

**APPENDIX B - GEOFF CARMODY RETIREMENT INCOMES POLICY: BETTER
TARGETING FEBRUARY 2009**
(Refer following pages)

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February 2009

RETIREMENT INCOMES POLICY: BETTER TARGETING

REFORMS TO CURRENT SUPERANNUATION AND AGE PENSION POLICIES THAT PRESERVE SIMPLICITY AND IMPROVE OUTCOMES AGAINST RELEVANT DEFINITIONS OF ADEQUACY

REPORT COMMISSIONED BY CHALLENGER FINANCIAL SERVICES GROUP

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EXECUTIVE SUMMARY

This policy note has been commissioned by Challenger Financial Services Group, and prepared by Geoff Carmody & Associates (GCA) with costing input from Access Economics.

FOCUS OF THIS POLICY NOTE

The focus of this policy note has two key elements:

- Better targeting of Australia's superannuation incentives.
- Better targeting of the Australian age pension.

The report also links these proposals to the issue of longevity risk, which is covered in more detail in separate reports commissioned by Challenger Financial Services Group.

BROAD CONCLUSIONS

This report argues that current tax concessions for superannuation, and access to the age pension by recipients of tax-free superannuation, could and should be better targeted.

What constitutes 'better' targeting requires a framework of principles for 'good' retirement income policy design. This report suggests four principles, of which the most important are the first three:

- I. Governments should be less concerned about adequacy of retirement incomes for well-off people than for lower income people. This is the rationale for the age pension as a safety net, and the current government co-contribution, for example. This is a policy objective that is both targeted and, potentially, sustainable.
- II. Governments must be concerned about the pressures on the Commonwealth Budget over time, including those arising from the ageing of the Australian population. Policy settings – including for retirement income policy – must have regard for the sustainability of the Budget costs thereof.
- III. Tax concessions and other incentives to undertake voluntary saving for retirement should be targeted to reflect propositions I. and II. This ensures that they are best used to deliver adequacy (as defined above) in a sustainable way.
- IV. Where there are clear and unavoidable trade-offs and/or conflicts between policy objectives, these should be made explicit and so dealt with in designing policy responses. For example, raising the level of the age pension, and introducing looser means tests for eligibility, might be seen as boosting the adequacy of the age pension (albeit at a cost to the Budget over time). However, that initiative, at the margin at least, (a) reduces incentives for individuals to save to provide for their own retirement incomes, and possibly (b) also affects their incentives to work more generally.

Given this framework, defining an *adequate* retirement income benchmark is also important. This report suggests that there are four possible definitions or benchmarks:

- An absolute retirement income adequacy benchmark.
- A 'community standards' retirement income adequacy benchmark.
- A 'relative to pre-retirement income' adequacy benchmark.
- A long term Budget sustainability adequacy benchmark.

There is some tension between these benchmarks, especially between the third and fourth definitions.

Given the design principles for retirement income policy noted above, the tension can be resolved by concentrating primarily on the first and fourth of these adequacy benchmarks (with, possibly, some attention being given to the second benchmark).

Given this framework, built from design principles and adequacy benchmarks based on these principles, we conclude that:

- Reducing current taxation concessions for superannuation saving by higher income earners, and/or increasing such concessions for middle and lower income earners, would be a better way to target such concessions.
- Access to the age pension should be better targeted to deliver a more 'level playing field', in terms of age pension access, as between people of pension age relying on non-superannuation income (especially from continued paid employment) and people enjoying tax-free superannuation benefits.
- Both of these reforms will help deliver useful benefits:
 - They will help improve incentives to own-provide for retirement income by those most likely otherwise to be able to access the age pension.
 - They will help to encourage preservation of superannuation for longer, and extend paid workforce participation.
 - They will help to reduce looming Budget pressures associated with an ageing population.
 - They will help to reduce longevity risk.

POLICY RECOMMENDATIONS

This report concludes that the Henry Review should consider making the following recommendations for structural reforms to the current Australian retirement income policy.

Superannuation concessions

For superannuation, better targeting of superannuation concessions and incentives, including:

- I.** Shifting all contributions taxation out of superannuation funds and back to employers, the self-employed, or individual contributors.
- II.** As a result of this reform, it becomes feasible to introduce a more progressive (and better-targeted) contributions tax rate scale. This is recommended.
- III.** There are many possible variants of such a progressive contributions tax rate scale, ranging from the standard income tax rate scale through to substantial targeted tax discounts (including refundable credits paid by the Government into the contributors' superannuation funds).
- IV.** As part of this restructuring, consideration should be given to abolition of the current Government co-contribution, especially where lower-income contributions tax discounts are introduced, because the latter are potentially better targeted and involve no EMTR problems.
- V.** Ideally, abolition of the superannuation fund earnings tax. This maximises the dollar impact of the accumulation process, improving retirement income adequacy, reduces super fund administration costs (the benefits of which should be passed on to contributors), reduces longer-term Budget pressures, and reduces longevity risk.
- VI.** In declining markets, reducing or suspending minimum annual draw-downs in the pension phase to provide some relief for those not needing to crystallise losses, thereby preserving superannuation balances, contributing to lower longer-term Budget pressures and reducing longevity risk (in part, this recommendation has already been implemented).
- VII.** As quickly as possible, closing the current gap between the superannuation preservation age and the age pension age.

VIII. Making annual tax-free superannuation drawings above a specified dollar amount assessable (but not taxable) for income tax purposes. This would help to preserve superannuation balances, contributing to lower longer-term Budget pressures and reducing longevity risk.

Superannuation benefit recipient access to the age pension

For access to the age pension, especially by those in the superannuation benefit phase, better targeting of such access, including:

- I.** Considering a longer-term program for raising the age pension age above 65 years, especially if, as seems likely, pension benefit levels are to be increased.
- II.** For the purposes of the age pension means test, reviewing the application of that test to income taken in the pension phase of superannuation.
- III.** Specifically, where tax-free superannuation is included in assessable income for purposes of applying income tests related to the age pension, the Medicare Levy exemption, SATO and LITO, that income should be 'grossed up' to place it on the same footing as income from non-superannuation sources, (and especially income from working).
- IV.** In addition, where tax-free superannuation is included *on a concessional or part-exempt basis* in assessable income for purposes of applying income tests related to the age pension, the Medicare Levy exemption, SATO and LITO, that income also should be fully 'grossed up' (offsetting both the concessional treatment under the means test and the tax-free nature of such benefits) to place it on the same footing as income from non-superannuation sources, (and especially income from working).
- V.** As to 'grandfathering' of these reforms, we suggest that they should be applied only to people not currently accessing the age pension. Alternatively, they may be applied only to people aged 60 or over not currently accessing superannuation benefits.

COSTINGS OF PROPOSED SUPERANNUATION TAX REFORMS

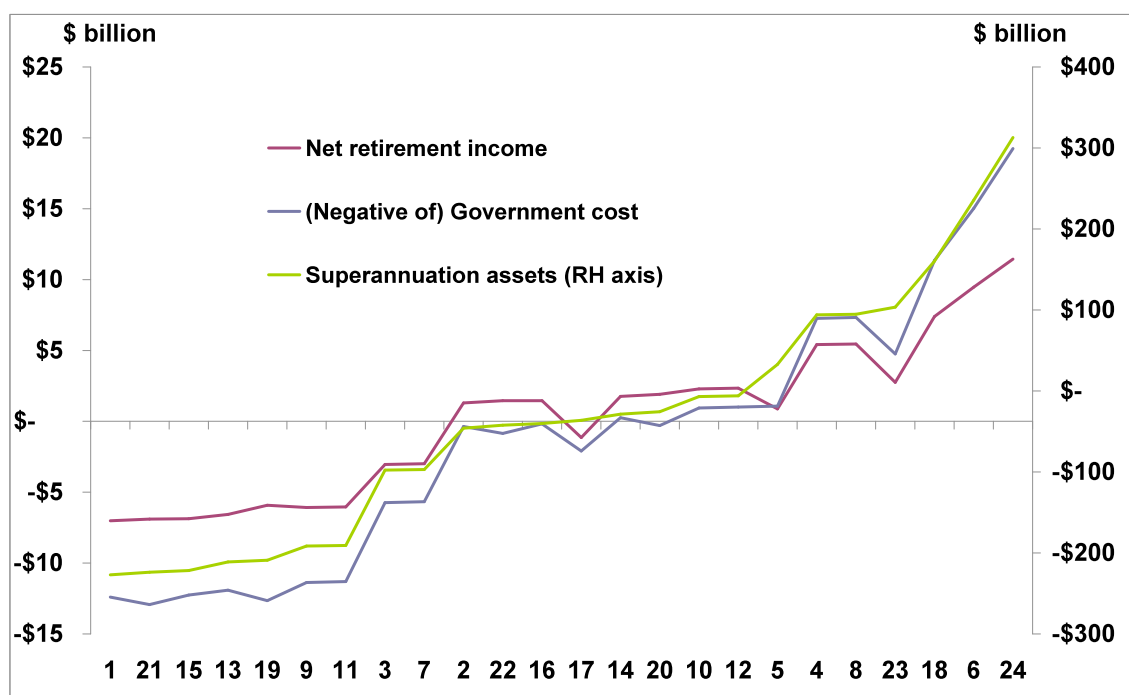
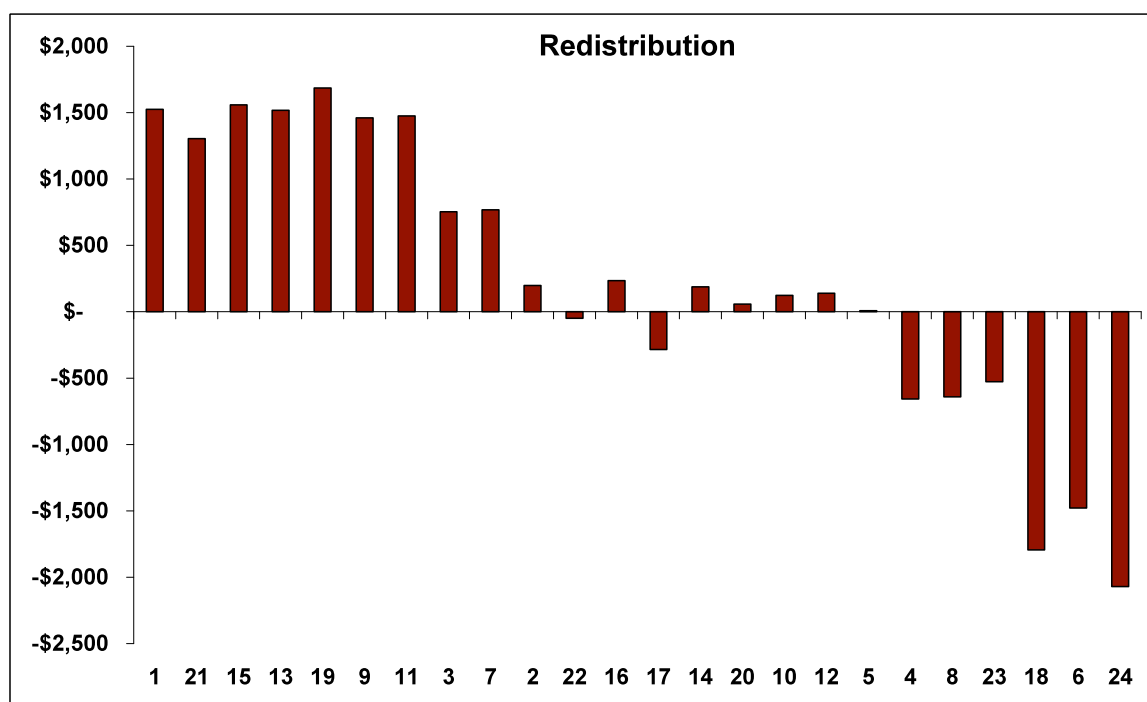
Chart 1 below ranks the 24 reform options presented in this report by their impact on the size of the super system (change in assets, shown as dollar figures in today's dollars), and shows that:

