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# TAX & SUPERANNUATION: THE SHORTCOMINGS OF THE SUPERANNUATION TAXATION EXPENDITURES

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# CONTENTS




**Mercer understands the big picture and implications**

This report is the third from Mercer analysing tax and superannuation.

Our 2012 report: Tax,Super and the Age Pension: Assessing the Value of Total Government Support, modelled the equity and fairness of superannuation tax concessions relative to the cost of the age pension to Government. Our modelling showed the value of support the Government provides for retirement income is remarkably level across the income spectrum. Indeed Commonwealth Treasury modelling confirms our finding.

Our second report in 2013, Tax & Superannuation: Benchmarking Australia, revealed it is not true that super tax concessions are overly generous in this country. Of the top eight retirement savings and income systems in the world, Australia only ranks sixth for the generosity of tax concessions.

# EXECUTIVE SUMMARY

"A more holistic approach is required, taking into account both superannuation and the age pension, to make the sort of long-term policy needed to ensure Australians' retirement security.

Superannuation taxation concessions lead to larger retirement benefits for Australians which reduce future age pension payments at a significant saving to the Government. Yet, this saving appears to be ignored in Commonwealth Treasury's tax expenditure calculations, which has led to a short-sighted debate around superannuation tax concessions based on flawed assumptions.

An estimate of the cost to Government of superannuation tax concessions is only part of the story. With the inevitable increasing costs associated with an ageing population, age pension costs and savings must be included in any reasonable debate about Australia's retirement savings and income system.

Mercer has produced this report to demonstrate a more holistic approach is required, taking into account both superannuation and the age pension, to make the sort of long-term policy needed to ensure Australians' retirement security.

In this report we prove there is a direct relationship between tax concessions and age pension costs and increasing the taxation of superannuation will reduce future super benefits and thereby increase future age pension payments. Therefore, using the superannuation tax expenditure figures and ignoring age pension savings, to shape long-term policy is a flawed approach.

Australia's three-pillar retirement savings and income system of compulsory super, voluntary contributions to super and the age pension really does provide equitably for all Australians in their retirement.

While increasing the taxation of superannuation may be a quick fix to respond to an immediate revenue shortfall, there are much better long-term solutions, including better integration between super and the age pension.

# BACKGROUND

The taxation of superannuation has been subject to much speculation and commentary in recent times. Furthermore the superannuation tax rules seem to be tweaked every year or so, which does not engender public confidence in our long-term retirement savings industry.

This discussion is particularly prompted every year when the Commonwealth Treasury produces the Tax Expenditures Statement which provides details of more than 350 tax expenditures. The latest Statement, published in January 2013, showed the largest projected tax expenditures for 2012-13 are for superannuation and owner-occupied housing with the superannuation tax expenditure shown as $31.9 billion with an expected growth to $44.8 billion in 2015-16.

Naturally the significant tax expenditure numbers attract considerable attention from interested parties who may be aiming to increase Government revenue, claim additional Government support or improve equity within the community.

Mercer's latest report – Tax & Superannuation: The Shortcomings of the Superannuation Tax Expenditures – demonstrates that by ignoring Government savings from reduced age pensions costs the Commonwealth Treasury approach is fundamentally flawed and, if used to develop long-term retirement income policy, is likely to lead to sub-optimal outcomes for individuals, households and the Government.

# PROVING THE POINT

Initially let us consider Commonwealth Treasury's approach to the calculation of the tax expenditures for superannuation. There are several items that are included in the total superannuation tax expenditure, but two of them:

1. the concessional taxation of employer contributions; and
2. the concessional taxation of superannuation fund earnings,

