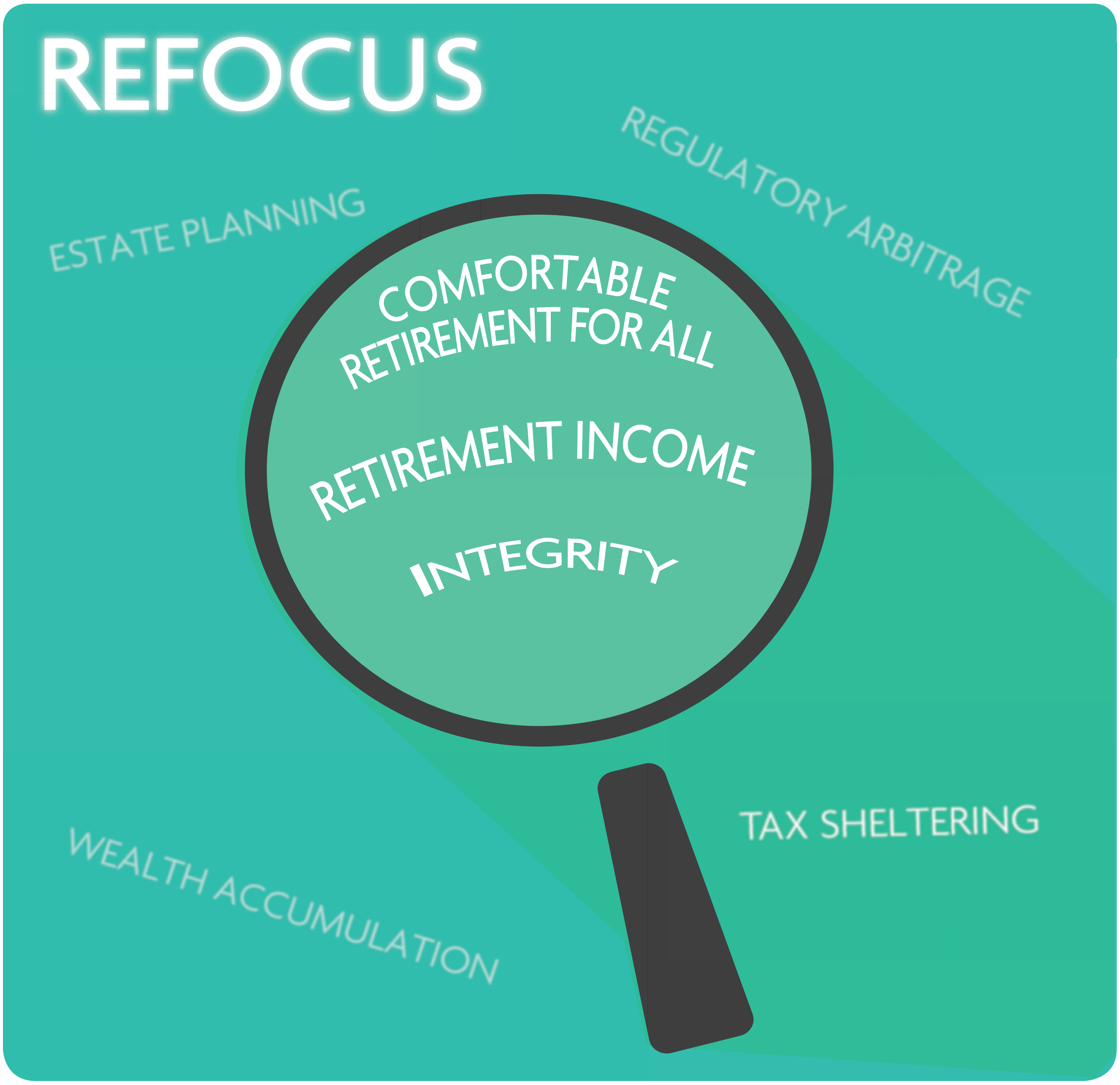

TAX DISCUSSION PAPER

SUBMISSION

August 2015

Industry Super Australia

ABOUT INDUSTRY SUPER AUSTRALIA

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KEY POINTS

- Existing retirement incomes policy settings are the result of ad hoc changes, and increasingly incoherent:

    - The recent Age Pension changes undermine incentives to save and put a comfortable retirement out of reach for middle income earners. As a result of recent Age Pension changes, for many low and middle income earners, an additional dollar of retirement savings results in substantially less than an additional dollar of lifetime retirement income.

    - Superannuation tax concessions are outdated and misdirected - substantially increasing the retirement incomes and residual wealth of the highest income earners at the expense of those on lower income rungs. Currently the strongest savings incentives apply to those who will retire on incomes well above that necessary to have a comfortable standard of living.

    - Superannuation tax concessions provide low and middle income earners with insufficient benefits and incentives to save. Without reform for persons on very low incomes, the taxation of super contributions and earnings can be a tax impost rather than a tax concession.

- Under current policy settings, over half of Australians will retire on incomes below that necessary to support a comfortable standard of living but this can be improved by better targeting assistance to those who most need it.

- Our principal recommendation remains that reform of Australia's retirement income policy settings is urgent and should be considered in a dedicated cross-partisan 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.

- To support further policy development, we have modelled an indicative package of reforms to show how tax and transfer settings around retirement income could not only be more coherent, but also more efficient including:

    - A 25% rebate for all income earners on contributions up to a value of $7,500 a year and capping contributions to $50,000 per annum;

    - A 'Super Seed' Government contribution of $5,000 a year to lower income earners aged 27-36, which includes many parents taking time off work or working part time while caring for children;

    - A fairer Age Pension asset test with a taper of no more than $2 per $1,000 of assets; and

    - Level earnings taxes of 15% in accumulation and the retirement phase (with a rebate for earnings under $50,000 per annum in retirement).

- Australia's expenditure on retirement security is low by OECD standards. ISA's indicative package will boost aggregate super savings by $620 billion by 2055, deliver modest long run budget savings compared to settings in place today, but will cost around 0.4% of GDP compared to the recently legislated Age Pension means test.

- We modelled proposals by others, such as a $2.5 million cap on an allocated pension, and found it ineffective in better targeting concessions.

EXECUTIVE SUMMARY

A number of retirement security policy settings have changed in recent years, from the scrapping of the Low Income Super Contribution (LISC), to the freeze in the increase to the Superannuation Guarantee (SG), to the Age Pension cuts for low and middle income earners passed just last month.

These changes have been made in a piecemeal manner, driven by short term budget or political priorities, and without sufficient consideration of their long term effects on incentives, adequacy, or the integrity of the superannuation system. These ad hoc changes have undermined low and middle income earners' retirement security, and gender equity of the superannuation system.

All the while, positive changes, such as rebalancing superannuation tax concessions, remain off limits, meaning the system will continue to provide the strongest incentives to those who will retire well above a comfortable standard and never require an Age Pension whilst missing the opportunity to direct stronger incentives to those on lower income rungs who stand to gain most by lifting their incomes above the Age Pension alone.

Superannuation tax concessions are outdated and poorly targeted, and this problem can be solved in one of three ways, or a combination of them: (i) reducing the ability to place excessive amounts of assets into the tax preferred superannuation environment, (ii) reducing the misallocation of concessions to those who do not need them by introducing progressivity into the structure of the concessions, and (iii) requiring superannuation assets to be used solely for retirement income rather than bequests and wealth transfer (or appropriately taxing such uses), which should reduce the incentive to use the super system for mere wealth accumulation.

What is really needed is a considered, dedicated multi-partisan 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.

It is too early to make firm recommendations. However, to support further policy development, we have put together and modelled an indicative package of reforms to show how tax and transfer settings in respect of retirement income could not only be more coherent, but also more efficient (Table 1). The elements of this package are discussed in Sections 2.1 to 2.4.

We have focused on the long term outcomes of the indicative package, recognising that phasing changes in will take time. Looking at the outcomes for Australians currently aged 25 to 29, the indicative package raises the retirement living standards of low income Australians by over 75%, and lifts the retirement incomes of single women in the bottom decile by over 100%. The package allows more middle income earners to be in reach of a comfortable retirement, and provides significantly more rational incentives to save. And the package rebalances excessively generous superannuation tax concessions from the top 1% and 5% of income earners.

The indicative package delivers modest long term savings compared to current system settings, however it does not deliver as significant savings as the recently legislated changes to the Age Pension asset test. The post 2017 Age Pension means test is broken – it achieves budget savings in an untenable manner, by providing *less* than $1 of retirement income for every additional $1 of private savings for many low and middle income earners. In our judgment, such a means test is unsustainable.

Table 1 – Summary of indicative package

Superannuation contributions reform	All superannuation contributions made from after-tax income, receive a 25% offset, which offset is capped at $7,500 p.a. Contributions capped at $50,000 p.a., with additional "catch up" contributions in limited circumstances.
Superannuation earnings tax reform	Accumulation and decumulation earnings taxed at 15% per year, with all tax rebated for earnings below $50,000 p.a. in the retirement phase.
Age Pension means test	Asset test taper rate of $2, with the asset free area at the midpoint between old levels and new levels. It achieves fiscal savings that are a midpoint between the old and new asset test.
"Super Seed"	The superannuation system is meant to have comprehensive coverage, yet a sizeable percentage of Australians at different points in their working life do not have sufficient earnings to attract employer contributions or have them paid at a low level, or cannot maintain continuity of contributions during spells away from paid work. They are not served well by current settings, and receive insufficient benefit from the compounding effect of earnings. "Super Seed" is a direct $5,000 Government contribution into the superannuation of income earners in the bottom three income deciles whilst age 27 to 36 inclusive (which particularly includes many parents temporarily in unpaid work – i.e., caring for children). This targeted contribution – which is substantially smaller per person than the super tax concessions to top income earners – takes advantage of the impact of compounding, boosting retirement incomes in a relatively efficient manner.

This submission also reviews other recent policy proposals, and provides some information regarding potential interim reforms or "integrity measures."

Specifically, we suggest that the proposals to further increase the Age Pension age and preservation age are likely to be inequitable and are misguided. These proposals presume that potential Age Pension recipients who retire before the Age Pension eligibility age do so voluntarily, and therefore the Age Pension eligibility acts as a disincentive to work. However, empirical data about retirement decisions shows that the majority of people retire before the Age Pension age and do so involuntarily. Moreover, the prevalence of chronic health conditions and disability is greater for those on lower incomes. As a result, raising the Age Pension age is likely to be ineffective at materially lifting participation rates, as well as being regressive. Insofar as there is an observed tendency for higher income individuals to retire around age 60, when superannuation earnings can become tax free, there may be a basis for pushing back the age at which an individual can make this election.

We found that the proposal to limit to $2.5 million the amount that can be rolled into a tax free income stream simply means that, for individuals with amounts in excess of $2.5 million, their income stream will be smaller and their residual assets in superannuation will be larger. Modelling indicates that the proposal actually increases the value of lifetime tax concessions received by high income earners, and increases their residual capital available for bequests, compared to a baseline scenario where individuals roll their full balance into a retirement account and drawdown an amount consistent with observed behaviour.

We found that the proposal to cap non-concessional contributions at $1 million over a lifetime could be open to gaming behaviour. By replacing annual caps with a lifetime cap, it operates as an option for wealthy individuals to place significant assets in a tax-preferred environment early on, and achieve substantial concessional compound earnings. A $1 million contribution at around age 20 today could reasonably be expected to grow to over $6 million by retirement (in 2015 dollars). Based on experience with the increase in the non-concessional cap to $1 million in 2007, policy makers should expect significant behaviour change to take advantage of the option to access superannuation earnings tax concessions. The lifetime cap also could be difficult to administer and police.

If policy makers are interested in making piecemeal or ad hoc changes, we would generally counsel against doing so. However, measures such as restoring the Low Income Super Contribution and the prior scheduled increases in the Superannuation Guarantee would be helpful to adequacy and equity. The concept of an annual cap on non-concessional contributions equal to the concessional contributions cap also could be worth considering, as it would help contain some of the inefficient allocation of concessions. We provide some modelling on these interim integrity measures.

The submission concludes with a discussion of observed tax minimisation and excess super strategies.

REFOCUS

1. Introduction

1.1 Current tax and transfer settings are not delivering

In our first submission regarding the Tax Discussion Paper, we assessed whether existing tax and transfer settings in respect of retirement security will efficiently and effectively deliver retirement incomes and living standards that meet community expectations.

We found that, after over two decades of sustained GDP growth, the community expectation of a retirement income above subsistence level remains out of reach for many. We found that current policy settings are failing to deliver a comfortable retirement to the majority of existing retirees, and that a majority of future Australians will also retire on incomes too low to support a comfortable living standard. We have used the comfortable retirement income standard prepared by the Australian Superannuation Funds Association (ASFA) as a benchmark.[1]

In addition to poor overall adequacy, distributional analysis showed a wide chasm in retirement incomes between the bottom income earners and the top, and between men and women.

A key driver of these outcomes is the outdated and inequitable structure of superannuation tax concessions. The concessions supercharge the wealth and incomes of persons with significant means, while offering relatively little support and weak incentives to save for most income earners.

This misallocation – which sees the greatest tax concessions directed at those who will never likely access the Age Pension and who will have retirement incomes well above community norms – results in an opportunity cost to improve retirement outcomes for those who wouldn't otherwise retire comfortably, and to reduce fiscal outlays.

Since our first submission, a change to the means testing of the Age Pension has been legislated. The legislation will increase the threshold of assessable assets above which pension payments are reduced, and increase the "taper rate" by which the pension is reduced for each $1,000 of assessable assets over the threshold from $1.50 to $3.00 per fortnight. This legislation will not only reduce Age Pension support for those who were unable to obtain a comfortable retirement but also undermine incentives for additional savings in an effort to get there.

In the face of this fairly bleak outlook, our principal recommendation remains that reform of Australia's retirement income policy settings is urgent and should be considered in a dedicated multi-partisan 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.

It is widely acknowledged that superannuation tax concessions and retirement incomes policy more generally require reform. Continuing to delay making needed reform will further undermine confidence and certainty, and interfere with the ability of individuals and institutions to make long term decisions.

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

This submission outlines some potential reform approaches to inform public debate, recognising that it is too early to fashion firm recommendations.   We also will model or comment on certain proposals suggested by others, such as the proposal to limit allocated pension accounts to $2.5 million, and the proposal to raise the pension age.

Finally, we will provide a few possible interim “integrity measures” that could be considered in the near term. While we generally oppose continued ad hoc and piecemeal changes, if further piecemeal change is undertaken, it should at least occur on an informed basis.

1.2 After the recent Age Pension means test changes, around half of all Australians will have inadequate retirement incomes

Prevailing tax and transfer policy settings are not meeting community expectations of a comfortable retirement for all. Table 2 shows the proportion of single males, single females and couples retiring over the coming decades who are expected to have retirement incomes below those necessary to support a comfortable living standard.

- For all Australian’s retiring through 2055, more than half will not have incomes sufficient to support a comfortable living standard, taking into account the Age Pension, superannuation income and income from wealth outside superannuation.
- For those retiring in the near term, over two thirds will be on incomes below a comfortable standard. The situation is particularly perilous for women, with almost 80 percent projected to receive incomes below a comfortable standard.
- The living standards of retirees will improve as the superannuation system matures, but not enough. Around half of all Australians retiring in 2055 will still have incomes insufficient to support a comfortable living standard despite being in the super system for approximately forty years.

Table 2 - % of retirees not achieving comfortable benchmark

	Overall	Retiring 2015	Retiring 2055
Single males	57%	70%	58%
Single females	69%	78%	64%
Couples	54%	65%	55%

Source: ISA-Rice Warner modelling

Tax and transfer settings are not delivering retirement incomes sufficient to support a comfortable living standard.

This is, in part, because the settings are poorly structured delivering excess support to those who don’t need it and insufficient incentives and even contrary outcomes to those who would benefit most.