- Retiree incomes and Government costs (shown in today's dollars) move inversely – when incomes to retirees rise, costs to Government rise.
- As retiree incomes are typically less affected than Government costs (because there is a lag between the revenue costs to Government and the ultimate effect on retiree incomes), there is also a close relationship between retiree incomes and the overall size of the super system (that is, 'funds under management').

Chart 2 below includes the same scenarios (ordered the same way) but shows their redistributive effects (the difference in dollars going to the eighth and second lifetime income deciles).

These show the opposite pattern to Chart 1.

That is, savings to Government, reductions in retiree incomes, and reductions in the stock of assets in the superannuation system, tend to improve relative adequacy, and vice versa.

CHART 1: THE 24 TAX REFORM OPTIONS: SUMMARY TRENDS**CHART 2: THE 24 TAX REFORM OPTIONS: SUMMARY REDISTRIBUTIVE EFFECTS VERSUS THE 'MODEST BUT ADEQUATE' STANDARD****IMPACT OF PROPOSED AGE PENSION MEANS TEST REFORM**

This report does not provide comprehensive costings of the 'grossing up' means test proposal noted above. There are far too many retirement income situations to cover.

The main purpose of this report is to present a reform option that would:

- Reduce immediate and longer-term calls on the Budget funding for the age pension.

- Improve incentives favouring longer workforce participation and own-provision for retirement.
- Help contribute to addressing longevity risk.

The 'cost' of the proposal to the Commonwealth Budget should be significantly negative.

The 'grossing up' of incomes from superannuation noted above can, alternatively, be expressed as an increase in the *effective* taper rate for the age pension income test. On the basis of data provided to Challenger Financial Services by Towers Perrin, Table 1 below illustrates the effect of 'grossing up' on effective taper rates under the age pension income test.

Table 1. 'Grossing-up' effects on age pension income test taper rates

Assessable annual income band	% effective taper rate
Up to \$21,999	40.0
\$22,000 - \$22,999	40.6
\$23,000 - \$23,999	41.5
\$24,000 - \$24,999	42.3
\$25,000 - \$25,999	43.1
\$26,000 - \$26,999	43.8
\$27,000 - \$27,999	44.4
\$28,000 - \$28,999	45.0
\$29,000 - \$29,999	45.6
\$30,000 - \$30,999	46.1
\$31,000 - \$31,999	46.9
\$32,000 - \$32,999	47.7
\$33,000 - \$33,999	48.3
\$34,000 or over	48.8

COMPULSORY ANNUITISATION AS A RESPONSE TO LONGEVITY RISK

The evidence provided by Towers Perrin and Access Economics suggests that compulsory annuitisation options would:

- Increase the size of the 'pool' through which more retirees insure against longevity risk, rather than leaving that to governments.
- A larger 'pool' would also allow better pricing of the products, also improving adequacy of the resulting income streams given the available amount of superannuation savings.
- Over time, this shifting of longevity risk to retirees would underwrite lower age pension Budget costs relative to baseline, and also help improve retirement income adequacy.

The logic of compulsion, and the gains it can deliver, rely heavily on its insurance 'pooling' advantages (ie, the effective reduction in scope for 'adverse selection').

Should such measures be introduced, it will be important that the rules relating to compulsory annuity products are designed to preserve this longevity risk insurance 'pooling' effect and the cost saving/cost spreading that comes with it.

1. INTRODUCTION AND BACKGROUND

This policy note has been commissioned by Challenger Financial Services Group, and prepared by Geoff Carmody & Associates (GCA) with costing input from Access Economics.

1.1 FOCUS OF THIS POLICY NOTE

The focus of this policy note has two key elements:

- Better targeting of Australia's superannuation incentives.
- Better targeting of the Australian age pension.

The report also links these proposals to the issue of longevity risk, which is covered in more detail in a separate reports commissioned by Challenger Financial Services Group.

The primary report objectives are to:

- Develop specific options for reforming Australia's current superannuation arrangements.
- Provide at least indicative Commonwealth Budget costings for those options, where feasible.
- Develop specific options for reforming Australia's current age pension arrangements.
- Provide at least indicative Commonwealth Budget costings for those options, where feasible.
- Link these proposals to the issue of longevity risk as an issue with which (non-age pension) retirement income systems must deal.

GCA understands that one possible use for the report is as an input into the Challenger Financial Services Group submission to the Henry Review of Australia's future tax system. In particular, the report is to provide responses to at least some of the questions posed in the Henry Review consultation paper on retirement income released on 10 December 2008.¹

The Treasurer has requested that the Review Panel bring forward its consideration of the retirement income system and report to the Government by the end of March 2009. To that end, the Review panel has requested written submissions from interested parties by 27 February 2009.

As is made clear in the Treasurer's letter to Dr Henry on this matter,² the specific areas of interest to the Government are:

- the *adequacy* of the retirement income system; and
- the *appropriateness* of the current taxation arrangements.

Adequacy considerations cover not only retirement income levels for a particular year, but also income levels over the entire retirement period. In this context, longevity risk is highly relevant. All of these issues figure prominently in the questions asked by the Review Panel in the abovementioned consultation paper (see also section 2 below).

In relation to the development of reform options for Australia's superannuation system, this report will comply with clause 5 of the Terms of Reference for the Henry Review: that is, preservation of tax-free superannuation payments for the over 60s.³

¹ *Australia's future tax system retirement income consultation paper*, December 2008.

² *Australia's future tax system retirement income consultation paper* December 2008, third (un-numbered) page.

³ *Australia's future tax system: architecture of Australia's tax and transfer system*, August 2008, page 328.

1.2 STRUCTURE OF THIS POLICY NOTE

The remainder of this report is structured as follows:

- Section 2 briefly highlights key questions that have been asked by the Henry Review Panel, and summarises key structural problems with the current retirement income system in Australia.
- Section 3 reviews relevant definitions of retirement income adequacy as a guide to directions for retirement income system reform. This section gives some emphasis to how these definitions impact on Commonwealth Budget sustainability (given the ageing of the population and current eligibility conditions for the tax-funded age pension).
- Section 4 sets out options for reforming Australia's current superannuation system as a vehicle for own-provision of retirement incomes.
- Section 5 sets out options for reforming Australia's current age pension system as a social safety net for retirement income provision.
- Section 6 presents costings of the reform options presented in section 4.
- Section 7 presents costings of the reform options presented in section 5.
- Section 8 present some observations on how the reform options covered in this report affect the problem of longevity risk.
- Section 9 presents some concluding observations and summarises GCA's policy recommendations.
- As necessary, more detailed material is presented in Attachments to the full report.

2. THE PROBLEMS WITH THE STATUS QUO: OVERVIEW

2.1 HENRY REVIEW PANEL QUESTIONS

The Henry Review retirement income consultation paper⁴ draws attention to some key themes in relation to retirement incomes policy in Australia:

- The 3-pillar system – the age pension; the superannuation guarantee (SG); and voluntary savings – is generally supported.
- The SG pillar will take time to mature (2037).
- The level of concessions provided to encourage additional savings is a matter of debate.
- Longevity risk is seen by some submissions to be an important issue.⁵
- The remaining questions about the retirement income system in Australia relate to whether or not it is broad and adequate, acceptable, robust, simple and approachable, and sustainable.⁶

The specific questions asked in the retirement income consultation paper develop these themes:

- We need to agree, and be clear about, the objectives to which retirement income policy should be directed. (Consultation question Q1.1).
- How can individuals partly or wholly excluded from the mature SG system be accommodated? In effect, why should the system rely on employment income rather than pre-retirement income (however sourced) more generally? (Consultation question Q2.1).
- What is an appropriate concept of adequacy for retirement income? (Consultation question Q2.2). This is taken up specifically in section 3 below.
- What role should the Government take in supporting retirement income outcomes, linking this question back to 'adequacy' concepts? (Consultation question Q2.3).
- How does the retirement income policy address pre- and post-retirement preferences of individuals? (Consultation question Q3.1).
- Is the current level of superannuation income tax concessions appropriate and sustainable into the future? Are these concessions properly targeted? (Consultation question Q3.2).
- What are the appropriate ages for access to the age pension and to superannuation savings? (Consultation question Q4.1).
- Can individuals and private markets deal with investment and longevity risk? What role, if any, should governments play in these areas? (Consultation question Q4.2).
- Is the current system too complex? How could current complexity be reduced? (Consultation question Q5.1).
- What should be the role of the age pension and means testing of access to it? Is this role sustainable? (Consultation question Q6.1).

⁴ *Australia's future tax system retirement income consultation paper*, December 2008.

⁵ *Australia's future tax system retirement income consultation paper*, December 2008, Executive Summary, page 1.

⁶ *Australia's future tax system retirement income consultation paper*, December 2008, Executive Summary, page 1.

- How does retirement income policy affect workforce participation? What changes would reduce disincentives to work? Does the sustainability and cost of the system affect workforce decisions of younger generations? (Consultation question Q6.2).
- How could financial intermediation affect the effectiveness of retirement income policy? (Consultation question Q6.3).

