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CURRENT TAX AND TRANSFER SETTINGS DO NOT ACHIEVE RETIREMENT SECURITY

SUBMISSION

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Industry Super Australia

ABOUT INDUSTRY SUPER AUSTRALIA

Industry Super Australia undertakes collective projects on behalf of a number of industry super funds with the objective of maximising the retirement benefits of over five million industry super members. Please direct questions and comments to:

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KEY POINTS

- Superannuation tax concessions and the age pension are the fiscal policy tools that, in combination, support the retirement security of Australians.

- Superannuation and the age pension should, together, seek to provide a comfortable living standard to Australians in retirement.

- Existing tax and transfer settings in respect of retirement security are falling short of this objective.
  - The majority of Australians currently aged 65-69 will not have retirement incomes that enable a comfortable standard of living.
  - As superannuation matures, outcomes will improve, but not enough. About half of younger Australians currently aged 25-29 will not have retirement incomes that enable a comfortable standard of living.
  - The retirement system is badly failing single women. Three out of every four single women currently aged 65-69 will not have retirement incomes that enable a comfortable standard of living. For single women currently aged 25-29, over half will not have retirement incomes that enable a comfortable standard of living.
- Poorly targeted superannuation tax concessions are part of the problem. Superannuation tax concessions are inefficient, supercharging the wealth and incomes of persons with significant means, while offering relatively little support and weak incentives to save to those who will not retire comfortably.

- As currently structured, superannuation tax concessions more than double the superannuation retirement income of the wealthiest Australians, while only lifting retirement incomes from superannuation for middle income earners by a third, and perversely *cutting* the superannuation income of the poorest by 14 per cent.

- This misallocation which sees the greatest concessions directed at those who will never likely access the age pension results in an opportunity cost to improve retirement outcomes for those who wouldn't otherwise retire comfortably, and to reduce fiscal outlays on the age pension.

- Even when combined with the age pension, superannuation tax concessions do not efficiently support broad retirement security because they are not well targeted.

- This submission's principal recommendation is that reform of Australia's retirement income policy settings is urgent and should be considered in a dedicated bipartisan retirement income review that can consider settings in an integrated way and recommend adjustments to tax, age pension, and regulatory settings to deliver optimal outcomes consistent with the system's objectives.

EXECUTIVE SUMMARY

This submission has three parts: (1) a discussion of the efficiency and effectiveness of existing tax settings in relation to the existing retirement security system, (2) empirical observations about tax and the economy that challenge certain assumptions in the Tax Discussion Paper, and (3) responses to selected questions presented in the Tax Discussion Paper.

Tax and the retirement system

Australia has experienced rising living standards and an improving quality of life for a long time. Consistent with this, Australian aspirations include a retirement that, at a minimum, is secure and provides a reasonably comfortable standard of living. This submission assesses whether Commonwealth policy is delivering on this objective by efficiently supporting the ability of Australians to have a comfortable retirement, drawing on cutting-edge multigenerational, whole-of-population retirement income modelling. We have used the comfortable retirement income standard prepared by the Australian Superannuation Funds Association (ASFA) as a benchmark.[1]

Fiscal policy – Government taxes and transfers – has an important role to play in delivering on this social objective. There are two integrated levers of fiscal policy that are used to deliver retirement security (i) age pension outlays and (ii) superannuation tax concession expenditure. Superannuation tax concessions help Australians save during their careers to achieve retirement security and a comfortable income. Age pension payments help bridge the gap when savings are insufficient to generate a reasonable income, whether that is due to lower wages, or efforts in areas that do not result in paid compensation, such as caregiving.

Although public policy has an important role to play ensuring all Australians enjoy a secure, reasonable and comfortable retirement, policy need not support lifestyles in retirement beyond a reasonable standard, nor support the accumulation of wealthy estates across generations.

The Commonwealth allocates significant fiscal resources to retirement security, but the outcomes are not adequate today, and will not be adequate in the future under existing policy settings.

- Under existing policy settings, almost half of Australians will not receive enough income in retirement to have a comfortable standard of living. For Australians retiring between now and 2055, half of single men, two out of every three single women, and 45 per cent of couples will retire below this reasonable standard.

Even with workers receiving 12 per cent compulsory superannuation for most of their working lives, the retirement that millions of the Australian people experience will not match the expectations of the community.

Why is public policy underperforming, and what can we do better?

One problem is well-known: superannuation tax concessions are poorly targeted. Whilst it is reasonable for Government to provide all income earners with tax concessions to compensate for the deferral of consumption required by mandatory super savings, these concessions are not well-structured.

[1] The current ASFA comfortable standard is $58,444 of combined annual income for a couple, and $42,569 of annual income for singles.

Greater levels of Government support flow to those whose retirement will be above a comfortable standard than to those who will be below it. Over 35 per cent of superannuation tax concessions are allocated to the top ten per cent of income earners. The concessions, and greatest incentives to save, flow to those whose retirement will be well above a comfortable standard and are unlikely to require the age pension. Whilst it is entirely legitimate for individuals to aspire to as affluent a retirement as they wish, there is no need for Government to underwrite what is more than comfortable.

In addition, many low income earners, including many women, actually pay more tax on their superannuation savings (both contributions and earnings) than on their ordinary income. This gives rise to the perverse outcome that tax settings actually reduce their retirement savings.

Existing tax and transfer settings will leave many Australians without enough, yet offer extraordinary support to a privileged few to accrue wealth well in excess of that required to live very comfortably.

- Couples in the top 1% retiring in 2055 (currently aged 25-29) will have incomes of over $600,000 per year. This is more than nine times higher than the incomes that couples in the bottom decile will receive. This disparity in income is much larger than current income inequality in Australia, where the top decile has incomes about 5.75 times higher than the bottom decile.
- Over $5 million of lifetime Government support (by way of superannuation tax concessions) will be provided to couples in the top 1 per cent income decile retiring in 2055.
- The bottom decile of couples currently aged 25-29 will pay extra tax of about $75,000; superannuation involves a tax charge for these individuals, not a concession.
- Factoring in the age pension doesn't address the disparity in government support. Each member of a couple currently aged 25-29 in the bottom decile is projected to receive around $840,000 in total support through to life expectancy. This outcome sees the top 1 per cent still obtain three times the level of government support received by the bottom decile, giving no regard to the very different marginal utility or value of those benefits to the recipients.

Tax and transfer settings are not achieving their social policy objective and they are inefficient.

However, success is within reach. Total Commonwealth expenditure on retirement security is low by OECD standards. Age pension outlays are projected to be around 3 per cent of GDP in 2055;[2] and superannuation tax concession expenditure an additional 3 per cent. Aggregate Commonwealth support does not necessarily need to increase in order for all Australians to live comfortably in retirement; the Commonwealth simply has to allocate its resources more efficiently.

Tax, the economy, and wellbeing

ISA is dedicated to ensuring that public policy supports the wellbeing of Industry SuperFund members in retirement. As the custodians of the retirement savings of millions of Australians, Industry SuperFunds have a significant interest in the efficient functioning of the Australian economy, financial system, and investment environment.

The Tax Discussion Paper includes certain observations and assumptions about the interaction between tax and the economy that are open to challenge. For example, the Discussion Paper generally describes tax as a means of "raising revenue to fund public services." Tax need not do this, and often does other than this.

Certainly Government pays for or directly provides goods and services, from education, to health care, to common defence, consistent with Australian values of fairness, equality, equity, dignity, and the common good. While Government pays for or provides some goods and services, it also uses taxation to encourage, discourage, or withdraw private sector capacity to provide some goods and services.

[2] This estimate is around 0.5 per cent of GDP less than projections in the 2015 Intergenerational Report due to, among other things, the use of more realistic assumptions about the drawdown of superannuation savings, as discussed in Section 4.

Government fiscal policy, to an even greater degree than monetary policy, has the potential to substantially determine the supply and demand for specific goods and services, as well as aggregate demand, employment, and capacity utilisation.

If expenditure is very low or poorly targeted, community expectations of public services will not be met. However, if expenditure or direct provision is excessively high, it may exceed the productive capacity of the economy and generate inflation, or leave too little productive capacity for private endeavours by the community.

If taxation is very low or poorly targeted, economic and other forms of power could be too consolidated, increasing income inequality, weakening aggregate demand and undermining the role of government. However, if taxation is excessively high, too little expenditure power will be available for private endeavours. If taxation is excessively high and also poorly targeted and designed, some individuals may seek to exploit design flaws through tax arbitrage.

For these reasons, as will be discussed in more detail in Section 2 of this submission, analysis of tax, especially matters such as company tax and tax on savings, should consider not just revenue collection and investment incentives, but a broad range of factors.

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1. Assessment of existing tax settings in respect of retirement security

The retirement income that a person receives is affected in a direct way by three major public policy levers:

- tax and transfer settings,
- superannuation market regulation (for example, the way in which workplace default funds are selected affects the incentives and quality of the superannuation fund to which a person is a member), and
- superannuation product regulation (for example, regulation that enables innovative approaches such as collective defined contribution plans and group self-annuitisation can support higher and more stable incomes in retirement).

This submission will focus on tax settings in respect of retirement security.

Tax concessions are provided for a reason. Superannuation tax concessions are provided to support the social policy objectives of the superannuation system.

Superannuation exists to provide retirement benefits. Specifically, ISA's view is that the objective of the superannuation system, in conjunction with the age pension, is to deliver a comfortable retirement to all Australians. This is a clear, measurable goal.

Superannuation tax concessions should be provided consistent with this objective. Superannuation tax concessions are not for bequests or wealth accumulation.

In determining what is an objectively[3] "comfortable retirement" standard, we have used the comfortable retirement income benchmark prepared by ASFA.[4] This is consistent with other research assessing the adequacy of retirement incomes in Australia.[5]

Assessing superannuation tax concessions against this benchmark involves analysing whether (i) they are achieving their purpose (i.e., whether retirement incomes for all Australians are sufficient to have a comfortable standard of living in retirement) and (ii) doing so efficiently.

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[3] We have used an *objective* benchmark for "comfortable" because Government's obligations to citizens should reflect reasonable or community standards. An additional reason we have not used a *subjective* benchmark, such as replacement rates, is because this approach to measuring adequacy is regressive and would call for greater Government support to flow to the well-off. For example, if the retirement system sought to ensure retirees achieved replacement rates of 50% of pre-retirement income to two individuals, one who had $200,000 of income, and one who had $50,000 of income, holding all else even, the Government support to the higher income earner would be four times that to the lower income earner: $100,000 and $25,000, respectively.

[4] ASFA characterises its "comfortable" standard as a budget that enables "an older, healthy retiree to be involved in a broad range of leisure and recreational activities and to have a good standard of living through the purchase of such things as; household goods, private health insurance, a reasonable car, good clothes, a range of electronic equipment, and domestic and occasionally international holiday travel." The standard assumes that the retiree owns their home.

The current value of the ASFA comfortable standard is $58,444 of combined annual income for a couple, and $42,569 of annual income for singles. For projections, we have indexed this amount to wages growth, estimated to be 4% nominal.

[5] See, e.g., Burnett et al., Measuring Adequacy of Retirement Savings, Melbourne Institute Working Paper Series, No. 5/14, 2014.

Section 1.1 of this submission assesses the adequacy of retirement incomes under existing policy settings. We review the projected retirement incomes of single men, single women, and couples aged 25 to 69 by income decile, to determine whether such incomes will be sufficient to support a comfortable standard of living in old age. Our analysis looks at the living standard Australians will have based on all sources of retirement income: the age pension, superannuation, and private wealth.

Section 1.2 assesses the efficiency of government support for retirement incomes by analysing lifetime aggregate government direct and indirect expenditure support (age pension and superannuation tax concessions) by decile for single men, single women, and couples aged 25 to 69.

To provide these analyses, ISA and Rice Warner have constructed a detailed group-based integrated population, retirement income, and fiscal model, which we have benchmarked against publicly available Treasury analysis and projections. Section 4 discusses the structure and capability of the model, including assumptions. Importantly, the methodology used to analyse tax concessions addresses many existing shortcomings that unnecessarily cloud public debate.

While the existing ISA-Rice Warner model has superior capability to any other in the private sector, the collaboration between ISA-Rice Warner on model development is ongoing. When finalised, the model will provide cohort population at the percentile level rather than deciles, include stochastic variables where appropriate, industry segment overlays, and other refinements.

ISA and Industry SuperFunds have determined that public policy should no longer be able to be proposed without a comprehensive understanding of how it is likely to affect the wellbeing of all Australians over the long term.

1.1 Adequacy: In the long term, about half of Australians, and the majority of single women, will not retire comfortably under existing policy

Key points

- Many Australians will retire on incomes below a comfortable standard. For all Australians retiring from now through 2055, about half will not achieve a comfortable retirement, taking into account age pension, superannuation income, and income from wealth outside of superannuation.
- The living standards of retirees improve as the superannuation system matures. Notwithstanding this improvement, many Australians will still retire below a comfortable living standard. Around 45 per cent of Australians who are currently aged 25-29 will not have incomes sufficient to support a comfortable standard of living in retirement.
- The retirement system is badly failing single women. Over two thirds of single women aged 55-69 will retire on incomes below a comfortable standard. Even younger women face a difficult future. More than half of women currently aged 25-29 will retire on incomes below a comfortable standard.

Discussion

The existing retirement incomes system is not delivering a comfortable retirement income to most retired Australians, nor are outcomes improving as well as expected as the superannuation system matures.

Table 1 shows the percentage of single males, single females, and couples retiring in 2015 through 2055 that achieve an objectively comfortable retirement under existing policy settings.

Of near term retirees, people currently aged 65-69, about two out of every three will have incomes insufficient to achieve a comfortable living standard.

This improves over the long term, but not enough. For younger Australians, currently aged 25-29, just under half will still retire on incomes below a comfortable benchmark.

Policy change will be required if all Australians are to realise the community expectation of a comfortable living standard in retirement.

Table 1 - % of retires achieving comfortable benchmark

Group	Retiring in				Average all years
	2015 (age 65-69)	2025 (age 55-59)	2035 (age 45-49)	2055 (age 25-29)	
Single Males	35%	47%	55%	51%	50%
Single Females	24%	29%	37%	44%	37%
Couples (per person)	37%	46%	59%	59%	55%

Source: ISA-Rice Warner modelling

In the aggregate, public policy will not deliver community expectations of a comfortable retirement.

However, understanding these disappointing high level outcomes requires digging deeper into:

(i) The *dynamics* of retirement incomes over time, starting with retirees in the near term (retiring in 2015) and looking out to cohorts retiring in the long term (2055), as this provides insight into the challenges to retirees in the near term and separates short term system challenges from long term system challenges, so public policy can be trained on both in a targeted way.

(ii) The *distribution and sources* of retirement incomes across income deciles as this provides insight into whether increasing incomes is resulting in increasing wellbeing,[6] and because it gives insight into the appropriate long term public policy response.

It is important to support the long term objective of delivering a comfortable retirement to all Australians, while not losing sight of the many millions of Australians who are currently retired and who will retire in the coming decades.

1.1.1 Dynamics of retirement income adequacy over time

The capacity of public policy in respect of superannuation – a funded long term retirement savings and income policy – to uplift retirement security to current retirees and those who will retire in the next decade or so is limited. For these retirees, the level of income provided by, and the eligibility to receive, the age pension is the primary public policy tool. (This does not mean that the age pension is not important to retirees in the long term; the age pension remains a material factor for the majority of individuals retiring in 2055, as shown in Figures 3 through 5 below.)

Overall, a mature superannuation system, with a 12 per cent Superannuation Guarantee for most of a working life, means about 20 per cent more retirees have a comfortable standard of living.

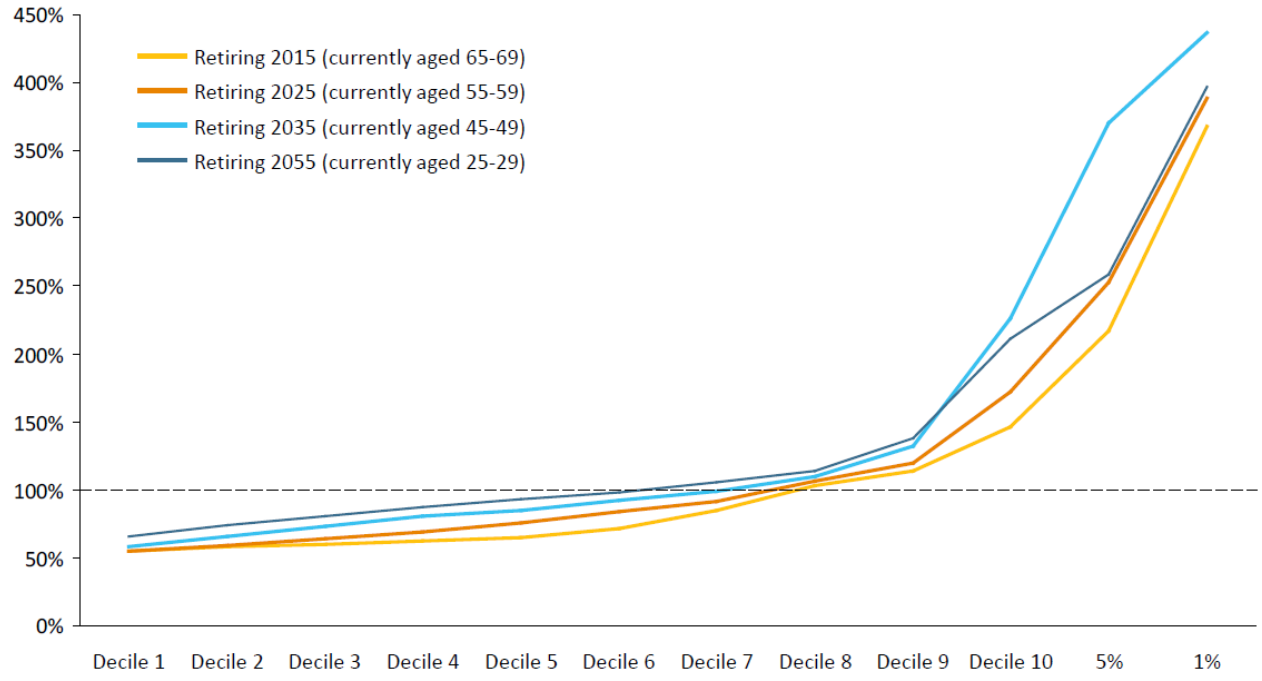
[6] Stiglitz, Sen and Fitoussi, Commission on the Measurement of Economic Performance and Social Progress, 2009 (observing that "If average income is increasing but at the same time inequality is increasing, it is not clear whether societal well-being is increasing or decreasing.")

To show the effects on retirement adequacy of existing policy settings over time, we have compared the retirement income using all income sources (age pension, superannuation, and private wealth) to a comfortable benchmark for single males, single females, and couples in each income decile that retire in 2015, 2025, 2035 and 2055.

Figure 1 shows the percentage of a comfortable retirement income that single females will receive. For single women currently aged 25-29, only 20 per cent (those in the 8th income decile and above) will have retirement incomes at or above a comfortable standard. Incomes for those in the bottom two deciles are only about half the comfortable standard. The shape of this graph for single males is very similar.

The difference in adequacy between deciles is striking and persistent. For single women going into retirement in the coming decades, the majority will not achieve a comfortable standard, but the top 10 per cent, and particularly the top five per cent and one per cent will receive incomes around three to four times the standard.

Figure 1 – Retirement income as a % of comfortable standard, single females



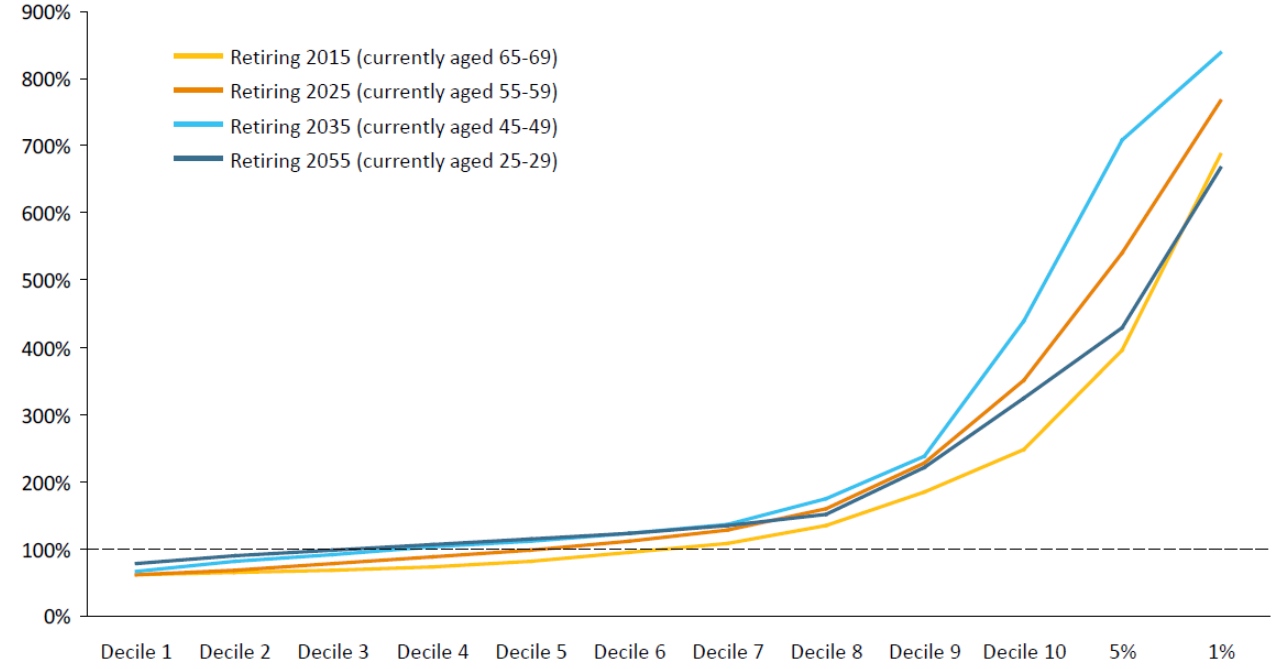
Source: ISA-Rice Warner modelling

The majority of Australians (three out of every four) retire as couples, and Figure 2 shows the retirement incomes to be received by this largest cohort as a percentage of a comfortable retirement income. While couples fare better than single men and single women, it is still the case that a majority of retirees in 2015 and 2025 are projected to receive retirement incomes below a comfortable standard.

30 per cent of younger couples, currently aged 25-29, will not achieve a comfortable standard under existing policy settings.

Once again, there are striking and persistent differences in income adequacy between deciles. For couples going into retirement in the coming decades, 40 per cent will not achieve a comfortable standard, but the top 10 per cent, and particularly the top five per cent and one per cent will achieve incomes around seven or eight times the standard.

Figure 2 – Retirement income as a % of comfortable standard, couples by income decile



Source: ISA-Rice Warner modelling

The above graphs show some of the relativity of retirement incomes, including that the top income earners are well above comfortable, while the majority are below.

We explore these distributional and equity issues more closely in the following section.