1.3 Policy settings are poorly targeted and regressive

Key points

- Superannuation tax concessions are outdated and have failed to keep pace with structural changes in the personal income tax system and technology improvements which could target concessions much more effectively;
- Superannuation tax concessions disproportionately benefit and lift incentives to save for those who will have retirement incomes well above a comfortable standard. For example, single males in the top one percent will receive total lifetime tax concessions of nearly $2.8 million per person.
- For income earners in the top one percent, superannuation tax concessions 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, and men tend to have less broken work patterns, 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 income 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 impost 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.
- The recent Age Pension means test changes have undermined the financial incentive to save for those on low and middle incomes. As a result of the means test changes, annual Age Pension payments are reduced by $78 per $1000 of assessable assets when such assets may only generate reliable returns of $50 (an effective marginal tax rate of 156% for assets above the free area)
- For people affected by the Age Pension asset test, combined Age Pension payments and superannuation pension payments increase by less than the value of additional savings, assuming typical drawdown rates and historical average real returns.
- The incoherence is clear by simply comparing two low-to-middle income earners. One who has super savings of $400,000 at age 65 and one who has voluntarily saved an additional $100,000 over their working life, bringing their total super savings at retirement to $500,000. The person who has saved an additional $100,000 should receive at least an additional $100,000 of retirement income over their retirement years to life expectancy, but this is not the case under the new Age Pension means test. In real terms the additional $100,000 of savings nets less than $14,000 extra income to life expectancy and with a further $22,500 left over in residual savings (total $36,500). That is not logical. In comparison, under the existing asset test an additional $100,000 in savings will boost income and residual capital by at least as much as the original amount saved in real terms.

1.3.1 Superannuation tax concessions

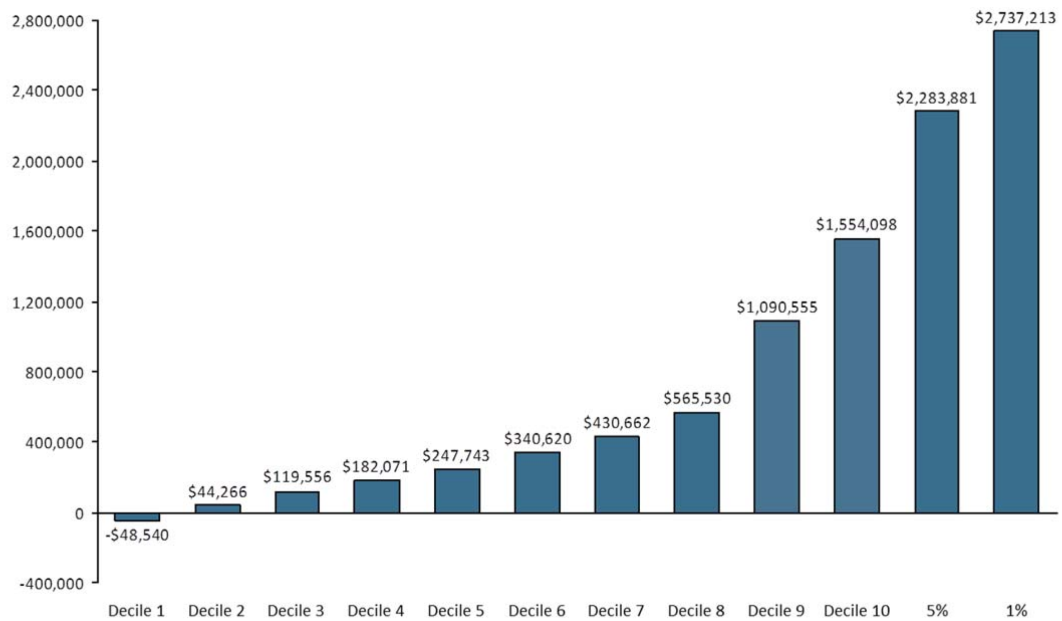
The majority of superannuation tax concessions, by dollar value, flow to those who are projected to have incomes above a comfortable standard. In addition, those on low incomes receive little benefit from superannuation tax concessions. In fact, for those on incomes below the tax free threshold, the tax on superannuation contributions and earnings is higher than their effective rates on income.

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, the concessions need to be rebalanced. There is no need for Government resources to support retirement incomes well above a comfortable standard. Low income earners need to receive a fair concession, and the concessions to those on high incomes need to be adjusted downward.

Figure 1 shows the lifetime value of superannuation tax concessions for men retiring in 2055 (currently aged 25-29) by income decile. Those in the top decile, particularly the top 5% and 1%, receive extraordinary levels of government support for retirement incomes. It also shows that those in the bottom of the income distribution are not well-served by the structure of super tax concessions.

Low income earners are not well-served by superannuation tax concessions because superannuation contributions and earnings generally are taxed at a flat 15% in the accumulation phase[2] (with earnings being tax free in retirement). The 15% tax on contributions and accumulation earnings is higher than the marginal rate of income tax paid by those in the bottom decile (i.e., 0% because of the tax free threshold).

Figure 1 – Lifetime superannuation tax concessions, single males retiring in 2055, 2014 prices, by income decile and top 5% and 1%



Source: ISA-Rice Warner modelling
Note: Tax concessions valued as the difference between the total retirement income from, and residual capital balance in, superannuation 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, utilising effective tax rates within and outside of superannuation, assuming 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 in the drawdown phase.

As Figure 1 makes clear, superannuation tax concessions are very valuable to high income earners. For those on high incomes, the contributions concessions are important, but the real value arises from the earnings concessions and related policy:

(i) the extremely generous contributions caps in Australia relative to other countries (see Table 3), which enables the returns from significant assets to be concessionally taxed (or even untaxed),

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[2] Except that contributions subject to Division 293 pay an additional 15% tax.

(ii) the extraordinarily flexible approach to *in specie* and business transfers into superannuation, which can be exploited to bring in assets and time the realisation of gains (discussed in more detail in Section 5), combined with

(iii) a flat concessional rate of tax on superannuation earnings at 15% in accumulation (and 0% in retirement). A 15% tax on earnings is over 30% lower than the marginal tax rate on income for many high income earners.

Table 3 - 2015 retirement plan contribution caps, selected jurisdictions

Country	Annual concessional contributions cap	Annual non-concessional contributions cap	Total	Total as a % of Australian combined cap
Australia	A$30,000	A$180,000	A$210,000	100%
Canada	C$24,930 (~A$27,000)	None	C$24,930 (~A$27,000)	13%
United Kingdom	£40,000 (~A$86,000)	None	£40,000 (~A$86,000)	41%
United States	US$18,000 (~A$25,000)	None	US$18,000 (~A$25,000)	12%
Japan	¥660,000 (~A$8000)	None	¥660,000 (~A$8000)	4%
France	€38,040 (~A$58,000)	None	€38,040 (~A$58,000)	28%

Source: US Internal Revenue Service; HM Revenue and Customs; Canada Revenue Agency; Australian Tax Office; Towers Watson; Direction de l'information légale et administrative: Service-public.fr; ISA calculations.

Notes: USA contribution cap is lesser of $18,000 and 100% of salary; USA permits additional contributions of up to $6,000 for persons over 50 years old in 2015. The UK contribution cap allows unused amounts to be carried forward for up to three years. Australia allows those 50 years and older to make concessional contributions of $35,000 per year. Australia allows up to $540,000 to be contributed in a single year by bringing forward two years of non-concessional contribution cap space. Japan contribution limit is highest permitted for an employee (i.e., assumes no separate entitlement to an employer defined benefit plan). France contribution limits are for the Plan d'épargne retraite populaire. Currency conversion as of 30 July 2015, rounded up to the nearest $1,000.

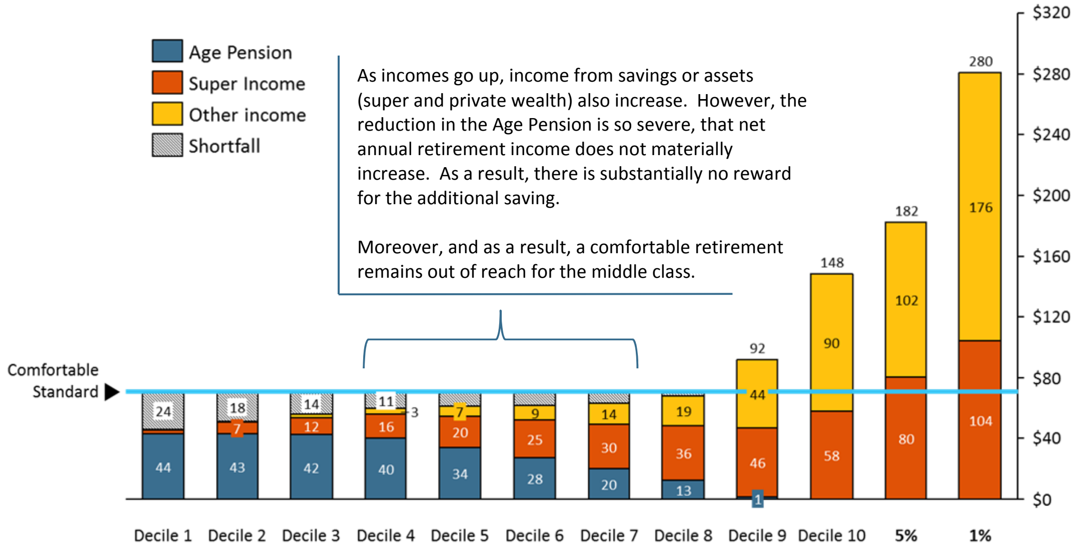
1.3.2 Age Pension means test

The recent Age Pension means test changes are a clear example of the perils of ad hoc policy making.

In legislating the change to the asset test, little consideration seems to have been given to the impact this would have in terms of (i) the incentives for people to save and to increase their superannuation contributions, and (ii) retirement living standards. Figure 2 shows retirement income from all sources including from the Age Pension, superannuation and income from wealth outside superannuation under the new asset test for single females.

Figure 2 illustrates how the more aggressive taper rate undermines the incentive for people to increase their super contributions since any increase in retirement income from this source will be largely clawed back through lower pensions. This is particularly the case for females in income deciles four through eight. A similar pattern is evident for single males and couples.

Figure 2 – Average annual retirement income by source, single females retiring in 2055, 2014 prices, by income decile and top 1% and 5%, $000s



Source: ISA-Rice Warner Modelling

The excessively steep taper rate of the Age Pension, and how it undermines the incentive to save for retirement, is perhaps best demonstrated by a simple cameo comparison (Table 4). As shown in Table 4, an additional $100,000 of savings translates into only about $36,000 of additional lifetime retirement income and residual super at life expectancy. In other words, the new Age Pension means test imposes a 75% marginal tax rate on savings.

Table 4 – Comparison of super balances of $400,000 and $500,000 (2015 dollars)

Starting Pension Balance	**$400,000**	**$500,000**	**+$100,000**
Present value of total superannuation pension income to life expectancy	$571,616	$714,517	+$142,901
Present value of total Age Pension to life expectancy	$974,254	$845,256	-$128,998
Total Retirement Income to life expectancy	**$1,545,869**	**$1,559,772**	**$13,903**
Residual superannuation balance at life expectancy	$89,456	$111,814	$22,358
TOTAL Retirement Income (Age Pension and superannuation) and Residual Balance	**$1,635,325**	**$1,671,587**	
Difference			**$36,262**

Source: ISA-Rice Warner modelling
Note: For a single male retiring in 2055

In addition to substantially reducing the incentive to save and undermining the prospect of middle income earners to achieve a comfortable retirement living standard, the new Age Pension means test also effectively nullifies the beneficial effects of other recent public policy changes.

The superannuation guarantee (SG) is scheduled to increase to 12% by 2025. This increase will significantly increase annual retirement incomes of all deciles. However, the new Age Pension asset test substantially reduces the beneficial impact of this policy change for middle income earners.

Figure 4 shows the impact on the annual retirement incomes of single women of the increase in the SG on retirement incomes under both the old and new assets test. The significant adverse effect of the new Age

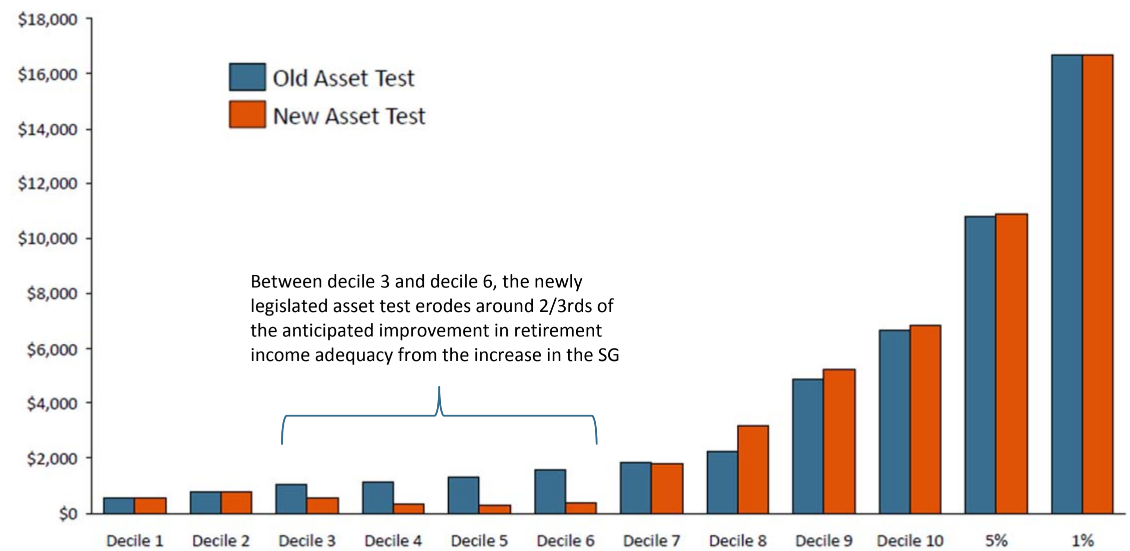
Pension asset test on women in income deciles four through seven of this group undermines the policy objectives of the SG increase. A similar pattern is evident for single men from the third through to the seventh decile and couples from the second to the sixth deciles.

These effects are not confined to the legislated increase in the SG, they apply to *any* other policy measure or discretionary decision to increase savings inside or outside super (except the family home). This is particularly relevant when considering steps to improve retirement income adequacy of women. Voluntary savings efforts or employer initiatives, such as to maintain SG contributions during parental leave, risk not actually improving overall retirement incomes much at all.

The loss of the retirement income purchasing power of additional savings may only be avoided by rapidly spending savings – seemingly contrary to the policy objective to smooth income over retirement and encourage an orderly drawdown of assets.

This hopefully unintended interaction between steps to lift superannuation benefits and Age Pension means test changes is a clear example of the perils of piecemeal, ad hoc policy change. It underscores the importance of considering superannuation and the Age Pension as integrated pillars of retirement security policy.

Figure 3 – Impact of the SG increase under the old and new Age Pension means test on average annual retirement incomes, single females retiring in 2055, 2014 prices



Source: ISA-Rice Warner modelling

2. Possible reform directions

Key points

- There are at least four structural problems with existing retirement security policy:
  – *Poor adequacy, driven in part by the tight connection between incomes, super, and compound earnings.* Adequacy is poor for those on low and middle incomes, especially women. This is due in part to the fact that superannuation benefits are tightly connected to wages and consistent earning patterns. The SG is a percentage of income, and the capacity to make voluntary contributions is very

sensitive to income. As a result, low income earners and those whose working life is disrupted are able to contribute markedly lower levels of savings into super, which reduces the potential power of compounding investment returns, and the power of the superannuation tax concessions, especially the earnings tax concession over time.

  – *Age Pension and superannuation integration.* The new Age Pension means test substantially undercuts any net increase in retirement living standards arising from superannuation and private savings, resulting in a great weakening of incentives to save.

  – *Superannuation contributions caps and contributions tax concessions.* The taxation of superannuation contributions is poorly structured. Those on low incomes are taxed at a higher rate on superannuation contributions than they are on ordinary income. Those on high incomes or with significant assets are able to shelter the returns on assets from taxes that would otherwise apply due to Australia's extraordinarily large contributions caps.

  – *Superannuation earnings tax concessions*. Superannuation earnings tax concessions also are poorly structured. Those on low incomes are taxed at a higher rate on superannuation earnings than they are on ordinary income. The earnings tax is flat, which means the concession is more meaningful for those with significant assets. The earnings tax falls to zero percent in retirement, which encourages distortions in investment, as well as tax arbitrage, a practice typically reserved for those with significant means.

- These weaknesses in existing policy suggest a few reform directions. We will discuss these item-by-item in more detail in the body of this section.