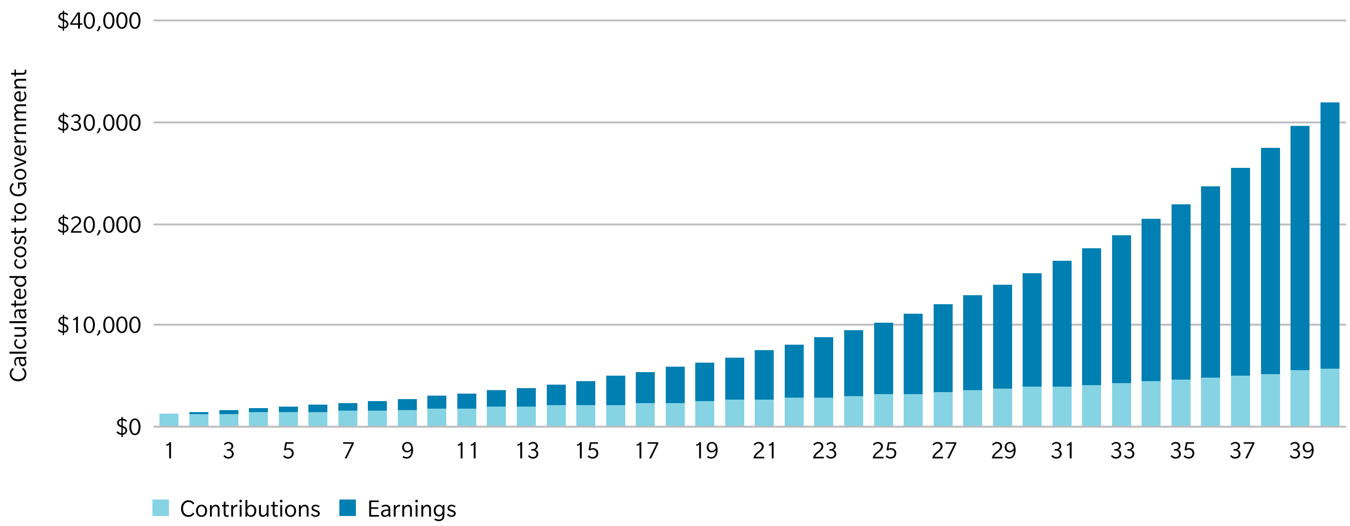
make up 95% of the total expenditure and we have therefore concentrated on these two items.

For most Australian workers their employer superannuation contributions (including the compulsory 9% Superannuation Guarantee) are taxed at 15% and not at the individual's marginal income tax rate. Similarly, the investment income earned by their superannuation fund is taxed at 15%, which is often reduced to a net effect of about 8% after allowing for dividend imputation and capital gains tax credits.

## THE COST OF SUPERANNUATION TAX CONCESSIONS

Figure 1 shows the annual value of these two taxation concessions (as calculated by Commonwealth Treasury) for an average income earner[1] over an assumed working career of 40 years. In effect, Commonwealth Treasury uses the difference between the individual's marginal income tax rate (ie 34% for average income earners, including the Medicare levy) and the 15% superannuation tax rate.

**Figure 1:** The calculated costs for an average income earner




1. It is assumed the individual works full time for 40 years and earns the average wage (currently about $72,500) each year. The assumptions used in the modelling are outlined in the Appendix.

The cost to Government of the concession on the superannuation contributions gradually increases as the average wage is assumed to increase by 4% pa. However, the concession in respect of the investment earnings rises more steeply as the member's balance in the superannuation fund increases with both contributions and investment earnings. This means in the latter years, the concession in respect of the investment earnings becomes more valuable. This is consistent with the Commonwealth Treasury's numbers which show the investment earnings concession is now 30% higher than that for contributions.

However, concentration on the working years is only part of the story for an individual's retirement arrangements. The provision of retirement income is a journey through both the accumulation years (working) and the payout phase (retirement). These are very different stages but both must be considered to assess the full picture. Moreover, due to increasing longevity improvements Australians are living longer so the payout phase increasingly becomes a larger portion of the total lifetime.

**It's all about the journey...**

When thinking about Australians' retirement savings and income, consider a car journey that commences in the crowded suburban streets of a major city and then moves onto on a modern multi-lane freeway. When considering the average speed and fuel consumption for the whole journey it would be wrong to take a measurement part way through, for example, at the end of the suburban crawl. It would be misleading to ignore the future benefits (in terms of both average speed and fuel economy) of the freeway. And so it is with our retirement savings and income system. There are taxation concessions in the accumulation years but to ignore the future age pension savings is misleading and likely to lead to poor policy decisions.

> "It is clear the accumulated superannuation benefit reduces future age pension payments at a significant saving to Government."