1.1.2 Distribution and sources of retirement income

Key points

- Distributional analysis shows a wide chasm in retirement incomes between the bottom income earners and the top. This has profound implications for wellbeing. The difference between rich and poor in retirement will be greater than the current variance in incomes during working life. Currently, the top decile of income earners has income about 5.75 times higher than the income of the bottom decile.[7] Our analysis of retirement incomes indicates that the top decile of couples retiring in 2055 will have income almost ten times higher than the income of couples in the bottom decile.
- For policymakers looking carefully at whether the age pension and superannuation, combined, will deliver a comfortable retirement, the unfortunate conclusion is that it will not. For single males, only those in the top 10 per cent have sufficient super and age pension to meet the standard. Only the top five per cent of single women have sufficient super and age pension. Couples fare better: deciles eight nine and 10 have sufficient super and age pension to achieve a comfortable retirement income.
- The age pension is an important component of retirement income for most people. For younger Australians aged 25-29, assisted by a reasonably mature superannuation system, a majority will still

[7] See, e.g., ABS Gross weekly equivalised cash income of households, ABS Cat No. 4363.0.55.001, Appendix 5, Deciles for Income Items (2011-13).

need the age pension to achieve a comfortable retirement. For single males aged 25-29, the age pension contributes more than superannuation to retirement income through the 5th decile; and a part pension is received into the 9th decile.

- The age pension is particularly important to women. For single women, the age pension contributes more than superannuation to retirement income through the 7th decile; and a part pension is received into the 10th decile. This is because women earn a lot less than men; women in the 5th decile of female income earners would roughly fall in the 3rd decile of single male income earners.
- Although most age pension payments are made to those who would not otherwise have income sufficient to support a comfortable standard of living in retirement, some age pension payments are made to individuals that are above a comfortable standard.

Discussion

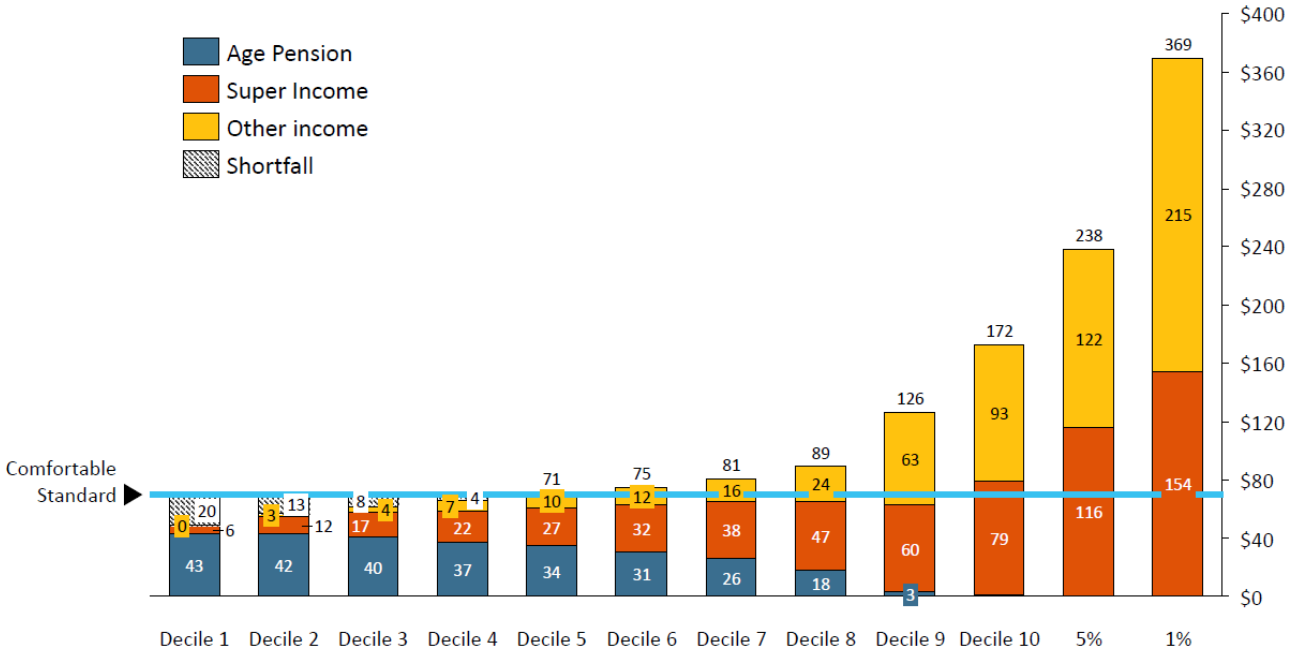
Figure 3, Figure 4, and Figure 5 below show the distribution of annual retirement income by decile. Specifically, these figures show the projected annual retirement income for males, females, and couples, retiring in 2055 (currently aged 25-29), arising from the age pension, superannuation, and wealth outside superannuation.

We have included only cohorts retiring in 2055 to focus the analysis on the distribution and sources of retirement income.

For single males (Figure 3), 40 per cent of this group will not achieve a comfortable retirement, even drawing on all sources of income. Single men in deciles five to eight just exceed a comfortable retirement due to private wealth, not super and the age pension. In contrast, the top one per cent will receive annual retirement income of over $350,000.

The age pension is vital to younger men, contributing materially to incomes through the 8th decile.

Figure 3 – Annual retirement incomes, single males, retiring at 2055, 2015 prices, by income decile, $000's



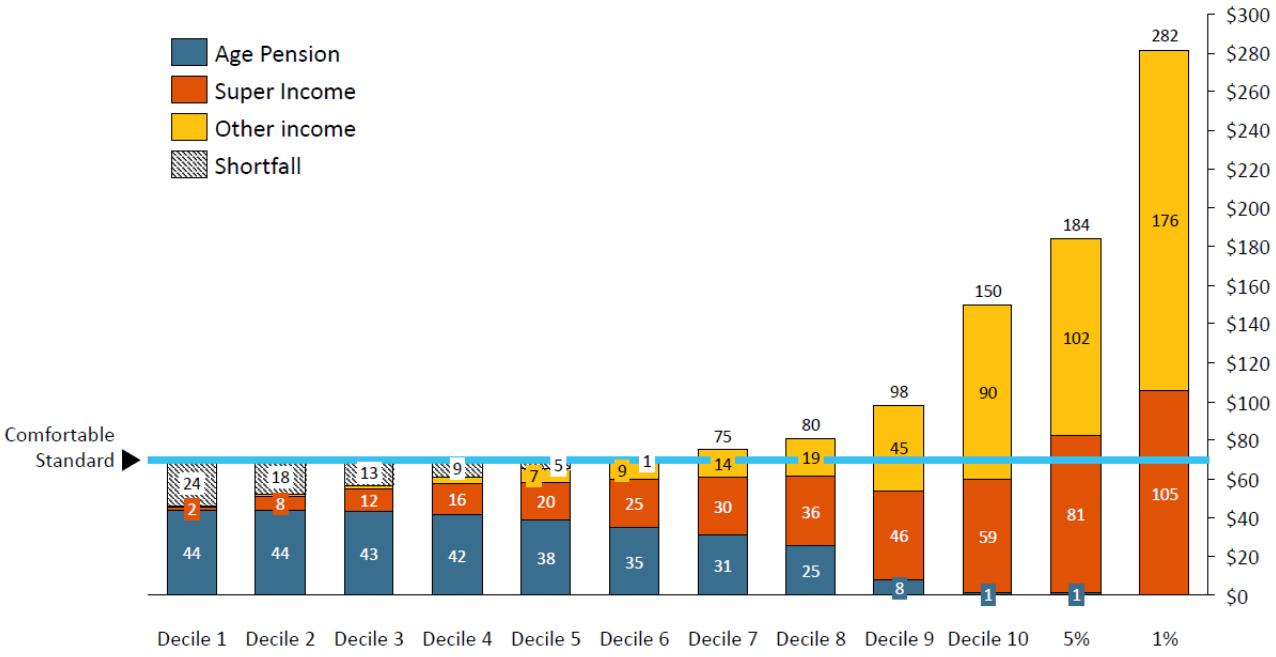
Source: ISA-Rice Warner

For single women (Figure 4), the shape of the graph is similar, but about 60 per cent of this group will not achieve a comfortable retirement. The top one per cent of women, however, each will have an annual retirement income of around $280,000.

Due to the lower wages paid to women, the power of superannuation is less than for men: only the top 5 per cent of single female income earners will have enough income from super alone to support a comfortable retirement.

The age pension is vital for younger women, contributing materially to incomes through the 9th decile.

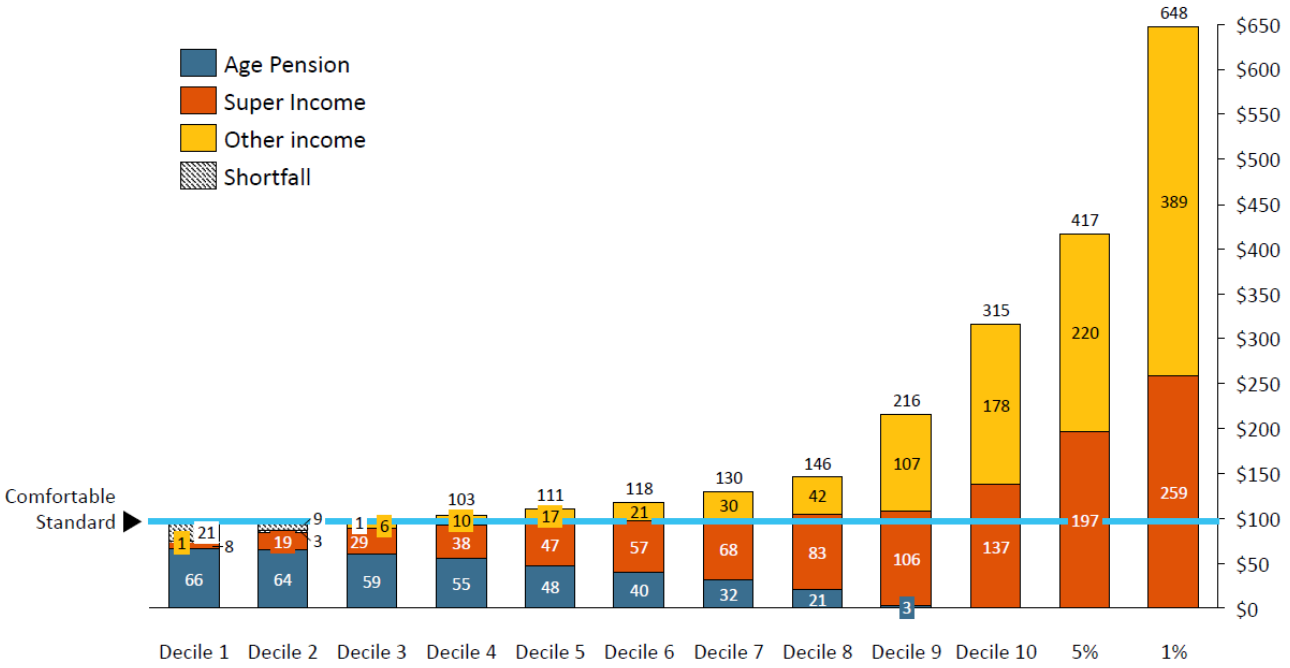
Figure 4 – Annual retirement incomes, single females, retiring at 2055, 2015 prices, by income decile, $000's



Source: Source: ISA-Rice Warner modelling

The majority of Australians retire as couples, and Figure 5 shows the retirement incomes of couples currently aged 25-29 (retiring in 2055). About 30 per cent of couples retiring in 2055 will have incomes below a comfortable standard. The top one per cent of couples, however, will have annual retirement income of well over $600,000.

Figure 5 – Annual retirement incomes, couples, retiring at 2055, 2015 prices, by income decile, $000's



Source: ISA-Rice Warner modelling

Almost half of the population will not achieve a comfortable retirement under existing policy settings, even when the superannuation system is mature.

Moreover, the distribution of incomes varies widely. The top one per cent of couples will receive over nine times the income of the bottom decile of couples, notwithstanding the age pension. This wide variation in income appears to be more extreme than differences in income during working life, and does not accord with Australian social norms.[8]

1.2 Efficiency: Tax concessions are poorly targeted, and contribute to the suboptimal performance of the retirement system

Key points

- While there is disagreement about how to best measure superannuation tax concessions, they unambiguously benefit those on higher incomes (regardless of how they are measured).
- The analysis presented here avoids shortcomings of Treasury's comprehensive income tax benchmark approach to measuring superannuation tax concessions by simply comparing the retirement income derived from an identical portfolio of assets inside the superannuation system compared to holding such assets as an individual taxpayer.

[8] See, Andrew Leigh, What do Australians think about equality?, Inside Story, 4 July 2013 (discussing research by Harvard Business School and Empirica Research finding that a majority of Australians would prefer a society that is more egalitarian).

- Using a simple point in time estimate, currently about 35 per cent of superannuation tax concessions are allocated to the top decile of income earners. This remains substantially the same in a mature system: about 36 per cent of superannuation tax concessions are allocated to the top decile of income earners retiring in 2055.[9]
- The value of these concessions is significant. For example, single males in the top one per cent will receive total lifetime tax concessions of a staggering $2.8 million per person.
- For the top one per cent, superannuation tax concessions more than double their retirement income and residual capital for bequest.
- Superannuation tax concessions also disproportionately benefit men rather than women. Because most high income earners are men, the majority of the tax concessions flow to them.
- Although high income earners benefit significantly from tax concessions, many low income earners are detrimentally affected. Individuals in the bottom decile pay more tax on their superannuation savings than they do on ordinary income. Instead of a tax break, they suffer a tax impost.
- The tax penalty experienced by the bottom decile is significant. For single males, they pay about $45,000 more in taxes on their superannuation savings than if those savings were taken as ordinary income and saved directly. This amount is about three years of wages for income earners in the bottom decile.

Discussion

Tax concessions within superannuation can powerfully affect retirement outcomes. For most, but not all, Australians, the concessional tax treatment of superannuation allows a higher level of savings to be accrued and subsequently consumed than if equivalent assets were held directly. ISA believes the difference in retirement income (and residual capital) between these environments is the true value of the tax concessions.

Treasury analysis has long made clear that superannuation tax concessions disproportionately benefit people on higher incomes. Moreover, many people on low incomes actually pay more tax on their wage income that is contributed into super, and more on their earnings in super, than their ordinary income.

Typically, tax concessions should benefit those who need the assistance. Superannuation tax concessions perversely do the opposite.

As a result, the recent Financial System Inquiry concluded that "Tax concessions in the superannuation system are not well targeted at improving retirement incomes."[10] The Treasury analysis shows that the top 20 per cent of income earners received the majority of superannuation tax concessions.

ISA and Rice Warner modelled the distribution of tax concessions in 2015 (Figure 6).

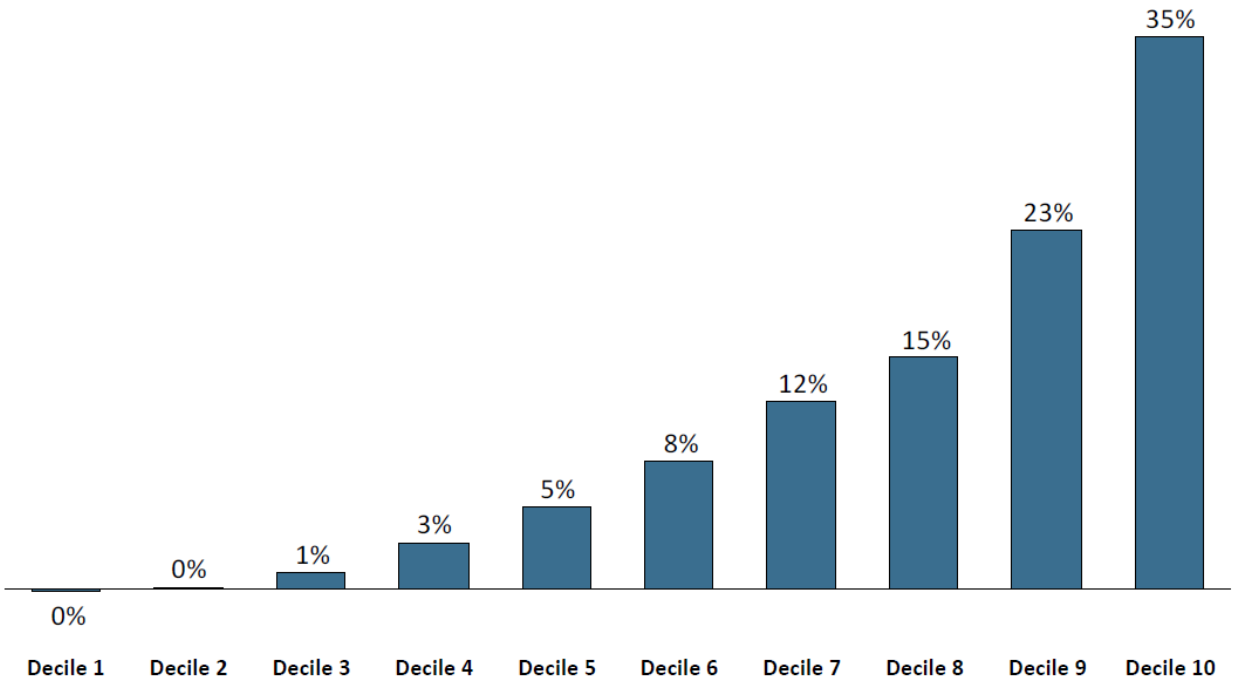
We also analysed the nature of concessions in a mature system by examining the concessions received by single males, single females, and couples retiring in 2055, delineated into income deciles, the top five per cent and the top one per cent, for each of these groups.

[9] We note that the method by which superannuation tax concessions differs from the method employed by Treasury. These differences are discussed in detail in Section 4. The methodology will result in different valuations of the tax concessions, but should not affect the relative distribution or percentage of such values across the distribution. As a result, our estimated share of tax concessions to the top decile is essentially similar to Treasury's.

[10] Financial System Inquiry, Final Report at 90

In both instances, our analysis accords with the Financial System Inquiry's characterisation of the superannuation tax concessions as being poorly targeted.

Figure 6 – Share of total superannuation tax concessions by income decile, 2015



Source: ISA-Rice Warner modelling

The long term projections provided by the ISA-Rice Warner modelling are particularly useful to determine whether the disparity in tax concessions will moderate over time as the superannuation system matures. They do not.

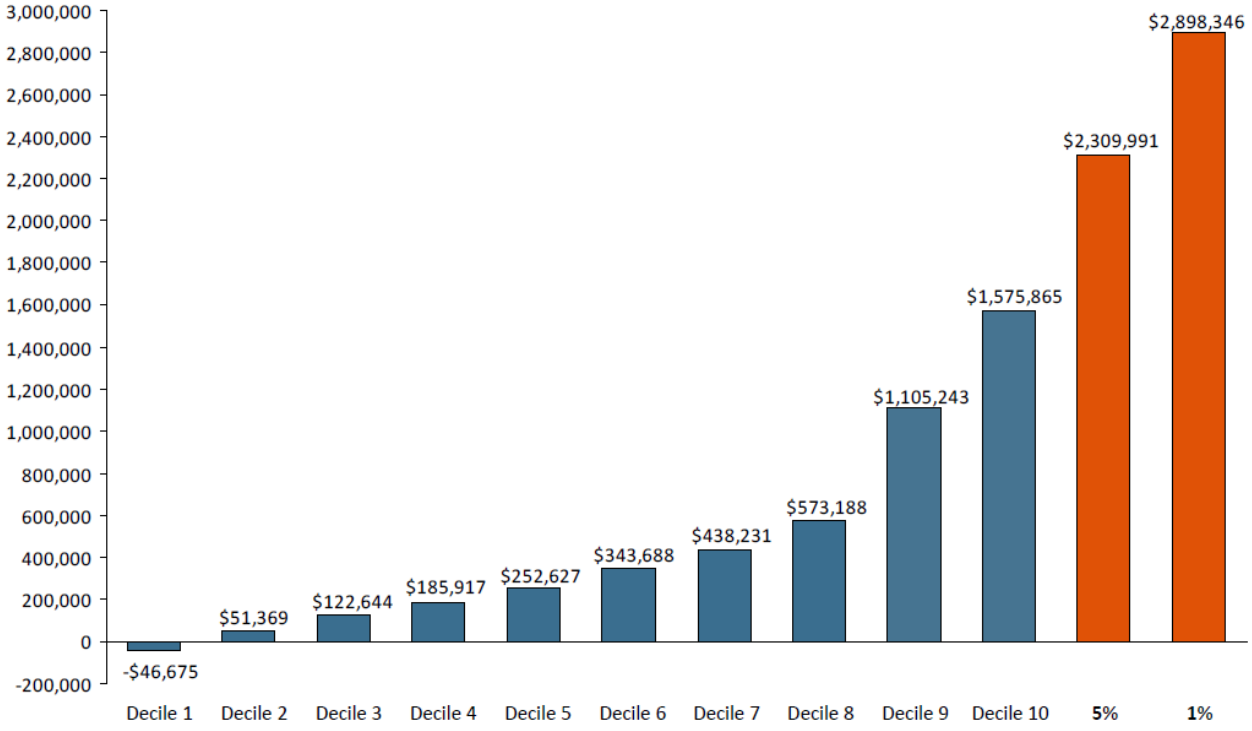
The different outputs by gender in the ISA-Rice Warner modelling are particularly useful because income deciles for men and women are quite different: in particular, a relatively small proportion of the top 10 per cent of income earners are women.

As a result, analysis showing that the top 10 per cent of all income earners receive the plurality of tax concessions also means that such concessions disproportionately flow to men rather than women. In this way, the distribution of superannuation tax concessions is poorly targeted because it disproportionately flows to higher income earners and because it disproportionately flows to males.

ISA-Rice Warner modelling also provides the projected value of tax concessions (in 2015 dollars), not just the percentage of tax concessions received by groups (i.e., the Treasury analysis referenced by the Financial System Inquiry indicates that about 37 per cent of the value of superannuation tax concessions in a particular year was received by the top decile of income earners. Treasury analysis did not indicate how many millions of dollars of tax concessions were granted across the distribution, or on a lifetime basis).

Figure 7 shows the lifetime value of total tax concessions by decile for single males retiring in 2055.