  – *Age Pension coherence.* A more coherent Age Pension means test is a cornerstone reform. Without it, a sizable amount of any improvement to superannuation settings, such as more efficient tax concessions, will have little and possibly immaterial effects on member outcomes. Moving to a single means test which deems income from assets would be ideal but difficult to design without some adverse consequences or significantly increasing expenditure. A simpler reform would be to partially unwind the taper rate to $2 per fortnight per $1000 of assessable assets instead of $3, and possibly move the new free area to the midpoint between the old and new thresholds.

  – *Superannuation tax concessions should be rebalanced to ensure there are appropriate incentives for everyone to contribute to super and better target concessions to those with inadequate savings. Accordingly contributions should receive progressive concessions, and non-concessional contributions caps should be reduced.* The Australia's Future Tax System review (the Henry Review) suggested that superannuation contributions should be made from post-tax income, with a flat offset. Because the concessions are delivered via a tax offset, there is no need to separately classify concessions that are concessional and non-concessional, reducing complexity. The value of the offset must be capped for equity reasons. The cap on contributions into the concessional superannuation environment should be reduced, which would substantially curtail the excessive allocation of tax concessions to those in the highest brackets of income and wealth, and would bring Australia closer in line with other countries. Appropriate flexibility to allow catch up contributions for those with inadequate savings should be permitted.

  – *Superannuation earnings tax concessions should be consistent across accumulation and retirement, and introduce progressivity*. It is fiscally unsound, and regressive, to exempt superannuation earnings from all tax in retirement when end benefits are also exempt. Applying a consistent rate of tax in the accumulation and decumulation phase will not only support the ability to develop innovative retirement income products that better pool retired and working members, it will also reduce complexity and reflect the growing consensus that the superannuation system is focused on delivering retirement income, not on accumulating savings. By applying a tax offset for earnings below a reasonable threshold, the earnings tax concessions can be made less regressive, and better targeted to help those who would be most influenced by an increased incentive to save, and whose wellbeing would be most improved.

- *Super Seed*. Adequacy would be improved for those on low and middle incomes if superannuation tax concessions were fair to them, as outlined above. In addition, insofar as the substantial majority of low income earners will receive an Age Pension, a targeted transfer into superannuation on behalf of low income earners at a relatively young age will better unlock for them the benefit of compounding investment returns. An injection into super on behalf of a low income earner at a young age could reasonably be expected to better uplift retirement incomes for that person than an Age Pension transfer of the same size around 40 years later (whether net of a Government opportunity/borrowing costs or not).

This section will describe, and provide modelling to show, the outcomes of a possible reform to address each area of policy weakness (except a change to the Age Pension means test, because the effect would simply be to partially revert the effects of the recent asset test changes, which are shown above).

After all major component are discussed, we will then analyse an indicative package of reforms. The package includes a reform to the Age Pension means test because, otherwise, any improvements to the efficiency and effectiveness of superannuation and other private savings would largely be nullified by the excessively high taper rate legislated from 2017.

We have conducted market soundings about the practical feasibility of the indicative reforms discussed here, and understand that these reforms should be more straightforward for consumers than existing policy settings, and feasible for super funds to implement, with the ATO playing a key role in determining individual member eligibility by aggregating information from employers and accounts held across the system.

The reforms discussed in this section are indicative only, and do not necessarily reflect final policy positions of Industry Super Australia.

As noted above, our principal recommendation is to conduct a cross-partisan and comprehensive review of retirement security policy. The indicative reforms discussed in this submission could, however, help contribute to the total mix of information that would preliminarily inform such a review.

2.1 Superannuation contributions reform directions

The Henry Review recommended that privately funded super should remain a key component of the retirement system and should continue to receive concessional tax treatment. However, consistent with Section 1 of this submission and as discussed in detail in our first submission, the Henry Review found “the structure of the existing tax concessions is inequitable because high-income earners benefit more than low-income earners.” [3]

In order to deliver a more equitable distribution of concessions between high and low increase earners, the Henry Review proposed an alternative framework for the delivery of tax concessions for super, specifically:

- The tax on superannuation contributions in the fund should be abolished
- Employers superannuation contributions should be treated as income in the hands of the individual, and taxed at marginal personal income tax rates

[3] Australia’s Future Tax System review (the Henry Review), May 2010

- A flat-rate refundable tax offset should be provided for all superannuation contributions up to an annual cap[4]
- The cap should be doubled for people aged 50 and older
- Voluntary contributions should also be eligible for the offset subject to the cap
- An annual cap on concessional contributions should continue to apply

The Henry Review modelled a flat rate refundable offset at a rate of 20% for all contributions up to $25,000 per year (meaning a maximum offset of $5,000).[5]

We modelled the original Henry proposal, and found certain refinements would be beneficial.

For our indicative reform, we have increased the rate of the offset or rebate from 20% to 25%, with a corresponding change to the cap on the value of the offset to reflect the increase in the concessional contributions cap to $30,000 since the publication of the Henry Review. As a result, the maximum offset a taxpayer could receive per year would be $7,500. For modelling purposes, all amounts are indexed over time to wages. Contributions are made to the fund net of tax, with the rebate calculated by the ATO and paid to the fund. This approach is necessary to avoid reductions in disposable income from the original Henry rebate proposal.

The dollar cap on the size of the offset at $7,500 performs the same function as a concessional contributions cap (insofar as the 25% offset applied to contributions into super of $30,000 would result in an offset of $7,500; additional contributions could not receive an offset).

As a result, the Henry Review contributions tax proposal should allow for the distinction between concessional and non-concessional contributions to be abolished, and the level of tax concessions to be regulated by means of the offset percentage, the offset dollar amount cap, and a single contributions cap. Doing so also solves a problem with the administrative complexity and fairness of the current approach to contributions concessions: currently, some employees whose SG contributions are insufficient to reach the concessional contributions cap, do not have access to salary sacrifice arrangements through their employer to fully utilise the available contributions concessions. By abolishing the complex distinction between concessional and non-concessional contributions, and making all contributions eligible for a tax offset, up to an annual offset cap, this anomaly is removed.

For our indicative reform, we have set an annual cap on super contributions of $50,000. As shown in Table 3, above, Australia's superannuation system allows vastly larger contributions into tax preferred retirement savings than do other jurisdictions. Australians (with the means to do so) can secure concessional treatment on the earnings of significant assets by contributing them to superannuation to a much greater degree than the wealthy in other countries. Australia allows individuals to place about 800% more into super than the USA and Canada allow their citizens to place into tax preferred retirement savings plans, and more than double what the UK allows. Capping annual contributions into super to $50,000 per year (an amount approximating to pre-tax median annual earnings) would continue to see Australia as providing comparatively relaxed access to tax concessions for those with high incomes or wealth relative to other countries.

An annual cap on contributions of $50,000 is indicative only. It is a simple, straightforward figure. It is also provisionally expected to be reasonably appropriate because $50,000 is well in excess of the median after tax

[4] According to the Henry Review that the size of the offset should ensure that the majority of taxpayers do not pay more than 15 per cent tax on their contributions

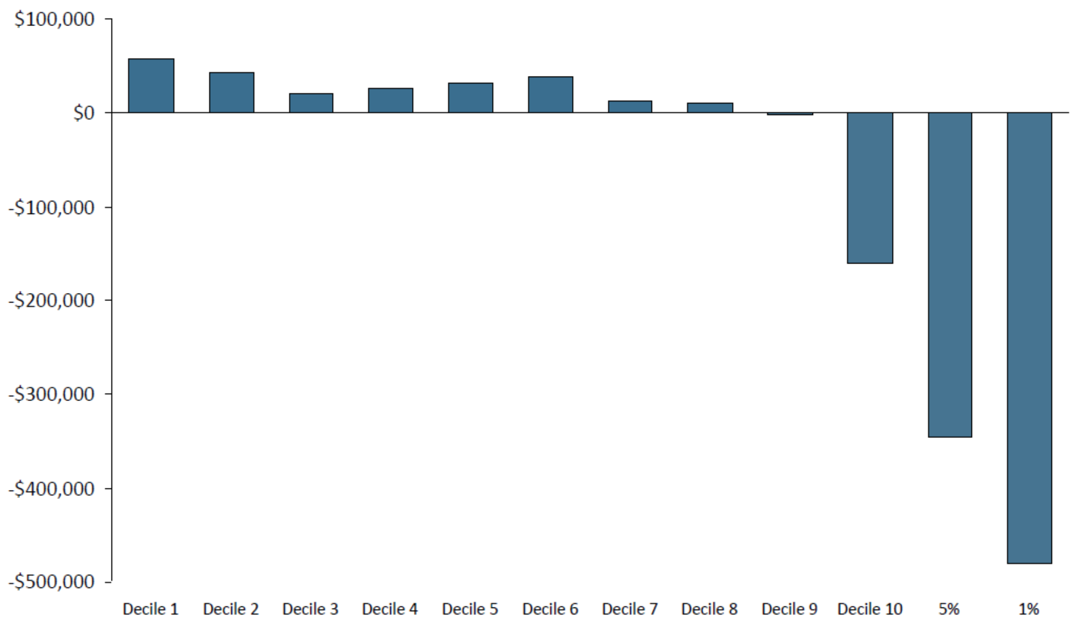
[5] Australia's Future Tax System review (the Henry Review), May 2010: Recommendation 18

income, and therefore only high income earners (or the partners of high income earners) or those with significant assets to transfer into super would generally benefit from a higher cap.[6]

Modelling supports this hypothesis. Figure 4 shows the projected change to the combined lifetime value per person of superannuation tax concessions of single males currently aged 25-29 by income decile if superannuation contributions were made on a post-tax basis, with a 25% tax offset (which would be a net payment for those whose marginal rate of income tax is below 25%), with the value of the offset capped at $7,500 per year and contributions into super capped at $50,000 per year (both indexed).

As shown in Figure 4, the indicative proposal has a modest beneficial effect on those in income deciles one through eight, a minimal effect on those in decile nine, with the bulk of the rebalancing of tax concessions from those income quantiles that would be well above a comfortable retirement to those yet to achieve it.

Figure 4 – Change to the value of lifetime superannuation tax concessions, single males retiring 2055, 2014 prices, by income decile, 5% and 1%



Source: ISA-Rice Warner modelling

While the rebalancing of tax concessions under the indicative proposal reduces the value of concessions to the top income earners, it is important to note there are no material adverse effects on incomes relative to public policy goals. In particular, no income deciles that previously had a comfortable retirement cease to have a comfortable retirement.

Moreover, although the effect on average retirement income for males in the top 1% is materially adverse, annual average retirement income for those in this group is projected to remain over $325,000 per year. It

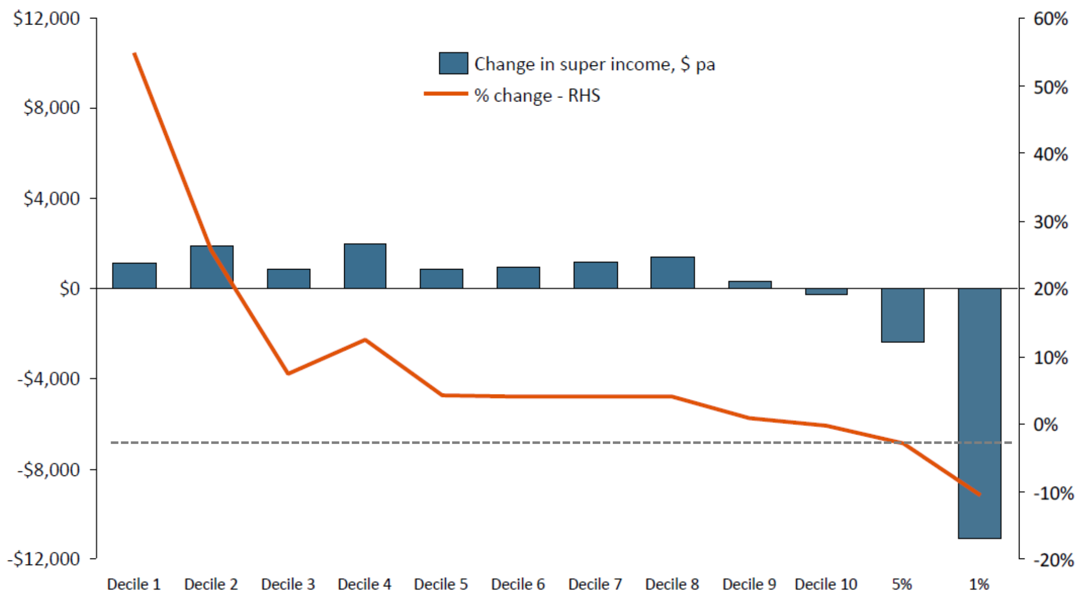
[6] There are rare instances in which individuals with otherwise low superannuation balances might receive a windfall or an inheritance. For these individuals, whose super balances are below that which could support a comfortable retirement, it may be appropriate for the ATO to issue exemptive relief. The circumstances in which an individual of otherwise modest means receives a sufficiently large lump sum that would enable a $50,000 contribution into superannuation are rare.

Consistent with best practice policy development, it would not be appropriate to construct a general rule (i.e., a high contribution cap) to accommodate exceptional circumstances.

would be difficult to justify additional public policy support to individuals on retirement incomes over $300,000.

These effects on retirement incomes of the indicative policy change are shown in Figure 5, which plots the average annual retirement income arising from superannuation after application of the indicative proposed change to superannuation contributions.

Figure 5 – Change to annual retirement incomes arising from superannuation, single males retiring 2055, 2014 prices, by income decile, 5% and 1%



Source: ISA-Rice Warner modelling

The ISA indicative reforms are designed to form part of an integrated package that would rebalance concessions and other policy measures in a way that lifts retirement outcomes for the many Australians who will retire on incomes insufficient to enable a comfortable standard of living, and increase the efficiency of the Government support allocated to retirement income security. The indicative package and its aggregate modelled effects are set out in Section 2.4.

2.2 Superannuation earnings tax reform directions

The superannuation earnings tax concession is a very powerful public policy tool, which can substantially increase the retirement incomes and wealth available for bequest of high income earners.

With individuals able to place $210,000 into super year-after-year, and up to $570,000 into superannuation in a single year, the super system provides extraordinary capacity for those with significant wealth and incomes to shelter their wealth from earnings tax. Once wealth is in the super system, there is little requirement in the tax law or superannuation law that this wealth be applied for retirement income. Significant assets are available for bequest and intergenerational wealth transfer.

While the existing earnings tax settings are not well-balanced, it is important that workers are compensated for mandatory savings preserved for retirement through some tax concessions.

Perhaps the most powerful reform to recalibrate the earnings tax concessions in super is the lowering of the contributions caps to move Australia closer in line to other advanced economies.

We also have sought to describe an indicative policy that extends the concept expressed in the Henry Review of a single rate of tax on earnings for superannuation earnings in the accumulation and retirement phase.

In conceptual terms, Henry favoured a consumption or expenditure tax approach to savings, which implies a 0% tax on earnings from savings. The Henry Review proposed that a 7.5% earnings tax should apply both in the accumulation and in the retirement phase, because a 7.5% gross rate of tax was expected to be about a 0% net rate of tax within superannuation after including offsets, capital gains tax concessions and negative earnings. Such a tax treatment when considered alongside concessional taxation of contributions and zero tax on end benefits is in fact more concessional than an expenditure tax benchmark.

We modelled a nominal 7.5% rate of tax on all superannuation earnings (an effective rate of zero) and found the results to be regressive and (if implemented in a realistic manner, including a long phase in) to substantially reduce Commonwealth tax revenues.

We also considered a nominal level rate of 10.0% on earnings in both accumulation and decumulation. Whilst it had a more moderate fiscal impact, the transition time frames to avoid reductions in retirement income for those with moderate levels of savings closer to retirement (by phasing in the increase in tax on earnings in retirement whilst reducing it during accumulation) were largely unworkable, undermining the benefits from pooling assets between each phase.

We also examined the feasibility of taxing superannuation earnings at the marginal rate of the individual taxpayer, less an offset, but found this to be impractical for funds to implement at this time without applying excessively high withholding tax.

In light of these equity, revenue, and administrative considerations, for our indicative reform to rebalance superannuation earnings tax settings, we have proposed to tax superannuation earnings at 15% in both the accumulation and retirement phase (less existing CGT discounts and imputation credits), and to deliver progressivity through an offset on earnings below $50,000 per year in the retirement phase, with the offset threshold indexed.[7]

Figure 6 shows the effect on the level and distribution of tax concessions in superannuation upon implementation of this indicative reform. The indicative reform seems to be well targeted, affecting only those in the tenth decile, with the largest effects upon the top 5% and 1% of income earners.

