus on the superannuation balances they hold. The relevant issue for pension eligibility is the value of the asset (the balance) and the income generated

Figure 3: Pensioners as a percentage of retirees and general population



Sources: ABS Commonwealth Year Books 1982, 1988, 1992, 1997, 2002, 2007 and 2012.[22]

from that. Annual income in employment is relevant only if your objective is to raid superannuation for additional tax revenue. It has nothing to do with the performance of the system, or the goal of reducing pension expenditure.

With tax concessions determined by superannuation balances rather than incomes, there is no need for annual limits on contributions. The system is better off if a person with a moderate balance who can contribute $50,000 one year and $10,000 the next is allowed to do so, rather than being limited to $30,000 the first year, with $20,000 in unused cap space the next year.

Once someone has a balance sufficient to ensure they will never access the age pension, providing incentives through tax concessions is largely a waste of money. Indeed, if superannuation is about reducing pension expenditure there is no need for those people to be incentivised or compelled to contribute to superannuation at all.

When looking at the benefits that accrue to taxpayers it is important to realise there is a temporal component to an individual's pension entitlement. The fact that 30% of retirees are not eligible for the pension at any one time does not mean that 30% of retirees *never* receive a pension in their lives. Those who have just retired and have access to their superannuation may be above the pension eligibility threshold but over time superannuation balances will be diminished and pension eligibility will increase. The proportion of those aged 65-69 on the pension is just over 60%, while for those aged 75 and over it rises to nearly 75% (interestingly it is 80% for those aged 70 to 84).[25]

The impact of this increase in eligibility over time on total pension cost may be offset somewhat by the fact that some retirees will not outlive their superannuation. A simple comparison shows this: given that 95% of retirees are under 90 years of age and 70% of pensioners are under 80 years of age, a universal pension scheme covering those aged 65 to 85 would cost a lot more than a universal pension covering those aged 85 to 105.[26]

This suggests the marginal benefit to taxpayers of each additional dollar in superannuation declines beyond a certain threshold balance, particularly once the balance is sufficient to ensure that the retiree will only receive a part pension later in life. On that basis, the objective of superannuation policy should be to make as many people as possible independent of the pension for as long as they can, not to maximise the proportion of the population who are independent of the pension for their entire lives.

More specifically, while there is a benefit in encouraging those with moderately high balances to save towards longer independence, the largest potential benefit to taxpayers comes from getting those with relatively low balances up to a level where their pension eligibility is substantially reduced.

Concessions should be redirected from the top to the middle, but not to the bottom. There is no benefit to taxpayers in compelling people whose balances at retirement are so low that they are immediately eligible for a full pension to participate in the superannuation system. Indeed, as noted above, there is an additional cost in the form of income support payments and childcare benefits. This suggests that the income threshold for compulsory participation in superannuation should be raised, with those on very low incomes able not only to opt in (something those with greater expected lifetime incomes are more likely to do) but also to access what superannuation they do have to supplement or supplant reduced childcare and family tax benefits.

How it would work in practice

The principles above suggest that rather than one balance threshold, there should be at least two, preferably three, creating several different tiers each with differential tax rates.

Balance	Applicable tax rate		
	Contributions	Earnings - accumulation	Earnings - retirement
$0 to $300,000	0%	0%	0%
$300,001 to $800,000	10%	10%	10%
$800,001 to $1,800,000	20%	20%	20%
$1,800,001+	Marginal Rate	30%	30%

The levels of these thresholds reflect the relative benefit to taxpayers, not a specific lifestyle or income to retirees. They are set based on annuity values for certain key thresholds in the age pension means test. This is not an exact science, and some space is built into each level to allow for variations in returns etc.

It is worth noting the impact of deeming on the two limbs of the pension means test. Superannuation actually counts under both limbs of the pension means test—it is an asset for the purposes of the asset test and is deemed to generate income (the first $49,200 is deemed to get a return of 1.75% and the rest 3.25%) and so also applies under the income test. The asset test kicks in at a higher level, but reduces pension eligibility at a faster rate.

What this means is that the deemed income on superannuation will push a single pensioner onto a part pension with a superannuation balance just over $150,000 (despite the asset test thresholds from 2017 being $250,000 for homeowners and $450,000 for non-homeowners). However from around $300,000 for homeowners, and $550,000 for non-homeowners, pensions are reduced under the asset test rules, effectively rendering deeming irrelevant for balances above these amounts.

Therefore the lowest level (the superannuation 'tax free threshold') reflects a superannuation balance sufficient to deliver an annuity payment above the income test minimum from age 65 to age 90, with a remaining balance above the asset level sufficient to trigger the deemed income test of $150,000 (assuming a nominal return of 4.25%, with some allowance for increases in the income test thresholds over time). Basically, someone above this level is always on a part pension.

The limit of the second level represents roughly an amount that would deliver an annuity equivalent to a full pension from age 65 to age 90, while ending up with a balance above the first level (also assuming a nominal return of 4.25% and allowing for an increase in pension payments over time). Importantly for the overall cost of the system, this level could be raised or lowered to make the scheme revenue neutral.

The third and final limit (assuming again a nominal return of 4.25%, allowing for an increase in payments over time and a buffer for unexpected outcomes) represents an amount that would:

1. deliver an income above the upper limit of the pension income test from age 65 to age 90

2. leave a sufficient balance to remain ineligible for the pension under the asset test limits

Beyond this point there is little, if any, benefit to taxpayers in terms of reduced pension payments from additional superannuation contributions. It is also more than three times the expected balance at retirement of someone working full-time on average wages.[27] From $1.8 million onwards, concessions are minimised and further contributions to superannuation would be entirely voluntary.

Conclusion

For the majority of people this scheme should result in a net reduction in tax paid over their lifetime. Until their superannuation balances reached $300,000 (and once they fell below it in retirement) they would pay no tax. Even for those with balances of $300,000 to $800,000 their tax would be lower than it is currently on contributions and earnings in accumulation (with a corresponding tax increase in retirement). This would be funded by increasing taxes on those with higher balances, who would at least be free from the requirement of contributing to superannuation and therefore effectively receiving higher wages.

These reforms rightfully focus superannuation tax concessions not on generating additional revenue nor as a tax shelter for the rich but on ensuring the age pension remains sustainable in the face of a rapidly ageing population. Grandfathering and transitional arrangements could ensure than those who have already made their retirement plans would be protected from substantial adverse change.

The percentage of tax concessions received by the 'rich' may still be high, but the concessions would properly reflect the benefit to taxpayers of reduced pension payments. Importantly those on middle incomes would see an increased benefit for much of their working lives, which should lead to greater numbers being independent of the pension during the early stages of their retirement.

This scheme should be combined with another pension eligibility reform: including the family home in the pension means test. The savings from this reform (which we have estimated at nearly $15 billion a year) could be channelled into superannuation reforms such as the ones above.[28] This would effectively encourage retirees to hold more cash in superannuation (which generates an income) and less in their home. These twin reform streams should mean that many more people would enjoy higher living standards in retirement, while ensuring that the pension is a sustainable safety net for those who can't take care of themselves.

The debate over superannuation has focused far too much on the tax and revenue implications of superannuation policy at the expense of the primary purpose of the system: income in retirement. Both sides of politics should reassess their superannuation reforms with this in mind. This would result in a very different set of reforms than those being debated right now.

Endnotes

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