Clearly, the Henry Review Panel is concerned about:

- Retirement income policy objectives.
- More specifically, adequacy and sustainability aspects related to those objectives.
- The appropriateness and targeting of superannuation income tax concessions, and access to the age pension.
- Preservation age/age pension access age issues.
- The private sector/public sector roles in dealing with investment and longevity risk.
- The implications of the retirement income system on workforce participation decisions.

In relation to some of these issues, the consultation paper makes some telling points. For example, in its consultation paper the Review Panel notes that:

- 5 per cent of individuals (the higher-income portion) accounted for over 37% of concessional superannuation contributions in 2005-06⁷;
- under current policy 77% of older Australians are still projected to receive some level of Age Pension (and associated benefits) by 2046-47⁸.

The Review Panel is obviously concerned *inter alia* about longevity risk (see question Q4.2), the solutions to which involve, in part, better retirement saving arrangements.

This issue is covered in this report to the extent that the options generated in sections 4-7 below will improve the quantum of retirement savings for targeted individuals, and the sustainability of government assistance for retirement savings and incomes.

Section 8 below also provides some more specific comments in relation to longevity risk.

2.2 PROBLEMS WITH THE CURRENT AUSTRALIAN RETIREMENT INCOME POLICY

As noted above, the Review Panel's focus is on:

- Policy **objectives**.
- **Adequacy**, including over the full retirement period.
- **Appropriateness** of existing incentives.
- Appropriate **targeting** of incentives.
- Policy **sustainability**.
- Policy effects on **work incentives**.

These are interdependent issues.

⁷ Australia's future tax system retirement income consultation paper, December 2008, page 22.

⁸ Australia's future tax system retirement income consultation paper, December 2008, page 33.

However, it is possible to break into this interdependence by considering ‘adequacy’ and ‘sustainability’ as starting concepts when deciding policy objectives.

This is done in more detail in section 3 below.

For now, however, it’s worth flagging four key policy principles:

Box 2.1 Four basic design principles for retirement income policy

- I.** Governments should be less concerned about adequacy of retirement incomes for well-off people than for lower income people. This is the rationale for the age pension as a safety net, and the current government co-contribution, for example. This is a policy objective that is both targeted and, potentially, sustainable (see II. below).
- II.** Governments must be concerned about the pressures on the Commonwealth Budget over time, including those arising from the ageing of the Australian population. Policy settings – including for retirement income policy – must have regard for the sustainability of the Budget costs thereof.
- III.** Tax concessions and other incentives to undertake voluntary saving for retirement should be targeted to reflect propositions I. and II. This ensures that they are best used to deliver adequacy (as defined above) in a sustainable way.
- IV.** Where there are clear and unavoidable trade-offs and/or conflicts between policy objectives, these should be made explicit and so dealt with in designing policy responses. For example, raising the level of the age pension, and introducing looser means tests for eligibility, might be seen as boosting the adequacy of the age pension (albeit at a cost to the Budget over time). However, that initiative, at the margin at least, (a) reduces incentives for individuals to save to provide for their own retirement incomes, and possibly (b) also affects their incentives to work more generally.

Measured against these four policy principles:

- The current targeting of Australia’s superannuation tax concessions, and possibly the eligibility for the age pension, are poor.
- Adequacy – for policy-relevant groups – of superannuation saving is called into question, both in terms of annual retirement income initially, and also adequacy over the full retirement period.
- This raises longer-term questions about policy sustainability, especially in a Budget context with an ageing population, and with the age pension as the ‘safety net’ fall back option for most Australians.

More specifically:

- Whatever the definition of retirement income adequacy, for many lower- to middle-income people, especially those in the transition phase to a ‘mature’ superannuation system, current arrangements are inadequate.
- The substantial Budget/tax concessions – ‘tax expenditures’ – operating under the current superannuation arrangements provide the largest incentives to those least in need of them to make provision for their retirement incomes, and little or no incentives for voluntary saving for retirement for many of those most in need of such incentives. (The Government Co-Contribution will also be addressed in this context.)
- The compulsion element – the Superannuation Guarantee – is probably effective in inducing superannuation saving, at least in respect of the ‘liquidity constrained’ cohort that cannot engage in ‘savings offset’ behaviour. (For higher income individuals, ‘savings offset’ responses to compulsion can be expected.) But its adequacy is also affected by its current tax treatment. Given that treatment, any given compulsory SG rate or level will be less adequate than would be the case without such tax treatment.

- The means testing of the Age Pension is also questionable in terms of targeting, although reforms in this area do run up against the inevitable trade-off between benefit abatement rates and own-income abatement ranges, and the implications of these for effective marginal tax rates (EMTRs).

Section 3 below looks more closely at adequacy concepts.

3. RELEVANT DEFINITIONS OF RETIREMENT INCOME ADEQUACY

There are several possible definitions of retirement income adequacy. These are more or less pertinent to retirement income policy design, based on the four design principles suggested in section 2 above.

3.1 ABSOLUTE INCOME ADEQUACY

The adequacy of retirement incomes in some absolute sense suggests a real income benchmark.

Such a benchmark seems broadly compatible with 'social safety net' considerations underpinning the age pension and the government superannuation co-contribution. It does not seem compatible with all other adequacy benchmarks, however. In particular, where real incomes are growing, it is not fully consistent with either a 'community standards' benchmark, or a pre-retirement living standards benchmark.

Nevertheless, this adequacy concept seems a sensible basic ingredient in formulating policy in relation to the level of the taxpayer-funded age pension and, if it be retained (see sections 4 and 6 below), in relation to the taxpayer-funded government superannuation co-contribution.

One corollary of that conclusion is that the first pillar of Australia's retirement income policy – the age pension – should be indexed to inflation, as a minimum adjustment.

3.2 INCOME ADEQUACY RELATIVE TO COMMUNITY STANDARDS

The 'community standards' concept of retirement income adequacy goes beyond the absolute income adequacy benchmark. It suggests that retirees should maintain their living standards relative to some measure of community living standards. Where real incomes increase, this suggests that real retirement incomes delivered via the 'social safety net' mechanism should also increase.

Again, this adequacy concept may be a sensible ingredient in formulating policy in relation to the level of the age pension and, if it be retained (see sections 4 and 6 below), in relation to the government superannuation co-contribution.

The indexing of the age pension to 25% of male total average weekly earnings (MTAWE), where that produces a higher pension level than indexation to the CPI, is an example of this adequacy benchmark in operation.

(Note that this adequacy concept, in practice, can produce some anomalies over time in relation to other retirement incomes. For example, the age pension can increase relative to self-funded retirement incomes, and in relation to some defined benefit superannuation schemes such as the CSS.)

3.3 INCOME ADEQUACY RELATIVE TO PRE-RETIREMENT LIVING STANDARDS

The notion of retirement income as a given minimum proportion of immediately pre-retirement income is widely used as an adequacy benchmark, especially in relation to own-provision for retirement income.

This may well be sensible as a guide to individuals to how much they need to save via superannuation to preserve a given (pre-retirement) living standard. That is, it may well be a useful guide to the extent to which people need to save via superannuation if they wish to provide satisfactorily for their own retirement.

That said, this adequacy concept is less immediately relevant to governments as a guide to how much, and how targeted, government support for retirement income should be. The key reason for this conclusion is that such an adequacy concept could be applied regardless of income level or need, and so conflicts with principle #1 in section 2 above.

3.4 ADEQUACY IN TERMS OF LONG TERM BUDGET SUSTAINABILITY

Because governments are heavily involved in all three pillars of Australia's retirement income system, both via tax concessions (tax expenditures) and direct Budget outlays, the long term Budget sustainability of Australia's retirement income policy is a central adequacy benchmark.

Indeed, if this were not the case, many of the Henry Review Panel questions in the retirement income consultation paper would be less relevant, or irrelevant.⁹

The Commonwealth Budget pressures driven over time by the ageing of the Australian population¹⁰ provide additional reasons to focus on this Budget sustainability concept of adequacy.

Arguably, this notion of adequacy is central to viable retirement income policy where governments are expected to play a central direct or facilitative role.

This adequacy benchmark can be compatible with the first benchmark cited above, and also the second, depending on age pension benefit levels and the targeting of those benefits.

It can also be compatible with the third adequacy benchmark noted above, but, again, targeting will be important to ensure that:

- Concessions encouraging own-provision for future retirement incomes today help to reduce significantly retirees' access to taxpayer-funded age pension and related benefits in future.
- Conversely, concessions are not allocated to individuals who will never have access to the age pension and related benefits in future.

3.5 INTERACTIONS BETWEEN THESE ADEQUACY BENCHMARKS

From a government perspective, the first, second, and, especially, the fourth of these adequacy measures is relevant to retirement income policy design. To the extent that the third adequacy concept affects the others, it too is relevant.

But the bottom line seems clear.

Governments are heavily involved in the delivery of Australia's retirement income policy.

Accordingly, long term Budget sustainability is an essential adequacy benchmark for retirement income policy design.

From a 'social safety net' perspective, sustainable policy must also deliver reasonable outcomes in terms of absolute real retirement income minima, and possibly also allow some alignment with growing real community standards.

Benchmarking adequacy against pre-retirement incomes can be useful, but from a government policy perspective, this guide to saving effort should be assessed mainly against its scope to allow retirees to avoid having to fall back on the age pension and related benefits.

This review of adequacy concepts also directs attention back to the 'appropriateness', 'targeting' and 'work incentive' issues raised in the retirement income consultation paper as well.

⁹ See the specific questions asked in *Australia's future tax system retirement income consultation paper*, December 2008. Effectively, all of the questions asked in this paper would be rendered less relevant, or irrelevant, if scarce Budget resources were not deployed to support the three pillars of Australia's retirement income policy.

¹⁰ See *Intergenerational Report 2002-03*, Budget Paper No. 5, 2002-03 Budget, and *Intergenerational Report 2007*, April 2007.

4. OPTIONS FOR REFORMING CURRENT SUPERANNUATION ARRANGEMENTS

In relation to the development of reform options for Australia's superannuation system, as noted earlier, this section of the report will comply with clause 5 of the Terms of Reference for the Henry Review: that is, preservation of tax-free superannuation payments for the over 60s. This also ensures that the reform options do not require yet more 'grandfathering' arrangements. Reform options will also be based on not generating any adverse retrospective effects on taxpayers.

It should be noted that this approach might leave some 'grey' areas. For example:

- No changes to the current tax-free arrangements for superannuation benefit draw downs by retirees over 60 raises questions about preservation age issues and alignment of the preservation age and the Age Pension age.
- These and other matters are dealt with later in section 4 of this report.