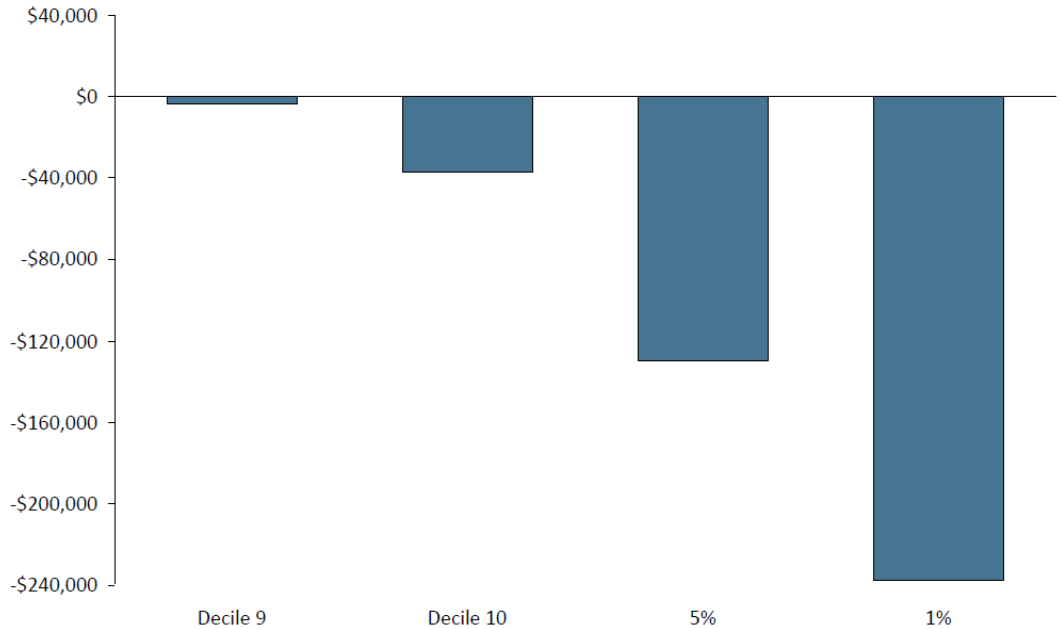
Figure 8 shows the effect on average annual retirement income arising from superannuation of this indicative reform.

There is a very modest effect on incomes, and the indicative reform also is well-targeted and progressive. The reason the reform is so modest, and only has material projected effects on those in the top decile is largely because so very few people achieve earnings in superannuation well in excess of $50,000 per year (indexed).

An additional outcome of the proposal is the removal of the unnecessary complexity of disparate headline tax treatment of earnings in accumulation and retirement. Eliminating the distinction between tax rates in accumulation and decumulation also removes an impediment to innovation, since doing so allows superannuation funds to more efficiently pool members who are in retirement and in accumulation. Such pooling facilitates innovation in retirement income products that incorporate intergenerational risk sharing, while also improving the opportunity to achieve economies of scale and reduce administrative complexity.

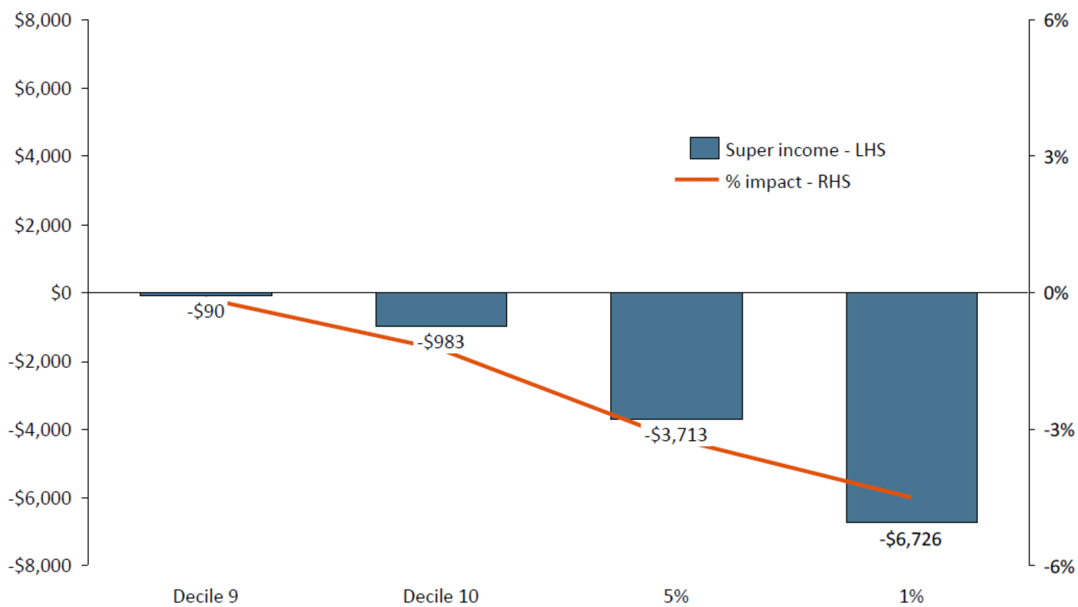
[7] The method of delivering a rebate on earnings below a threshold is much easier to implement than only taxing earnings above a threshold. Under a rebate method, earnings tax is withheld by the fund in a straightforward way, and any rebate would be calculated by the ATO and paid directly to a member's super account in an approach similar to that used for the LISC. The method of applying tax only on earnings above a certain level poses difficulties for super funds given that they cannot be certain what other superannuation earnings a taxpayer may have.

Figure 6 – Change to the value of lifetime superannuation contributions, single males retiring in 2055, 2014 prices, by income decile, 5% and 1%



Source: ISA-Rice Warner modelling

Figure 7 – Change to average annual retirement income arising from superannuation, single males retiring in 2055, selected income deciles, 5% and 1%, 2014 prices



Source: ISA-Rice Warner modelling

2.3 “Super Seed”

The SG is scheduled to increase to 12% by 2025. As the superannuation system matures, it does help raise retirement incomes and living standards for the majority of the population. However there remain gaps. .

Under current settings -- even a mature superannuation system with workers receiving a 12% SG for most of their working lives -- a sizeable percentage of the workforce do not benefit to the extent they should due to broken work patterns which impact on contribution levels, associated tax concessions and the compounding effects of both. This is particularly the case for women who take considerable spells from paid work to care for children; many of whom return to work a part-time basis.

A brief reference to Figure 2 above indicates that, even in a relatively mature superannuation system, income earners in the bottom three deciles receive comparatively less benefit from super than they should. Current settings are not adequately orientated toward increasing retirement benefits from superannuation to improve comfort in retirement for those in the lower income deciles.

This can be changed.

The aim of this proposal – which we refer to as “Super Seed” – is to lift the retirement outcomes of those in lower income deciles by providing a direct payment into their superannuation accounts at a relatively young age and then taking advantage of the impact of compounding. In this way, their retirement incomes are boosted in a relatively efficient and cost effective manner. It is proposed that the “Super Seed” replaces the co-contribution scheme for eligible groups. The existing co-contribution scheme while helpful has significant limitations. It has very low take-up (only 14% of income earners with taxable incomes eligible for the benefit utilise it)[8] and since the proportion of those making non-concessional contributions peaks at age 50-54[9] the benefits of compounding are limited.

In contrast, the ‘Super Seed’ proposal will have greater coverage since voluntary contributions are not required and it will be paid automatically. As it is paid early in a persons’ working life there will be significant compounding benefits. Further, since the ‘Super Seed’ payment is directed to those in the lower income deciles, it means their retirement incomes are boosted primarily through an increase in superannuation incomes, with little offsetting falls in Age Pension payments.

To implement this concept and provide modelled projections of its effects, we provided a $5,000 annual Government contribution into the active superannuation account of persons in the three lowest income deciles whilst they are aged 27 to 36 inclusive. The measure would provide no benefit to those in the income deciles four through ten.

The indicative reform proposal focuses on workers aged 27 through 36 to balance the need to ensure the payments are well targeted (including capturing periods of reduced earning capacity for parents whilst caring for children) with the need to enable as long a compounding effect as possible. If payments were made to individuals on low incomes at younger ages, there is a risk that they are in university or apprenticeships, or that the low incomes are not representative of stable career prospects for other reasons. If payments were made to individuals on low incomes at older ages, the power of compounding investment returns would be reduced.

The Super Seed concept would act to ameliorate the tight connection between retirement incomes from superannuation, on the one hand, and wage and salary income, on the other hand. Under the current system, most contributions come from wages and salary income and cease during periods out of the paid

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[8] ATO, Annual report Superannuation Co-contribution Scheme and Taxation Statistics, 2012-13

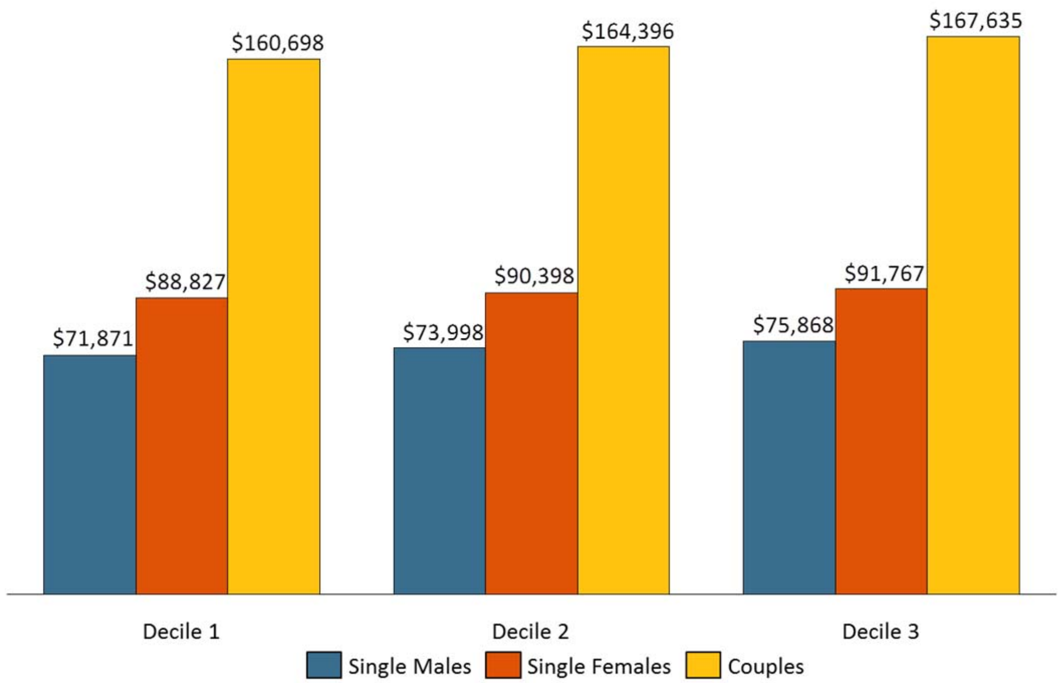
[9] Rothman, G. and Tellis, D. – Projecting the Distributions of Superannuation Flows and Assets, 16th Colloquium of Superannuation Researchers, University of New South Wales, 3 & 4 July 2008, Conference Paper 08/1.

workforce at significant cost to retirement outcomes. It is typically those in the lower income deciles (2/3rds of whom are women) that have irregular periods of paid employment or earnings below the $450 per month threshold such that they miss out on regular inflows into their superannuation accounts.

Modelling supports the intuition that Super Seed can materially lift retirement incomes for those with the greatest need.

Thanks to power of compounding, Super Seed has a significant impact on the superannuation balances of those in the bottom three income deciles. For example, for those now aged 25-29 and retiring in 2055 their superannuation balances are expected to be between $72,000 and $168,000 higher at retirement (Figure 8).

Figure 8 – Increase to super balances at retirement due to Super Seed, groups retiring in 2055, 2014 prices

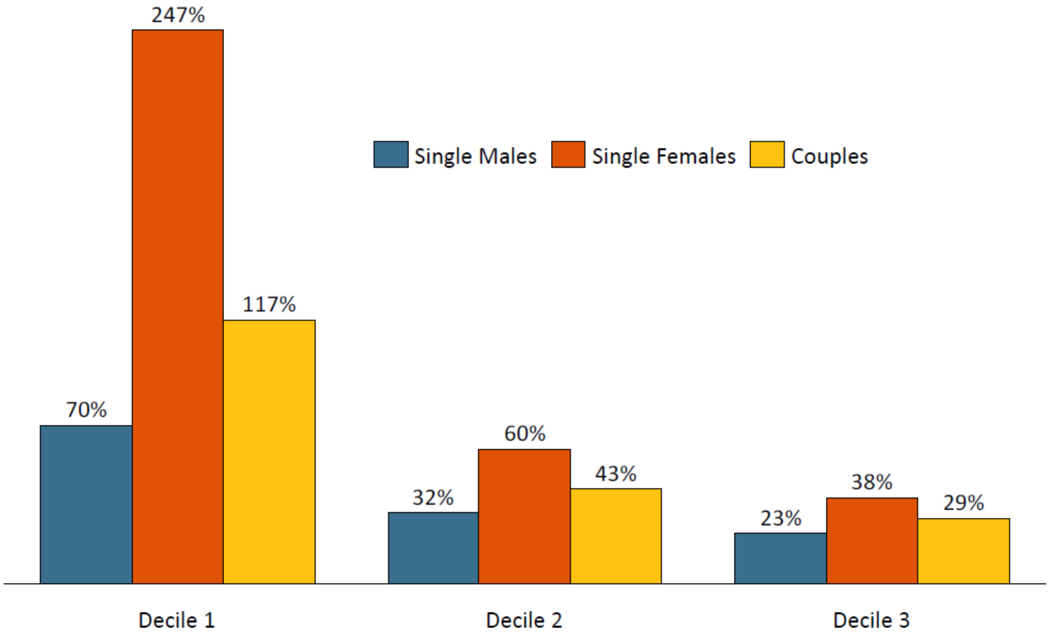


Source: ISA-Rice Warner modelling

The forecast increase in superannuation balances varies across the three incomes deciles, and across males, females and for each person in a couple because Super Seed replaces the current Government co-contribution scheme for these groups. That is, relative to the baseline of existing policy settings, and forecast over the projection period, halting the co-contribution scheme offsets some of the impact of the Super Seed reform. The size of offset depends on the extent to which the co-contribution was expected to be utilised by the various groups in baseline case.

At retirement, the higher account balances translate into a higher income streams from superannuation. The proportional increase in superannuation retirement incomes across the three deciles is significant, especially for the lowest decile (Figure 9), reflecting in part their otherwise small superannuation balances under existing policy settings in the baseline case.

Figure 9 – Percent increase to average annual retirement incomes arising from superannuation due to Super Seed, groups retiring in 2055



Source: ISA-Rice Warner modelling

Targeting

One potential issue with the Super Seed proposal is the need to ensure the payments are well-targeted to benefit those who would otherwise not have a comfortable retirement, while also ensuring that the administration and complexity of the program is minimal. That is, Super Seed would not achieve its objective efficiently if payments under the program went to individuals who, at retirement, had crossed many income deciles to emerge in the top income decile. There is no simple way to prevent this possibility from ever happening apart from enforced clawbacks. However, the indicative proposal has sought to minimise this risk in the simplest way, based on analysis of Australian income mobility research. Such research suggests the "leakage" is likely to be relatively small to moderate.

Research into Australia's income mobility across income quintiles found that over the observed period the best predictor of final income quintile was an individual's starting quintile.[10] Very few people in the lowest quintiles would finish in the highest. There is, however, significant movement between adjacent quintiles meaning that most of the "leakage" of the Super Seed would come from those in the lower half of quintile 2 (or income deciles 2 and 3).

The research suggests that around 10% to 15% of those receiving the Super Seed could retire in the income deciles above 3.

Fiscal effects

The fiscal outlays required to support Super Seed are moderate compared to other support for retirement income and the material increase in living standards and superannuation account balances. By 2055, with Super Seed in operation, aggregate superannuation balances are expected to be $440 billion higher. In the first year of operation, it is expected to cost $4.2 billion. However over time this cost is substantially offset

[10] Rohde, Tang and Rao, Income Inequality, Mobility, and Economic Insecurity in Australia 2010

by higher earnings taxes and some Age Pension offsets. By 2055 these offsets reduce the cost of the measure by almost half.