## THE POTENTIAL AGE PENSION SAVINGS

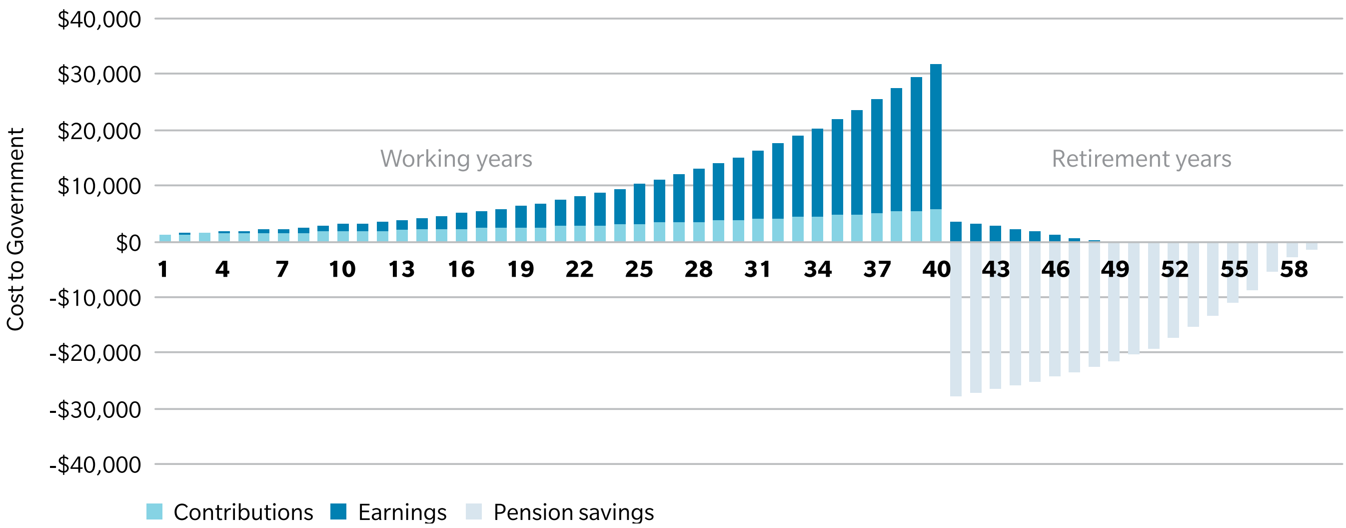
Figure 2 shows the savings to Government of the future age pension payments in respect of an average income earner who works for 40 years and then has a retirement period of 20 years. It is clear the accumulated superannuation benefit reduces future age pension payments at a significant saving to Government. These savings are totally ignored in the Commonwealth Treasury tax expenditure figures. The savings shown in the graph are not as high as they could be, as it is assumed that 15% of the superannuation benefit will be used immediately at retirement.

The savings will also increase as we live longer.

We note these savings reduce each year as the retiree is assumed to gradually draw on their account based pension for income in line with the Government rules. This is consistent with experience as many retirees commence with a part age pension but receive a full age pension in their later years.

There are also further concessions in respect of investment earnings in the retirement years. However, these are much lower in retirement as the individual's income and marginal tax rate have reduced.

**Figure 2:** The calculated costs and savings for an average income earner




The above example considered an individual earning the average wage throughout their working career. Table 1 considers the present value of the taxation concessions and age pension savings at different lifetime income levels.

## NET COST TO GOVERNMENT FOR RETIREMENT SUPPORT

**Table 1:** The present value of the concessions and age pension saving at different income levels assuming a 9% SG contribution

| **Income level (multiple of average wage)** | **0.75** | **1.0** | **1.5** | **2.0** |
|---|---|---|---|---|
| Concession on contributions | 35,762 | 47,683 | 88,464 | 117,952 |
| Concession on investment earnings | 67,903 | 93,347 | 195,901 | 288,032 |
| **Total concessions** | **103,665** | **141,030** | **284,365** | **405,984** |
| Age pension savings[2] | -13,251 | -54,383 | -151,108 | -223,073 |
| **Net cost** | **90,414** | **88,647** | **133,257** | **182,911** |
| **Net cost as a % of tax concessions** | **87.2%** | **62.9%** | **46.9%** | **45.1%** |

Table 1 highlights the following findings:

- The value of the taxation concessions rises with income, which is to be expected as both the amount of contributions and marginal tax rates rise with income;
- the age pension savings also increase with income as the superannuation balances are higher thereby leading to greater age pension savings in the future; and
- the net cost to government, after allowing for the age pension saving, reduces as a percentage of the calculated concessions, as income rises.

It should be noted the concession on investment earnings, as calculated by Commonwealth Treasury and shown in the above table, is overstated for most individuals. It is overstated because most individual taxpayers do not pay tax at their full marginal rate on their non-superannuation investment income. The reasons include the availability of imputation credits and capital gains tax concessions; the opportunity to invest through a lower income partner; geared investment opportunities (such as negatively geared property); and the common practice of investing in the tax exempt family home.