Figure 7 – Lifetime super tax concessions, single males, retiring at 2055, 2015 prices, by income decile and top 5% and 1%



Source: ISA-Rice Warner modelling

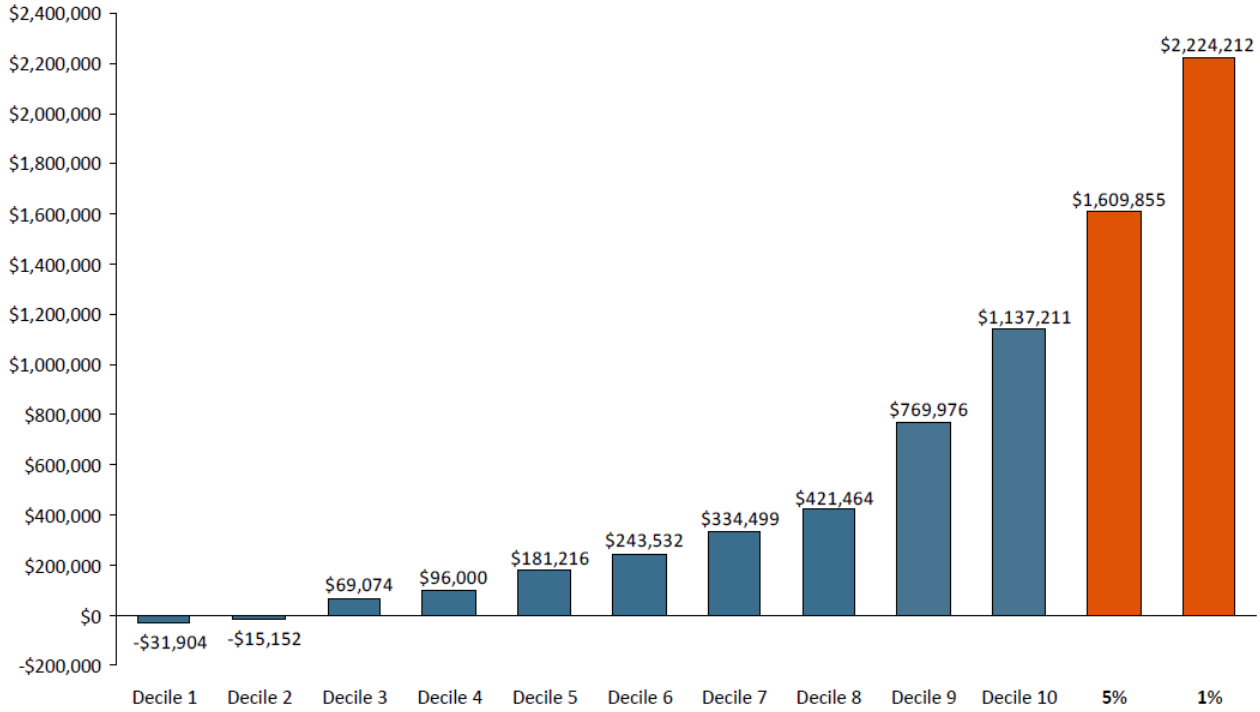
There are a number of striking observations to be drawn from Figure 7, including that:

- Tax concessions flowing to the top decile of single males are over $1.5 million per person. Arguably, the value of the concessions, in and of themselves, may be sufficient to live comfortably. This phenomenon is even stronger for the top five per cent and top one per cent. While these retirees could be called "self-funded," this is clearly false. For the top five per cent and the top one per cent, the Commonwealth is contributing over $2 million per person to their retirement income. Providing this level of support to those who are projected to receive over $350,000 in annual retirement income is not an efficient allocation of Commonwealth resources.
- Low income earners are not well-served by the tax concessions. Far from receiving a tax concession, single males in the bottom decile pay 15% more tax on their superannuation savings than they do on ordinary income. For individuals in the bottom decile, the lifetime cost of this extra tax is over $45,000, which is about three years of work.

  Put another way, the tax concessions in superannuation effectively extract about three years of a low income person's paid working life. Certainly this is not intended. Political leaders should act quickly to remedy it, and avoid the community disaffection that will no doubt occur as it becomes more widely understood.

The harm to individuals on lower incomes is greater for women. Figure 8 shows the lifetime value of total tax concessions by decile for single females retiring in 2055. For women, the bottom decile and the second decile pay more tax on their superannuation savings than ordinary income.

Figure 8 – Lifetime super tax concessions, single females, retiring at 2055, 2015 prices, by income decile and top 5% and 1%



Source: ISA-Rice Warner modelling

Figure 9 shows lifetime value of total tax concessions by decile in respect of couples retiring in 2055.

The majority of retirees are couples, so this is a particularly important cohort.

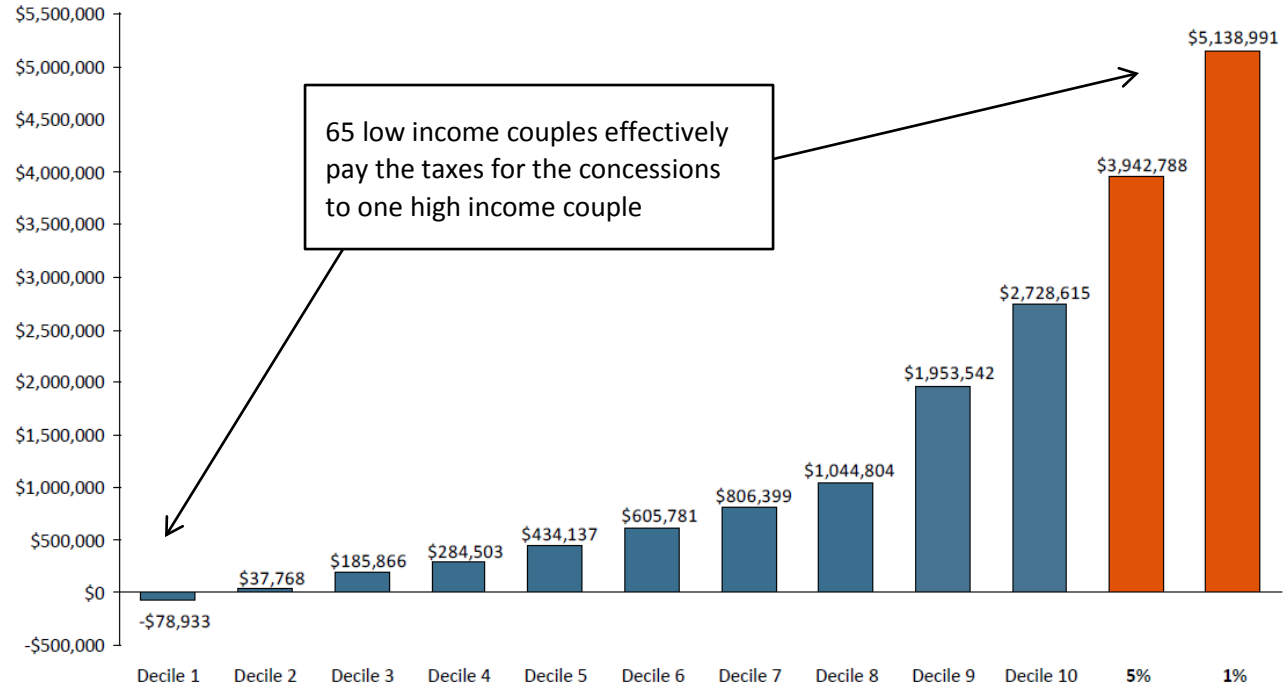
The shape of the chart is the same as Figures 7 and 8, but the magnitude of the disparity between the concessional support to the top and the low income earners is even more pronounced.

Under existing settings, the top one per cent of couples will receive Commonwealth tax concessions worth over five million dollars.

In sharp contrast, the bottom decile pays additional tax of over $75,000.

In effect, the additional taxes paid by 65 couples in the bottom decile fund the tax concessions to a couple in the top one per cent.

Figure 9 – Lifetime super tax concessions, couples, retiring at 2055, 2015 prices, by income decile and top 5% and 1%



Source: ISA-Rice Warner modelling

Looking carefully at how the tax concessions interact with savings and life expectancy, it becomes clear that they are of enormous substantive benefit to the top income recipients. For the top one per cent, the tax concessions ***more than double*** their retirement incomes and bequest, as shown in Table 2.

Table 2 – Effect of superannuation tax concessions on retirement income and residual capital, single males, retiring at 2055, top 1%

	With tax concession	Without tax concessions
Total retirement income from super through life expectancy	$4,472,485	$2,129,134
Residual capital in super after life expectancy	$934,939	$379,944
Total	$5,407,424	$2,509,078
Difference due to concessions		**$2,898,346**

Source: ISA-Rice Warner modelling, ISA calculations

1.2.1 Tax concessions and age pension payments: total government support is inefficient

Key points

- Age pension and superannuation tax concessions are both forms of Government support for retirement security. Many commentators combine age pension payments and the value of tax concessions to determine the total value of government support to individuals.
- Government support should prioritise those who will not otherwise receive incomes in retirement that support a comfortable standard of living. Accordingly, total government support for retirement security should in principle be higher for those on lower incomes.
- However, combined government support (superannuation tax concessions and age pension) flow predominantly to higher income deciles. For example, over five million dollars of Government support is provided to each couple in the top one per cent of incomes, which is three times higher than the total government support received by couples in the bottom decile.

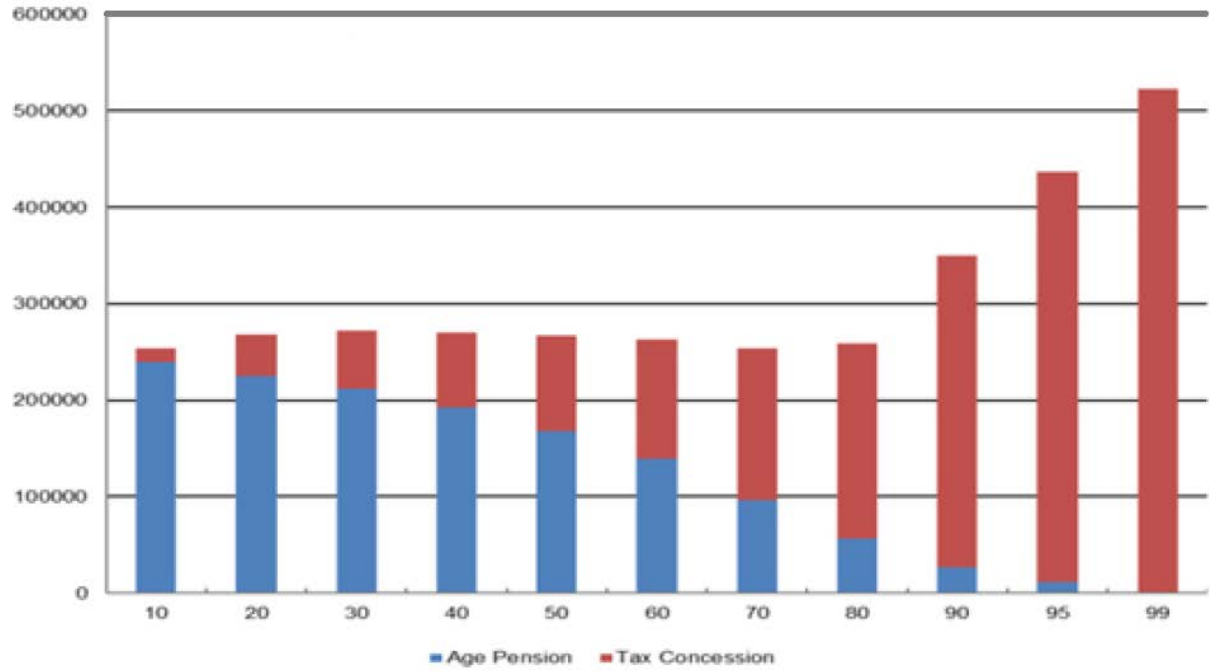
Discussion

Tax arrangements that raise the tax burden on the lowest income earners, while also allowing top income earners to accrue millions of dollars more in savings than they would without Commonwealth superannuation tax concessions, cannot be sustained.

However, the discussion of superannuation tax concessions is also often combined with an analysis of the distribution of age pension payments. This approach seeks to assess what *combined* amount of government support for retirement security – age pension and superannuation concessions – is allocated to individuals across the income spectrum.

Figure 10 is an example of such an analysis by Treasury, which presents the combined value of age pension and superannuation tax concessional support to currently retired single males as of 2012. Typically, government support should flow toward those most in need. Unfortunately, the Treasury analysis indicates that government support is not even equally distributed across income levels. Instead, the top income earners are receiving greater total government support than people on median and low incomes.

Figure 10 – Distribution of "total government support" (both superannuation tax concessions and Age Pension), 2012-2013



Source: Treasury

ISA and Rice Warner modelled the distribution of tax concessions and age pension payments in a mature system by examining the age pension and concessions received by single males, single females, and couples retiring in 2055, delineated into income deciles, the top five per cent and the top one per cent, for each these groups.

Figure 11 shows lifetime government support (combined age pension and superannuation tax concessions) for single males retiring in 2055. This modelling shows a similarly shaped graph to Treasury's but with some important differences reflecting policy changes since 2012 and the effects of a mature system. First, the superannuation tax concessions for the bottom decile of income earners retiring in 2055 are negative due to the abolition of the Low Income Super Contribution from 2017. Second, the degree to which the top income earners, particularly the top five per cent and top one per cent, are outliers from the rest of the population is greater.

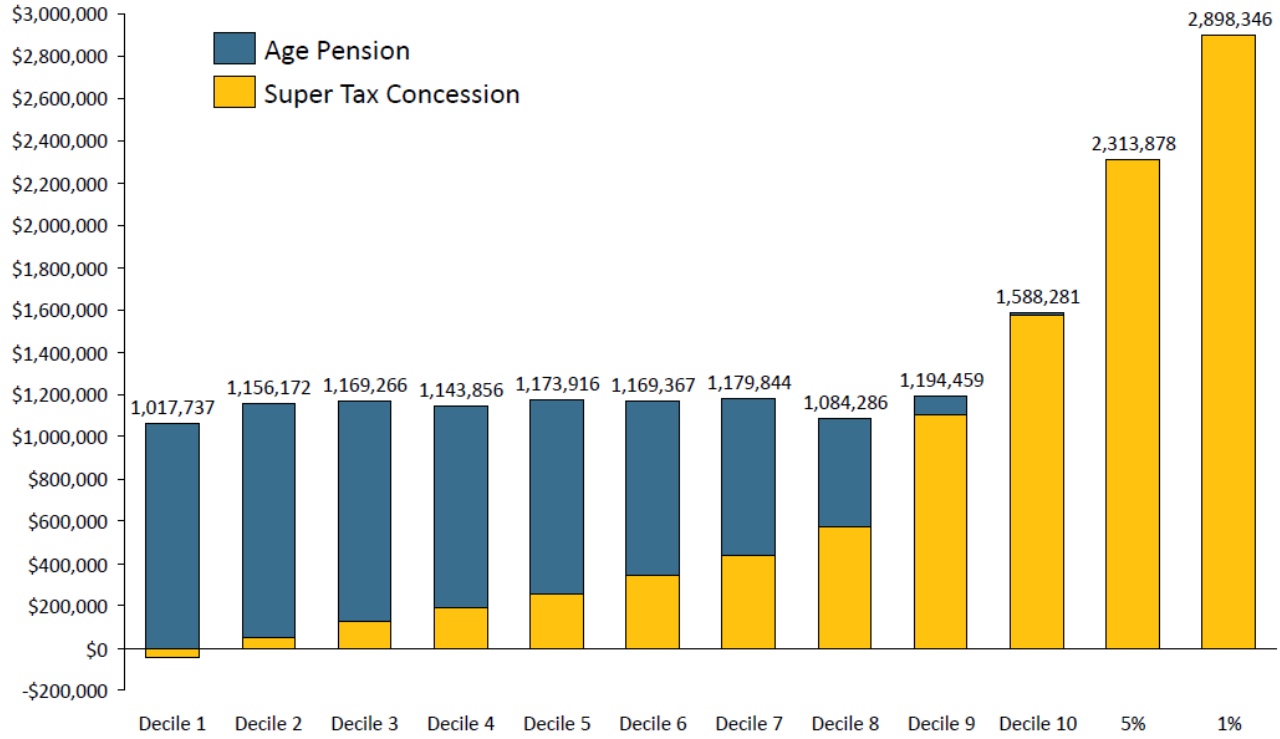
The Treasury analysis suggests the total level of Government support by way of tax concessions and age pension for the top one percent is twice that for the bottom decile. ISA-Rice Warner modelling suggests it is almost three times greater. Part of the reason for this is due to longevity differences between low and high income earners in Australia[11] which is integral to the ISA-RiceWarner model.[12]

The detailed distributional modelling undertaken by ISA and Rice Warner also reveals another stark reality. Some have claimed that the value of superannuation tax concessions are overstated because they are not adjusted to account for greater age pension outlays if the concessions were not available. Whilst such an adjustment could be made for concessions going to individuals up to the 9th decile, we find there would be no age pension offset for the top five and one percent. Therefore the entire value of the concessions to those groups involves no trade off or long term age pension saving to Government or future taxpayers.

[11] See, e.g., Clarke & Leigh, Death, Dollars and Degrees: Socio-economic Status and Longevity in Australia, Economic Papers, Vol. 30, No. 3, September 2011.

[12] For further detail see section 4.

Figure 11 – Government support, single males, retiring at 2055, 2015 prices, by income decile and top 5% and 1%



Source: ISA-Rice Warner modelling

Moreover, the significance of the age pension is underscored. For those who believe that superannuation should offset the age pension, perhaps even more significant reforms to superannuation are required to deliver that objective. These reforms will need to take the shape long advocated by Industry Super Australia, and opposed by the big banks:

- A strong quality filter overlaying the selection of workplace default funds to ensure that members receive the greatest value on their savings in the long term. Default funds should prioritise the maximisation of long term net returns and the most efficient retirement income stream in terms of stability, certainty, and amount.
- A substantial wind-back of the inefficient sales-driven retail approach to superannuation which raises costs and creates a feeding frenzy for advisers, salesmen, spruikers, fund managers, and a host of other rent seekers. This is on top of the additional systems complexity and resourcing needed to serve the complexity, including government resources to surveil and police the retail market.
- Elimination of related-party transactions that do not result in a benefit to members, and other practices endemic to the vertically integrated business models of the big banks.

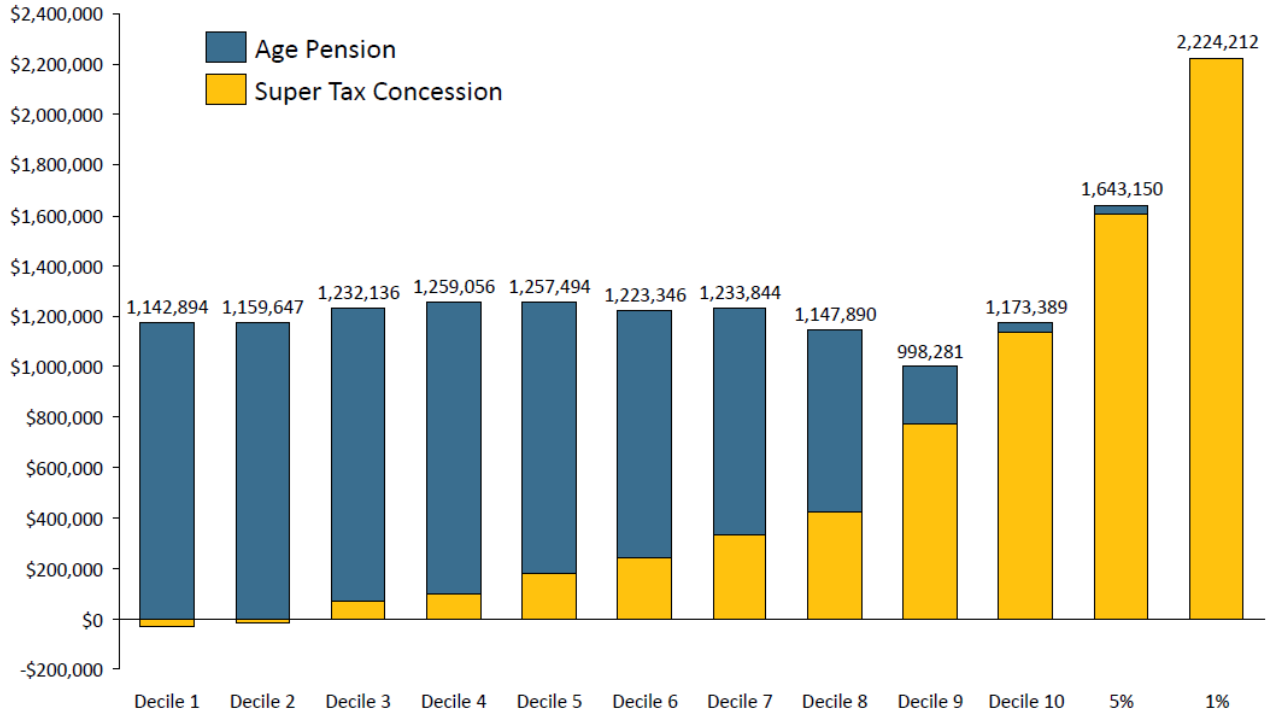
Figure 12 sets out the total lifetime government support by decile for single women retiring in 2055.

Women on average are paid less than men (including for similar work), and are more likely than men to be partly or fully occupied with unpaid work. As a result, the capacity of women to achieve large superannuation balances, and thereby benefit from earnings tax concessions, is relatively lower than for men. This phenomenon is reflected in Figure 12.

For single women, the age pension is even more important, delivering a significant share of the retirement income for females through the 9th decile. And the steep rise in relative total government support is most

noticeable only for the top one per cent of income recipients (which is because the top income earning women do not receive amounts equal to the top income earning men).

Figure 12 – Government support, single females, retiring at 2055, 2015 prices, by income decile and top 5% and 1%

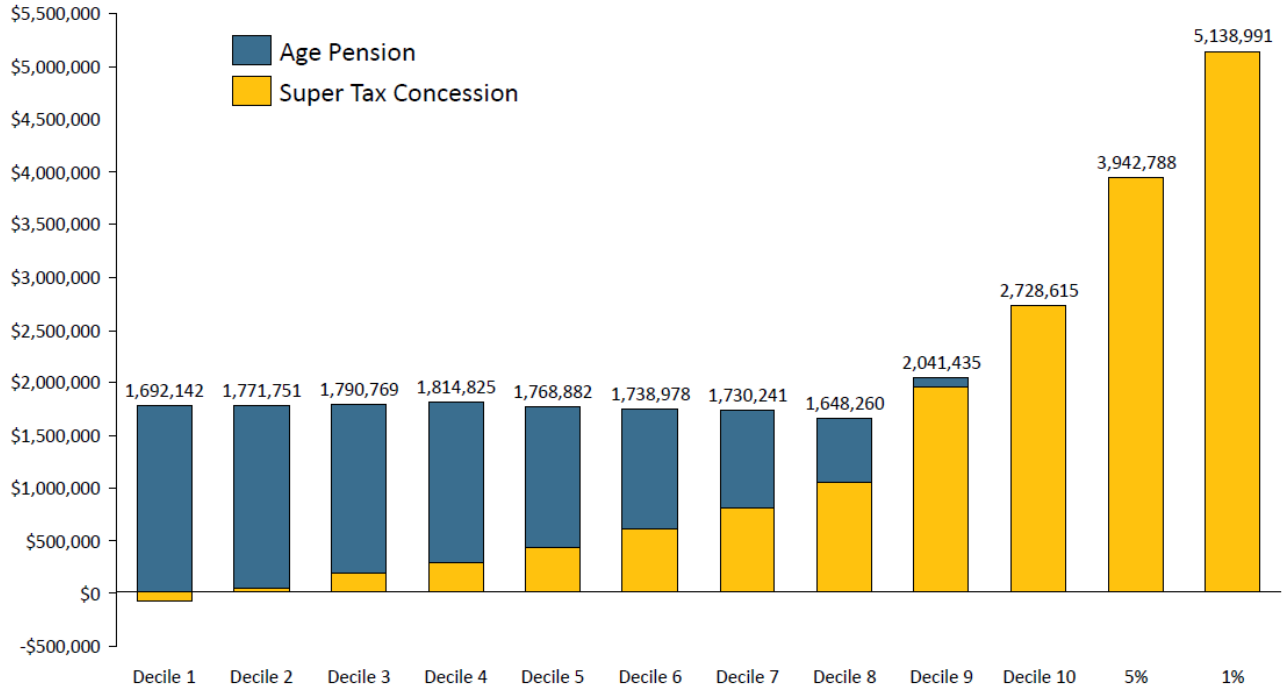


Source: ISA-Rice Warner modelling

The total lifetime government support by decile for couples retiring in 2055 is set out in Figure 13.