As far as possible, this section of the report will also seek reform options that are simple (i) from the perspective of complying superannuation funds, and (ii) from the perspective of employers and/or contributors. As regards (ii), reform options will be based on already-existing systems (eg., the PAYG system) for meeting taxation obligations.

4.1 WHAT'S WRONG WITH CURRENT SUPERANNUATION ARRANGEMENTS? GENERAL COMMENTS

Compared with an income tax benchmark, superannuation is concessionally taxed, especially from 1 July 2007. This concession is the largest single 'tax expenditure' reported in the Treasury's annual *Tax Expenditures Statement*.

For funded (otherwise known as accumulation, or 'taxed') superannuation schemes, the annual cost of this concession in 2007-08 was estimated at just under \$30 billion, and growing above that level in subsequent years.

Why treat this component of income concessionally?

There is a strong case for concessions. It can include several elements:

- **The market failure/merit goods argument.** People are short sighted and do not engage in saving (or saving enough) for long-term retirement income unless policy addresses this myopia.
- **The liquidity-constrained saving inability argument.** Even if people are rational and suffer no myopia about the future, they simply do not have enough income to meet all of their current consumption, non-super saving, and retirement saving needs.
- **The Intergenerational Report/Budget pressure argument.** The ageing of the population, increased longevity, and increasing dependency ratios, imply growing Budget pressure due to health and age pension demands on outlays, and lower tax revenues because of lower retirement incomes. Own-provision for future retirement income is an important response reducing these pressures, and, if properly designed, concessions encouraging such own-provision now could help to reduce Budget pressures in future.

The policy response in Australia includes 3 pillars: (a) a safety net – the means-tested age pension; (b) compulsory retirement savings – the Superannuation Guarantee, currently set at 9%; and (c) tax incentives plus government subsidies encouraging voluntary superannuation saving.

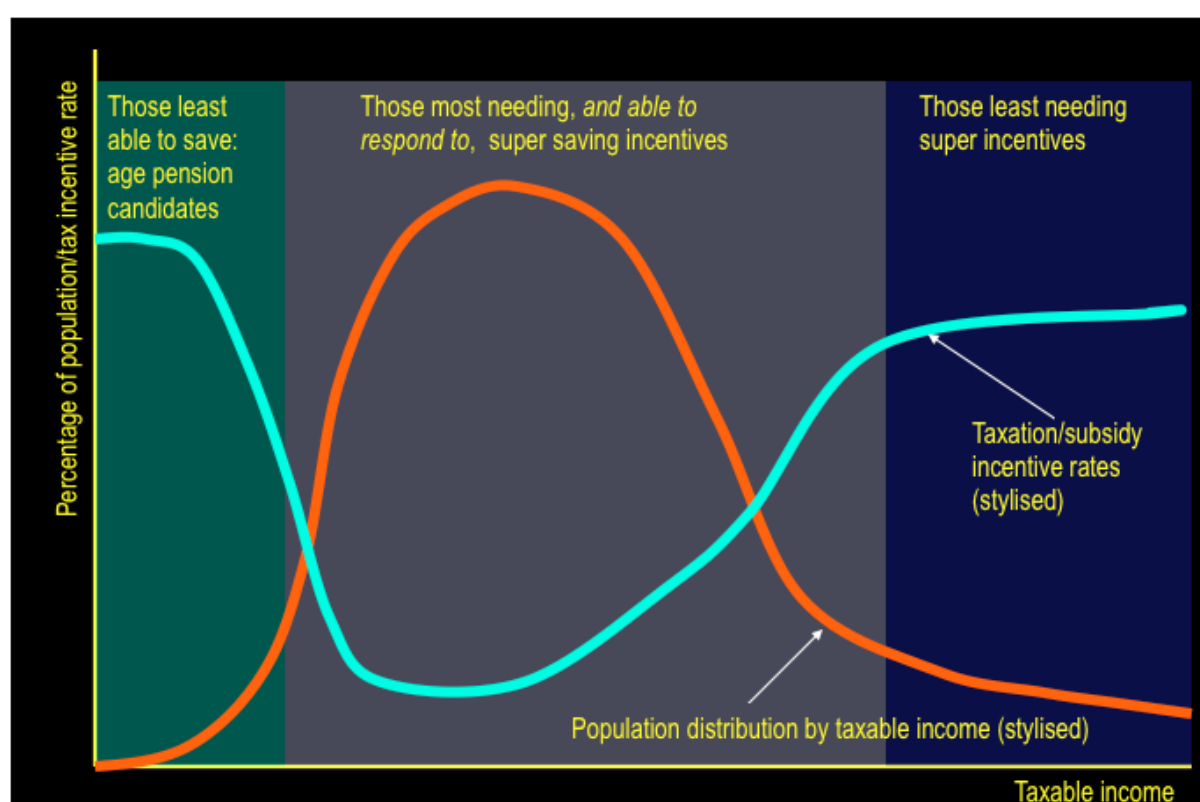
Australia's superannuation saving system is well regarded internationally.

But is it as efficient and fair as it could be?

All of the reasons for treating superannuation saving concessionally, considered together, and having regard for the retirement income policy design principles set out in Box 2.1 above, logically suggest that policy encouraging superannuation saving should:

- Concentrate on lower/middle income earners. These are most likely to suffer from myopia and be liquidity constrained. Only the Government co-contribution is so concentrated (and arguably not as well as it might be).
- Provide tax incentives for voluntary deductible contributions that are at least as strong for lower and middle-income earners as for higher income earners. The current tax incentives do the opposite: they are zero or negative for lower income earners and highest for those on the top personal tax rate, although, for some lower income earners, the Government co-contribution (albeit only for undeducted contributions) provides an offset (see Diagram 4.1 below).
- Provide only so much support via Budget subsidies (tax concessions or outlays) as to target taxpayers most likely otherwise to have access to the age pension. Current tax concessions, in this sense, can be viewed as a wasteful and inefficient use of taxation resources, because the greatest *practical* access to them in dollar terms goes to the higher income earners who are unlikely ever to access the age pension.

Diagram 4.1. Current Government superannuation incentives: a stylised illustration



For these reasons, the current tax-based current superannuation saving incentives, especially, are neither efficient nor fair.

4.2 WHAT'S WRONG WITH CURRENT SUPERANNUATION ARRANGEMENTS? SPECIFICS

The current tax treatment of superannuation (post-1 July 2007) displays three key features:

- It is relatively simple (apart from the co-contributions arrangements).
- It has probably shifted a lot of savings from other saving vehicles to superannuation – at least for older, wealthier, people. This may not increase net national saving immediately – or at least not much. To the extent that this initiative reduces the Budget surplus, the reduction is 'locked up' in private saving, rather than being exposed to public spending pressures. The fact that it is concentrated as a benefit to higher income earners reinforces this effect – because this group is best placed to save (or, indeed, to spend).

- The flip side to the last point is that, in a vertical equity sense, it is quite unfair. The largest concessions ('tax expenditures' relative to a personal income tax benchmark) are enjoyed by high-income earners, while low-income earners have much smaller (even negative) tax-based incentives to contribute to superannuation voluntarily (co-contribution arrangements aside). Taxing compulsory superannuation contributions only makes this unfairness worse.

In effect, post-1 July 2007, for standard accumulation ('taxed') schemes, Australia now applies a 'flat tax' of 15% on super contributions and earnings during the contribution/accumulation phases. That is, for such schemes, a proportional income tax of 15% applies to all contributions and earnings, while progressive direct taxation scales apply to most other forms of taxable income (and saving therefrom). Even the principal private residence is taxed more fairly (at least in the sense that it is effectively up-front *expenditure*-taxed via a *progressive* rate scale, rather than being *income*-taxed).

In the pension or benefit phase, accumulation scheme super fund payouts are tax-free. For payouts, this is conceptually no different from the tax treatment of interest income. However, earnings become tax-free too (unlike, say, savings earning interest outside superannuation). The concessionality becomes greater, because (after concessional taxation earlier) accumulation scheme draw-downs are not included in assessable income, even though they obviously provide income benefits. For some older contributions in the draw-down phase (such as those made before 1 July 1988 when the super contributions and earnings taxes were first introduced), the tax treatment of superannuation is more concessional still.

For defined benefit ('untaxed') schemes (such as the CSS/PSS), which may involve a sizeable taxpayer-funded contribution during the benefit phase, the new post-1 July 2007 concessions are not as large, but tax rebates increase their after-tax value to recipients as well.

While there is some debate about sustainability (eg., because of debates about work incentive effects), and although the issue is unlikely to become an obvious problem in the short term, there *are* questions about the sustainability of the post-1 July 2007 super tax regime as the population ages and demands on government budgets increase. The easing of the restrictions on access to the age pension (see section 5 below), combined with the non-assessability of super draw-downs, may well exacerbate this sustainability problem.

In short, the then Treasurer Costello's superannuation tax reforms from 1 July 2007 have:

- greatly simplified the tax treatment of superannuation and encouraged a shift into such saving;
- in doing so, however, the already-evident unfairness inherent in taxing super contributions and earnings at a flat 15% rate has been exacerbated;
- and the sustainability of the new, simpler, superannuation tax system has become a question of debate at a time when the Government has been emphasising the Budget problems likely to emerge as a result of an ageing population in its two *Intergenerational Reports*.

The policy focus for reforms in this area therefore should be on:

- re-balancing incentives to save via superannuation so that lower and middle income groups also have more significant incentives to save in this form (or at least are relatively less penalised for 'locking up' savings – including via compulsion – in superannuation than is now the case); and
- addressing concerns about the sustainability of the current superannuation tax regime; and, as part of this
- improving the fairness of superannuation tax treatment.

That said, for practical reasons, proposed reforms should also minimise or avoid additional 'grandfathering' complexities, and, if possible, reduce superannuation fund and other compliance burdens even further.

4.3 SUPERANNUATION POLICY REFORMS BASED ON A 'CLEAN SLATE' APPROACH

Before focussing on specific feasible reforms, it is useful to map out the reform options that could be considered if there were no practical constraints (eg., such as 'grandfathering' and Budget considerations) limiting policymakers' freedom to move. This mapping provides a wider context within which to evaluate more immediate practical policy options.