2.4 Indicative reform package

Government outlays and tax expenditures could be more efficient and better focused on lifting the living standards of retirees to an objectively comfortable level, without adversely affecting the incentives to save or to productively contribute to society.

We have packaged the three indicative reform proposals outlined above, along with a simple change to the Age Pension means test so that the benefits of the reform are not obscured by the overly steep taper rate that was recently legislated.

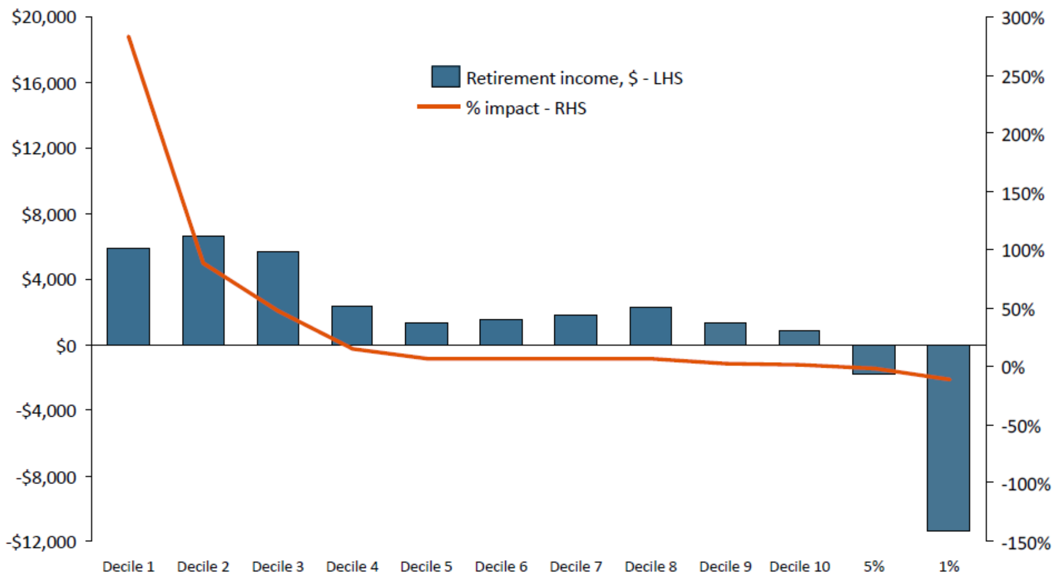
A summary of the indicative reform package was set out in Table 1, above.

2.4.1 Effect on retirement incomes

Figure 10 shows the change to average annual retirement incomes of the package on single females currently aged 25-29. The chart demonstrates the general uplift in retirement incomes to improve overall adequacy, which appropriately responds to the general observation that adequacy is insufficient insofar as the majority of Australians will retire on incomes below a comfortable standard.

Figure 10 also shows the effect on incomes of rebalancing government support. The introduction of progressivity in tax concessions on contributions, and on earnings in retirement, together with the Super Seed injection, has raised the retirement incomes for those in the bottom three deciles. The increases are material in dollar terms and as a percentage of retirement incomes under the existing policy settings reflected in the baselines case. Gains become more modest through the middle of the income distribution with Age Pension offsets (even under the revised asset test included in the indicative package of reforms), however they are still significant boosting retirement income for middle deciles by around 6.5% per annum.

Figure 10 – Change to average annual retirement incomes, single females retiring 2055



Source: ISA-Rice Warner modelling

2.4.2 Effect on the level and distribution of tax concessions

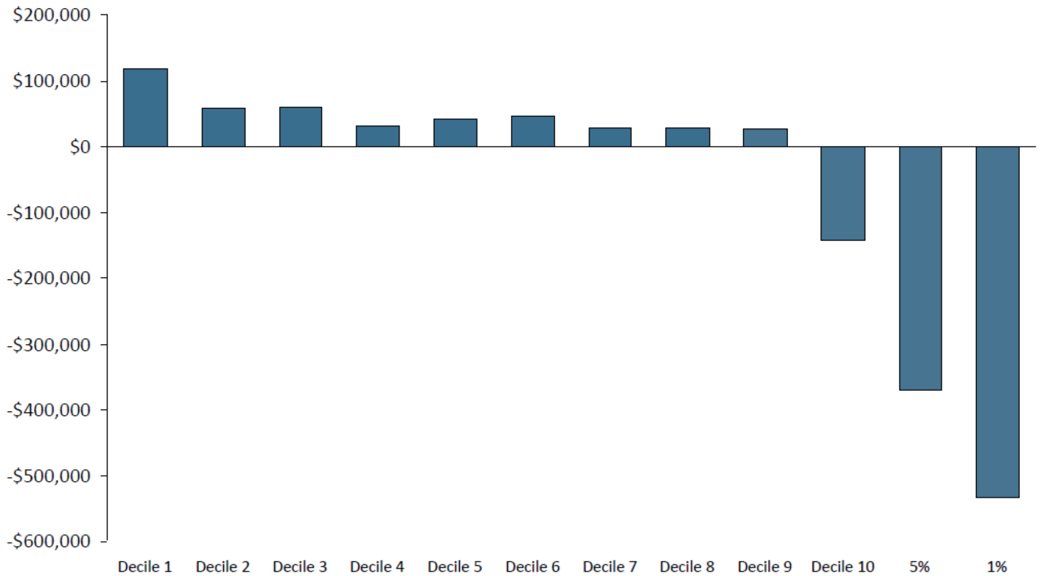
The current allocation of tax concession to high income earners is inefficient on two fronts: this cohort does not require a significant additional incentive to save, and this cohort will achieve a comfortable retirement without Government support.

Accordingly, one of the key desired effects of the package of indicative reforms is to rebalance superannuation tax concessions to better assist those on lower income rungs and provide them with stronger saving incentives. In particular, there is an urgent need for superannuation tax concessions to more uniformly uplift the superannuation benefits of Australians. It is inequitable and unsustainable for the current structure to double the retirement incomes and residual capital of the top 1% of male income earners, while reducing the incomes of those in the bottom decile.

While superannuation tax concessions should be recalibrated, it remains the case that all mandatory super savings should receive a tax concession benefit to compensate for the compulsory shift away from current consumption.

Figure 11 shows the change to the level and distribution of super tax concessions after implementation of the indicative package. The tax concessions are reduced primarily due to the reduction in the amount that can be contributed into superannuation, and not from a reduction in the concession on contributions. Indeed, the indicative proposal provides a 25% tax offset on contributions, which is larger than the 15% net concession on contributions by individuals subject to Division 293. The 15% tax on earnings above $50,000 extended into the retirement phase also has a modest effect.

Figure 11 – Change to the distribution of lifetime superannuation tax concessions, single males retiring in 2055, by income decile, 5% and 1%, 2014 prices



Source: ISA-Rice Warner modelling

2.4.3 Gender equity

Australian women on average have lower living standards in retirement than do men.

The pay gap between men and women has remained stubbornly high for decades and the structure of the superannuation system ratchets this differential into even more significant differences in retirement incomes:

- Lower wages combined with longer periods of unpaid work to raise children and perform caregiving means the compounding effects upon investment apply to a much lower base.
- These inequities are supercharged by the structure of government tax concessions. The flat rates of super tax concession on contributions and earnings are regressive, becoming more valuable for higher income earners, and are actually an impost on very low income earners. The majority of those in the bottom income deciles are women.
- Women have longer life expectancies, counselling in favour of higher – not lower – superannuation.

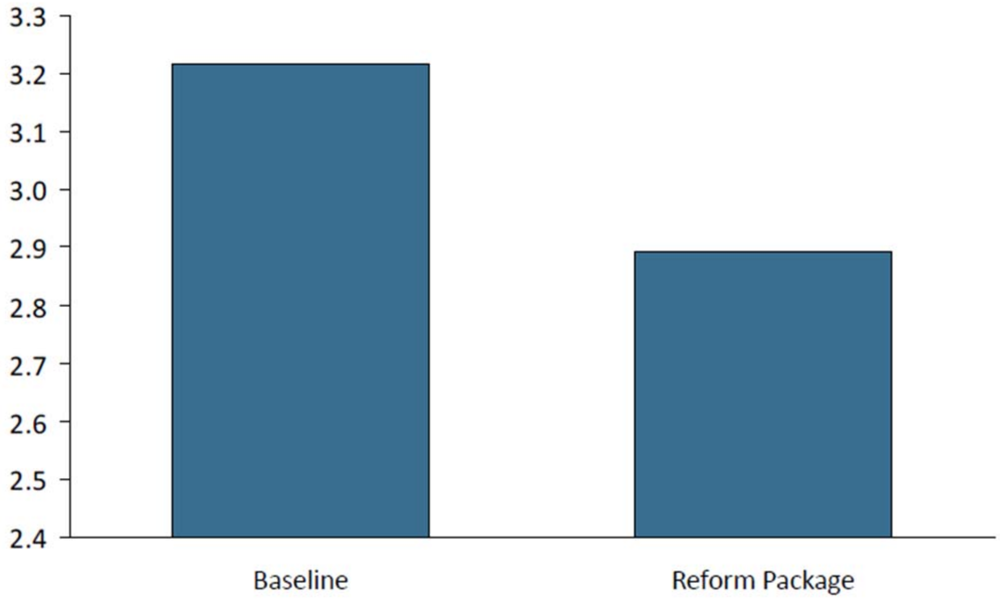
The indicative reform package modelled in this submission substantially improves the retirement living standards of women. The Super Seed contribution, alone, lifts the superannuation retirement income of single women retiring in 2055 by almost 250%.

The package as a whole rebalances assistance across the income distribution and particularly between high and low income earners. Given the concentration of women among lower income groups (63% of wage and salary earners with incomes under $37,000 are female)[11] the proposed reform package begins to address the retirement income inequities between men and women.

[11] ABS 63100, Table 2 Employees in main job, Weekly earnings in all jobs–By full-time or part-time status in all jobs–By sex

Figure 12 shows the change in the ratio of retirement income received by those in the top income decile and those in the bottom before and after the proposed reform package.

Figure 12 – Indicative gender equity: ratio of retirement income of top decile to bottom decile



Source: ISA-Rice Warner modelling

2.4.4 Fiscal effects: change to aggregate Age Pension and tax expenditure

The current Age Pension means test is incoherent, as described above in Section 1.3.2. It not only puts a comfortable retirement out of reach for middle income Australians, it also undermines the incentive to save for retirement. Under the newly-legislated means test, modelling shows that nearly a full dollar of Age Pension income is lost for every dollar of retirement income arising from private savings. As a result, the incentives for individuals to save are weak and, taking into account the uncertainty of investment earnings, perhaps no more than ambiguous.

Any package of reforms designed to increase retirement income efficiency and encourage private savings must first reform the Age Pension means test.

A simple and straightforward reform is simply to reduce the Age Pension taper rate from $3 to $2 per $1000 of assessable assets above the asset free area. This change represents a saving compared to the existing $1.50 asset test, delivering savings around 0.3% GDP by 2055. It represents a midpoint compared to the estimated 0.6% of GDP saving by 2055 for the $3 asset test that has been legislated from 2017. Combined with the other measures, growth in the Age Pension will be constrained to 2.8% GDP in 2055 (0.3% GDP less than if no changes were made to the Age Pension or superannuation).

Together with the other measures in the package is revenue neutral (delivering a small saving of almost $3.5billion or 0.07% GDP in 2055) compared to the existing $1.50 asset test. Increased expenditure on measures such as the Super Seed is not only more efficient, but offset by increased earnings tax revenues from the $620 billion increase superannuation assets. However when assessed against the revised $3 asset test, the indicative package results in a fiscal impact of 0.46% GDP.

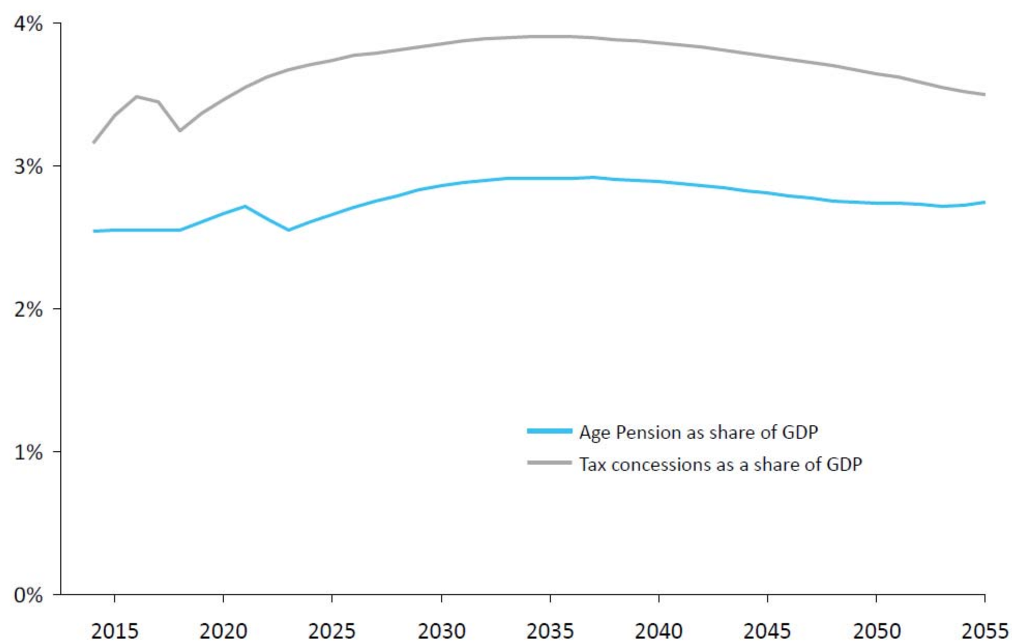
Table 5 – Fiscal effects at 2055 of indicative reform package under different Age Pension asset tests

	Change ($millions) vs current $1.50 Asset Test	Change ($millions) vs legislated $3 Asset Test
Superannuation assets	619,948	619,948
Gov't co-contribution ('Super Seed')	8,098	8,098
Age Pension	(16,305)	8,321
Contribution tax	(8,978)	(8,978)
Earnings tax	4,193	4,193
NET	(3,422)	21,204
% GDP	(0.07%)	0.46%

Source: ISA-Rice Warner modelling

While the indicative package of reforms is not revenue neutral compared to the flawed $3 asset test, the burden on the Commonwealth budget for the substantially improved adequacy is eminently manageable. Figure 13 shows the projected Age Pension and superannuation tax concession expenditures as a percentage of GDP to 2055, which shows aggregate expenditure at just 6.2% of GDP at the end of the projection.

Figure 13 – Age Pension outlays and superannuation tax concessions expenditure under indicative reform package



Source: ISA-Rice Warner modelling

2.4.5 Fiscal efficiency

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.

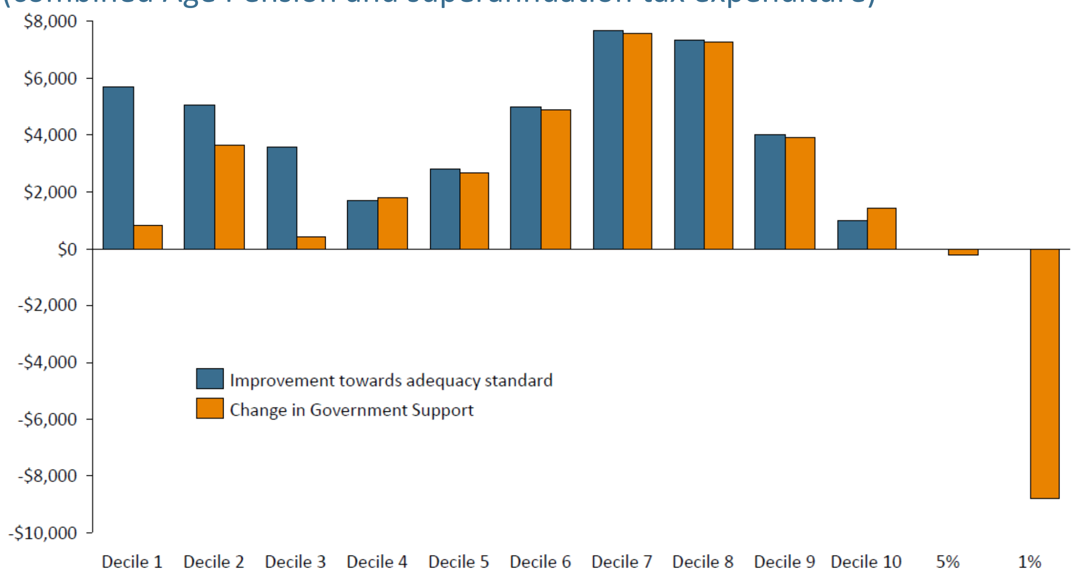
A high fiscal efficiency measure indicates that a dollar of government support is well-targeted because it is relatively effective at increasing retirement income up to a comfortable benchmark. By contrast, a dollar of government support that does not increase retirement income of those below the comfortable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

The existing retirement income system, particularly the structure of superannuation tax concessions, is not as efficient as it could be. Superannuation tax concessions substantially increase the retirement incomes and residual wealth of high income earners, focusing Government support and increasing incentives for those who would retire on incomes well above those necessary to have a comfortable standard of living.