Couples in the top decile and top one per cent and five per cent, as shown in Figure 9 above, receive extraordinarily valuable tax concessions. The value of these concessions dwarfs the value of the age pension. As a result of this phenomenon, the shape of the graph showing combined government support for couples (Figure 13) is similar to that for single men and single women, but the disparity in support levels between the top decile (and especially top five per cent and one per cent), on the one hand, and the bottom and middle class, on the other hand, is even greater.

Figure 13 – Government support, couples, retiring at 2055, 2015 prices, by income decile and top 5% and 1%



Source: ISA-Rice Warner modelling

1.3 Ad hoc changes to superannuation policy and age pension

Key points

- The abolition of the Low Income Super Contribution (LISC), delay of the increase to the Superannuation Guarantee, and the proposed changes to the age pension asset test are detrimental to retirement outcomes, especially in combination.
- The abolition of the LISC and delay to the SG will cut the super incomes of women by up to 10 per cent.
- The delay in the SG and abolition of LISC will entrench a $2 billion a year cost to the budget in the medium to long term.
- Single women are particularly disadvantaged by the asset test change with 50 percent who won't make a comfortable retirement income benchmark being negatively affected, including 30 per cent of single women aged 25-29 who otherwise could have had a comfortable income in retirement.
- The doubling of the asset test taper right would result in an effective tax (taper) rate of 156 per cent at a five per cent return, which could discourage discretionary savings, lead to overinvestment in housing, or force retirees into riskier asset classes.
- In combination with improvements in superannuation, there may be scope for improved targeting of the age pension, provided such changes are carefully designed. Approaches that may be appropriate to consider include a single means test as recommended by the Henry Taxation Review.

Discussion

There have been significant changes to superannuation policy in the past year, with legislation passed that would freeze the rate of the Superannuation Guarantee at 9.5 per cent until 2021-22 and remove the LISC from July 2017.

Government has also proposed changes to age pension indexation which have subsequently been replaced with a proposal to tighten the pension asset test.

It is not clear that the long term effects of these changes on the wellbeing of Australians were known or carefully considered. Governments have not always clearly explained the long term adequacy and fiscal effects of proposals.

Abolition of the Low Income Super Contribution and freezing of the Superannuation Guarantee increase

Two superannuation policy changes were adopted by Government in 2014: abolition of the LISC, and a delay in the schedule by which the Superannuation Guarantee would increase to 12 per cent.

The LISC currently is paid to about 3.6 million Australians, including one in two working women. Due to recent legislation, the LISC will end in 2017. The abolition of the LISC will weaken the fiscal and member efficiency of the existing superannuation taxation settings, and lead to an increase in future age pension expenditures and adversely affect millions of Australians, including many working women.

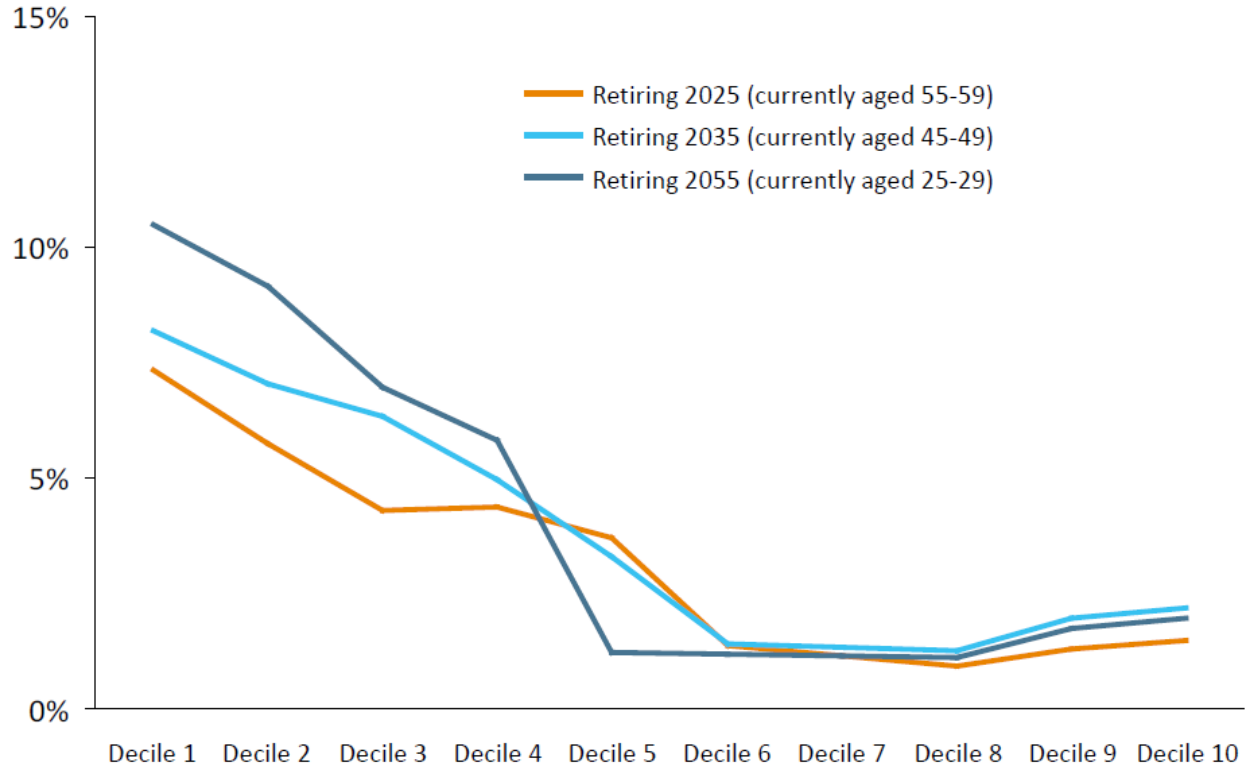
In addition, the Government passed legislation delaying the scheduled increase in the Superannuation Guarantee to 12 per cent of wages.

These changes have adversely affected low income wage earners, especially women, whose superannuation savings are determined to an even greater degree than median income earners by the level of compulsory contributions and for whom the tax efficiency of superannuation requires a supplement such as the LISC.

Figure 14 shows the impact for single females if the LISC was maintained and previously legislated SG schedule restored. The effect on single females is significant, with deciles one through four receiving a significant boost to income.

The changes, whilst made for short term budget savings, will actually create a long term fiscal impost. ISA-Rice Warner modelling suggests increased age pension expenditures and forgone superannuation earnings tax will entrench a permanent cost to the budget that will be worth almost $2 billion a year by 2055 at current prices – an impact that has seemingly been overlooked in pursuit of short-term budget savings.

Figure 14 – Increase in annual superannuation retirement income to single females if LISC and SG increase schedule are restored



Source: ISA-Rice Warner modelling

Age pension asset test change proposal

With our superannuation system still maturing and gender based disparities in accumulation, the age pension serves an important purpose in assisting Australians achieve a dignified retirement.

For this reason proposals to significantly alter age pension policy setting deserve the highest level of scrutiny. With good justification, proposals to reduce the indexation of the age pension have been abandoned. In their place, changes to the asset test have been proposed.

These changes have been better received, due to only relatively small impacts on the existing cohort of pensioners. However detailed analysis of the impact of the changes over time is concerning.

Before considering detailed impacts a discussion of the existing means test is warranted

Recent reviews of pension means testing and alternative proposals

Both the Harmer review of retirement incomes and the Australia's Future Tax System Review found the existing means test was complicated an inefficient, with the assets test singled out as a particular cause of concern.

The Harmer Pension Review noted:

> In summary, the Review's concerns are that the assets test, rather than acting as a backup, can now operate as the primary test for some pensioners with relatively moderate levels of financial assets which would be better assessed under the income test. Instead of this group of pensioners being income tested on the value of their income, their pension is reduced on the basis of the wealth that was generating this income. This means that the income and assets tests are not interacting efficiently and effectively. These trends and

> pressures on the assets test parameters were a part of the context of the reduction of the assets test taper rate from $3.00 to $1.50 in September 2007.[13]

The Australia's Future Tax System Review also observed :

> The assets test can create relatively high effective marginal tax rates on income from savings. A pension reduction of $1.50 per fortnight per $1,000 worth of assets over the asset test threshold equates to an effective marginal taper rate on income of 78 per cent, assuming a 5 per cent annual income return. Effective marginal tax rates will vary depending on asset holdings and the assumed rate of return.[14]

The recent proposal to double the taper rate to a $3 per fortnight loss of pension per $1,000 of assets results in an effective taper of 156 percent assuming a 5 percent return, adopting the same methodology as the Australia's Future Tax System Review.

To reduce the effective tax or taper rates on savings, pensioners may seek out higher risk assets or alternatively divert savings into exempt assets such as the family home, although the likelihood of these behavioural responses is uncertain.

These considerations aside, detailed modelling of the proposed asset test change finds its impact will increase sharply over time, and will reduce retirement incomes of certain groups who have insufficient means for a comfortable retirement under existing policy settings.

Summary of impacts

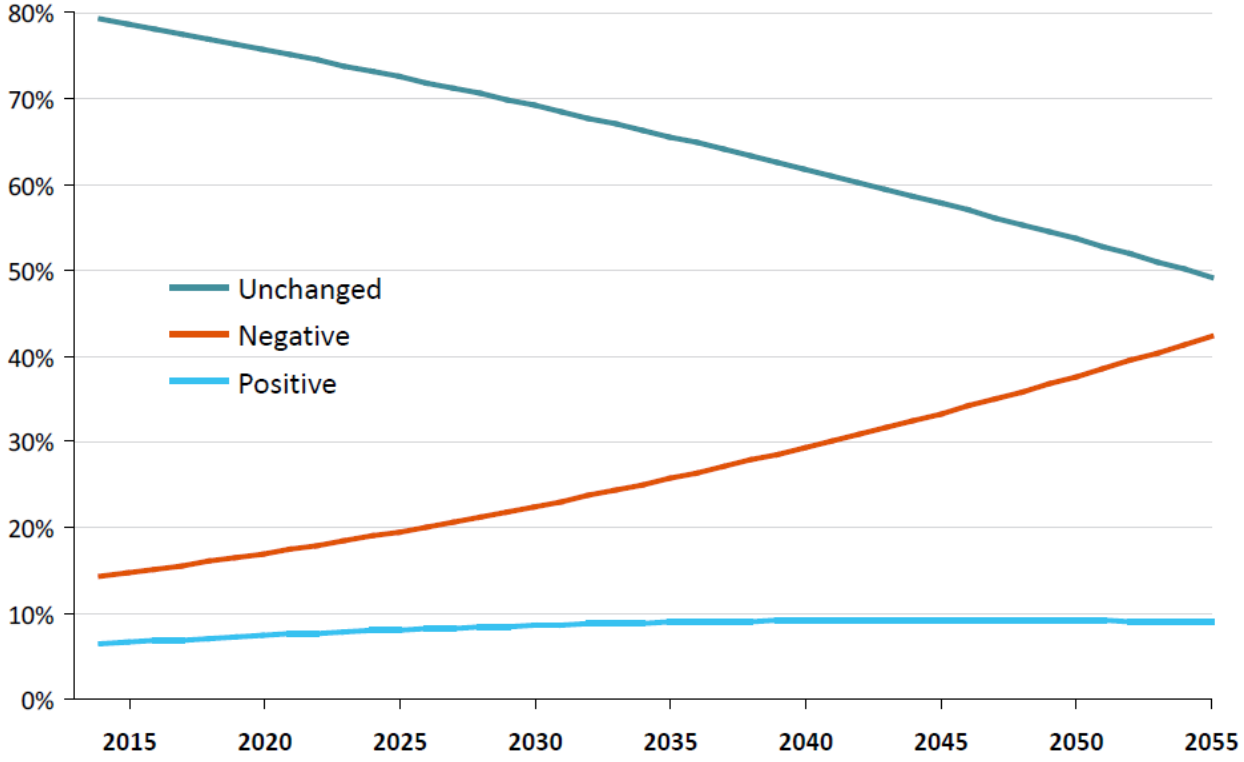
The proportion of new retirees affected by the proposed change will increase sharply over time. The proportion of new cohorts of retirees affected by the asset test change increase from one in three today to seven in 10 by 2050. This influx will increase the overall proportion of the age pension population who are worse off from just over 10 per cent in 2017 to over 40 per cent by 2055.

Figure 15 shows the proportion of couples retiring from 2015 through 2055 affected by the proposed age pension changes.

[13] Harmer, Pension Review Report, pp 135-136

[14] Australia's Future Tax System Review, Retirement Income System - Report on Strategic Issues, Section 6.2 pp 42-43, 2009

Figure 15 – Share of population affected by proposed age pension asset test change, single females retiring 2015 through 2055

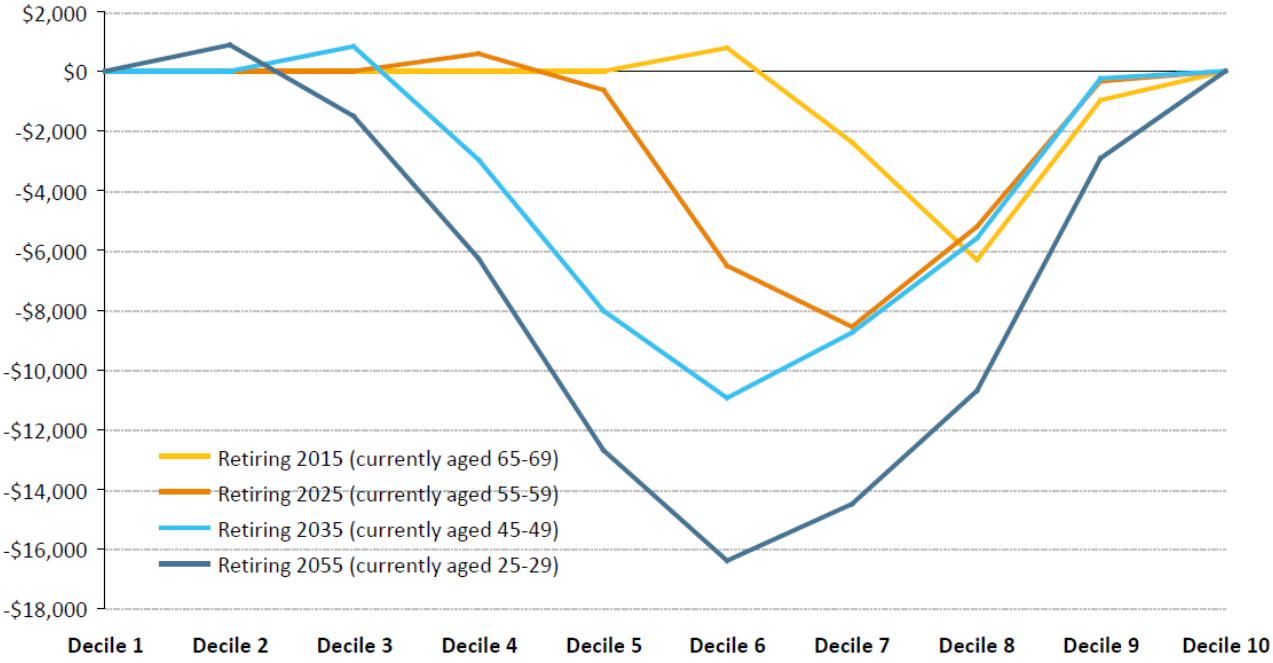


Source: ISA-Rice Warner modelling

Our modelling indicates these proposed taper rate changes would have significant detrimental effects, which effects will deepen over the coming decades. It will amount to a 15 per cent overall cut in the retirement income of some people who are not on a comfortable retirement, while higher income groups remain largely unaffected.

Figure 16 shows the retirees affected, and the degree by which their annual income is reduced over the long term.

Figure 16 – Proposed age pension asset test change effect on annual income by decile, couples, 2015 prices



Source: ISA-Rice Warner modelling

Observing the dynamics of this proposed policy change over time reveals that:

- The impacts of the change increasingly fall on those earning below average incomes
- For couples due to retire in 10 years' time, the largest impacts are felt just below average earnings ($62,000 or 80 per cent average full time earnings).[15] They stand to lose $4,300 a year each or $112,000 each over their entire retirement
- For those 20 years from retirement (aged 45-50 today) the big impacts start being felt by a couple in decile 4, each earning as little as $45,000 today, who would lose $1,500 a year each
- By contrast, a couple on $145,000 each experiences the barest of impacts, losing just $113 a year each
- Over the long run, there are more people affected on below average incomes than above (3 rungs below average earnings compared with just one rung above, in the first 10 years of this change)
- Within 10 years around half of all new retirees leaving the workforce will be affected by these changes

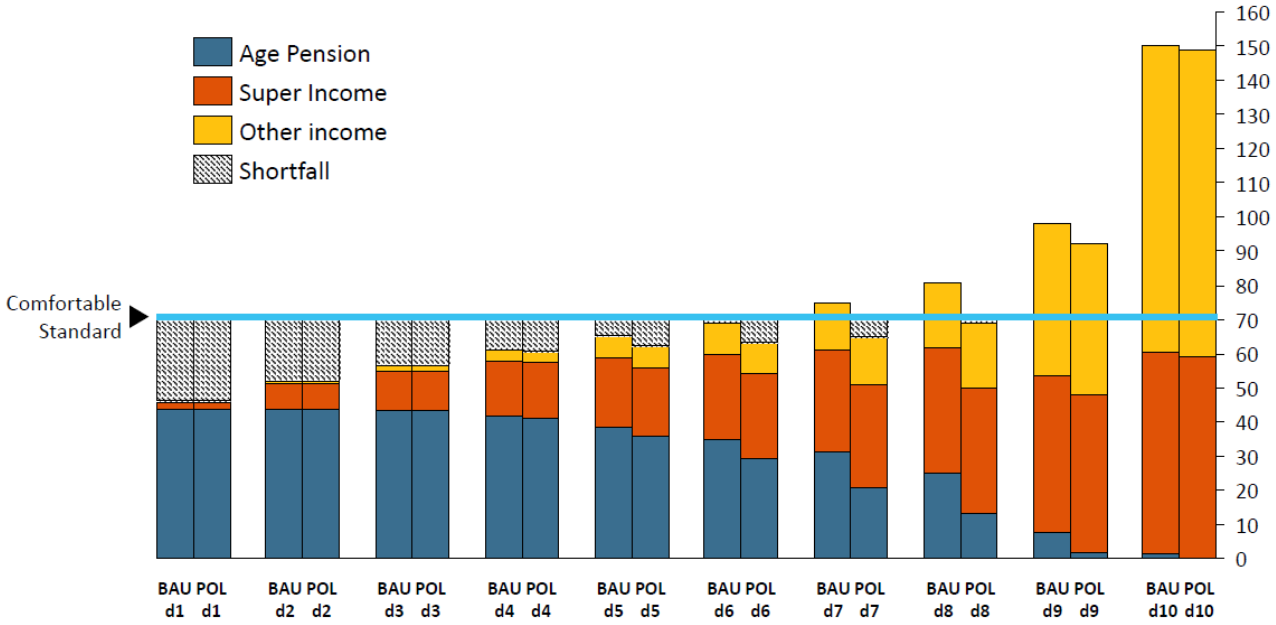
As significant as these changes would be for couples, the impact on single women is perhaps more stark because it will result in a substantial number of women not achieving a comfortable retirement, who would have without the proposed age pension changes.

Figure 17 shows the effect of the proposed changes on single women retiring in 2055.

The tightening of age pension support will result in the following outcomes, which suggest the proposal is poorly targeted: 50 per cent of women retiring in 2055 who won't achieve a comfortable retirement under the proposal are also negatively affected by it, and 30 percent who could have made a comfortable retirement, but for the change, will instead fall below the benchmark.

[15] Average full time earnings are currently just over $75k per annum

Figure 17 – Effect of asset test change proposal, single females, retiring 2055, 2015 prices, by income decile, 5% and 1%, $000's



Source: ISA-Rice Warner modelling

These impacts suggest the proposed age pension asset test change is not well targeted. In principle, there may be scope for improved targeting of the age pension, provided such changes are carefully designed, involve a comprehensive assessment of superannuation settings, and would better achieve the objective of the retirement system.

Significant additional changes to superannuation would be required. For example initial modelling by ISA-Rice Warner suggests restoring the SG to the previously legislated schedule and retaining the LISC would not offset the detrimental effects of the proposed age pension asset test change. Approaches that may be appropriate to consider include a single means test as recommended by the Henry Taxation Review.

1.4 The Commonwealth budget consequences of poorly targeted tax concessions

Key points

- The age pension is sustainable, with expenditure in 2055 at just 3.1 per cent of GDP. This is lower than the 3.8 per cent of GDP projected in the most recent Intergenerational Report (IGR). Although the IGR also includes service and related pensions, it may have overestimated age pension expenditure for a variety of reasons, including that (i) it does not adequately take into account the variance in life expectancy of individuals receiving the age pension, and (ii) it assumes that individuals draw down their superannuation savings as a steady income stream that is exhausted at life expectancy.
- Superannuation tax concession expenditure will exceed age pension outlays as a share of GDP for most years through to 2055, and grow to three per cent of GDP. This is driven by a number of factors, including that (i) superannuation assets in the pension phase, where earnings are tax free, are increasing, (ii) age pension expenditures are indexed to Male Total Average Weekly Earnings, which is

lower than the rate of return on investments, and (iii) rising concessional and non-concessional superannuation contribution caps, and the ability of an ageing population to access age-sensitive caps.

- ISA measured the fiscal efficiency of Government support to determine if such support was effectively adding to retirement income up to a comfortable standard, or was going to those above such a standard. For those retiring in 2055, Government support is generally additive to retirement income up to a comfortable standard, and therefore efficient, except for support to the top five per cent and top one per cent of income earners.

Discussion

It has long been established that concessional tax treatment is appropriate for superannuation for a variety of reasons. These include that:

- Amounts in superannuation are preserved until retirement, and concessions help to compensate for deferral of consumption.
- Tax credits and concessions delivered early in life, if subject to compound interest, could reasonably be expected to be an efficient way of lifting retirement welfare (and could reduce expenditure on age pension on a greater than dollar-for-dollar basis).