In broad terms, the following options for superannuation tax reform might be considered:

- I. **Full income tax treatment:** that is, contributions are made out of after-tax income, and earnings are taxed at the contributor's marginal income tax rate (including the Medicare Levy where applicable). All draw downs would then be tax-free (just like interest income is today).
- II. **Full income tax treatment** (ie., application of the standard progressive personal tax rate scales), **but only when superannuation savings are drawn down in retirement.** This is roughly similar to progressive personal expenditure taxation, because contributions (with or without a limit) would be out of before-tax income, and earnings would not be taxed during the accumulation phase.
- III. **Full income tax treatment** (ie., application of the standard progressive personal tax rate scales), **but only in respect of superannuation contributions.** Superannuation earnings and draw-downs would be tax-free. This is roughly similar to the tax treatment of the principal private residence, which is capital gains tax-free, but must be purchased and maintained out of after-tax income (ie., 'up-front' expenditure tax treatment).
- IV. Some combination of these three options.

The first option seems too difficult, in practice, to be contemplated for Australia today. It would be fairer, in some vertical equity sense, than the status quo. But, for Australia, it raises major 'grandfathering' issues, substantial additional complexity, not least for superannuation funds, and is inconsistent with the notion and objectives of compulsory superannuation:

- If governments want to force people to contribute to funding their own retirement, and as a policy objective seek less reliance on the taxpayer-funded age pension, why would they then fully tax compulsory contributions when this directly undermines superannuation adequacy and thereby increases reliance on the age pension? (Indeed, why tax *compulsory* superannuation contributions at all?)
- Of course, that problem exists today, even under the post-1 July 2007 superannuation tax regime, but full income tax treatment would make the situation much worse.

The second option, in broad terms, is actually not new to Australia. It was the type of approach to superannuation taxation that applied in Australia before 1 July 1988, when the then Treasurer, Paul Keating, introduced his superannuation tax reforms, including 15% taxes on eligible contributions and super fund earnings (as well as introducing tax offsets at the benefit stage, plus Reasonable Benefit Limits and other adjustments):

- However, both Treasurer Keating's reforms, and, even more so, those introduced by Treasurer Costello, have shifted the relative tax burden on superannuation away from the benefit or draw-down phase and towards the contributions and earnings phases.
- As noted, these reforms have made the tax treatment of superannuation more income tax-like in the accumulation phase – but with a flat rate of 15% rather than a progressive rate scale.

Many tax experts favour this 'back-end' tax treatment, where only the benefit stage is taxed, but at full progressive rates. From a tax design perspective, there is much to be said for it. But it would involve a policy U-turn from the path first charted by Treasurer Keating in July 1988. Transitional and 'grandfathering' complexities, plus apparent (if not real) Budget costs, would be policy problems.

The third option would be an innovation for Australia – at least for the tax treatment of superannuation. It would place superannuation on roughly the same footing as the principal private residence. That is,

both would be 'purchased' out of after-tax income, but earnings on both investments would be tax-free and realisation of both investments (when the family home is sold or superannuation savings are drawn down) would also be tax-free. It would continue the current trend started by Treasurer Keating.

The fourth option is neither 'fish nor fowl'. An almost infinite range of possible combinations of options 1 to 3 exists. Policy approaches that involve phasing over time would be amongst these options.

4.4 PRACTICAL REFORMS TO SUPERANNUATION TAXATION ARRANGEMENTS

Table 4.1 below summarises some practical policy reform options relating to the tax treatment of eligible contributions and (accumulation phase) earnings (explanatory footnotes appear overleaf).

Table 4.1 Superannuation policy reform: illustrative tax reform options

Option	Contributions tax rate	Earnings tax rate*	Other changes**
1.	Standard income tax (a)	15%	None
2.	Standard income tax (a)	0%	None
3.	15 percentage points rebate (b)	15%	None
4.	15 percentage points rebate (b)	0%	None
5.	30 percentage points rebate (c)	15%	None
6.	30 percentage points rebate (c)	0%	None
7.	15 percentage points rebate (c)	15%	None
8.	15 percentage points rebate (c)	0%	None
9.	Variable tax discount #1 (d)	15%	None
10.	Variable tax discount #1 (d)	0%	None
11.	Variable tax discount #2 (e)	15%	None
12.	Variable tax discount #2 (e)	0%	None
13.	Variable tax discount #3 (f)	15%	None
14.	Variable tax discount #3 (f)	0%	None
15.	Variable tax discount #4 (g)	15%	None
16.	Variable tax discount #4 (g)	0%	None
17.	Abolish Co-contribution	15%	None
18.	Abolish Co-contribution	0%	None
19.	17. + Variable tax discount #5 (h)	15%	None
20.	18. + Variable tax discount #5 (h)	0%	None
21.	17. + Variable tax discount #6 (i)	15%	None
22.	18. + Variable tax discount #6 (i)	0%	None
23.	Zero tax on SG contributions (j)	15%	None
24.	Zero tax on SG contributions (j)	0%	None

Footnotes:

- * Accumulation phase: tax rate assumed to be zero in pension phase (as is currently the case).
- ** Other changes are dealt with in section 4.5 below.
- (a) Including Medicare Levy as applicable; applies to all other options. Standard tax bracket thresholds.
- (b) Non-refundable rebate payable as superannuation. Standard tax bracket thresholds.
- (c) Refundable rebate payable as superannuation. Standard tax bracket thresholds.
- (d) 100% discount for 15% bracket; 50% discount for 30% bracket; 25% discount for 40% bracket; 0% for 45% bracket. Discounts payable as superannuation. Standard tax bracket thresholds.
- (e) 15% refundable super tax credit for 0% tax bracket; 100% discount for 15% bracket; 50% discount for 30% bracket; 25% discount for 40% bracket; 0% for 45% bracket. Tax credits and discounts payable as superannuation. Standard tax bracket thresholds.
- (f) 15% refundable super tax credit for 0% tax bracket; 50% discount for 15% bracket; 25% discount for 30% bracket; 10% discount for 40% bracket; 0% for 45% bracket. Tax credits and discounts payable as superannuation. Standard tax bracket thresholds.
- (g) 15% refundable super tax credit for 0% tax bracket; 50% discount for 15% bracket; 25% discount for 30% bracket; 0% discount for 40% bracket; 0% for 45% bracket. Tax credits and discounts payable as superannuation. Standard tax bracket thresholds.
- (h) 200% refundable super tax credit for 0% tax bracket; 150% discount for 15% bracket; 100% discount for 30% bracket; 25% discount for 40% bracket; 0% for 45% bracket. Tax credits and discounts payable as superannuation. Standard tax bracket thresholds.
- (i) 150% refundable super tax credit for 0% tax bracket; 125% discount for 15% bracket; 75% discount for 30% bracket; 25% discount for 40% bracket; 0% for 45% bracket. Tax credits and discounts payable as superannuation. Standard tax bracket thresholds.
- (j) Zero contributions tax on all SG contributions (capped where SG contributions are capped).

The remainder of this sub-section of the report provides brief explanations of the rationale for the options presented in Table 4.1 above. Costings for the 24 options are presented in section 6 below.

Options 1 & 2. Standard income tax rates on contributions; 15% or 0% tax on earnings

These options are perhaps the simplest that comply with the constraints on reforms set by the Henry Review Terms of Reference and the design principles set out in Box 2.1 above.

In effect, all eligible contributions become ‘undeducted’, or ‘after tax’ contributions. This means that lower income people are able to contribute a larger proportion of gross-of-tax superannuation saving into complying super funds. Because lower income people generally find it harder to save than higher income people, this provides a larger after-tax saving benefit to the former than the latter, as is currently the case for income more generally under the progressive income tax rate scale.

This is one way of targeting tax concessions in the way set out earlier in this section of the report.

There are no ‘grandfathering issues’: the reform would apply prospectively only.

For contributions, employers (or employees) would make the contributions to the complying super funds on a ‘tax paid’ basis. Super funds would be relieved of the responsibility of deducting contributions tax on all contributions from the implementation date, simplifying their operations.

For employers, the application of the standard PAYG scales applies to superannuation contributions (including SG) just as it does for ordinary wages and salaries. This should not be a significant additional complexity.

For earnings, there are two taxation options: 15% (the status quo) or zero. We assume that current discounts (eg, the 33% discount for realised capital gains by complying super funds) would continue. The former entails no additional complexity for super funds. The latter involves little change (given the need still to claim refundable imputation credits, etc), although CGT obligations disappear.

Option #1 involves a net increase in taxation of superannuation, except for those in the zero and 15% tax brackets.

Option #2 is less clear-cut. Depending upon the accumulation period, the contributions made, and the earnings rate, this option can produce net benefits to the superannuation contributor broadly equal to, or even higher than, the status quo. The latter conclusion applies especially to those in the 15% tax bracket. The former applies to those in the highest tax brackets.

Options 3 & 4. 15 percentage points rebate of tax on contributions; 15% or 0% tax on earnings

These options comply with the constraints on reforms set by the Henry Review Terms of Reference and the design principles set out in Box 2.1 above, but do so by offering the same percentage point tax rebate (15 points), on a non-refundable basis, to taxpayers making superannuation contributions.

As with options 1 and 2, this means that lower income people are able to contribute a larger proportion of gross-of-tax superannuation saving into complying super funds. Because lower income people generally find it harder to save than higher income people, this provides a larger after-tax saving benefit to the former than the latter, as is currently the case for income more generally under the progressive income tax rate scale.

This is another way of targeting tax concessions in the way set out earlier in this section of the report.

There are no 'grandfathering' issues: the reform would apply prospectively only.

For contributions, employers (or employees) would make the contributions to the complying super funds on a 'tax paid' basis. Super funds would be relieved of the responsibility of deducting contributions tax on all contributions from the implementation date, simplifying their operations. Governments would 'top up' these super contributions by passing the rebates (on assessment) to the super funds concerned. Alternatively, employers could deduct standard marginal tax rates less the 15 percentage points discount, and contribute the balance to the employees' super funds on a PAYG basis.

For employers, the application of the standard PAYG scales applies to superannuation contributions (including SG) just as it does for ordinary wages and salaries, less a flat 15 percentage point discount. This should not be a significant additional complexity.

For earnings, there are two taxation options: 15% (the status quo) or zero. We assume that current discounts (eg, the 33% discount for realised capital gains by complying super funds) would continue. The former entails no additional complexity for super funds. The latter involves little change (given the need still to claim refundable imputation credits, etc), although CGT obligations disappear.

Option #3 involves a net increase in taxation of superannuation (albeit only a small increase, attributable to the Medicare Levy, for those in the 30% bracket), except for those in the zero and 15% tax brackets.

Depending upon the accumulation period, the contributions made, and the earnings rate, option #4 can produce net benefits to the superannuation contributor higher than the status quo.