Perversely, superannuation tax concessions provide much weaker benefits and incentives to save for low and middle income earners. Under current settings, for persons on low incomes, in particular, the taxation of super contributions and earnings can be a tax impost rather than a tax concession.

As shown in Figure 14, the indicative package of reforms we have modelled increases retirement income adequacy in a well-targeted way. In addition, the net outlays are far lower than the net increases in retirement income to those below a comfortable living standard. As Figure 14 makes clear, the indicative package lifts retirement incomes for low income earners in a very efficient way. Middle income earners have retirement incomes that rise on about a dollar-for-dollar basis with Government expenditure, reflecting the renewed coherence of the Age Pension means test. High income earners see relatively modest effects, except for those in the top 1%, who see a significant decrease in combined Government support. This seems appropriate because Government support to top income earners is about twice that provided to low income earners under current policy settings, and Government support should generally flow to those with the greatest need.

Figure 14 – Additional retirement income adequacy per dollar of Government support (combined Age Pension and superannuation tax expenditure)



Source: ISA-Rice Warner modelling

3. Possible integrity measures

Continued ad hoc policy making could further threaten the integrity and community support for the superannuation system, and further undermine the faith in the resilience of the Age Pension and related "social compact." It also is unlikely to end the current sense of uncertainty around the stability of policy settings, which is interfering with the ability of individuals and institutions to make long term decisions – a cross-partisan review seems necessary to resolve this uncertainty.

However, consideration could be given to certain interim measures.

Tax reform is necessarily a lengthy process. However, there are two measures that can be implemented immediately that will have a meaningful impact on the adequacy of retirement income and the probability that more Australians will achieve a comfortable standard of living in retirement.

These are the permanent restoration of the Low Income Superannuation Contribution beyond 2017 and a return to the previous scheduled increases in the Superannuation Guarantee.

In addition, one possible integrity measure that others have suggested, and may be worth exploring, is the reduction in the size of the non-concessional contribution cap such that it is equal to the size of concessional cap.

3.1.1 Low Income Superannuation Contribution

The LISC was introduced in response to the Henry Tax Review and was designed to address the inequitable contribution tax treatment of low income earners' SG contributions. The Henry review found the flat 15 percent contribution tax was regressive in its impact, with low income earners paying more tax on their super contributions than their take home earnings. These effects have become more pronounced over the years due to a shift in the composition of the workforce towards part-time and casual work and as personal income tax rates have been cut for low income earners.

The LISC operates as a tax offset, effectively refunding the contribution tax paid by low income earners on their SG and other concessional contributions up to $500 per annum, thus allowing low income earners to accrue a tax concession on their contributions like all other income earners. The operation of the LISC is integral to the compact whereby the Government offers compensation to individuals, by way of tax concession, for their deferral of consumption caused by the SG.

Arguably the deferral of consumption for low income earners is felt most acutely due to their budget constraints – making the LISC a particularly important measure. The importance is further heightened because lower income earners obtain little or no benefit from the superannuation earnings tax concession.

3.1.2 Restored SG schedule

The Superannuation Guarantee requires employers to contribute a minimum percentage of an employee's pay packet into their superannuation account. This minimum amount was on track to increase from 9 percent of employee earnings to 12 percent. In 2014, the SG was frozen at 9.5 percent for seven years, rather than increasing to 12 percent by 2019 (Table 6). Based on new laws, the SG rate will remain at 9.5% until 2021 when it will increase by 0.5% per annum until it reaches 12% in July 2025. The change has resulted in reduced employer SG contributions into employee super accounts relative to the schedule which was previously legislated.

Table 6 – Scheduled increases to Superannuation Guarantee

Year (commencing 1 July)	Previous SG Schedule	New SG Schedule
2013	9.25%	9.25%
2014	9.50%	9.50%
2015	10.00%	9.50%
2016	10.50%	9.50%
2017	11.00%	9.50%
2018	11.50%	9.50%
2019	**12.00%**	9.50%
2020	12.00%	9.50%
2021	12.00%	10.00%
2022	12.00%	10.50%
2023	12.00%	11.00%
2024	12.00%	11.50%
2025	12.00%	**12.00%**

SG Freeze

Source: ISA Briefing Note - Working life impact SG and LISC, April 2014

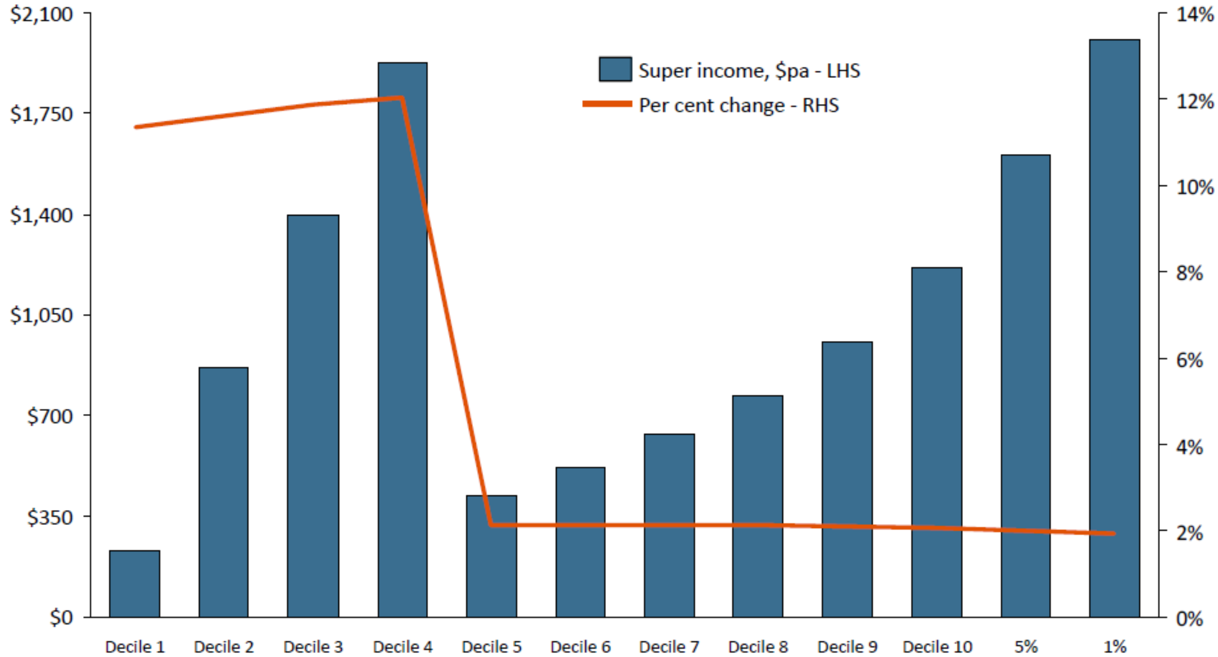
3.1.3 Restoration of the LISC and the previous schedule SG increases

Restoration of the LISC and the previous SG schedule would have a significant positive effect on retirement savings for individuals who are reliant on the SG, with the most positive impacts on those on moderate incomes. Many Australians would enjoy higher balances and, with the compounding effect of investment earnings, an increased proportion can be expected to achieve a comfortable standard of living in retirement.

Restoring the LISC would improve retirement incomes for those on low incomes, particularly women.

The combined effect on retirement incomes of restoring the prior SG schedule and the LISC is set out in Figure 15.

Figure 15 – Change to annual retirement incomes from superannuation, single females retiring 2055, by income decile, 5% and 1%, 2014 prices



Source: ISA-Rice Warner modelling

3.1.4 Alignment of the concessional and non-concessional contributions cap

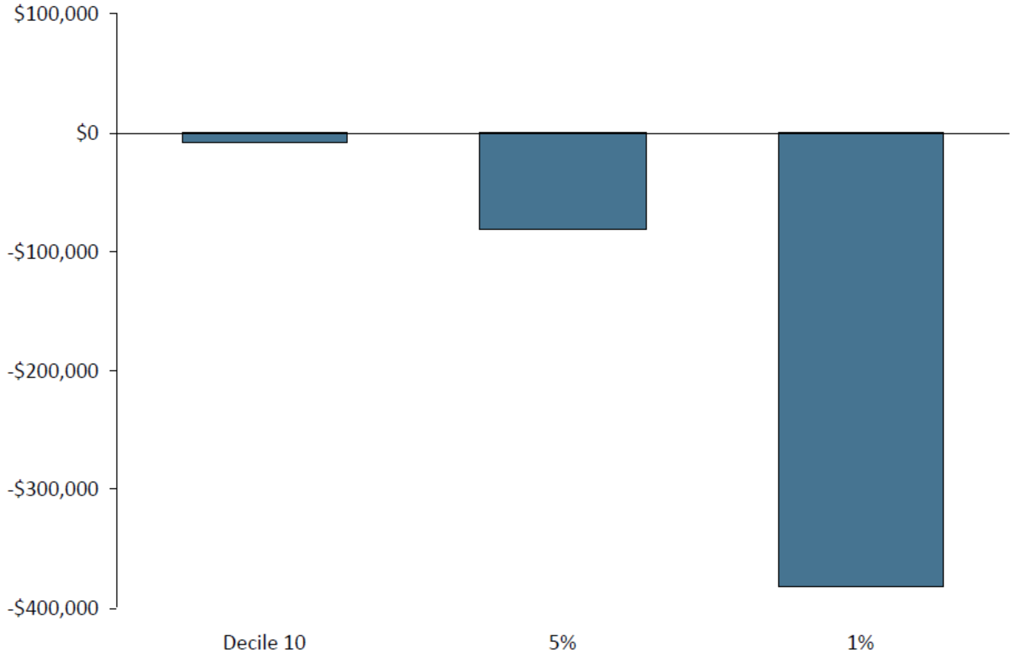
We understand that some industry participants have suggested aligning the annual non-concessional contributions cap with the annual concessional contributions cap, which currently is $30,000 per year for most taxpayers.

As noted above in Table 3, Australia's non-concessional contributions cap diverges significantly from the practices of other countries. Australia's generous caps would appear to enable significant assets to be contributed into the tax-preferred superannuation environment.

This is not necessarily problematic, except that the generous non-concessional contributions caps are combined with poorly targeted tax concessions, and very weak requirements that assets contributed into superannuation are used for retirement income. As a result, rebalancing superannuation tax concessions must involve one or more of the following: (i) reducing the ability to place excessive amounts of assets into the tax preferred superannuation environment, (ii) reducing the misallocation of concessions to those who do not need them by introducing progressivity into the structure of the concessions, and (iii) requiring superannuation assets to be used solely for retirement income rather than bequests and wealth transfer (or appropriately taxing such uses).

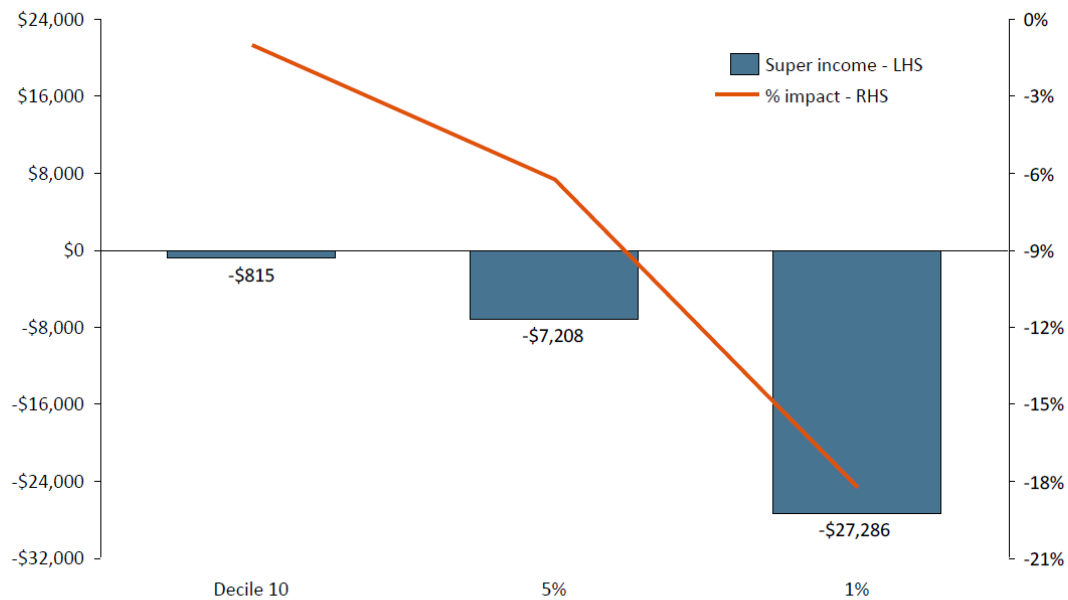
Modelling suggests that the proposed cap on annual non-concessional contributions at an amount equal to the concessional contributions cap would result in some outcomes consistent with efforts to contain superannuation tax concessions. Figure 16 shows the change to lifetime superannuation tax concessions for single males retiring in 2055. The effect of the proposal is limited to members of this cohort in the top decile, with the material effects limited to those in the top 5% and 1% of the income distribution. The effect on retirement income arising from superannuation is similarly targeted, affecting those in the top decile only (Figure 17). The proposal reduces retirement income, but not in a way that puts the comfort of affected persons in jeopardy: after applying the policy change, average annual retirement incomes for single males retiring in 2055 in the top 1% of the income distribution are still projected be over $330,000 per year.

Figure 16 – Change to lifetime superannuation tax concessions, single males retiring in 2055, by income decile, 5% and 1%, 2014 prices



Source: ISA-Rice Warner modelling

Figure 17 – Change to retirement income arising from superannuation, single males retiring in 2055, 10th decile, 5% and 1%, 2014 prices



Source: ISA-Rice Warner modelling

4. Consideration of certain reform proposals in the public debate

In recent times, a number of proposals have been proposed as reform options. We have sought to assess some of them, including by modelling the long term distributional effects on adequacy and incomes in a couple of instances where this is necessary to display potential issues with the proposal.

4.1 Proposed increases to the pension age and the preservation age

Under current legislated policy, the Age Pension age is set to increase from 65 to 67 between 2017 and 2024 and the preservation age is set to increase from 55 to 60 between 2015 and 2025.

There are proposals to considerably increase these age-based eligibility requirements. The Government has proposed an Age Pension age of 70 and the Productivity Commission has researched a proposal to raise the preservation age to 65.[12]

The case for a lift in Age Pension age is usually based on life expectancy, and usually ignores the more relevant factors to working at older ages such as disability, illness, involuntary retirement and actual labour force participation patterns.

The Productivity Commission heavily qualifies its results because of involuntary retirement, but it may have overstated the extent of voluntary retirement. The Commission only projects a fiscal benefit in 40 years' time, and provides no estimates of fiscal benefits between 2025 and 2055.

There are substantial equity concerns with raising the Age Pension age and preservation age based on rising life expectancy. Life expectancy varies significantly based on income and wealth. Raising the eligibility ages would harm the more vulnerable.

Raising the Age Pension and preservation age is sometimes argued based on claims it would lift participation rates by creating a greater incentive to work. Incentives can only be effective if individuals are *voluntarily* leaving the workforce, and remain able to work. The majority of retirements, even at the current Age Pension age, are *involuntary*. In addition, disability is common, and the prevalence of chronic health conditions is far greater among those on lower incomes.

Based on available information, proposals to raise the Age Pension age and preservation age seem likely to be ineffective in achieving their objective, and seem likely to harm those who are not well-placed to bear that harm.