However, if tax concessions are poorly targeted, they do not necessarily achieve these objectives.

Moreover, poorly targeted tax concessions result in Commonwealth resources being expended in ways that are not aligned with the public interest.

In particular, poorly targeted tax concessions result in:

- government support to individuals who will achieve a very high standard of living in retirement (with or without the concessions) and,
- age pension outlays that are higher than necessary because concessions could be better directed to those who are not otherwise going to reach a comfortable retirement and in doing so reduce their call on the age pension.

When discussing the cost of superannuation tax concessions and the potential offsetting of the age pension, it is important to reference (briefly) the lively debate about the measurement of superannuation tax concessions and age pension expenditure.

Measuring superannuation tax concessions

Treasury tax expenditures estimates measure of the immediate budgetary impact of superannuation tax concessions, allowing comparison of the cost of those concessions with the cost of direct expenditures.[16] These estimates are point-in-time and not designed to show the cumulative impact of concessions or possible behavioural responses (although Treasury's revenue gain method seeks to address the latter). Whilst the measures have limitations in assessing the revenue that would be gained under alternative tax settings, they do assess reasonably well the extent to which tax concessions uplift savings to those eligible. Conceptually, they can be compared to support provided through the age pension.

As Section 4 discusses in more detail, ISA's assessment of the value of superannuation tax concessions differs somewhat from Treasury's. For modelling purposes, we compare the difference in effective tax rates that apply within superannuation to the same assets outside of superannuation for the age, sex, and income groups in the model and aggregate the outcomes.

[16] C.L. Brown, Retirement Income Modelling Task Force, Treasury, Tax Expenditures and Measuring the Long Term Costs and Benefits of Retirement Income Policy

Modelling age pension outlays

Some published projections by the Commonwealth, particularly in the Intergenerational Reports, are likely to overstate the future age pension expenditure for a handful of reasons, including: (i) that low income earners (the recipients of the greatest amounts of projected age pension expenditure) have life expectancies that are below the Australian median, and (ii) the projections assume individuals draw down their superannuation savings as evenly as possible over the life expectancy, whilst in fact Australians generally draw down their superannuation at lower and slower rates, resulting in more superannuation to weigh against full age pension eligibility for a longer period.[17]

The current approach understood to be used by Treasury is not realistic and, from a budget standpoint, may overstate the future costs of the age pension. This can undermine the ability to make reasoned policy choices.

The modelling collaboration between ISA and Rice Warner includes fiscal projections. We will utilise these modelled outputs to comment on the fiscal effects of existing tax settings in respect of superannuation.

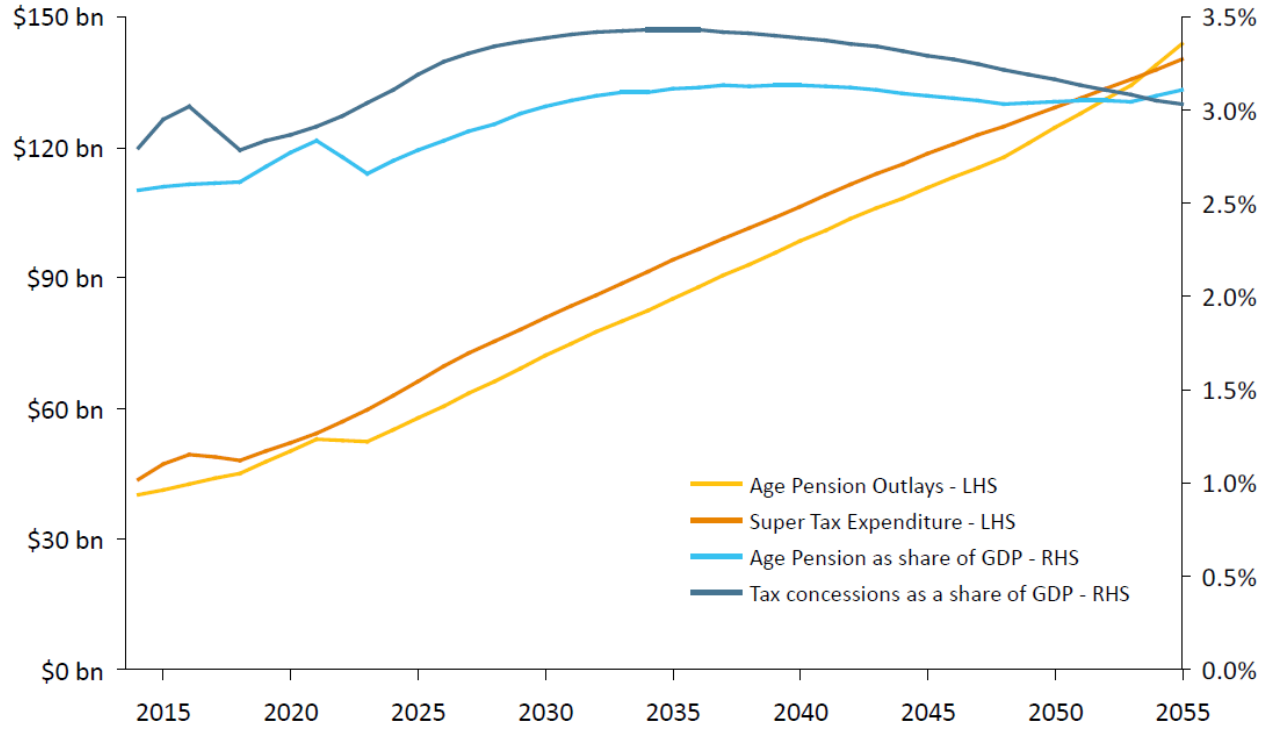
Figure 18 shows the annual superannuation tax concession expenditures and annual age pension outlays, in the aggregate and as a share of GDP, through 2055.

- Total expenditure on retirement security (age pension and superannuation tax concessions) is projected to be 6.1 per cent of GDP.
- Superannuation tax expenditure via concessions generally exceeds age pension outlays.

[17] A study by Lim-Applegate et al (2007) found that the more recent pensioners are wealthier and among these, the part-rate age pensioners are drawing down their wealth in retirement at a fairly low pace. A substantial portion of this group (26% in 2003-2004) experienced an increase in real wealth (not including their homes). The analysis suggests that this is mostly due to careful draw down activity by retirees.

It has also been recently reported in the press that Treasury analysis indicates that most superannuation account holders will still have around half of their superannuation balances at the time of average life expectancy. It points to the facts that superannuation balances may be used for estate planning, not retirement purposes (Tingle & Mather, 2015)

Figure 18 – Age pension and superannuation tax expenditure



Source: ISA-Rice Warner modelling

The projected age pension outlays and superannuation tax expenditure differ from Treasury projections. Some of the reasons why this is the case are outlined in Section 4. In addition, Treasury Tax Expenditure Statements assess the superannuation earnings tax concession on the basis of Treasury's expectation of taxable income, which will include recent fluctuations against expectations, including recent periods of low and negative returns on some superannuation investments, and losses from foreign exchange fluctuations.[18]

1.5 Fiscal efficiency of existing settings

It is possible to measure the efficiency of government support for retirement security.

Fiscal efficiency measures the dollars of superannuation income and age pension income to individuals, up to an objectively comfortable standard, per dollar of combined government support, across the distribution.

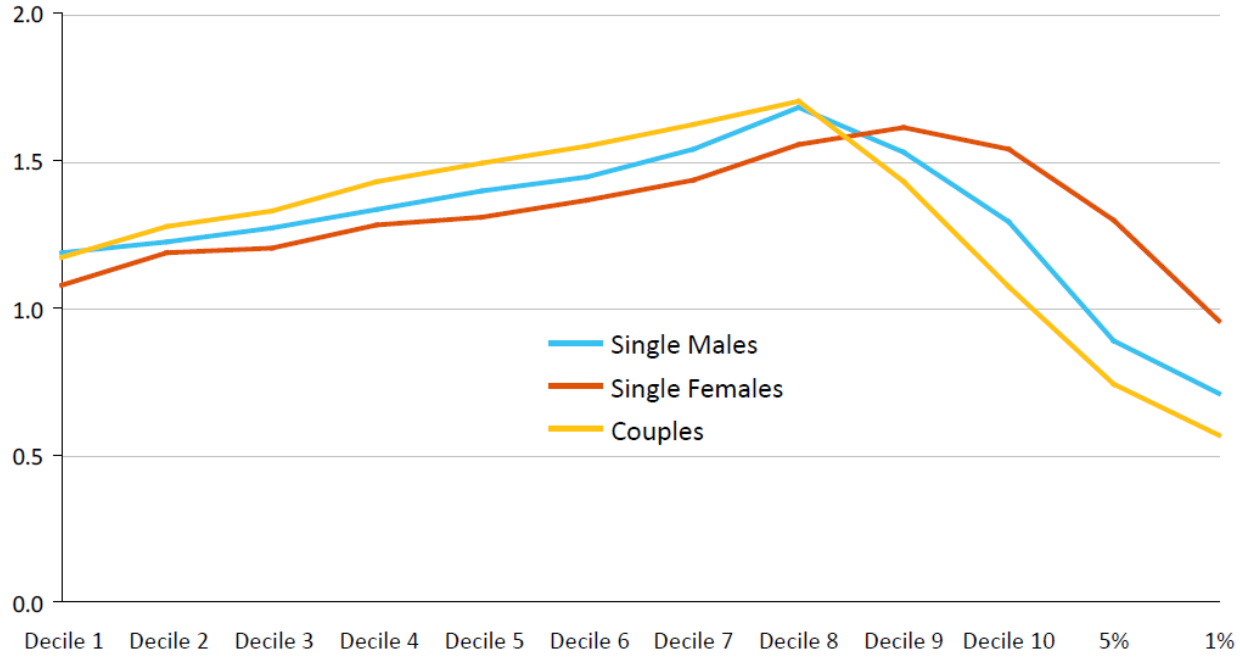
A high fiscal efficiency measure indicates that a dollar of government support is well-targeted because it is relatively effective at increasing retirement income up to a comfortable benchmark. By contrast, a dollar of government support that does not increase retirement income of those below the comfortable benchmark is not efficient.

For example, a tax concession that cost government $100, but raised retirement incomes for those below a comfortably standard an aggregate $200, would be efficient.

Figure 19 shows the fiscal efficiency of government support under existing policy settings for people entering retirement in 2055.

[18] See, e.g., Budget Paper No.1 Budget 2015-16

Figure 19 – Fiscal efficiency, 2055 retirees



Source: ISA-Rice Warner modelling; ISA calculations

The shape of Figure 19 indicates that the efficiency of government support to low income Australians, and to the top income earners are not efficient as to individuals in the 8-10th decile. This is consistent with other observations in this submission, specifically that:

- low income earners do not receive much superannuation or superannuation tax concessions, and therefore the benefits of compound earnings on tax concessions from government are small or non-existent, and
- high income earners receive excessively generous superannuation concessions, resulting in additions to retirement income well above the comfortable benchmark.

In subsequent submissions that analyse reform options, we will be able to show the relative changes to the fiscal efficiency of government support of those options.

1.6 Territories for reform

In a forthcoming submission, ISA will model and suggest certain policy reform options to inform the Green Paper.

From our standpoint, the need to better allocate tax concessions (particularly in respect to those on the highest incomes) and to uplift the retirement incomes to women and other low and middle income earners who won't achieve a comfortable retirement under existing policy settings is indicated.

Otherwise, public policy will fail to realise its objectives in respect of retirement security due to poor design. While many Australians will fail to retire comfortably, a small number of high income earners will each receive millions of dollars in government support, which more than doubles their retirement incomes and bequests.

1.7 Other tax settings that affect superannuation and the investment environment

Tax concessions can influence the level of savings and investment, and the types of activities that receive funding.

Below is brief commentary focusing on dividend imputation, capital gains tax concessions, taxation of savings other than superannuation (especially bank deposits), and company tax.

1.7.1 Dividend imputation

Dividend imputation corrects for the taxation bias against equity that arises from the treatment of debt interest payments.[19]

The Financial System Inquiry's Interim Report correctly observes that, by reducing the distorting effect of interest payment tax deductibility, dividend imputation encourages a less leveraged non-financial corporate sector, which in turn makes the Australian economy more resilient to economic shocks.

The differences in the taxation of income generated through equity versus debt investment have been cited as a contributing factor to the "equity bias" in the Australian market and the level of corporate bond market activity.

1.7.1.1 Background

Under Australian tax law, firms have the option to issue franked dividends to shareholders. These are dividends paid from after-tax profit, for which shareholders receive both the after-tax dividend in cash and a franking credit which can be offset against the shareholders tax liability or, if that liability is exhausted, redeemed in cash from the tax office. New Zealand also has dividend imputation. A number of other countries have different forms of shareholder tax relief.

Dividend imputation as an approach to corporate taxation was introduced in 1987 to address a distortion in corporate financing and taxation under which firm income is taxed at both firm and investor levels. If the profit of a firm is taxed, a dividend is paid to shareholders from after tax income, and then the income of the shareholder (including the after-tax dividends) is also taxed, then that income has been double-taxed. This implies a higher rate of taxation for that income than for other income.

The classic treatment also distorts firm financing decisions – against equity financing and in favour of debt financing, because interest payments are tax deductible to the firm and therefore only taxed at the investor level. It also discourages firms from paying dividends, encouraging profits to be retained in the firm, or paid back to shareholders via alternate methods, such as share buy-backs.

Finally, dividend imputation results in a more consistent tax treatment of incorporated and unincorporated businesses, and income paid as salary versus income paid as dividends, which is relevant where a major shareholder is also a major employee.

An important historical context for the introduction of imputation is that the corporate sector in Australia, following financial deregulation from 1983 onwards, had seen a significant increase in leverage to levels a Reserve Bank researcher suggests had 'departed from sound management principles.'[20]

[19] Some, suggest that dividend imputation may act as a "subsidy" to domestic equity. This description is open to doubt because it implies the *ex ante* environment is neutral.

[20] Ryan, Chris, 'Inflation and Corporate Taxation, Reserve Bank of Australia', Research Discussion Paper, December 1990

In the 1991-92 recession, the numerous corporate collapses of highly leveraged firms appears to vindicate that assessment.

Analyses of dividend imputation, including comparative studies with other systems, have found it an effective approach to address distortions that favour debt financing.[21] The Henry Review noted these benefits to dividend imputation and others (including that it discourages firms to avoid income tax) and recommended that it be maintained.

1.7.1.2 Effect on investment preferences

Some argue that dividend imputation could make domestic equity more attractive to local investors than overseas equity, and domestic equity more attractive than corporate bonds.

But there are problems with this argument, especially for professionally managed investment, because the argument assumes foreign and Australian equity are substitutes in a portfolio, which is not the case. Debt is clearly not a substitute for equity, but that obvious fact does not deter commentators.

Second-guessing asset allocations within superannuation is relatively uncommon for good reason, as such asset allocations generally reflect the disinterested judgment of trustees in receipt of professional advice and concern the facts and circumstances of different beneficiaries; nonetheless, the superannuation system's allocation to equity has been questioned by some.

Analysing the appropriateness of superannuation funds' allocation strategy needs to consider various factors, including the return profile of the strategy in combination with the beneficiaries' total household balance sheet exposures and in relation to the beneficiaries' time horizon.

The typical large not-for-profit super funds default allocation has been designed such that it would over the long term outperform a portfolio with higher fixed interest allocations. Not only would a higher allocation to fixed interest result in lower long term net returns, but it would increase risk exposure to housing insofar as corporate bonds issuance has been predominantly by banks, and the largest asset allocation on bank balance sheets is to home loans.

Taxation aside, the level of demand for corporate bonds is affected by their risk-return profile relative to other options. In particular, superannuation funds have limited capacity to hold defensive illiquid assets, and there appear to be stronger performing assets in this category than corporate bonds. The Deputy Governor of the Reserve Bank has also made the point that the relative risk-return characteristics of corporate bonds could explain the investment preferences of super funds.[22]

Australia's domestic corporate bond market is over 60 per cent of GDP and around two-thirds the capitalisation of the stock market. Australia's annual corporate debt security issuance is around 0.85 per cent of GDP, broadly in line with that of Germany (0.8 per cent) and Japan (1.2 per cent), but lower than some other countries, including Sweden, France, and the US, all over 2 per cent. Whether a debt market less like Germany and more like the US is desirable is uncertain – the touchstone should be whether corporations are able to raise funding (debt or equity) for business activities efficiently and effectively. There is little evidence that non-financial companies have been unable to meet their financing needs.[23]

The Tax Discussion Paper's observation that dividend imputation does not encourage new investment into Australia might be true in a crude "first order" sense. However, it ignores the possibility that a dividend

[21] See, id.; see also, Stewart, M. F., Brooks, R. W. and Jugurnath, B. 'Dividend Taxation and Corporate Investment', *Review of Quantitative Finance and Accounting*, Volume 31 Number 2, 2008

[22] Lowe, Dr Philip, *Opportunities and Challenges for Market Based Financing*, 25 March 2014 ("[T]he issue is not so much a lack of appetite for bonds, but rather the relative risk-return and liquidity characteristics of the corporate bonds on offer."

[23] See, e.g., Kosev and Wakeling, *Trends in Corporate Financing*, Reserve Bank of Australia, working paper, July 2014.

imputation has resulted in a relatively deleveraged corporate sector in Australia, which changes the risk profile of the returns of Australian firms. An overseas investor considering investing in Australia or a company in some other jurisdiction would need to consider not only the company tax the firm made, but the capital structure of the firm (and a myriad other factors). A more highly leveraged foreign firm (more risk) would need to achieve a higher (post-tax) return to justify the investment.

1.7.2 Capital gains and negative gearing

1.7.2.1 The effects of CGT on investment decisions

Capital Gains Tax was introduced in Australia in 1985. Prior to the introduction of the tax, capital gains were tax free. The purpose of the tax was to reduce tax avoidance behaviour where other forms of income were masked as tax-free capital gain. The introduction of capital gains tax also helped business with their investment decisions by removing certain distortions.[24]

The 1999 Ralph Review of Business Taxation recommended changes to CGT to "support a stronger investment culture among Australian households." One of the recommendations to achieve this was to reduce capital gains tax by one-half. The Government adopted this recommendation, along with some exemptions in regard to small businesses.

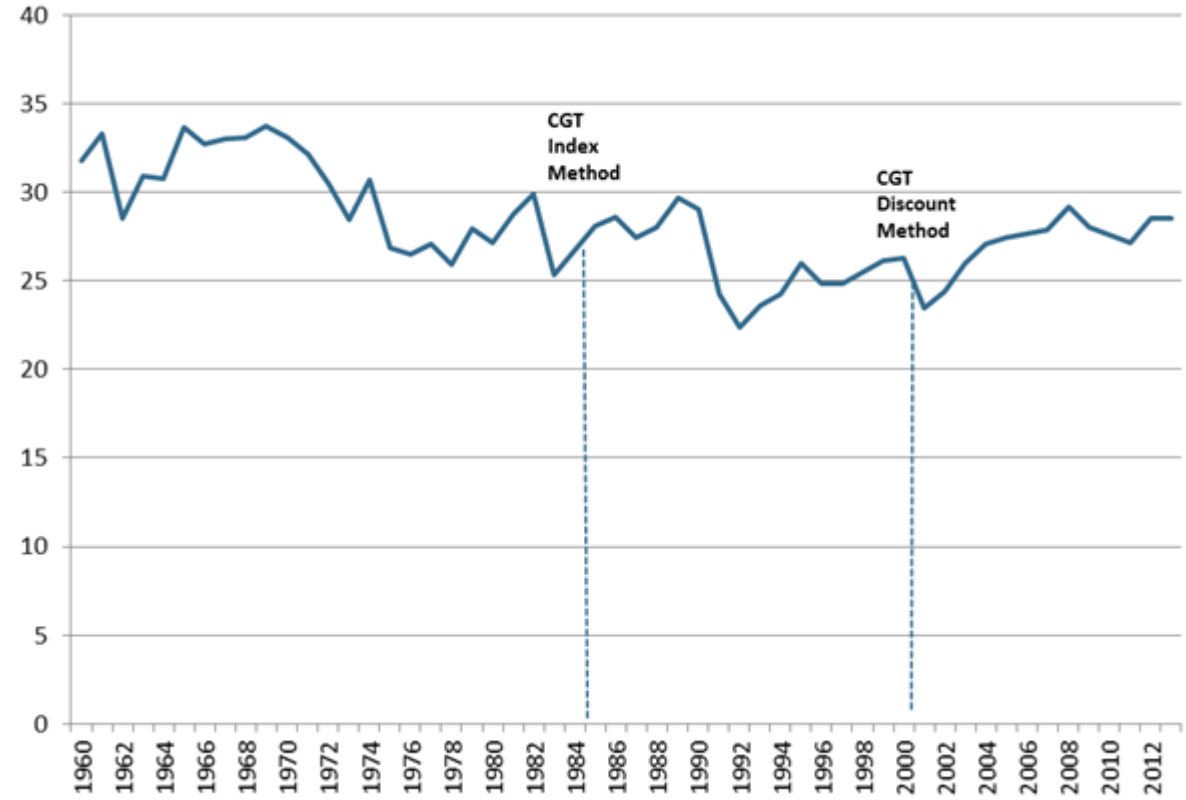
From 2001, the "index method" was replaced by the "discount method" if the asset was held for at least 12 months. The "discount method" allows individuals and trusts to report only half of net capital gains for taxation purposes and superannuation funds to report two-thirds of the capital gain. The discount method generally does not apply to companies.[25]

While proponents of the CGT concessions changes of the last decade believed it would increase investment in productive capital, the data do not indicate this belief was justified. Figure 20 shows the investment to GDP ratio in Australia over time, and highlights when CGT was introduced, and when concessions were introduced and reformed. There is no apparent sensitivity to Australia's level of investment as capital gains tax was introduced or when concessions were changed to the "discount method."

[24] See, Treasury, Reform of the Australian Tax System, 1985 ("As for investment, the introduction of a Capital Gains Tax could be seen as ameliorating some of the present distortions on decisions to invest. At the margin the absence of a CGT means that decisions to invest are determined not only by the overall yield of a project but also by the composition of that yield as between capital gains and income.")