Options 5 & 6. 30 points refundable rebate of tax on contributions; 15% or 0% tax on earnings

These options comply with the constraints on reforms set by the Henry Review Terms of Reference and the design principles set out in Box 2.1 above, but do so by offering the same percentage point tax rebate (30 points), on a refundable basis, to taxpayers making superannuation contributions.

As with options 1 to 4, this means that lower income people are able to contribute a larger proportion of gross-of-tax superannuation saving into complying super funds. Because lower income people

generally find it harder to save than higher income people, this provides a larger after-tax saving benefit to the former than the latter, as is currently the case for income more generally under the progressive income tax rate scale.

This option is one of those moving into the Government's superannuation co-contributions territory. The design advantages of these options (and options 11-16, and 19-22 below) are covered in the discussion of abolition of the current Government co-contribution (options 17-18) below.

This is another way of targeting tax concessions in the way set out earlier in this section of the report.

There are no 'grandfathering issues': the reform would apply prospectively only.

For contributions, employers (or employees) would make the contributions to the complying super funds on a 'tax paid' basis. Super funds would be relieved of the responsibility of deducting contributions tax on all contributions from the implementation date, simplifying their operations. Governments would 'top up' these super contributions by passing the refundable rebates (on assessment) to the super funds concerned. Alternatively, but only in part for lower income earners, employers could deduct standard marginal tax rates less the 30 percentage points discount, and contribute the balance to the employees' super funds on a PAYG basis.

For employers, the application of the standard PAYG scales applies to superannuation contributions (including SG) just as it does for ordinary wages and salaries, less a flat 30 percentage point discount. This should not be a significant additional complexity. That said, for those in the zero or 15% tax brackets, employers could only reduce the PAYG deduction to zero. Governments would have to make up the difference.

For earnings, there are two taxation options: 15% (the status quo) or zero. We assume that current discounts (eg, the 33% discount for realised capital gains by complying super funds) would continue. The former entails no additional complexity for super funds. The latter involves little change (given the need still to claim refundable imputation credits, etc), although CGT obligations disappear.

Option #5 involves a net increase in taxation of superannuation (albeit only a small increase, attributable to the Medicare Levy), for those in the 45% bracket. Those in other tax brackets enjoy reduced tax rates overall. Option #6 entails reduced superannuation tax overall.

Options 7 & 8. 15 points refundable rebate of tax on contributions; 15% or 0% tax on earnings

These options comply with the constraints on reforms set by the Henry Review Terms of Reference and the design principles set out in Box 2.1 above, but do so by offering the same percentage point tax rebate (15 points), on a refundable basis, to taxpayers making superannuation contributions.

As with options 1 to 6, this means that lower income people are able to contribute a larger proportion of gross-of-tax superannuation saving into complying super funds. Because lower income people generally find it harder to save than higher income people, this provides a larger after-tax saving benefit to the former than the latter, as is currently the case for income more generally under the progressive income tax rate scale.

This option is one of those moving (in this case, only slightly) into the Government's superannuation co-contributions territory. The design advantages of these options (and options 11-16, and 19-22 below) are covered in the discussion of abolition of the current Government co-contribution (options 17-18) below.

This is another way of targeting tax concessions in the way set out earlier in this section of the report.

There are no 'grandfathering issues': the reform would apply prospectively only.

For contributions, employers (or employees) would make the contributions to the complying super funds on a 'tax paid' basis. Super funds would be relieved of the responsibility of deducting contributions tax on all contributions from the implementation date, simplifying their operations. Governments would 'top up' these super contributions by passing the refundable rebates (on assessment) to the super funds concerned. Alternatively, but only in part for the lowest income

earners, employers could deduct standard marginal tax rates less the 15 percentage points discount, and contribute the balance to the employees' super funds on a PAYG basis.

For employers, the application of the standard PAYG scales applies to superannuation contributions (including SG) just as it does for ordinary wages and salaries, less a flat 15 percentage point discount. This should not be a significant additional complexity. That said, for those in the zero tax bracket, governments would have to make up the difference.

For earnings, there are two taxation options: 15% (the status quo) or zero. We assume that current discounts (eg, the 33% discount for realised capital gains by complying super funds) would continue. The former entails no additional complexity for super funds. The latter involves little change (given the need still to claim refundable imputation credits, etc), although CGT obligations disappear.

Option #7 involves a net increase in taxation of superannuation for higher income earners (albeit only a small increase, attributable to the Medicare Levy, for those in the 30% bracket). Those in the zero and 15% brackets enjoy reduced tax rates overall. Option #8 entails reduced superannuation tax overall, at least in a 'mature' system.

Options 9 & 10. Variable tax discount on contributions #1; 15% or 0% tax on earnings

These options comply with the constraints on reforms set by the Henry Review Terms of Reference and the design principles set out in Box 2.1 above, but do so by offering, in effect, a separate, more progressive, superannuation contributions rate scale based on standard income tax bracket thresholds.

The discounts involved (these might be inclusive of, or exclusive of, the Medicare Levy) are:

- 100% discount for the 15% tax bracket.
- 50% discount for the 30% tax bracket.
- 25% discount for the 40% tax bracket.
- 0% discount for the 45% tax bracket.

The beauty of these superannuation savings-targeted discounts is this:

- 'Standard' reductions in lower income tax rates, in dollar terms, must flow to all higher income groups without reducing their marginal tax rates, unless they are targeted and withdrawn, in which case the withdrawal generates higher effective marginal tax rate problems (EMTRs).
- In contrast, these superannuation saving discounts can be completely quarantined to lower income groups without giving rise to any EMTR problems, because they apply to saving out of marginal taxable income.

As with options 1 to 8, this means that lower income people are able to contribute a larger proportion of gross-of-tax superannuation saving into complying super funds. Because lower income people generally find it harder to save than higher income people, this provides a larger after-tax saving benefit to the former than the latter, as is currently the case more generally under the progressive income tax rate scale.

This is another way of targeting tax concessions in the way set out earlier in this section of the report.

There are no 'grandfathering' issues: the reform would apply prospectively only.

For contributions, employers (or employees) would make the contributions to the complying super funds on a 'tax paid' basis. Super funds would be relieved of the responsibility of deducting contributions tax on all contributions from the implementation date, simplifying their operations. Governments would 'top up' these super contributions by passing the discounts (on assessment) to the super funds concerned. Alternatively, employers could deduct standard marginal tax rates less the relevant discount, and contribute the balance to the employees' super funds on a PAYG basis.

For employers, the application of the standard PAYG scales applies to superannuation contributions (including SG) just as it does for ordinary wages and salaries, less a discount based on a similar rate scale. This should not be a significant additional complexity.

For earnings, there are two taxation options: 15% (the status quo) or zero. We assume that current discounts (eg, the 33% discount for realised capital gains by complying super funds) would continue. The former entails no additional complexity for super funds. The latter involves little change (given the need still to claim refundable imputation credits, etc), although CGT obligations disappear.

Option #9 involves a net increase in taxation of superannuation for higher income earners (albeit only a small increase, attributable to the Medicare Levy, for those in the 30% bracket). Those in the 15% bracket enjoy reduced tax rates overall. Option #10 entails reduced superannuation tax overall, at least for lower and middle income earners.

Options 11 & 12. Variable tax discount on contributions #2; 15% or 0% tax on earnings

These options comply with the constraints on reforms set by the Henry Review Terms of Reference and the design principles set out in Box 2.1 above, but do so by offering, in effect, a separate, more progressive, superannuation contributions rate scale based on standard income tax bracket thresholds, including refundable tax credits for the zero tax bracket provided they are transferred to the taxpayer's super fund.

The discounts involved (these might be inclusive of, or exclusive of, the Medicare Levy) are:

- 15% refundable super tax credit for 0% tax bracket
- 100% discount for the 15% tax bracket.
- 50% discount for the 30% tax bracket.
- 25% discount for the 40% tax bracket.
- 0% discount for the 45% tax bracket.

The beauty of these superannuation savings-targeted discounts is this:

- 'Standard' reductions in lower income tax rates, in dollar terms, must flow to all higher income groups without reducing their marginal tax rates, unless they are targeted and withdrawn, in which case the withdrawal generates higher effective marginal tax rate problems (EMTRs).
- In contrast, these superannuation saving discounts can be completely quarantined to lower income groups without giving rise to any EMTR problems, because they apply to saving out of marginal taxable income.

As with options 1 to 10, this means that lower income people are able to contribute a larger proportion of gross-of-tax superannuation saving into complying super funds. Because lower income people generally find it harder to save than higher income people, this provides a larger after-tax saving benefit to the former than the latter, as is currently the case more generally under the progressive income tax rate scale.

This is another way of targeting tax concessions in the way set out earlier in this section of the report.

There are no 'grandfathering' issues: the reform would apply prospectively only.

For contributions, employers (or employees) would make the contributions to the complying super funds on a 'tax paid' basis. Super funds would be relieved of the responsibility of deducting contributions tax on all contributions from the implementation date, simplifying their operations.

Governments would 'top up' these super contributions by passing the discounts (on assessment) to the super funds concerned, and for those on the zero tax bracket, transfer the 15% credit to their super funds. Alternatively, (apart from for taxpayers in the zero tax bracket) employers could deduct

standard marginal tax rates less the relevant discount, and contribute the balance to the employees' super funds on a PAYG basis.

For employers, the application of the standard PAYG scales applies to superannuation contributions (including SG) just as it does for ordinary wages and salaries, less a discount based on a similar rate scale. This should not be a significant additional complexity.

For earnings, there are two taxation options: 15% (the status quo) or zero. We assume that current discounts (eg, the 33% discount for realised capital gains by complying super funds) would continue. The former entails no additional complexity for super funds. The latter involves little change (given the need still to claim refundable imputation credits, etc), although CGT obligations disappear.

Option #11 involves a net increase in taxation of superannuation for higher income earners (albeit only a small increase, attributable to the Medicare Levy, for those in the 30% bracket). Those in the zero and 15% brackets enjoy reduced tax rates overall. Option #12 entails reduced superannuation tax overall, at least for lower and middle income earners.

Options 13 & 14. Variable tax discount on contributions #3; 15% or 0% tax on earnings

These options comply with the constraints on reforms set by the Henry Review Terms of Reference and the design principles set out in Box 2.1 above, but do so by offering, in effect, a separate, more progressive, superannuation contributions rate scale based on standard income tax bracket thresholds, including refundable tax credits for the zero tax bracket provided they are transferred to the taxpayer's super fund.