4.1.1 Age Pension Age

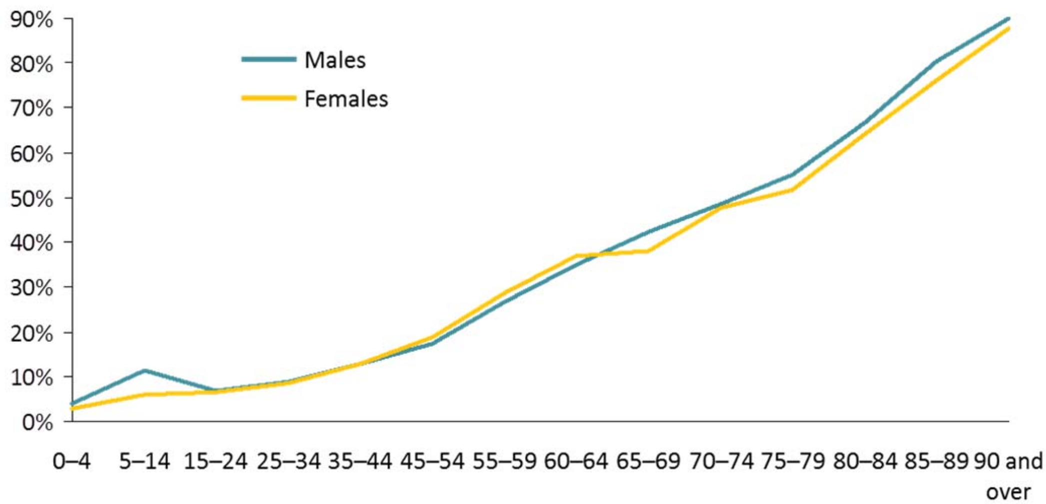
Most of the workforce has retired before the Age Pension age. The 2006 Census indicated that the labour force participation of 63 year olds was less than 50% and that of 64 year olds less than 40%. Furthermore, labour force participation continues to drop after the Age Pension eligibility age, with participation rates being around 30% at 65, 25% at 66, 20% at 67 and 15% at 68. There are very few full-time workers beyond 70. These participation rate drops have nothing to do with life expectancy which is around 86 for men and 89 for women.[13]

[12] Productivity Commission *Superannuation Policy for Post-Retirement*, Productivity Commission Research Paper, July 2015

[13] 2015 IGR, p 5

The 2015 Intergenerational Report[14] indicates that disability free life expectancy for a male is 62.4 years and for a female is 64.5. So the drop in labour force participation in the early 60s could well have much more to do with disability and very little to do with mortality rates. Figure 18 presents the rise in disability rates with age.

Figure 18 – Disability rates by age and gender, 2009



Source: ABS Catalogue No. 4430.0 - Disability, Ageing and Carers, Australia 2009

Disability is a major driver of social security take-up. According to the Productivity Commission, in 2013-14, almost 90 percent of those who took up an Age Pension at 65 transitioned from another Government payment.[15] Rising Age Pension age for women has almost been fully offset by increased use of disability support pension (and some minor use of other payments) for the women affected.

[14] 2015 IGR, p 8

[15] 2015 IGR, p 33

This Productivity Commission analysis may overestimate the proportion of retirements which are voluntary. Most people take a considerable drop in income when they retire. Table 7 uses HILDA data from 2003 and 2007 to show that around 35% of retirements appear voluntary, and even fewer are driven by financial circumstances.

Table 7 - Main reason for retiring, men and women aged between 60 and 64 completely or partly retired (%)

Reason provided	2003		2007	
	Men	Women	Men	Women
Became eligible for the Age Pension	0.0	3.3	0.0	0.8
Offered reasonable financial terms to retire early or accept a	6.4	0.0	4.4	1.1
Superannuation rules made it financially advantageous to retire	4.7	0.0	4.4	1.5
Could afford to retire / Had enough income	3.0	4.4	11.3	6.1
Spouses / Partners income enabled me to retire	0.0	3.7	0.0	1.9
Made redundant / Dismissed / Had no choice	14.6	7.0	9.8	6.8
Reached compulsory retirement age	0.4	0.7	0.5	0.0
Could not find another job	2.6	2.2	1.0	2.7
Fed up with working / Work stresses, demands	12.0	13.0	4.4	11.8
Pressure from employer or others at work	1.7	0.7	2.0	1.9
Own ill health	37.3	22.6	41.2	19.4
Ill health of spouse / partner	1.7	5.2	2.5	7.2
Ill health of other family member	0.4	2.2	0.5	3.0
Partner had just retired or was about to retire	0.4	4.4	0.5	2.7
Spouse / partner wanted me to retire	0.4	3.0	0.5	2.7
To spend more time with spouse / partner	3.4	2.6	3.9	3.0
To spend more time with other family members	0.4	9.7	1.0	8.8
To have more personal / leisure time	7.7	7.8	8.8	8.4
To have children / start family / to care for children	0.0	4.8	0.5	3.0
NEI to classify	9.0	2.2	0.0	2.7
Other	2.6	3.3	2.9	4.6
All	100.0	100.0	100.0	100.0
Voluntary Retirees	**35.6**	**33.0**	**35.3**	**33.5**

Source: HILDA

Disability and negative health outcomes are linked to wealth and income. A recent study of over 200,000 Australians over ages 45 to 106 found significantly lower levels and decreased prevalence of chronic health conditions as incomes increased.[16]

Raising the Age Pension age has not been demonstrated to lift the labour force participation of women and we do not yet have evidence that lifting it beyond age 65 will raise the participation of older people, most of whom are likely to retire before age 65. There is no obvious link between life expectancy rising to 89 and employment of people in their late 60s.

Statutory age rises can be effective in changing behaviour if retirement is voluntary. The Productivity Commission estimate that around 50% of retirements for 60-64 year olds are involuntary.[17] They estimate that 28% of men and 25% of women retire because of poor health and caring responsibilities. A further 20% of men and 11% of women have their employment terminated or cannot find work.

Caution needs to be exercised in proposing lifts in Age Pension age beyond 67.

4.1.2 Preservation Age

The same arguments about disability, health, and involuntary retirement apply to proposals to lift preservation age. The current schedule lifts preservation from 55 to 60 between 2015 and 2025.

Currently not many people retire in their late 50s, and it seems likely that the rising preservation age will not have much of a labour force impact in the next ten years.

The effects of the current schedule should be evaluated before proposals to lift the preservation age beyond 62 are legislated. Current retirement behaviour shows that most of the workforce will retire in the five years before Age Pension age, and for good reasons.

To the extent there is concern about the incentive effects of superannuation on truly voluntary retirement, the ability to achieve tax free earnings is perhaps more likely to be relevant than simple super access. There is a distinct peak in retirements at age 60, and the tax free benefits age may be a factor.

4.2 Proposed $2.5 million cap on retirement balances

A handful of commentators have suggested the idea of limiting the amount of superannuation that can be rolled into a retirement account, and thereby receive tax free earnings.

For example, ASFA has suggested:

> A limit of $2.5 million be placed on the superannuation funds an individual can rollover to commence an income stream in retirement. Amounts above this ceiling should remain in the accumulation phase and continue to attract the nominal earnings tax of 15 percent or be removed from superannuation.[18]

While we support the broad sentiment that improved equity and efficiency is needed, it is not clear that this proposal will deliver the desired outcome.

The proposed cap of $2.5 million on amounts that can be rolled into a pension account simply means that, for individuals with amounts in excess of $2.5 million, their pension account will be smaller and their residual assets in superannuation will be larger.

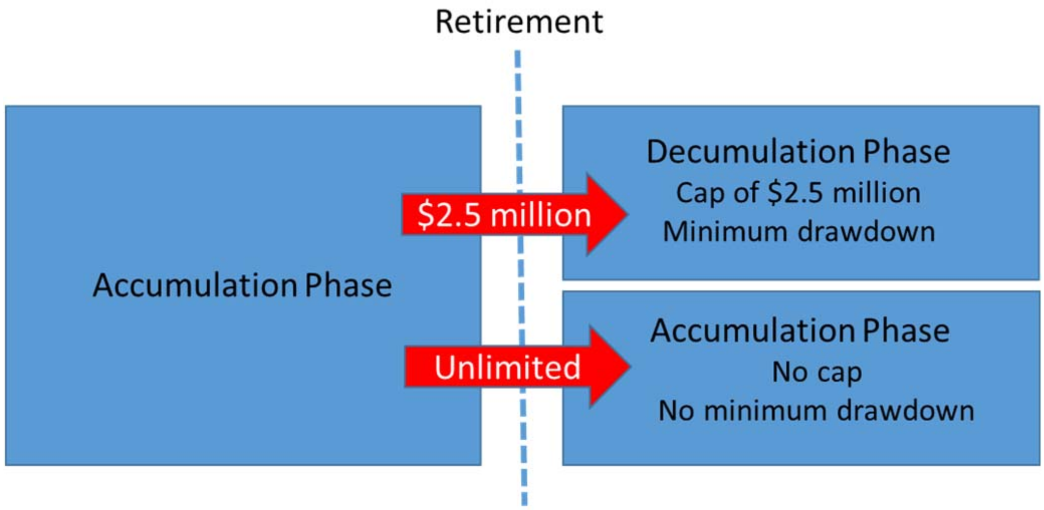
[16] Korda et al. BMC Public Health 2014, 14 :74

[17] Productivity Commission 2015, p 9

[18] ASFA Supplementary submission in response to the Tax Discussion Paper.

This means the earnings on amounts above $2.5 million will be taxed at 15%. But, crucially, these residual amounts are not subject to minimum drawdown requirements (Figure 19).

Figure 19 – Schematic of proposed $2.5m cap on retirement balances



Source: ISA

In assessing this proposal, our hypothesis was that the 15% tax on earnings of the amounts in superannuation that are not rolled into a pension account was likely to be outweighed by the elimination of the minimum drawdown requirements.

Modelling supports this hypothesis, showing that the proposal actually *increases* the value of lifetime tax concessions received by high income earners, and *increases* their residual capital available for bequests, compared to a baseline scenario where individuals roll their full balance into a retirement account and drawdown an amount consistent with observed behaviour. The net effect on wealth at life expectancy for single males retiring 2035 is positive, lifting it by about $125,000. For each member of a couple retiring in 2035, the net effect is to lift their wealth per person by about $80,000. There are no material effects for individuals retiring in 2055 because the $2.5 million cap, if indexed to wages growth, becomes insignificant.

Permitting an unlimited balance to remain in the accumulation phase with no minimum drawdown, yet still enjoying the 15 percent earnings tax concession, does not appear to reduce the misallocation of tax concessions compared to a baseline scenario where individuals roll their full balance into a retirement account and are subject to drawdown requirements.

With no drawdown requirements, amounts above $2.5 million that are permitted to remain in a tax-preferred environment seem unrelated to retirement security policy, and appear little more than wealth accumulation endeavours backed by Government tax expenditures that would be difficult to justify.

4.2.1 Cap of $1 million on non-concessional superannuation contributions

ASFA has also suggested that "Non-concessional contributions should also be capped at $1 million over a lifetime to prevent very large balances from accruing in the future as an integrity measure to complement the $2.5 million capital cap."[19]

This proposal initially seems to hit closer to the mark. It seems to reduce retirement incomes arising from superannuation and the value of the tax concessions to very high income earners, if we simply apply baseline levels of non-concessional contributions, but cap such concessions once they reach $1 million (indexed). For

[19] Id.

single males in the top 1% income decile retiring in 2055, it reduces super savings at retirement by about $390,000, or 13%.

However, the actual ASFA proposal is to allow a lifetime cap of $1 million, which suggests that up to the full $1 million can be contributed into super in a single year.

As a result, for those individuals who can afford to, a $1 million contribution into super can be made at age 18, and can still yield very large superannuation savings by the time they retire at 65.

Optionality tends to deliver benefits to those with the means to take advantage of the option, and a $1 million lifetime cap is this kind of option.

It could be argued that the number of individuals who can contribute $1 million in single year is small. However, policy makers should anticipate significant behaviour change: one only need look at the empirical results of the increase in the non-concessional contributions cap to $1 million in 2007 to support this view. We understand that those with the means took advantage of the 2007 cap increase, and many individuals borrowed money to make contributions.

The difference between (i) contributing $1 million at age 18 and making no further non-concessional contributions, and (ii) contributing $180,000 at age 18 and a further $180,000 every year up to a $1 million cap is, at age 65, about $490,000 (2014 dollars) assuming an effective earnings tax rate of 7%. This additional capital at retirement only continues to grow until life expectancy, resulting in additional lifetime accumulation of around $1.4 million (2014 dollars), if drawdowns are disregarded to simplify the comparison.

While the optionality aspect of the $1 million lifetime non-concessional contributions cap deserves further scrutiny, ASFA's suggestion that non-concessional caps should be reduced has merit and would help to contain excessive misallocation of superannuation tax concessions. It could be more effective in doing so if the lifetime cap were combined with annual cap to reduce the optionality.

5. Excess superannuation saving and tax minimisation strategies

Very high superannuation balances are likely to indicate the misuse of superannuation as a wealth accumulation and estate planning vehicle rather than as a source of retirement income. The misuse of the embedded tax concessions in super reduces the cost-effectiveness and fairness of the retirement income system.

This section examines:

- The groups which have excess balances, contributions and tax concessions;
- When excessive accumulations behaviour changed; and
- Some of the tax strategies being utilised.

5.1.1 The Groups with Excess Balances, Contributions and Concessions

Appendix 1 of the Challenger Limited Submission to the Tax White Paper presents Treasury staff[20] analysis of the distribution of high contributions and high concessions.

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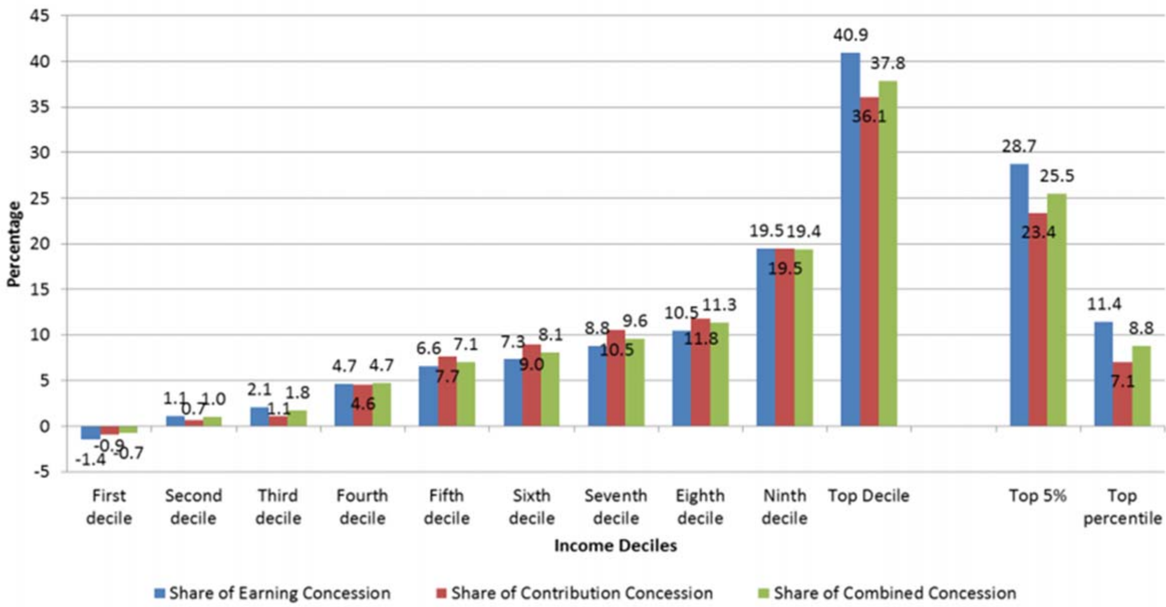
[20] Phil Gallagher (2012) *The Distribution of Government Support for Retirement Income – Point in Time and Lifecycle Estimates*, Presentation to the Colloquium of Superannuation Researchers, Friday 13 July 2012

Figure 20 shows that those in the top 1, 5 and 10 percent of taxable income had considerably more than a proportional share of contribution and earnings concessions. For example, the top 5 percent had 28.7% of earning concessions and 23.4% of contribution concessions in 2009-10. The lower contribution concession shows the effect of contribution limits.