[25] See, Treasury, Capital gains tax: historical trends and forecasting frameworks

Figure 20 – Investment to GDP, Australia

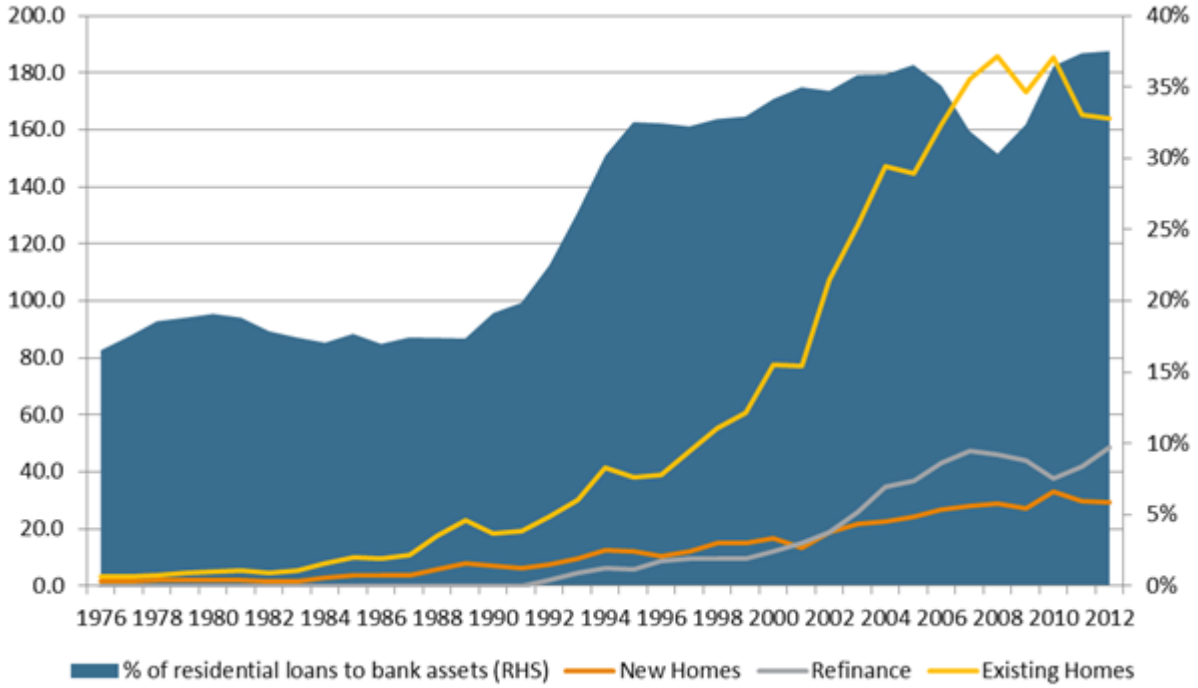


Source: World Bank, ISA

Although CGT concessions have not noticeably increased investment, they have, together with negative gearing, apparently caused significant distortion to bank lending decisions, and therefore the flow of funds, particularly funding that is allocated to housing resales.

Australian banks have significantly increased their mortgage book over the years. Figure 21 shows the substantial growth in housing-related bank lending activity over the years.

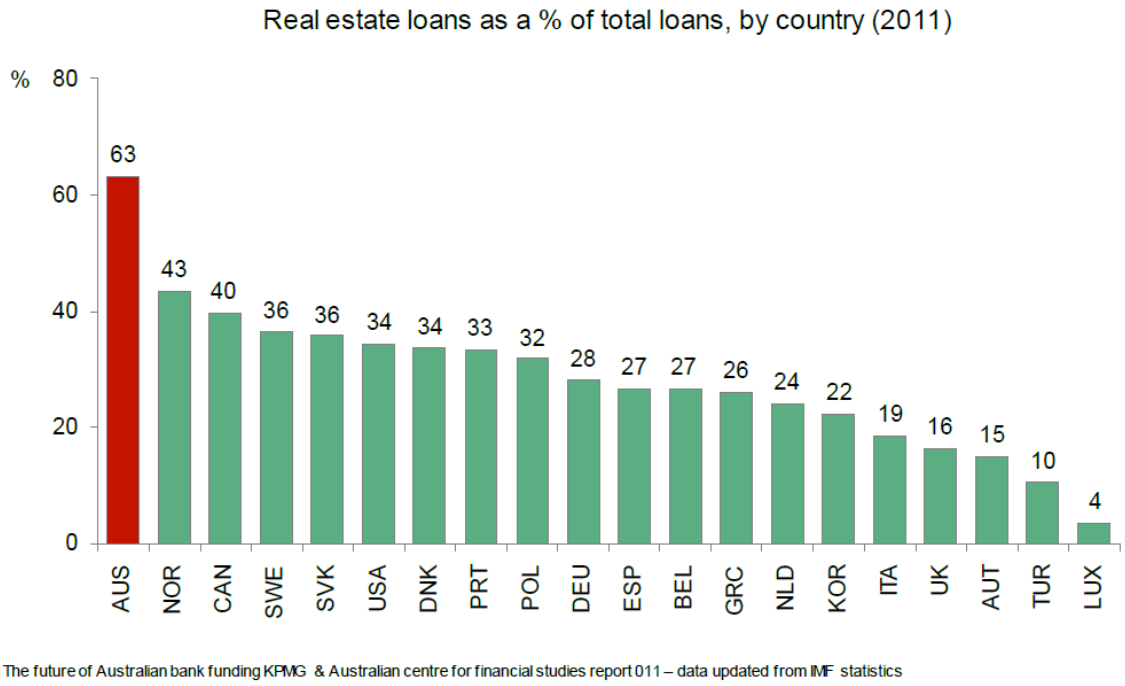
Figure 21 – Bank finance, residential, by purpose, $ billions and %



Source: ABS Housing Finance (ABS 5609.0) Lending Finance (ABS 5671.0) and RBA Statistics (D2 Bank Assets)

Compared to banks in other advanced economies, Australian banks hold relatively more mortgages as a share of loans (Figure 22). Mortgage assets generally do not increase the productive capacity of the economy and can crowd out debt finance for businesses.

Figure 22 – Bank assets, selected jurisdictions



Source: The future of Australian bank funding KPMG & Australian centre for financial studies report 011 – data updated from IMF statistics

Source: Boston Consulting Group

While CGT concessions and negative gearing have distorted bank lending toward housing, CGT has perhaps had other effects.

In the cash equities market, the presence of capital gains tax concession may have contributed to the increasing activity in secondary trading, not primary fund raising. CGT concessions are available simply by holding a financial instrument for one year, no economic capital needs to be formed (i.e., the investment does not need to be provided to an operating firm for purposes of capital formation). In the late 1990s the ratio of primary capital raised to the turnover of secondary equity markets was, on average, about 1:10 (i.e., for every one dollar of public capital raising there was about $10 of trading activity). In 2012, the ratio was 1:28.[26]

1.7.2.2 CGT reform territories

There are at least two directions policymakers interested in reforming CGT may wish to explore. Each might better target the concessions toward the purpose of economic capital formation.

- The first option is to tailor CGT such that concessions are provided for economic capital formation. Current CGT provides for a lower tax rate than for wage income, which is intended to create incentives for investment. However, the design of CGT does not ensure that the concessions are related to real economic investment, i.e., in capital formation. The design does not distinguish between the purchase of a financial instrument in the secondary market, and the funding of an enterprise. As a result, purchases of financial instruments that result in no investment in capital (or even proceeds being received by an operating company) are eligible for CGT concessions. This could be part of the reason why economies with developed financial systems and large numbers of financial instruments nonetheless have declining investment to GDP ratios.[27] Tax preferences for capital gains could

[26] Industry Super Australia Submission to the Financial System Inquiry Interim Report, 2014, p47

[27] Since 2008, research considering the efficiency of modern finance has found troubling results. Cecchetti and Kharroubi (2013) found a negative relationship between financial sector growth and productivity growth. Gambacorta et al. (2014) results indicate that banking sector size and capital markets size have a non-linear relationship with growth and become negative after a certain

differentiate between (i) gains on financial instruments acquired in the secondary markets, and (ii) gains on financial instruments acquired in primary transactions (i.e., in exchange for funding an operating company). Gains on instruments obtained in the secondary markets could have concessional treatment if there is a post-acquisition funding injection, to the extent of that injection. Otherwise it is not clear that CGT concessions are achieving their purpose.

- The second option is to place the concessional rate for holding periods on a sliding scale. The current CGT concessional treatment is based on holding periods, not actual investment as noted above. In addition, it is not a particularly long holding period, and is binary. It may be worth considering extending the period of time before the full concession is available to reflect something more akin to a long-term investment.

1.7.3 Taxation of savings other than superannuation

The Tax Discussion Paper requests comment on whether different forms of savings should have similar tax treatment. In particular, the Discussion Paper seeks consideration of whether interest on amounts deposited in bank accounts be taxed at full marginal rates while interest and earnings on amounts contributed into superannuation are taxed at concessional rates.

Concessional treatment of superannuation savings is appropriate. They can help Australians achieve a comfortable retirement by enabling contributions and earnings to compound to a greater degree. They also encourage Australians who can make voluntary contributions to do so.

The tax concessions for superannuation, while they could be better targeted, have also resulted in a marked shift in household assets and risk exposure.

Before universal super, most households kept the overwhelming majority of wealth in real estate, particularly the family home, with around 10 per cent of wealth also held in bank accounts. In 1990, only the top 10 per cent of households by wealth had holdings of any significance in other financial assets, such as shares in listed companies (Figure 23).

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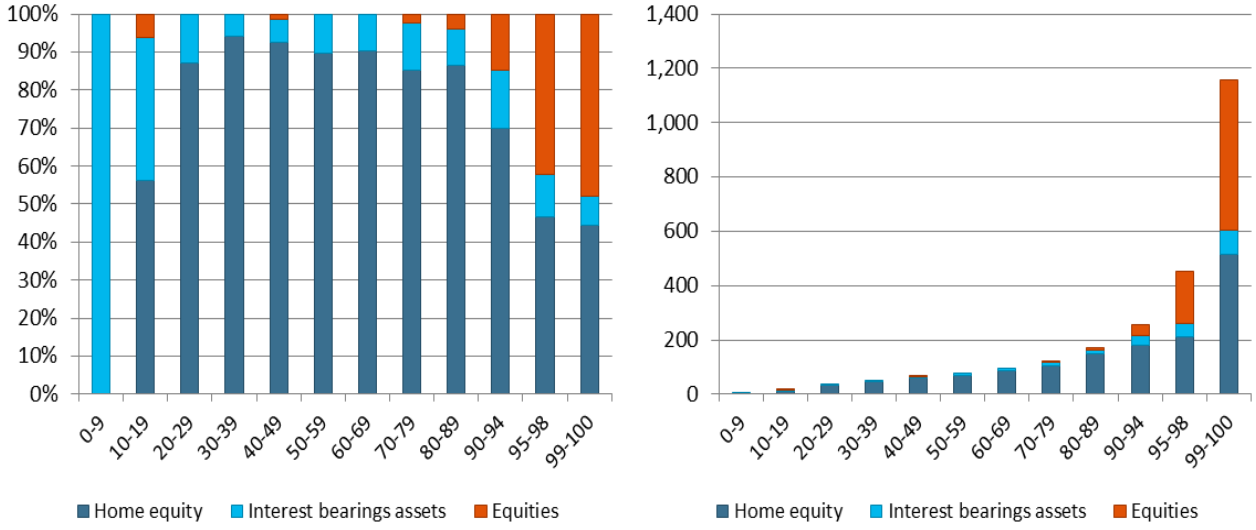
point. Other studies finding large financial sectors can be a drag on growth include: Arcand et al. (2012; Beck et al. (2012); Cecchetti and Kharroubi (2012); Law and Singh (2014); Philippon (2012); Feldkircher (2014); Sawyer (2014); Greenwood and Scharfstrein (2013), Demirgüç-Kunt and Huizinga (2010); Epstein & Crotty (2013); Hein (2011); Barajas et al. (2013); see also earlier research such as Rioja & Valev (2004); Aghion et al. (2005) among others.

Recent Bank of International Settlements research by Cecchetti & Kharroubi (2015) extends their previous study, showing that financial growth disproportionately harms financially dependent and R&D-intensive industries. IMF staff have also recently released a study showing that the effect of financial development on economic growth is bell-shaped: it weakens at higher levels of financial development, and also contributes to economic instability and increases the volatility of growth (Sahay et al., IMF Staff Discussion Note, 2015).

Figure 23 – Composition of household assets, proportions and '000s dollars, by wealth decile, 1990

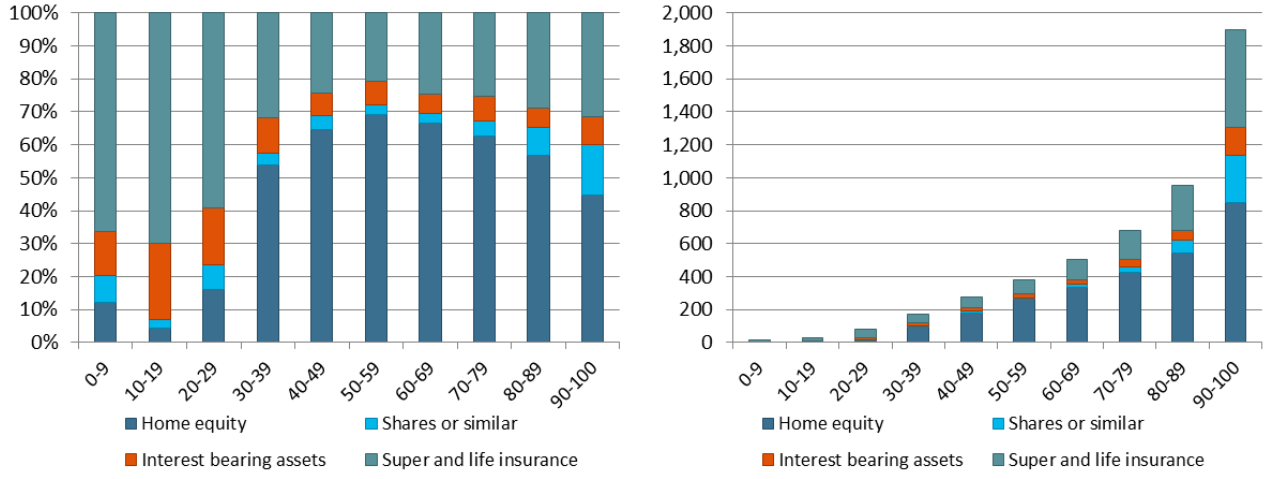


Source: ABS data (IDS microdata) cited in Bacon 1995 (from RIM Group Treasury)
Note: The 90-100 decile is split across three categories

Two decades later, in 2010, households all the way across the wealth distribution hold financial assets (Figure 24). Direct holdings of shares, while still highly skewed, exhibits some distribution across the middle deciles, due in part to a series of major privatisations and demutualisations in the 1990s that saw many households issued with shares for the first time.

The most significant change over this period, however, is the significant proportion of wealth held in the form of super right across the wealth distribution. Super has added substantially to the diversification of assets held by most working Australian families.

Figure 24 – Composition of household assets, proportions and dollars, by wealth decile, 2010



Source: Hilda (2012) Wealth Survey

Universal superannuation has unambiguously improved the asset diversification of Australian households, broadening the asset base beyond property for the first time for families outside the wealthiest 10 per cent. Exposure to equities, bonds and commercial property is now shared much more broadly across the wealth distribution. New asset classes have been developed, such as infrastructure equity and debt, which are available to all workers through workplace default funds and investment options. APRA-regulated

superannuation funds have also contributed to a reduction in 'home bias' by investing a significant minority of assets overseas. All these factors contribute to improved risk-adjusted returns and provide at least marginally reduced exposure to the housing market, where all previous non-cash wealth was held for all but the wealthiest households.

1.7.4 Company tax

The Tax Discussion Paper suggests that Australia's company tax may need to be reduced in order for Australia to compete for investment in the global capital markets and as a desirable location for corporate operations.

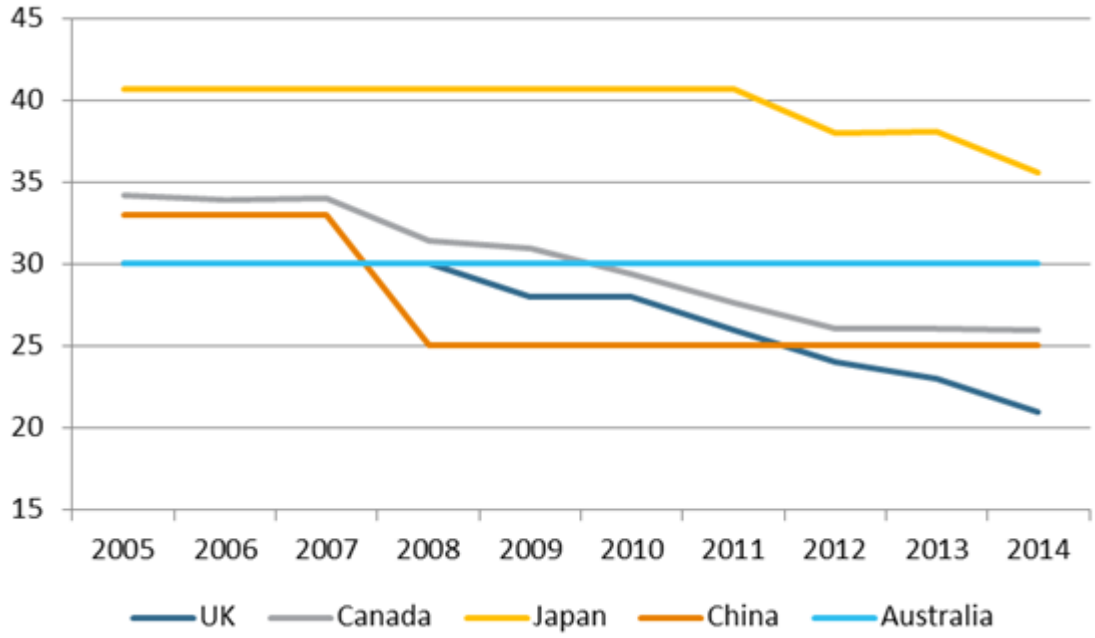
The argument made is that foreign investors will not invest in Australia if corporate tax rates are higher than other jurisdictions, and that other jurisdictions have acted to lower their company tax.

Whilst the Discussion Paper argues that hurdle rates of return for foreign investment in Australia are heavily affected by the corporate tax rate,[28] there are many other factors that will influence investment decisions. Even if the belief that foreign investment is highly sensitive to corporate tax rates were true, many advanced economies have corporate tax rates that are higher than Australia.

More importantly, the belief that foreign investment is highly sensitive to corporate tax rates is not supported by the evidence.

Figure 25 shows the changes in corporate tax rates for Australia and the economies frequently referenced in the Tax Discussion Paper's treatment of corporate tax. It shows that these jurisdictions have, indeed, reduced corporate tax rates in recent years.

Figure 25 – Changes in corporate tax rates, selected countries



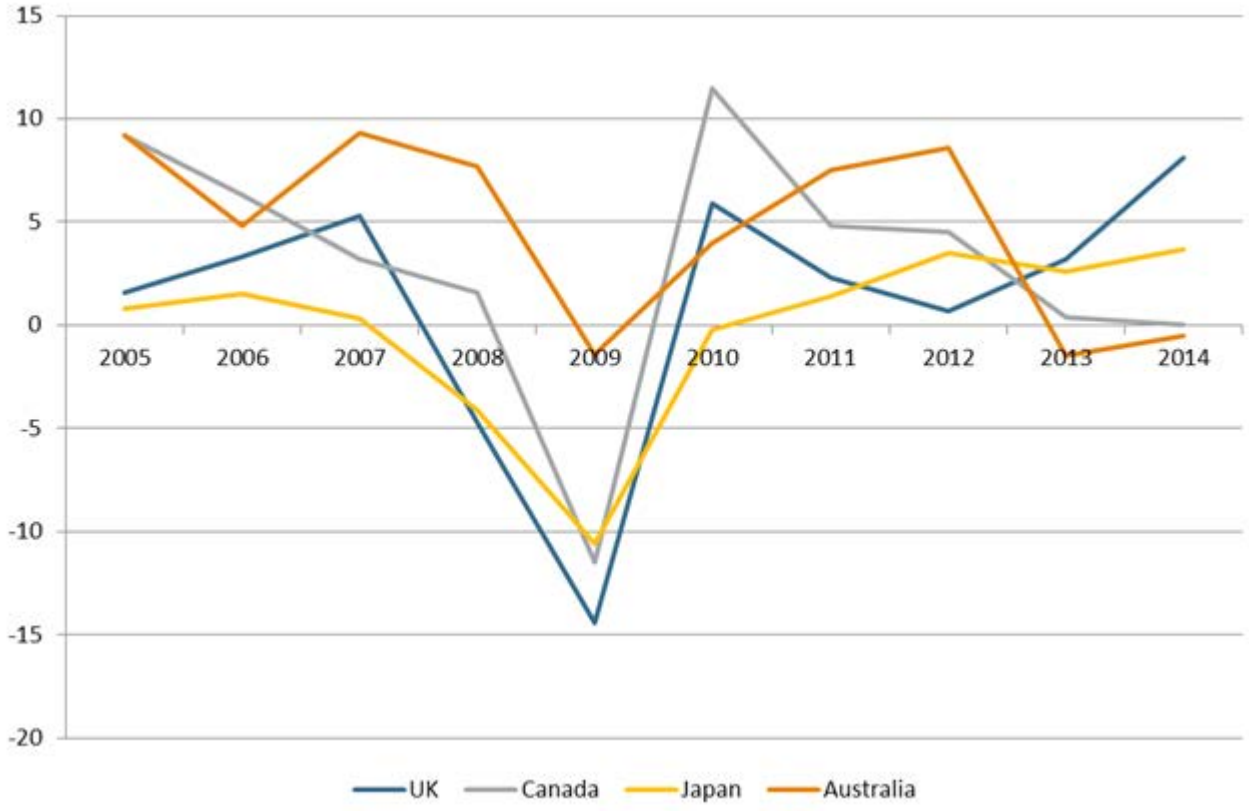
Source: Trading Economics

However, the hypothesis of the Tax Discussion Paper is that such corporate tax rate cuts have lifted investment.

[28] The Australian Government, Re:Think - Tax discussion paper, March 2015 (see, e.g., Box 5.1, page 79)

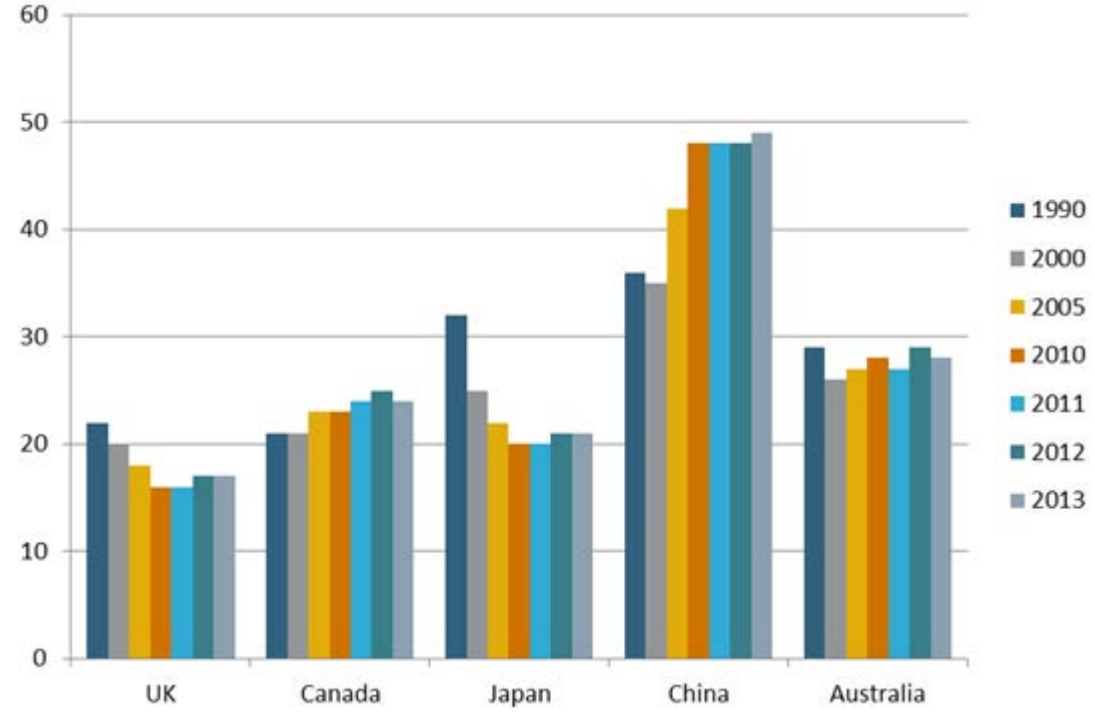
Figure 26 shows changes in real gross fixed capital formation for these economies. Figure 27 shows the investment to GDP ratios of these economies. Neither figure shows a relationship between company tax and investment.