The discounts involved (these might be inclusive of, or exclusive of, the Medicare Levy) are:

- 15% refundable super tax credit for 0% tax bracket
- 50% discount for the 15% tax bracket.
- 25% discount for the 30% tax bracket.
- 10% discount for the 40% tax bracket.
- 0% discount for the 45% tax bracket.

The beauty of these superannuation savings-targeted discounts is this:

- 'Standard' reductions in lower income tax rates, in dollar terms, must flow to all higher income groups without reducing their marginal tax rates, unless they are targeted and withdrawn, in which case the withdrawal generates higher effective marginal tax rate problems (EMTRs).
- In contrast, these superannuation saving discounts can be completely quarantined to lower income groups without giving rise to any EMTR problems, because they apply to saving out of marginal taxable income.

As with options 1 to 12, this means that lower income people are able to contribute a larger proportion of gross-of-tax superannuation saving into complying super funds. Because lower income people generally find it harder to save than higher income people, this provides a larger after-tax saving benefit to the former than the latter, as is currently the case more generally under the progressive income tax rate scale.

This is another way of targeting tax concessions in the way set out earlier in this section of the report.

There are no 'grandfathering issues': the reform would apply prospectively only.

For contributions, employers (or employees) would make the contributions to the complying super funds on a 'tax paid' basis. Super funds would be relieved of the responsibility of deducting contributions tax on all contributions from the implementation date, simplifying their operations.

Governments would 'top up' these super contributions by passing the discounts (on assessment) to the super funds concerned, and for those on the zero tax bracket, transfer the 15% credit to their super funds. Alternatively, (apart from for taxpayers in the zero tax bracket) employers could deduct standard marginal tax rates less the relevant discount, and contribute the balance to the employees' super funds on a PAYG basis.

For employers, the application of the standard PAYG scales applies to superannuation contributions (including SG) just as it does for ordinary wages and salaries, less a discount based on a similar rate scale. This should not be a significant additional complexity.

For earnings, there are two taxation options: 15% (the status quo) or zero. We assume that current discounts (eg, the 33% discount for realised capital gains by complying super funds) would continue. The former entails no additional complexity for super funds. The latter involves little change (given the need still to claim refundable imputation credits, etc), although CGT obligations disappear.

Option #13 involves a net increase in taxation of superannuation for higher income earners. Those in the zero and 15% brackets enjoy reduced tax rates overall. Option #14 entails reduced superannuation tax for lower and middle income earners.

Options 15 & 16. Variable tax discount on contributions #4; 15% or 0% tax on earnings

These options comply with the constraints on reforms set by the Henry Review Terms of Reference and the design principles set out in Box 2.1 above, but do so by offering, in effect, a separate, more progressive, superannuation contributions rate scale based on standard income tax bracket thresholds, including refundable tax credits for the zero tax bracket provided they are transferred to the taxpayer's super fund.

The discounts involved (these might be inclusive of, or exclusive of, the Medicare Levy) are:

- 15% refundable super tax credit for 0% tax bracket
- 50% discount for the 15% tax bracket.
- 25% discount for the 30% tax bracket.
- 0% discount for the 40% tax bracket.
- 0% discount for the 45% tax bracket.

The beauty of these superannuation savings-targeted discounts is this:

- 'Standard' reductions in lower income tax rates, in dollar terms, must flow to all higher income groups without reducing their marginal tax rates, unless they are targeted and withdrawn, in which case the withdrawal generates higher effective marginal tax rate problems (EMTRs).
- In contrast, these superannuation saving discounts can be completely quarantined to lower income groups without giving rise to any EMTR problems, because they apply to saving out of marginal taxable income.

As with options 1 to 14, this means that lower income people are able to contribute a larger proportion of gross-of-tax superannuation saving into complying super funds. Because lower income people generally find it harder to save than higher income people, this provides a larger after-tax saving benefit to the former than the latter, as is currently the case more generally under the progressive income tax rate scale.

This is another way of targeting tax concessions in the way set out earlier in this section of the report.

There are no 'grandfathering issues': the reform would apply prospectively only.

For contributions, employers (or employees) would make the contributions to the complying super funds on a 'tax paid' basis. Super funds would be relieved of the responsibility of deducting contributions tax on all contributions from the implementation date, simplifying their operations.

Governments would 'top up' these super contributions by passing the discounts (on assessment) to the super funds concerned, and for those on the zero tax bracket, transfer the 15% credit to their super funds. Alternatively, (apart from for taxpayers in the zero tax bracket) employers could deduct standard marginal tax rates less the relevant discount, and contribute the balance to the employees' super funds on a PAYG basis.

For employers, the application of the standard PAYG scales applies to superannuation contributions (including SG) just as it does for ordinary wages and salaries, less a discount based on a similar rate scale. This should not be a significant additional complexity.

For earnings, there are two taxation options: 15% (the status quo) or zero. We assume that current discounts (eg, the 33% discount for realised capital gains by complying super funds) would continue. The former entails no additional complexity for super funds. The latter involves little change (given the need still to claim refundable imputation credits, etc), although CGT obligations disappear.

Option #15 involves a net increase in taxation of superannuation for most taxpayers. Those in the zero and 15% brackets enjoy reduced tax rates overall. Option #16 entails reduced superannuation tax for lower and middle income earners.

Options 17 & 18. Abolish Government co-contribution

The Government's co-contribution is a targeted benefit.

We consider that the current co-contribution scheme effectively represents a policy admission that the status quo, relying on flat taxes paid by super funds, offers no incentive, either absolutely or relative to higher income earners, for lower income groups voluntarily to contribute to superannuation. Yet such groups are those where incentives to save are most needed.

Actually, for those eligible, the co-contribution incentives are very strong at present, but they need to be, given the liquidity-constrained cohort to which they apply.

Nevertheless, it could be argued that the co-contribution is not very effective for at least three reasons:

- It offers the maximum dollar benefit to those least able to save anything, let alone for superannuation, and is conditional on those savings being made.
- The own-savings *quid pro quo* needed to attract the Government co-contribution must be on an 'undeducted' basis. This is fine for those in the zero tax bracket, although those genuinely in need in such circumstances (as opposed to 'surgeons' wives') will be unable to save much. If anything, they are likely to be dis-saving.
- The withdrawal of the co-contribution produces an EMTR problem for lower income groups that is specifically directed at superannuation saving. Just as taxpayers' income rise to the point where some saving becomes feasible, the Government co-contribution imposes an additional marginal penalty against saving for retirement!

There is a good argument for abolishing the Government co-contribution, not so much *per se*, but especially if combined with some of the options already described.

It could also be combined with options 19-22 below.

Options 19 & 20. Options 17, 18 + Variable tax discount #5; 15% or 0% tax on earnings

Abolish the Government co-contribution, but introduce a variable tax discount as described below.

These options comply with the constraints on reforms set by the Henry Review Terms of Reference and the design principles set out in Box 2.1 above, but do so by offering, in effect, a separate, more progressive, superannuation contributions rate scale based on standard income tax bracket thresholds, including refundable tax credits for the zero tax bracket provided they are transferred to the taxpayer's super fund.

The discounts involved (these might be inclusive of, or exclusive of, the Medicare Levy) are:

- 200% refundable super tax credit for 0% tax bracket
- 150% discount/super tax credit for the 15% tax bracket.
- 100% discount for the 30% tax bracket.
- 25% discount for the 40% tax bracket.
- 0% for the 45% tax bracket.

The beauty of these superannuation savings-targeted discounts is this:

- 'Standard' reductions in lower income tax rates, in dollar terms, must flow to all higher income groups without reducing their marginal tax rates, unless they are targeted and withdrawn, in which case the withdrawal generates higher effective marginal tax rate problems (EMTRs).
- In contrast, these superannuation saving discounts can be completely quarantined to lower income groups without giving rise to any EMTR problems, because they apply to saving out of marginal taxable income.

As with options 1 to 16, this means that lower income people are able to contribute a larger proportion of gross-of-tax superannuation saving into complying super funds. Because lower income people generally find it harder to save than higher income people, this provides a larger after-tax saving benefit to the former than the latter, as is currently the case more generally under the progressive income tax rate scale.

This is another way of targeting tax concessions in the way set out earlier in this section of the report.

There are no 'grandfathering issues': the reform would apply prospectively only.

For contributions, employers (or employees) would make the contributions to the complying super funds on a 'tax paid' basis. Super funds would be relieved of the responsibility of deducting contributions tax on all contributions from the implementation date, simplifying their operations.

Governments would 'top up' these super contributions by passing the discounts (on assessment) to the super funds concerned, and for those on the zero tax bracket, transfer the 200% credit to their super funds. Alternatively, (apart from for taxpayers in the zero and 15% tax bracket, where the government would need to 'top up' the relevant super fund contribution) employers could deduct standard marginal tax rates less the relevant discount, and contribute the balance to the employees' super funds on a PAYG basis.

For employers, the application of the standard PAYG scales applies to superannuation contributions (including SG) just as it does for ordinary wages and salaries, less a discount based on a similar rate scale. This should not be a significant additional complexity.

For earnings, there are two taxation options: 15% (the status quo) or zero. We assume that current discounts (eg, the 33% discount for realised capital gains by complying super funds) would continue. The former entails no additional complexity for super funds. The latter involves little change (given the need still to claim refundable imputation credits, etc), although CGT obligations disappear.

Option #19 involves a net reduction in taxation of superannuation for most taxpayers. Option #20 entails reduced superannuation tax overall for lower and middle income earners.

Options 21 & 22. Options 17, 18 + Variable tax discount #6; 15% or 0% tax on earnings

Abolish the Government co-contribution, but introduce a variable tax discount as described below.

These options comply with the constraints on reforms set by the Henry Review Terms of Reference and the design principles set out in Box 2.1 above, but do so by offering, in effect, a separate, more progressive, superannuation contributions rate scale based on standard income tax bracket

thresholds, including refundable tax credits for the zero tax bracket provided they are transferred to the taxpayer's super fund.

The discounts involved (these might be inclusive of, or exclusive of, the Medicare Levy) are:

- 150% refundable super tax credit for 0% tax bracket
- 125% discount/super tax credit for the 15% tax bracket.
- 75% discount for the 30% tax bracket.
- 25% discount for the 40% tax bracket.
- 0% for the 45% tax bracket.

The beauty of these superannuation savings-targeted discounts is this:

- 'Standard' reductions in lower income tax rates, in dollar terms, must flow to all higher income groups without reducing their marginal tax rates, unless they are targeted and withdrawn, in which case the withdrawal generates higher effective marginal tax rate problems (EMTRs).
- In contrast, these superannuation saving discounts can be completely quarantined to lower income groups without giving rise to any EMTR problems, because they apply to saving out of marginal taxable income.