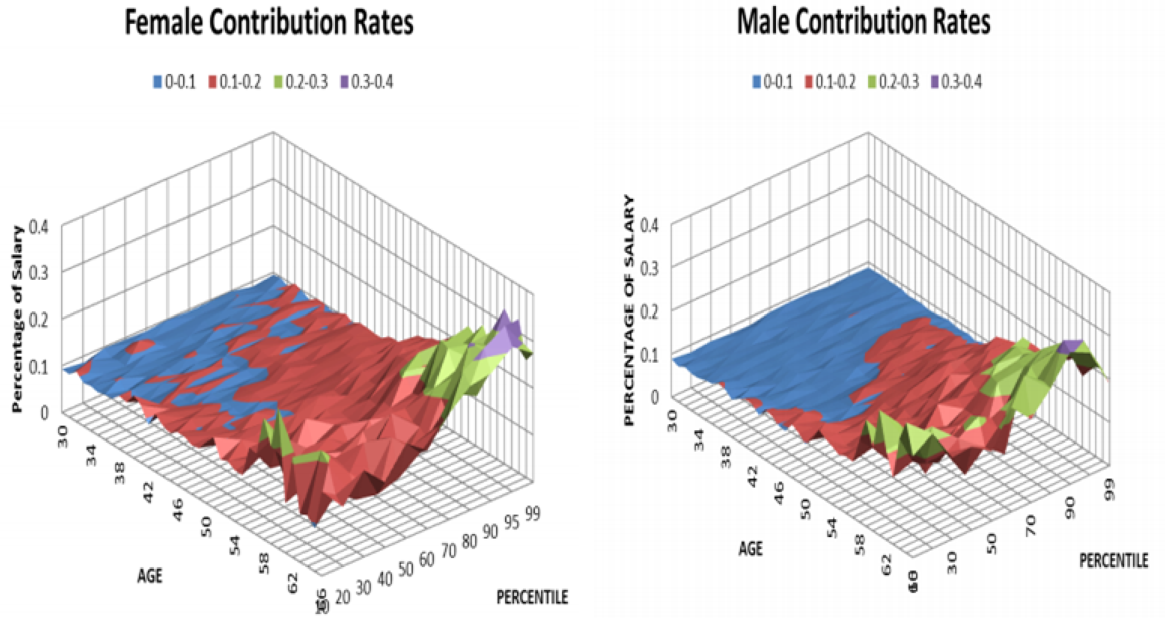
The Treasury analysis also shows that it is high income people in their 60s who have the highest concessional contribution rates. Figure 21 shows that this group exceeded 20 percent and even 30 percent contribution rates.

Figure 20 – Share of Superannuation Tax concessions by Decile and for the top 5 and 1 percentiles



Source: Gallagher 2012

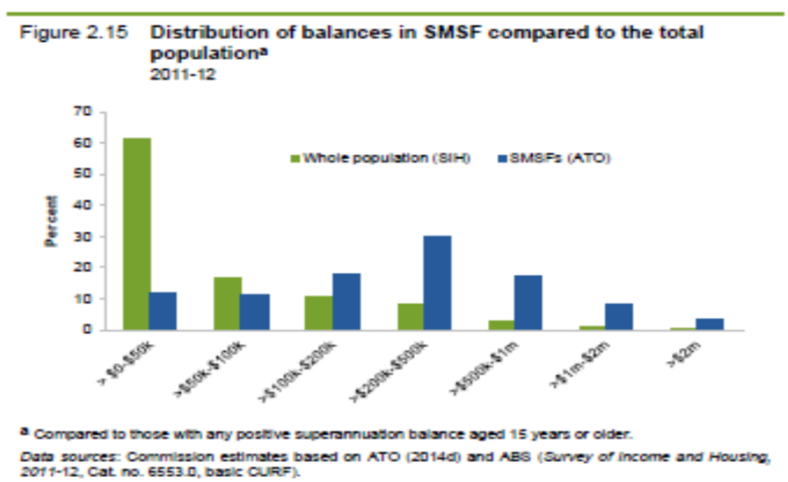
Figure 21 – Distribution of Concessional Contributions by Age and Gender



Source: Gallagher 2012

The Productivity Commission Research Report on Superannuation Policy for Post-Retirement demonstrates that people in SMSFs have far higher balances than the remainder of the population. The Productivity Commission's Figure 2.15 is reproduced in Figure 22.

Figure 22 – Distribution of balance in SMSF compared to the total population



Source: Productivity Commission

The ATO has published tables which show the extent to which SMSFs have very high balances. These have been used to create Table 8. In 2013, there were over 4000 people with SMSF balances over \$5 million, over 1000 with SMSF balances over \$10 million and almost 40,000 with balances in excess of \$2 million.

Table 8 – Distribution of member balances in SMSFs

SMSFs Number of members by asset range (rounded to the nearest 5)					
Asset Ranges per member	**2009**	**2010**	**2011**	**2012**	**2013**
> $0-$50k	104,750	102,970	105,385	115,400	100,155
>$50k-$100k	100,025	101,300	101,780	108,725	106,225
>$100k-$200k	147,280	153,200	160,325	170,715	176,035
>$200k-$500k	230,765	246,965	266,610	283,255	306,540
>$500k-$1m	126,805	140,645	157,625	164,040	186,150
>$1m-$2m	59,860	68,650	78,360	81,065	97,120
>$2m-$5m	17,325	21,765	27,020	27,660	35,410
>$5m-$10m	1,575	1,675	2,700	2,860	3,035
>$10m	-	835	900	955	1,010
Total	**787,600**	**837,170**	**900,715**	**953,720**	**1,011,685**

Source: https://www.ato.gov.au/Super/Self-managed-super-funds/In-detail/Statistics/Annual-reports/Self-managed-superannuation-funds--A-statistical-overview-2012-2013/?anchor=Appendix1#Appendix1

Clearly, older high income people and people with assets in SMSFs are more likely to have excess contributions and accumulations. Other clues to the policy changes associated with excess assets and contributions come from APRA time series.

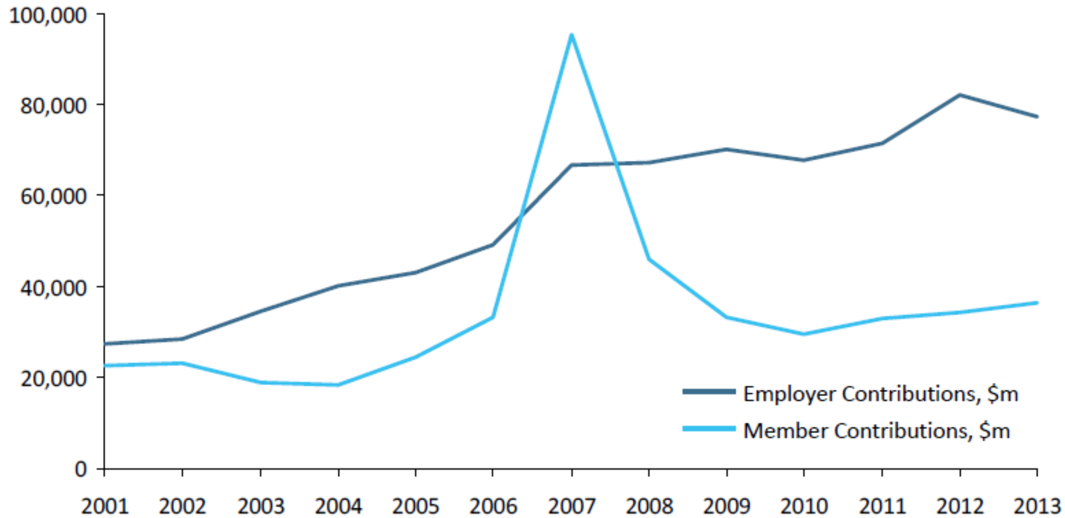
5.1.2 Policy changes associated with very high contributions and balances

Perhaps the biggest change in superannuation policy in the last 15 years was “Simpler Super” in 2006-07. The policy included:

- Tax free benefits after age 60 for funded schemes
- The reduction in the pension asset test taper from 7.8% to 3.9% ($3 to $1.50 per $1000 of assets)
- A temporary limit of $1 million of non-concessional contributions between 10 May 2006 and 30 June 2007
- A drop in the concessional contribution cap for over 50s from $105,113 a year to $50,000 on 1 July 2007.

Figure 23 shows that these changes were associated with an incredible spike in member -largely non-concessional (undeducted) - contributions and an appreciable rise in employer contributions. The increase in member contributions was reversed by the cessation of the $1 million cap in 2008 along with the start of the Global Financial Crisis (GFC).

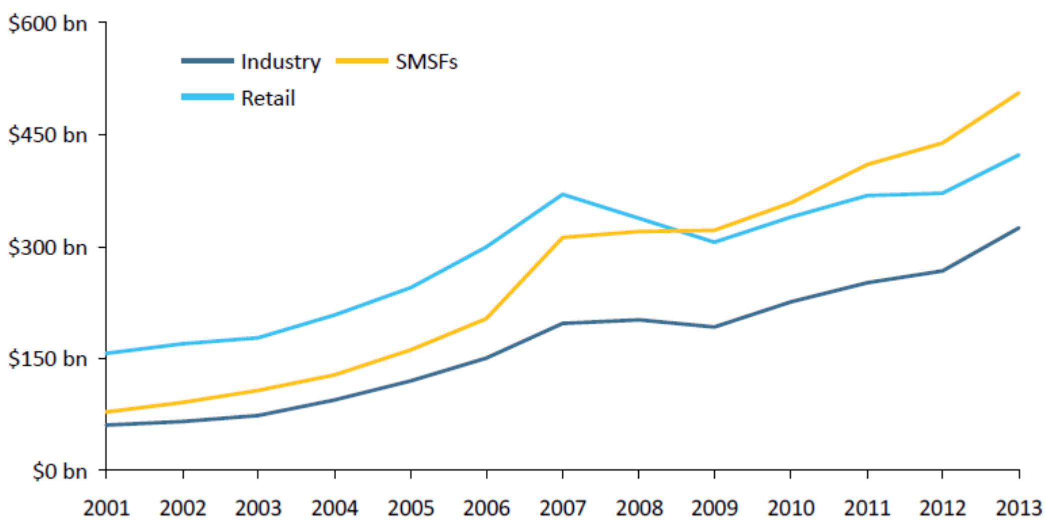
Figure 23 – APRA contributions time series $ million



Source: APRA

Industry funds and award super began in 1987. SMSFs began in 1998. Figure 24 shows that both SMSFs and retail funds showed a dramatic increase in growth with the first year of Simpler Super. Although retail and industry fund assets declined in response to the GFC, SMSFs continued to grow. The APRA Quarterly Bulletin for March 2015 shows that SMSFs had only 8% of the member accounts of industry funds, but had $159.7 billion more in assets. SMSFs have shown remarkable growth since 1998 and this was accelerated by the removal of the taxation of end benefits for retirees over 60 in 2007.

Figure 24 – Assets of Selected Fund Types, 2001 to 2013



Source: APRA

5.1.3 Tax strategies associated with very large superannuation balances

Some of the tax strategies associated with very large accumulations in APRA funds and SMSFs are:

- Consistently high levels of concessional (deducted) contributions
- Large non-concessional contributions

- Minimum drawdown of assets in account based pensions
- Withdrawal of assets prior to death (or recontribution).

Tax strategies which are particularly effective in SMSFs include:

- Deferral of capital gains until retirement
- In specie contributions
- Use of the real business property exemption to achieve tax deductions for dealing with oneself
- Limited recourse loans.

The high contribution rates of high income and older employees and the self-employed have been the subject of policy control for a long time. The age based contribution caps were generous for older workers with the Howard Government dropping the concessional contribution cap for over 50s from $105,113 a year to $50,000 on 1 July 2007. In 2015-16 the general concessional contribution cap is $30,000 and that for those 49 and over is $35,000. These levels seem appropriate, allowing average workers to catch-up on contributions, but not extending tax concessions to high income areas.

The cap for non-concessional (undeducted) contributions is $180,000 in 2015-16 but three years contributions (up to $540,000) can be made in the one year if the person is under 65. This means that an SMSF with 4 members can make a non-concessional contribution of $2.16m in a single year. The rationale for this is that the wealth being used has previously been taxed – but it may well be difficult to establish when if ever. Anecdotally, people borrowed to make use of the $1m transitional non-concessional contribution limit. Borrowings would not have been taxed as income. Bequests would not be taxed as income. Proceeds from cash in hand businesses may not be taxed as income. Proceeds from pre-1985 asset sales would not be taxed as income.

The very generous non-concessional cap combines with the *in specie* contribution rules and limited recourse loans to allow wealth transfer and the ability to generate deductions from dealings with yourself or a related party. The *in specie* contributions are contributions to a fund in the form of an asset other than money.

Generally a fund must not intentionally acquire assets (including in specie contributions) from related parties to the fund. However, there are some significant exceptions to this rule, including:

- Listed shares and securities; and
- Business real property (land and buildings used wholly and exclusively in a business).

The transfer of assets from a related party can allow the returns or capital gain from that asset to become tax free if the members of the fund are over 60 and retire. But there is also a tax benefit in the accumulation phase. Capital gains are fully assessable for a company but only 2/3 assessable for a superannuation fund in the accumulation phase.

If the shares transferred into a fund generate franked dividends, they will generate a direct payment of imputation credits from the ATO for members in the retirement phase. The level of imputation credits for retired members can be four or five times a full rate Age Pension. This is because the imputation credits are designed to remove dual taxation which is not possible when the member with dividends cannot be taxed on any income received.

The business real property exemption (say the contribution of a car showroom) can set up a situation where a family company pays rent to their own SMSF. The company can claim a deduction equal to 30% of the rent, but as income of the fund the rent will only be taxed at 15% at most. If members of the SMSF are in the retirement phase the tax rate could be less, and could be zero percent if all members are retired.

A limited recourse borrowing arrangement requires an SMSF trustee to take out a loan from a third party lender. The trustee then uses those funds to purchase a single asset (or collection of identical assets that have the same market value) to be held in a separate trust. Any investment returns earned from the asset go to the SMSF trustee. If the loan defaults, the lender's rights are limited to the asset held in the separate trust. This means there is no recourse to the other assets held in the SMSF.

The introduction of limited recourse borrowing has allowed the negative gearing of SMSF assets, and may well be linked to the increase in SMSF investment in rental property (which has been of concern to the Reserve Bank because of increased demand and prices for investment property). It also means that asset acquisitions that cannot be funded by the very generous non-concessional (undeducted) contributions can be funded by debt inside the fund.

The desirability of SMSFs is sometimes attributed to an interest in investment control. However, the incredibly high levels of assets in many SMSFs suggest family wealth management and estate planning is also a powerful motive. As shown in Table 8, there were 136,575 SMSF members at June 2013 with over $1 million in assets.

Wealth transfer to family members has been facilitated by the removal of the maximum withdrawal from allocated pensions in 2007. This means that an SMSF member over 60 approaching death can withdraw all of their funds and transfer them tax free to family members. If these assets went to the estate of the member, the transfer would be taxed at 17%.

If the member is under 60, they can use recontribution strategies to change the balance in their fund between the concessional and non-concessional component.

The most general remedy for the various tax-free retirement strategies is to tax high earnings in retirement accounts. Less general strategies could be changing imputation credits to imputation rebates to stop retired millionaires being paid many times the Age Pension by the ATO. Going forward, there are strong tax and prudential reasons to prospectively remove the real business property exemption and limited recourse borrowing from new SMSFs.

6. Conclusion

Existing retirement security policy is not as efficient or effective as it could be. The new Age Pension assets test undermines incentives to save, and puts a comfortable retirement further away for middle income Australians. Tax concessions allocate Government resources in ways that are not consistent with public policy goals, supercharging the wealth and retirement incomes of high income earners, while providing relatively little benefit to middle income earners, and a tax impost to very low income earners.

Without reform, a majority of Australians will retire on incomes below those necessary to support a comfortable living standard. Surely a country that has had sustained GDP growth for over two decades and boasts leading edge retirement income policy can not only aim higher, but achieve that aim.

The indicative package of reforms outlined in this submission suggests some directions that could be taken to improve outcomes in an efficient manner. Reforms such as these should be considered in a multi-partisan comprehensive retirement income review. Continuing to defer changes that the community know must occur in some manner, including the winding back of poorly targeted concessions, simply prolongs uncertainty and inhibits the ability of individuals and entities to plan confidently for the future. Reforms that are undertaken in good faith, that are measured, efficient, and implemented over time to disrupt as little as possible settled affairs, would be broadly welcomed.

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