Figure 26 – Changes in real gross fixed capital formation, selected countries



Source: OECD

Figure 27 – Investment as a per cent of GDP, selected countries



Source: World Bank

If the underlying theory informing the Tax Discussion Paper is correct (which it may not be), the confounding factors of greater relevance than tax are clearly substantial. Without fully assessing these factors and their particular relevance to foreign investment in Australia, adjustments to the corporate tax rate in Australia may come at significant revenue cost without spurring the additional investment required to expand the tax base.

The Tax Discussion Paper also does not consider how changes in the corporate tax rate might affect inequality in endowment, opportunity, and outcomes, as well as other factors relevant to reducing taxes (especially taxes on capital income).

1.7.5 Self-managed super funds

As of September 2013 the SMSF sector was estimated to hold assets of $530 billion, having grown at about 10 per cent per year since 2007, compared to 5.4 per cent per year for APRA-regulated funds during the same period.[29] SMSFs are regulated by the Australian Tax Office and hence, subject to a different regulatory framework than the APRA-regulated funds.

To date, data released on SMSFs by the ATO are not directly comparable to their APRA-regulated counterparts.

However, recent research is beginning to provide concerning evidence of considerable inefficiency and tax leakage in the sector.

[29] APRA Superannuation Bulletin 2013

1.7.5.1 Inefficiency

A recent paper by Arnold et al (2014) has shed light into the size, cost and tax expenses of SMSFs.[30] Figure 28 provides a breakdown of income, expenses and tax as a percentage of assets for the SMSF sample from 2008 to 2010, and ranks them by total asset size deciles. The level of expenses varies significantly between asset deciles. The difference in median expense ratio between the lowest and the highest asset decile is large (2.56 per cent). Most of the differences in expenses between the two groups are in insurance premium and management and administration expenses, pointing to the benefits of scale in SMSFs.

Additionally, the evidence points out that the top decile SMSFs (average account balance of more than $2.2 million) also benefit from lower tax expense ratio compared to the lower deciles. The top decile SMSFs only pay a tax expense ratio of 0.87 per cent while the bottom decile SMSFs' tax expense ratios are 3.78 per cent. This difference is driven primarily by tax on contributions and investment income. As SMSFs asset size grows, the ratio of tax on contributions and investment incomes will become progressively lower due to the flat tax rate structure in superannuation.

For most SMSF account holders, the running costs of SMSFs are significantly higher than the average fees charged in not-for-profit APRA-regulated funds. Analysis by the Boston Consulting Group for ISA found that the fees for median size SMSFs are 175 basis points per year, and that the fees for the bottom quintile of SMSFs by size are over 300 basis points per year.

These expense levels represent a significant leakage from the superannuation system, resulting in lower retirement accumulations for those with SMSFs. SMSF trustees and account holders with assets in this range are likely to qualify for full or part Age Pensions, so reduced accumulations in this range will also result in increased public pension outlays in coming years.

[30] Arnold, Bateman and Raftery, The size, cost and asset allocations of Australian self-managed superannuation funds, Centre for International Finance and Regulation, 2014

Figure 28 – Income, expenses and tax for SMSF sample, % of mean assets, 2008-2010, ranked by total assets size deciles

Decile band		1	2	3	4	5	6	7	8	9	10	Total
Mean as a percentage of total assets (mean) - all years												
Income												
Capital gains	48,234	0.88%	1.04%	1.13%	1.12%	1.17%	1.19%	1.09%	1.08%	1.06%	1.16%	1.12%
Rent	32,560	0.10%	0.15%	0.25%	0.37%	0.53%	0.62%	0.78%	0.84%	0.89%	0.78%	0.75%
Interest received	185,190	1.78%	1.45%	1.35%	1.30%	1.21%	1.20%	1.19%	1.17%	1.22%	1.26%	1.24%
Foreign income	72,899	0.07%	0.09%	0.12%	0.14%	0.15%	0.15%	0.15%	0.15%	0.16%	0.16%	0.16%
Dividends received	120,642	1.04%	1.13%	1.18%	1.20%	1.21%	1.19%	1.12%	1.13%	1.13%	1.13%	1.14%
Concessional contributions received	155,094	26.98%	17.64%	11.53%	11.66%	9.47%	8.60%	7.89%	6.98%	5.89%	3.62%	6.15%
Other income		0.03%	-0.13%	-0.08%	-0.04%	-0.03%	-0.04%	0.06%	0.13%	0.15%	0.25%	0.15%
Total income		30.87%	21.36%	15.48%	15.75%	13.72%	12.92%	12.28%	11.49%	10.50%	8.35%	10.69%
Less: expenses												
Interest paid	19,040	0.13%	0.11%	0.11%	0.09%	0.08%	0.08%	0.08%	0.06%	0.04%	0.02%	0.04%
Depreciation	14,680	0.08%	0.04%	0.03%	0.03%	0.03%	0.04%	0.05%	0.06%	0.05%	0.03%	0.04%
Insurance premiums paid	38,741	1.31%	0.63%	0.49%	0.37%	0.27%	0.21%	0.17%	0.14%	0.10%	0.05%	0.13%
Audit fees	98,532	0.64%	0.31%	0.21%	0.16%	0.13%	0.10%	0.08%	0.06%	0.04%	0.02%	0.06%
Investment expenses	57,923	0.48%	0.30%	0.28%	0.27%	0.28%	0.28%	0.28%	0.25%	0.24%	0.16%	0.22%
Management & administration expenses	177,328	2.85%	1.37%	1.04%	0.86%	0.71%	0.61%	0.51%	0.42%	0.34%	0.20%	0.40%
Other expenses	47,846	0.93%	0.41%	0.28%	0.21%	0.17%	0.15%	0.13%	0.12%	0.09%	0.05%	0.10%
Total expenses (mean)		6.43%	3.16%	2.43%	1.99%	1.66%	1.47%	1.30%	1.10%	0.90%	0.53%	1.00%
Total expenses (median)		*2.92%*	*1.84%*	*1.52%*	*1.28%*	*1.09%*	*0.97%*	*0.85%*	*0.72%*	*0.60%*	*0.36%*	*0.52%*
Net income before tax		24.44%	18.20%	13.05%	13.76%	12.06%	11.45%	10.98%	10.38%	9.60%	7.82%	9.69%
Less: income tax												
Tax on contributions		4.05%	2.65%	1.73%	1.75%	1.42%	1.29%	1.18%	1.05%	0.88%	0.54%	0.92%
Tax on investment income		0.13%	0.35%	0.45%	0.51%	0.56%	0.59%	0.61%	0.65%	0.69%	0.76%	0.66%
Less: franking credits	119,076	-0.39%	-0.44%	-0.46%	-0.47%	-0.47%	-0.46%	-0.43%	-0.44%	-0.44%	-0.44%	-0.44%
Net income tax expense		3.78%	2.55%	1.72%	1.79%	1.51%	1.42%	1.36%	1.26%	1.14%	0.87%	1.14%
Net income after tax		20.66%	15.65%	11.33%	11.97%	10.54%	10.03%	9.62%	9.13%	8.46%	6.95%	8.55%
Net income after tax (excluding contributions)		-2.27%	0.66%	1.53%	2.06%	2.49%	2.72%	2.91%	3.19%	3.45%	3.88%	3.33%
n		*20,942*	*20,942*	*20,942*	*20,942*	*20,942*	*20,942*	*20,942*	*20,942*	*20,942*	*20,942*	*209,420*

Source: Arnold, B, Bateman, H. & Raftery, A., 2014, The size, cost and asset allocations of Australian self-managed superannuation funds, Centre for International Finance and Regulation.

1.7.5.2 Negative gearing and other forms of leveraging by SMSFs

SMSFs have also become increasingly leveraged. In the year to April 2014, the number of SMSFs using geared products increased by more than 11 per cent. The concentration of SMSFs in property is also a concern. Between 2008 and 2013, SMSF investment in residential property increased from $10.6 billion to $17.5 billion. Including all instalment receipts and borrowings, the SMSF exposure to property is in the order of $85 billion.

The FSI recommended removing the exception to the general prohibition on direct borrowing for limited recourse borrowing arrangements by superannuation funds. ISA supports this recommendation. ISA is also concerned about the level of indirect leverage (such as leverage embedded in investments) in SMSFs. APRA-regulated funds' indirect leverage is reviewed by trustees and prudentially reviewed. It is not clear how indirect leverage is managed and reviewed by SMSFs' trustees. ISA recommends that the regulatory settings that permit indirect leveraging be reviewed further.

1.7.5.3 Tax Leakage

The popularity of the SMSF structure is largely because it is an effective tax shelter and estate planning vehicle.[31] By some measures, SMSFs as a sector have been paying no net tax since 2010 (Figure 29).

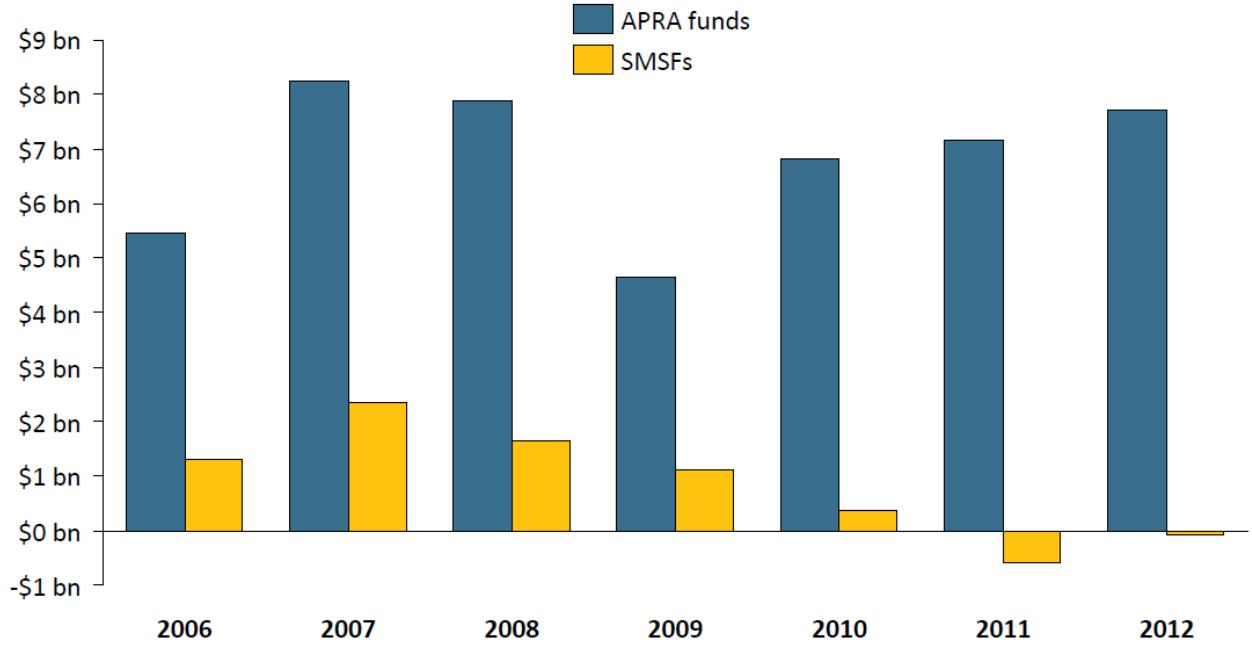
To date, there has been no comprehensive report into the value of tax minimisation by SMSFs. However, some of the more popular strategies have been described as 'tax leakage' in the press.[32]

The use of SMSFs as estate planning and tax sheltering vehicles is inconsistent with the objectives of Australia's retirement system.

[31] Based on ATO data, 'SMSFs are paying no net tax – even taking taxable contributions into account - at least for the three years through to 2012.' - Tria Investment Partners, 12 May 2014

[32] King, A., 2014, 'Tax leakage' alarm over super-wealthy SMSFs', the Australian Financial Review, 21 May 2014 http://www.afr.com/news/politics/national/tax-leakage-alarm-over-superwealthy-smsfs-20140603-iubtk

Figure 29 – Net tax paid by SMSFs and APRA-regulated funds 2006-2012



Source: Australian Tax Office Statistics 2011-2012. ISA calculation based on methodology from Tria Investment Partners[33]
Note: Net tax paid is calculated as the net of PAYG instalments raised & total amount due or refundable

1.7.5.4 Data and reporting quality

The quality of data and reporting by and regarding SMSFs makes it difficult for consumers, academics, and regulators to monitor and police SMSF conduct.

While allowing for the differences in nature of SMSFs and APRA-regulated funds (e.g. SMSFs do not have contribution fees, buy/sell spreads, insurance premium, among other differences), it is essential that some major measurements are consistent. ISA recommends changes to align reporting of the following:

Asset valuations. Currently, while APRA funds must report assets at market value in all circumstances, SMSFs are only required to do so in limited circumstances. Valuation and accounting practices should be consistent across APRA-regulated funds and SMSFs.

Accrual treatment of tax. While all APRA-funds treat tax on accruals basis, in some SMSFs, taxes are treated on a cash basis. Consistent tax treatment and reporting will ensure that net returns are properly calculated.

Costs. The cost amounts for SMSFs are based on the amounts of deductible expenses in SMSF annual tax returns. The ATO has suggested that this may lead to costs being under or overstated.

More superannuation assets are in SMSFs than any other sector, and greater information about them is necessary to determine whether the balance of the evidence indicating they are poor value for money is correct.

[33] Baker, A., 2014, 'What's worth $500bn and is paying no tax?', SMSF Adviser, Wednesday 28 May 2014 http://www.smsfadviseronline.com.au/columns/item/196-what-s-worth-500bn-and-is-paying-no-tax

2. Empirical observations regarding certain assertions and assumptions in the Tax Discussion Paper

ISA's focus in this submission is primarily on the efficiency and effectiveness of tax settings in respect of retirement security.

Nonetheless, there were a number of stated and unstated assumptions in the Tax Discussion Paper that are open to challenge. We have sought to highlight some relevant concerns.

2.1 The purpose of taxation

The Discussion Paper makes a number of assertions about the purpose of taxation. This influences the type and scope of tax reform the paper considers.

The Tax Discussion Paper states "The tax system raises the revenue required to fund public services."[34]

2.1.1 The claim that the purpose of tax is to raise revenue to fund public expenditure

The assertion that the purpose of taxation is to fund public expenditure is not supported by the evidence.

The empirical data on government tax receipts and outlays does not support the assertion that taxation is required to fund public expenditure. For example, the United States has spent more than it has taxed in the aggregate and nearly every year since its founding.[35] In the United Kingdom and in Australia, outlays have exceeded expenditure between 1900 and 2015.[36]

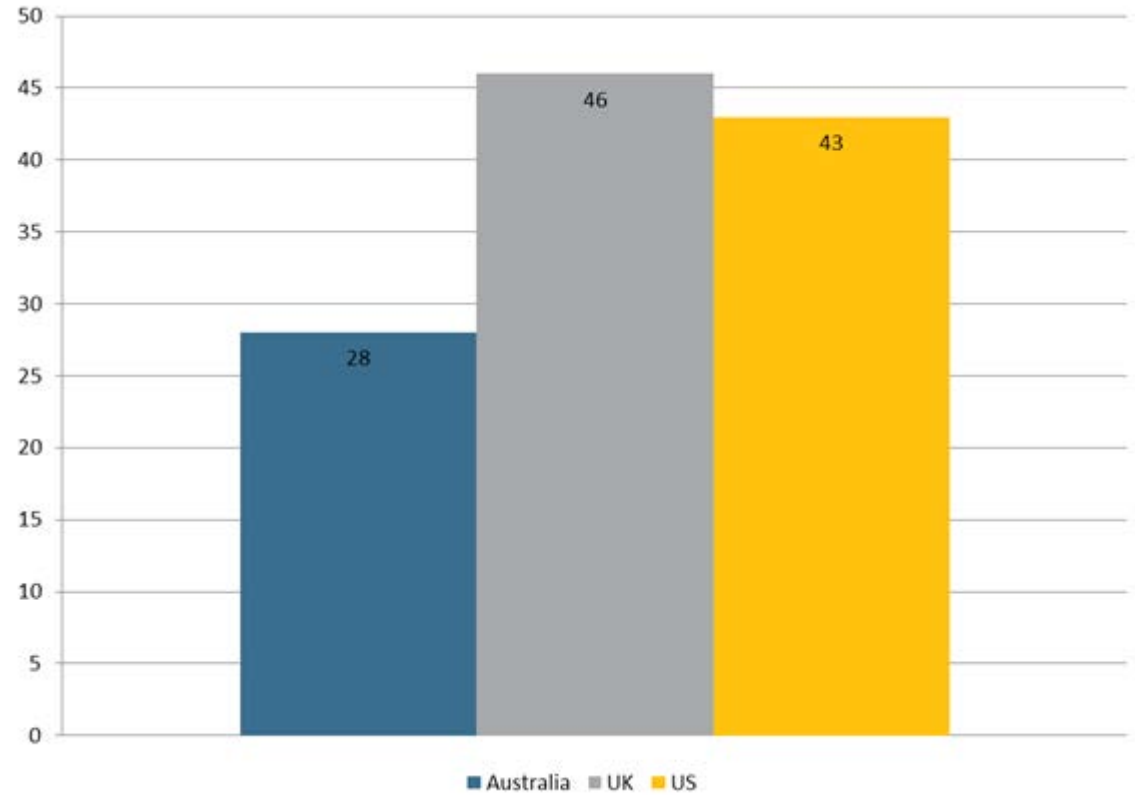
Figure 30 shows the number of budget deficits (i.e., instances in which "revenue" raised by tax was insufficient to cover expenditure). These countries continue to exist, and their expenditures have increased, suggesting tax is something other than a revenue raising device.

[34] The Australian Government, Re:Think - Tax discussion paper, March 2015, p 2

[35] Congressional Budget Office, The 2013 Long-Term Budget Outlook, Congress Of The United States, Figure 1-1. Federal Debt Held by the Public under CBO's Extended Baseline.

[36] For the UK see ukpublicspending.co.uk (Data Sourced from B.R. Mitchell, British Historical Statistics, and HM Treasury PESA. For Australia see Katrina Di Marco, Mitchell Pirie and Wilson Au-Yeung, A history of public debt in Australia, Treasury, Commonwealth of Australia, 2011

Figure 30 – Number of deficits since 1970-2017 (forecast)



Source: Australian Budget Paper 2013-2014, the US Census, the Guardian Data, ISA analysis

Operationally, taxation does not need to strictly precede spending (though over the medium to longer term, the relativities of taxation and expenditure express the fiscal policy settings of Government). The recent instances of economic stimulus, such as in Australia following the GFC and in Japan following the 2011 tsunami, demonstrate clearly that spending, as an operational task, do not necessarily need to be preceded by the raising of funds through taxation.

While government expenditure may both precede and exceed taxation (as evident both empirically and operationally), this may simply be a result of government using debt to smooth the rates of taxation in the short to medium term. In this scenario, taxation would fund public expenditure over the long term by servicing public debt accrued during short periods. However, the issuance of public debt is not necessary, as an operational matter, to provide funds to government.[37]

We also note that, operationally, a currency must be "spent" into existence by a sovereign before it can be taxed.

If expenditure is not necessarily tied to tax revenue, the appropriate limits and objectives of government expenditure policy may require reconsideration.

Although taxation revenue is not necessarily an operating constraint on government spending, this does not mean that governments are economically unconstrained in their spending. They are constrained by the limits of the real productive capacity of the economy, and the consequence of exceeding it: inflation.

> Governments' capacity to implement discretionary fiscal policy, and to provide economic and social services and infrastructure, is not constrained by their ability to collect tax revenue and/or borrow from the private

[37] Brett Fawley and Luciana Juvenal, 'Why Health Care Matters and the Current Debt Does Not', The Regional Economist, October 2011, Federal Reserve Bank of St. Louis p 5: "the government is not dependent on credit markets to remain operational."

sector, but rather their actions are constrained by the productive capacity of the economy to facilitate the associated demand pressures.[38]

Governments also are constrained by democratic forces and the electorate's tolerance of greater allocations of resources and productive capacity to public endeavours rather than to private.

2.1.2 The multifaceted nature of tax

Quite apart from raising revenue, tax is a public policy tool with range of significant applications.

Taxation adjusts aggregate demand

Taxation adjusts the aggregate demand in an economy, or the total demand for final goods and services in an economy. It does so by transferring money from the non-government sector to the government. This reduces the purchasing power of the private sector. If the government does not place the money back into circulation and retains it as a budget surplus, money is withdrawn form the entire economy. Hence, taxation is an instrument of fiscal policy which can assist in maintaining price stability. The existence of a budget surplus is often a result of fiscal policy acting as an economic stabiliser during the economic cycle, rather than fiscal policy reflecting the political cycle. This is consistent with Australia's economic history.

Taxation assists in promoting fairness and equality

Taxation, in conjunction with the transfer system, can also be used to distribute the product of the economy more fairly, and increase equality and opportunity within society. In this sense, the "tax-transfer system is the principal means of expressing societal choices about equity. The tax-transfer system is a reflection of the kind of society we aspire to be."[39] In Australia, such an expression is encapsulated in the phrase a "fair go." More generally, the principle of the social contract is one fundamentally of justice. These broader principles of liberal democratic societies elevates ensuring a "fair go" from simply one possible use of taxation to one of the primary purposes of taxation.

With respect to using taxation to reduce inequity, especially inequity of income, recent evidence has rejected the hypothesis that redistribution is damaging to economic growth: new analysis indicates that redistribution is generally benign and that the lower net inequality arising from redistribution is robustly related to faster and more durable growth.[40] These are important findings to note in any debate on tax reform, as constrained interpretations of the purpose and functions of taxation can result in the false conclusion that taxation imposes a cost on growth. Moreover, the negative effect of income inequality on growth is evident for the bottom four deciles of the income distribution, suggesting that the objective of redistribution should be broader than addressing poverty alone.