The range of incomes shown in the table cover the vast majority of full time workers for the following reasons:

- A low income earner (at say 0.5 times the average wage) is likely to represent part time or casual workers. If these individuals continued to receive income at these levels throughout their career, they would receive some taxation concessions but would also receive the full age pension due to their small superannuation benefit.
- While some individuals earn above twice the average wage, there are very few employees who have earnings above this level throughout their 40 year career. It is critical to assess superannuation throughout an individual's career and not on a year by year basis.

2. These savings are likely to be slightly increased following the introduction of deeming, as announced by the Government on 5 April 2013.

# ADDITIONAL CONCERNS

We have highlighted a major omission from the Commonwealth Treasury calculations, however there are several other reasons why their numbers need to be treated with caution when considering changes to superannuation policy, they include:

- **No allowance is made for behavioural change.** It is inevitable if the taxation concessions for superannuation are reduced, Australians will redirect their voluntary contributions towards other tax-effective investments.
- **There is an element of double counting.** If future contributions were to be taxed more heavily there would be reduced investment income in the future, thereby reducing the value of that concession.
- **The level of the concessions is directly influenced by the level of marginal income tax rates.** This means the recent reform to increase the tax free threshold actually increased the value of the superannuation concessions for middle income earners, with no change to superannuation.
- **The Tax Expenditures Statement represents a one year snapshot of a long-term investment.** This approach may be reasonable for a tax expenditure item that is short-term, such as the GST exemption on fresh food, but it is inappropriate for the development of a long-term sustainable policy as Australia begins to cope with the pressures of an ageing population.

In short, the level of super tax concessions shown in Table 1, based on the Commonwealth Treasury Tax Expenditures Statement, is significantly overstated. On the other hand, the future age pension savings will occur.

One final misconception needs to be highlighted. It is commonly assumed that should all the superannuation tax concessions be removed, then the budget revenue would increase by the level of these tax expenditures. This is not the case. Commonwealth Treasury acknowledges that behaviour would change and the potential revenue gain would be much lower than the quoted value of the tax expenditure.

# CONCLUSIONS

The taxation treatment of superannuation is an important long-term policy for both the Australian economy and for Australians as they prepare for a dignified retirement. However, superannuation is only one part of Australia's well respected three-pillar retirement savings and income system. A more holistic approach, taking both superannuation and the age pension into account, is needed to shape the long-term policy.

The Henry Tax Review supported the concept that superannuation should continue to be taxed more favourably than other forms of saving. The Tax Expenditures Statement makes no mention of this policy, nor does it highlight the concessional treatment of superannuation is less generous in Australia than the policies adopted in many other developed economies. Mercer research[3] shows that of the top eight retirement savings and income systems in the world, Australia only ranks sixth for the generosity of tax concessions. It is not true that super tax concessions are overly generous in Australia.

Increasing the taxation of superannuation has two very obvious effects; it reduces future superannuation benefits and thereby increases future age pension payments. Such an impact does not just affect low income earners. It will affect middle and higher income earners; many of whom will receive a part age pension in future years.

While increasing the taxation of superannuation may be a quick fix to respond to a short-term revenue shortfall, a much better long-term solution would be to improve the integration between the superannuation system and the means tested age pension. This could be achieved through a revision of the means testing arrangements or through the encouragement of income streams from superannuation, possibly through restricting larger lump sum payments. Such approaches would represent a long-term sustainable approach and are much better than regular tinkering with the tax system which reduces the community's confidence in Australia's retirement income system.

Mercer supports long-term policy settings that include each of the three pillars of compulsory super, voluntary contributions to super and the age pension. An inclusive and holistic approach to policy for the long-term will result in better outcomes for all Australians and will build confidence in superannuation.

3. 2013 Mercer – Tax & Superannuation: Benchmarking Australia

# APPENDIX

## MODELLING ASSUMPTIONS

The primary purpose of this research is to consider the level of government support for an individual's superannuation over their lifetime and the impact that this will have on their future age pension payments.

The underlying assumptions used in the calculations are described below.

*Net investment earning rate (after fees and taxes)*

| | |
|---|---|
| Accumulation period (pre age 65) | 7% pa |
| Post retirement period | 6.5% pa[4] |

*Discount rate*

| | |
|---|---|
| This rate was chosen as it reflects the expected growth of average wages over the longer term, representing a combination of inflation and productivity increases. | 4% pa |

*Age pension level*

| | |
|---|---|
| For a single individual at March 2013 | $20,667 pa |

*Income tax scales*

As applying for 2012-13 with the marginal tax thresholds indexed at 4% each year.

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