Taxation can support particular groups or promote activities

Australia's previous tax system review and the current Tax Discussion Paper both recognise that tax and transfer policies play an important role in supporting particular groups or activities. Policy can target improving social outcomes, such as promoting home ownership by excluding the family home from CGT, providing tax offset for care provided within the family, and increasing dignity in retirement through the concessional taxation of superannuation. Tax policy can target support for particular groups, such as those

[38] Hart, 'Discretionary Fiscal Policy and Budget Deficits: An 'Orthodox' Critique of Current Policy Debate', The Economic and Labour Relations Review, Vol. 19 No. 2, pp. 39–58, 2009, p 40-41.

[39] Henry, How much inequity should we allow?, 3 April 2009.
http://taxreview.treasury.gov.au/content/Content.aspx?doc=html/speeches/05.htm

[40] See, e.g., Ostry, Berg and Tsangarides, Redistribution, Inequality and Growth, IMF Staff Discussion Note, February 2014.

living in remote areas who receive a zone offset, and particular practices such as improving tax compliance and business efficiency by simplifying certain tax rules.

Taxation can address market failures

Taxation can impact market failures when the negative externalities of a market activity produce a marginal social cost that is not covered by the marginal private cost of the activity. Examples include the taxation of tobacco and alcohol, environmental pollution and financial institutions and practices which create systemic risk in the financial system. These taxes are sometimes called Pigouvian taxes after the British economist Arthur Pigou.

In designing tax settings that consider these many facets, the ease of administration and stability of the settings must also be considered.

The relevant point here is simply that if the purpose of taxation is not to fund public services as asserted by the Tax Discussion Paper, a more comprehensive discussion becomes possible.

3. Responses to selected questions

3.1 Question 18

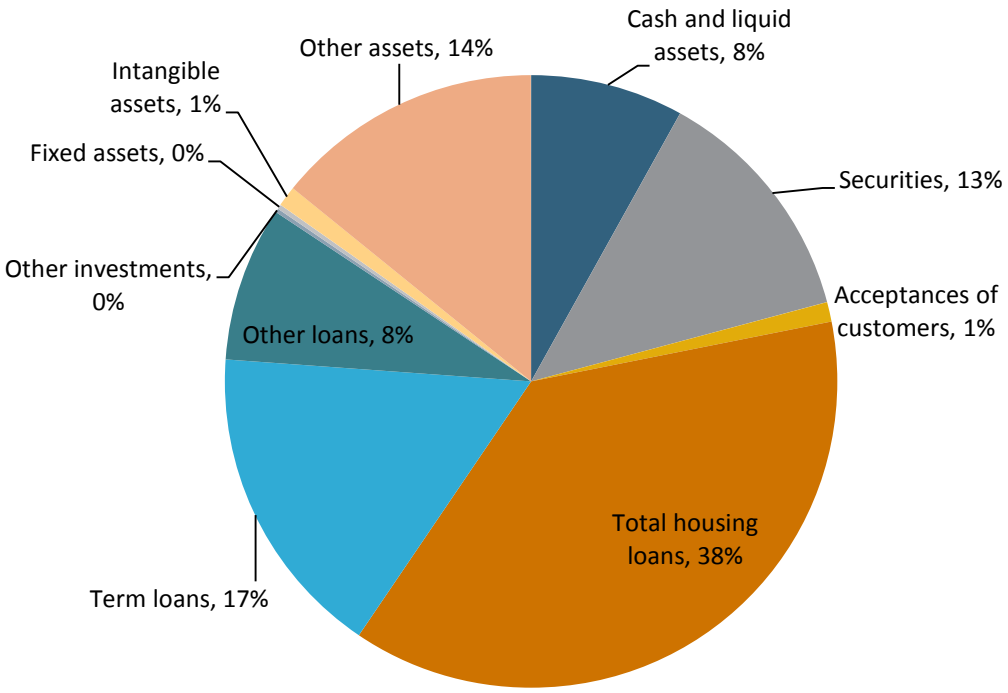
18. What tax arrangements should apply to bank accounts and debt instruments held by individuals?

ISA recommends against reducing tax rates on bank deposit interest income.

First, banks are already well funded, holding over twice the savings of the rest of the financial system combined.

Second, banks' asset allocation is relatively unproductive, with the majority in cash, housing loans, and term loans (Figure 22). Bank lending is particularly overweight housing. This argument has been made extensively. If the tax review determines to seriously consider a tax cut for bank deposits, ISA will provide significant evidence about the harmful effect this would have on the economy, and the distributional effects.

Figure 31 – Bank asset allocation, 2013

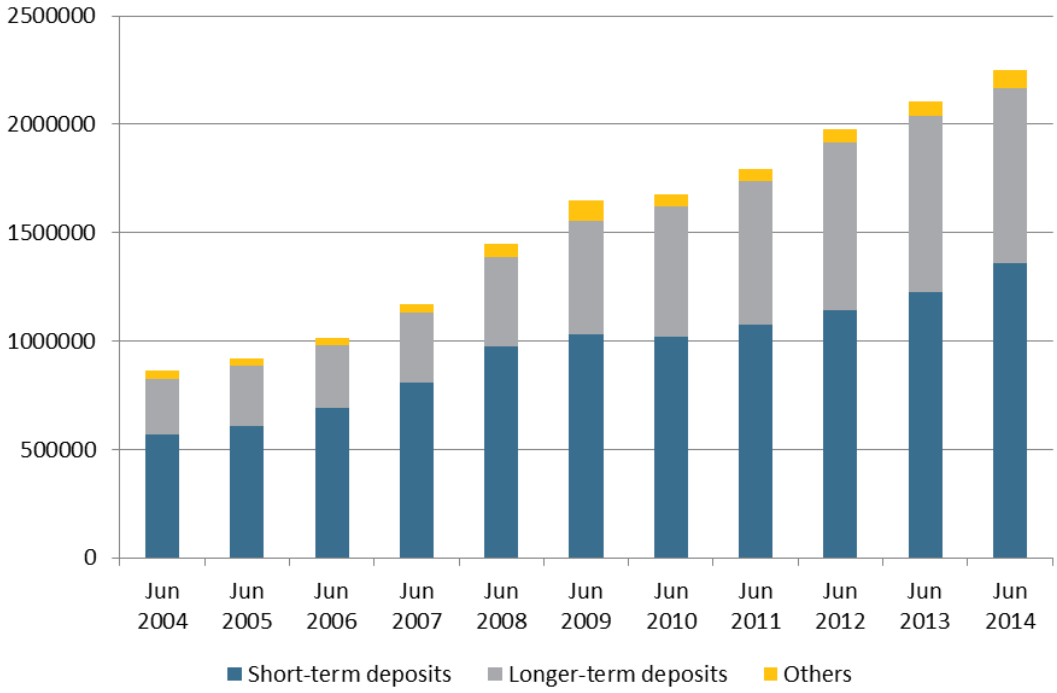


Source: APRA banking statistics

Greater encouragement for bank deposits and debt instruments would take away from investments in growth assets. One of the benefits of the superannuation system, with its focus on long term returns, is that it encourages members to invest some of their savings in growth assets. This is beneficial to capital formation and the flow of funds, in addition to its core objective of generating sufficient income in retirement and reducing longevity risk.

Third, most bank accounts are liquid (Figure 32). This means they are best characterised as short term savings.

Figure 32 – Bank deposit mix, $ millions

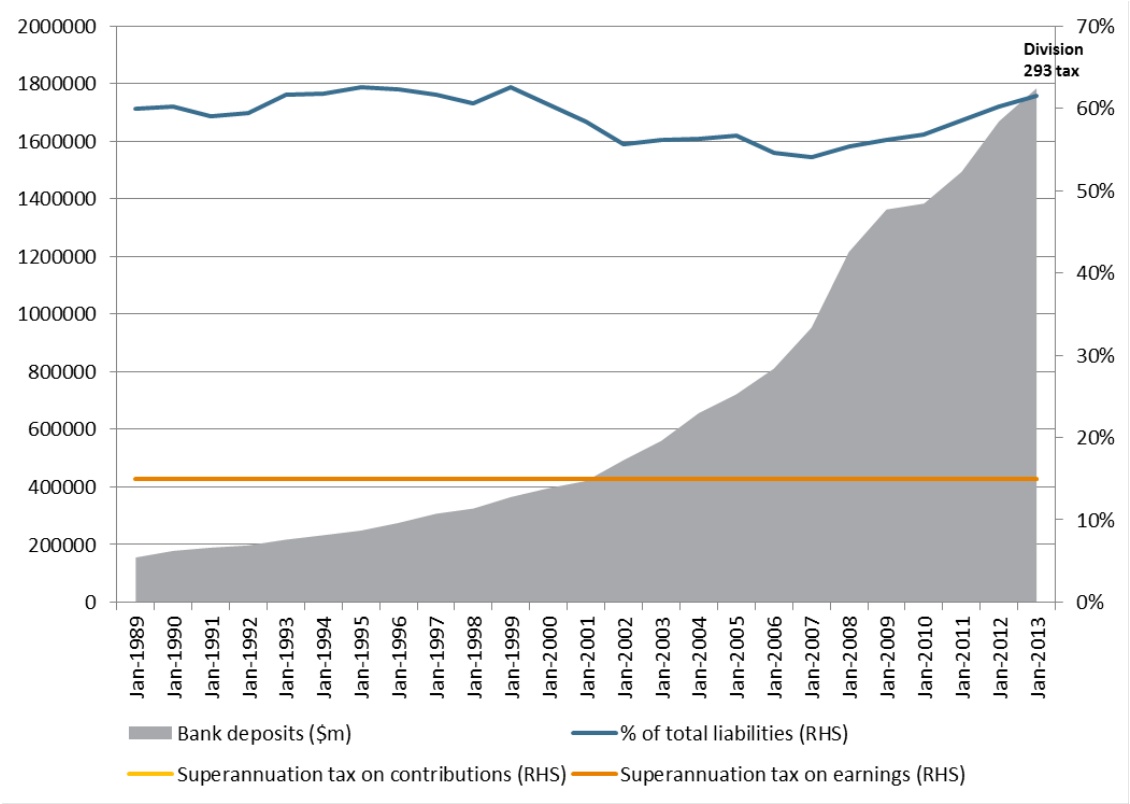


Source: APRA Banking Statistics
Note: Short-term deposits consist of Call/on demand deposits and Certificates of deposits

Fourth, lowering the tax rate on bank deposit income could encourage external debt financing corporate activity (as an outgrowth of the deductibility of interest payment, and then the reduced tax on interest income).

Finally, there is no evidence that the demand for (or growth in) bank accounts is sensitive to tax on savings, as shown in Figure 33.

Figure 33 – Bank deposit growth, changes in superannuation tax



Source: RBA Table B2 & ISA

Note: From 1 July 2012, individuals with total earnings greater than $300,000 have had to pay additional tax on taxable contributions above a $300,000 threshold. The Division 293 tax rate is 15%.[41]

3.2 Question 19, 21

> 19. To what extent is the rationale for the CGT discount, and the size of the discount, still appropriate?
>
> 21. Do the CGT and negative gearing influence savings and investment decisions, and if so, how?

The justification for capital gains tax treatment as currently fashioned can be questioned.

Current settings in CGT promote tax planning.

CGT settings do not appear to have affected the desirability of investment in productivity enhancing capital. (See Figure 20 above).

Although CGT changes have had no discernible effect on investment, CGT is integral to the use of negative gearing and the shift in funding toward housing resales and away from capital assets that lift productivity.

Please see Section 1.7.2 for more detail.

[41] ATO https://www.ato.gov.au/super/super-professionals/in-detail/superannuation-transfers,-contributions-and-rollovers/division-293-tax---information-for-tax-agents/

3.3 Question 20

> 20. To what extent does the dividend imputation system impact savings decisions?

Please see Section 1.7.1, above.

3.4 Question 22

> 22. How appropriate are the tax arrangements for superannuation in terms of their fairness and complexity? How could they be improved?

Section 1 of this submission discusses the efficiency and effectiveness of superannuation tax concessions.

- The majority of Australians will not retire on sufficient income to live comfortably.
- Existing tax settings provide millions of dollars of benefits to individuals who could live an opulent lifestyle without the concessions, while levying tens of thousands of dollars of additional tax on single men and women in low income deciles, and about $75,000 on low income couples.
- For all but a few Australians, a comfortable retirement would be impossible without the age pension. Over 80 per cent of individuals currently aged 25 to 29 will receive some age pension under existing settings. Superannuation does not replace the age pension.

Complexity exists in the taxation of superannuation. Some particularly complex features include different taxation depending on whether a member is retired or not. The differentiation of tax treatment on earnings in the accumulation and decumulation phase also can affect member incentives. Complexity is also introduced to accommodate 'transition to retirement' arrangements, and other policies that apply different eligibility requirements.

In a subsequent submission we will suggest improvements.

3.5 Question 23

> 23. What other ways to improve the taxation of domestic savings should be considered? How could they be applied in the Australian context?

Question 23 is prefaced by a reference to estate tax. We have otherwise discussed the taxation of savings in respect of superannuation and bank deposits.

Our brief position on estate tax is that it may need to be considered as a "safety valve" against excessive intergenerational endowment. Particularly if other means of targeting tax concessions on savings, corporate tax, and capital income cannot be developed to ensure that such concessions do not result in excessively wide distributions of opportunity and outcomes.

Estate taxes, or taxes on wealth or wealth transfers, have been considered in the "optimal tax" literature. The key point of the literature is that the appropriate taxation depends on the nature of the bequest, but a zero tax on wealth transfers or estates is never appropriate under real-world scenarios.

> One model states that bequests are simply an accident. People do not know how long they will live and so they keep more money than they turn out to need. If a significant share of bequests are accidental, estate taxation is quite efficient. However, if people are motivated to work and to save by the idea of leaving their families an inheritance, the tax will be distortionary. The impact of the distortion will depend on the bequest motive. If people have a specific amount they wish to leave to their children regardless of their needs and their behaviour, the outcome will be different from what it would be if the amount bequeathed is determined by a concern for the welfare of the heirs. Either way, it turns out that wealth and wealth transfer taxes are useful instruments in most cases. A zero tax is called for only in an extreme case, when individuals are perfectly altruistic (so that they effectively behave as if they were to live for ever).[42]

With that said, a number of factors are relevant in considering an inheritance or estate tax.

- *Gift tax*. An inheritance tax may enable the wealthy to reduce the amount they pay by giving away their wealth during their lifetimes. In the UK, there is a perception that inheritance tax allows the wealthy to reduce the amount they pay by giving away part of their wealth tax-free during their lifetimes, and is therefore inequitable.[43] Some countries have imposed gift taxes on gifts over a certain threshold in order to mitigate this practice. In a number of countries, including, Germany, USA, Switzerland, and Spain, gift taxes are imposed on lifetime gifts, although (as with the predecessor to inheritance tax namely capital transfer tax) the thresholds operate at different levels from transfers on death.
- *Protecting spousal transfers*. Another important equity issue is the uniformity of treatment between married and unmarried donors. This suggests that concessional treatment should be extended to bequests received by spouses. These are not intergenerational transfers, and if bequests to spouses were fully subject to a bequest tax, the assets of a couple would usually be taxed twice before reaching the next generation, while the assets of a single person would not. Consideration should be given so that transfers to spouses and civil partners are exempt.
- *Minimising double taxation*. Double taxation is commonly cited as an objection to estate taxes. The general view has been that double taxation in itself is not necessarily a good or bad thing. The Henry Review noted that any system that taxes economic flows at more than one point will involve an element of double taxation. For example, the current system taxes an individual's labour income as it accrues and taxes the part that is consumed a second time, through the GST.[44] Nevertheless, awareness of the risk of double taxation when designing an estate tax is appropriate.
- *Ensuring relief or concessions are fair*. Exemptions should be designed and reviewed to ensure that exclusion of certain assets are fair. In some countries, family businesses or farms are exempt, but these exemptions are often viewed as being exploited.
- *Minimising loopholes*. To be successful, estate tax loopholes would need to be minimised so that those for whom the tax is applicable operate on an even playing field.
- *Creating a simple and streamlined process*. The international experience is largely shaped by a vocal opposition to inheritance taxes with complexity cited as one of the key concerns. A simple and streamlined approach should underpin any consideration of the introduction of an estate tax to Australia.

[42] Cremer, Comment on Taxation of Wealth and Wealth Transfers, Dimensions of Tax Design, The Mirrlees Review, 2010, page 817

[43] Broadway, Chamberlain and Emmerson, Taxation of Wealth and Wealth Transfers, The Mirrlees Review, 2010, page 738

[44] http://taxreview.treasury.gov.au/content/FinalReport.aspx?doc=html/publications/Papers/Final_Report_Part_2/chapter_a3-1.htm

4. ISA-Rice Warner model and methodology

A group-based population retirement income model was used to examine the impacts of policy change as the population ages through to a projection period to 2055.

The population is constructed using ABS *Confidentialised Unit Record File* (CURF) microdata supplemented or benchmarked to:

- Rice Warner's Market Projections report and APRA superannuation statistics;
- Rice Warner's Super Insights data utilising de-identified member record data from 9.1 million superannuation fund members spanning all APRA regulated sectors
- Australian Taxation Office taxation statistics, and SMSF statistics;
- ABS population projections and life expectancy tables, with adjustments for new entrants and deaths;
- Treasury Tax Expenditures Statement and long term projections of age pension expenditure in the 2015 Intergenerational Report

The model constructs quinquennial age and sex specific cohorts of singles and couples that are then divided into equal deciles ranked by income with further representative groups created to capture quantiles covering the top five percent and one percent. For each group, an average balance sheet of assets and liabilities including a stock of superannuation and non-superannuation financial assets is ascribed. Owner-occupied and investment housing equity are tracked over time.

The model utilises variable longevity by decile consistent with Clarke and Leigh.[45] The method used increases mortality for the first income decile by 30%, and lowers the mortality for the 10th decile by 30% and linearly interpolate between. This gives a ratio of mortality between Decile 1 and Decile 10 of 1.86 and leaves overall population mortality unchanged.

All existing legislated policy settings for personal income tax, superannuation and age pension are used in the base case business and usual (BAU). The BAU does not include changes that have been announced by Government but not implemented, such as proposed changes to the age pension asset test. Modelling of this proposal and other policy changes is undertaken separately against the baseline scenario.

All relevant thresholds are indexed as required by legislation. One exception to this relates to personal income tax thresholds. Over the projection period personal income tax thresholds are assumed to maintain relative parity to wages – this is broadly consistent with historical ad-hoc adjustments by Governments to ensure average tax rates on personal income don't increase significantly over time.

Wages are assumed to grow 4.0 percent per annum and inflation 3.0 percent. Younger cohorts experience promotional wages growth up to age 40. Age pension is indexed to male total average weekly earnings (MTAWE) which is slightly higher than average wages growth.

During working life, extra concessional and non-concessional contributions follow existing observed patterns by sex, age, and income. High income earners whose SG contribution would breach the concessional contribution cap are assumed to make the balance of their SG amount non-concessionally. Discretionary income is assumed in the first instance pay off owner occupied housing debt then to accumulate private savings.

Nominal before tax investment returns of 7.2 percent per annum reflect existing long term industry averages during accumulation and drawdown.

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[45] Clarke & Leigh, *Death, Dollars and Degrees: Socio-economic Status and Longevity in Australia, ECONOMIC PAPERS, VOL. 30, NO. 3, SEPTEMBER, 2011*

At retirement age (the average of which is 65 in the model) individuals draw down an account based pension at the greater of minimum drawdown rates or a fraction of super assets equal to (1 / years to life expectancy). This approach was adopted because it better reflects existing behaviour and allows a small amount of capital for longevity risk or funeral or other expenses at death. In higher income groups, the amount allows a moderate reversionary benefit to a surviving spouse or bequest. Under this approach, the residual balance at life expectancy is less than the minimum drawdown rules currently permit[46] but not zero. This approach differs to our understanding of existing modelling practice by Treasury, which typically assume superannuation assets are drawn down to zero by life expectancy. Using the ISA-RiceWarner model, we find that assuming superannuation assets are drawn down to zero by life expectancy increases age pension outlays by approximately 0.5% of GDP by 2055 because this assumption reduces assets in superannuation that would otherwise weigh against the age pension means test.

All outcomes are deflated to 2014-2015 dollars using the assumed CPI deflator.

Under the policy change scenarios, all of the BAU assumptions apply with the following specific scenarios modelled. The average income during retirement to life expectancy from different sources is then compared to the BAU.

Measurement of Tax Concessions:

- For different cohorts, lifetime tax concessions are measured by comparing the total superannuation retirement income derived within superannuation and residual capital balance at life expectancy to the total retirement income and residual capital balance that would be derived if an identical portfolio of assets were held directly by the taxpayer. This approach fully accounts for the compounding value of tax differences over time, which are not evident in a point-in-time comparison.
- To avoid some of the shortcomings of the comprehensive income tax benchmark, the comparison assumes the use of all available tax benefits and offsets in either circumstance including dividend imputation, capital gains tax discounts, and personal tax offsets including the Seniors and Pensioner's Tax Offset (SAPTO) in the drawdown phase.
- The approach utilises effective tax rates in each realm rather than statutory rates. The approach more closely aligns the measurement of tax concessions to the actual differences in taxation treatment that would be apparent to a taxpayer.
- Nevertheless, it is likely this approach (and others) could underestimate the value of concessions to individuals with SMSF's who defer capital gains tax events to the zero rate drawdown phase in superannuation.
- The use of variable longevity in the model has important impacts on the measurement of lifetime tax concessions as wealthier individuals are likely to enjoy the benefits for a longer period than lower income earners.
- The measurement of aggregate tax concessions presented in the analysis also utilises effective tax rates rather than statutory rates with the difference in earnings tax estimated each year on a concessionally taxed base. The projections do not constitute an estimate of the revenue impact if the concessions were abolished but rather the value of the concession across the population over time.

[46] For example the approach adopted in the ISA-RiceWarner model results in residual capital amounts to between 10-20 percent of overall superannuation retirement income being left at life expectancy (depending on income) compared to approximately 40 percent under current minimum drawdown rules.

Assessment of the pause in the SG @ 9.5 percent and abolition of LISC

- The BAU is compared to the previously legislated SG schedule which was due to reach 12 percent by 2019;
- The BAU (where the LISC is due to be abolished from 2017) is compared to a scenario where the LISC continues indefinitely with the threshold pegged to the second marginal tax rate and maximum amount set with reference to the SG rate prevailing multiplied by the 15 percent contribution tax up to the income threshold.

Assessment of proposed change in the Age Pension Asset Test

- The BAU is compared to the asset test threshold and taper changes as outlined May 7 2015 Press Release of the Minister for Social Services. The relevant thresholds are assumed to be indexed as they are currently.
- No behavioural impacts are considered such as deferral of retirement, diversion of savings into non-assessable assets or gifting of superannuation savings to maintain pension eligibility, or the use of more aggressive investment strategies to maintain overall retirement income adequacy.

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