As with options 1 to 16, and 19 to 20, this means that lower income people are able to contribute a larger proportion of gross-of-tax superannuation saving into complying super funds. Because lower income people generally find it harder to save than higher income people, this provides a larger after-tax saving benefit to the former than the latter, as is currently the case more generally under the progressive income tax rate scale.

This is another way of targeting tax concessions in the way set out earlier in this section of the report.

There are no 'grandfathering issues': the reform would apply prospectively only.

For contributions, employers (or employees) would make the contributions to the complying super funds on a 'tax paid' basis. Super funds would be relieved of the responsibility of deducting contributions tax on all contributions from the implementation date, simplifying their operations.

Governments would 'top up' these super contributions by passing the discounts (on assessment) to the super funds concerned, and for those on the zero tax bracket, transfer the 150% credit to their super funds. Alternatively, (apart from for taxpayers in the zero and 15% tax bracket, where the government would need to 'top up' the relevant super fund contribution) employers could deduct standard marginal tax rates less the relevant discount, and contribute the balance to the employees' super funds on a PAYG basis.

For employers, the application of the standard PAYG scales applies to superannuation contributions (including SG) just as it does for ordinary wages and salaries, less a discount based on a similar rate scale. This should not be a significant additional complexity.

For earnings, there are two taxation options: 15% (the status quo) or zero. We assume that current discounts (eg, the 33% discount for realised capital gains by complying super funds) would continue. The former entails no additional complexity for super funds. The latter involves little change (given the need still to claim refundable imputation credits, etc), although CGT obligations disappear.

Option #21 involves a net reduction in taxation of superannuation for most taxpayers. Option #22 entails reduced superannuation tax overall for lower and middle income earners.

Options 23 & 24. Abolish contributions tax on SG contributions; 15% or 0% tax on earnings

The rationale for options 23 and 24 is simple.

If the SG is, in effect, a compulsory social security contribution (to use a term well understood in Europe), why should that contribution be taxed as well, with the revenue from such taxation going to other purposes, including recurrent government expenditure?

If Australia moved contributions taxation away from superannuation funds to employers and individuals, as proposed in this report, it would be more practical *after that reform* to distinguish between SG and non-SG contributions. PAYG and other systems are already set up to make this distinction in most cases anyway.

In that situation, removing contributions tax on SG contributions would become a practical option. The advantages of that would be:

- It would increase retirement income adequacy, including for the 'liquidity-constrained' – that is, lower income groups – without requiring an increase in the SG rate.
- It would improve the internal logic of having the SG in the first place: that is, a 'hypothecated' investment pool intended for the sole purpose of increasing own-provision for retirement income, with no 'leakages' via taxation into general Budget revenue.

There are several considerations leading to the view that SG contributions should be tax free (and possibly better targeted, although this latter point is not taken up in this report):

- Current concerns about the adequacy of the 9% SG could be reduced if it was not subject to a 15% contributions tax. Eliminating the contributions tax on the SG would increase the *effective* SG to the equivalent of about 10.6% on a taxed basis.
- The SG is already, for all intents and purposes, equivalent to a tax, albeit hypothecated. Nobody would suggest that another hypothecated tax – the Medicare Levy – should itself be taxed (ie, paid out of after-tax income). Why should the SG be taxed?
- The national saving implications of taxing the SG are, at best, zero. At worst, if the revenue is used to finance recurrent government expenditure, the national saving effects of taxing SG contributions are negative. To be sure, in the current economic situation, this might be of less concern. However, in the longer term, and allowing for an ageing population, this is a relevant policy consideration.

4.5 OTHER SUPERANNUATION POLICY MATTERS

There are several other superannuation policy matters that, for completeness, should be noted.

Minimum annual pension phase draw down requirements

Currently, under pension phase arrangements, the minimum annual draw down of benefits in any financial year is set as a fixed percentage (eg, 4%) of the benefit phase superannuation fund asset value at the beginning of that financial year.

As a result of sharply declining asset values currently, this provision has been a source of concern for retirees wishing to preserve their assets to cover their expected retirement period in full. For some, the minimum requirement has involved a much larger proportion of their current, or end-year, super fund assets, and has been an undesired draw down requirement given asset value reductions.

This is a policy-related impediment to effectively dealing with longevity risk.

While superannuation fund asset values are rising, the current provisions may be of no great concern. However, where market values are falling – especially where such declines are large – this is of concern in terms of longer-term preservation of the superannuation fund's asset value, and in this respect links in to concerns about longevity risk.

Allowing for the fact that asset values will rise, but also (hopefully less frequently) fall over time, GCA concludes that sensible modifications to these draw down rules would be as follows:

- For the current age cohorts specified in the draw down provisions, minimum pension phase draw down *rates* might be as currently set.
- However, these should be applied to the market value of the pension phase superannuation fund assets (i) at the beginning of, or (ii) at the end of, or (iii) on average over, the financial year in question, whichever is the lowest value.
- Alternatively, or as an additional provision, it may be worth considering temporary suspension of these draw down minima during specified 'extraordinary circumstances'. Of course, such circumstances would need to be defined, and inevitably a considerable degree of policy discretion would remain with the government of the day, but the current financial and economic crisis would seem to qualify.¹¹

Preservation age/pension age adjustment issues

Australia's population is ageing, and individuals are living longer. Longevity risk is likely to be increasing.

The age pension age for men and women needs to be increased.

The preservation age for access to superannuation needs to be increased even more, ultimately to be aligned with the pension age.

This would help to encourage a longer period of workforce participation, increase retirement income adequacy for any given superannuation saving rate, and minimise incentives for full or partial 'double dipping' (ie., accessing both superannuation and the age pension).

Incidentally, tightening, not easing, age pension means tests would also help – see section 5 below.

But, in practice, these changes take many years to implement, as the current progressive increase in the superannuation preservation age illustrates.

That's not a reason not to act in this area. Rather, it's a strong reason why policy needs to be changed sooner – to allow for the necessarily long lead-in time – rather than later.

Eligible contribution limits

At present, generous transition arrangements aside, access to the concessional tax treatment of superannuation fund contributions and earnings is restricted to flat dollar amounts of \$50,000 per annum per person as deductible contributions (with this threshold being indexed), plus \$150,000 per annum per person as undeducted contributions.

These limits favour higher income earners rather than lower income earners, because the latter, by definition, do not have the capacity to make superannuation contributions up to such annual limits. Are these limits too generous?

They certainly allow total concessional superannuation savings to accumulate well beyond the older Reasonable Benefit Limits (RBLs).

More fundamentally, when the current system is mature, what adequacy benchmark suggests that 40 working years accumulating retirement savings at \$50,000 per annum is an appropriate policy? Higher income earners will be able to accumulate the implied \$2,000,000, plus the compounding effects of super fund earnings.

But most people will not.

¹¹ We note that, in a statement on 18 January 2009, the Government has announced a variant of this option, under which 50% of the minimum draw-downs required for 2008-09 have been waived. In effect, the obligation for the first half on the financial year remains and that for the second half is no longer mandatory

In a 'mature' system, the current deductible and undeducted contribution limits may be:

- well above any adequacy benchmark driven by a policy requirement to reduce reliance on the age pension; and
- well beyond the saving capacity of lower and middle income earners, even averaged over a full working life.

An alternative would be gradually to lower the current annual flat dollar limits to levels much closer to the likely capacity to save for lower income earners who are most likely otherwise to access the age pension.

It would be possible to argue that a lower eligible **annual** superannuation limit would not only be fairer, but also would constitute a stronger incentive to start contributing voluntarily to superannuation sooner rather than later – one of the objectives explicitly supported by the Commonwealth Government.

Beyond noting these possibilities, these options are not pursued further in this report.

Making superannuation draw-downs above a specified annual limit assessable but not taxable

At present, there is no limit on the amount people 60 years or over can withdraw, tax-free, from accumulated super balances at any time.

This seems inconsistent with providing incentives to people to make their super balance last for their retirement period.

One option would be to make annual drawings of super benefits above (say) \$100,000 assessable income for tax purposes, but not taxable *per se*.

Some variant of this option would seem to strike a reasonable balance between providing incentives for people of pension age to continue participating in the workforce (the stated reason for making superannuation benefits for those 60 and over non-assessable), and paying some attention to longevity risk issues.

Increasing superannuation guarantee contributions

There have been regular calls for an increase in the current SG rate above 9%, often either to 12% or even 15%.

We consider that, whatever the merits of this proposal:

- It would be better, first, to improve the targeting of current tax expenditures in relation to superannuation as proposed in section 4.4 above.
- In part, removing the current taxation of SG contributions has a similar effect anyway (see options 23 and 24 in section 4.4).
- Given that the SG is set as a constant percentage of employee wages, an across-the-board increase in the SG does not concentrate the policy change on those most likely to be able to access the age pension (even acknowledging the 'cap' on maximum SG contributions, which is set quite high).
- Having regard to the definitions of 'adequacy' reviewed in section 3 above, and especially that relating to long term Budget sustainability (see section 3.4), some differentiation of the SG requirement, with higher requirements for middle- and lower-income earners, might seem appropriate.
- However, depending upon the incidence of any change in the SG rate, that may have some adverse effects at the margin on employment.
- To the extent that it did, it would be somewhat counterproductive.

Other policy options that discriminate more effectively in favour of lower income groups are preferable.

These have been the subjects of this report.

‘Soft compulsion’ as a policy option

The notion of ‘soft compulsion’ is conceptually fine, but in our opinion hardly constitutes a policy instrument of substance. Exhortation and moral suasion are easy to apply in all sorts of areas, but at the end of the day they remain based on the *voluntary* behaviour of the target individuals.

By all means exhort people to save for retirement as early as possible using voluntary options such as ‘soft compulsion’, and education about the ‘magic’ of compound interest, but don’t make it a central plank of policy.

If the case for more superannuation saving is strong, then harder-edged policy instruments are needed. We judge that more hard-edged incentives (or, failing that, compulsion) *are* needed, but concentrated on lower- and middle-income groups. This is the logic of compulsory superannuation and tax incentives to save in this form, (and the current co-contribution arrangements). It only fully works for the liquidity-constrained, and then mainly via compulsion.

It is also the underlying logic of concerns about growing demands on the age pension as the population ages, and the fourth adequacy concept presented in section 3 above.

5. OPTIONS FOR REFORMING CURRENT AGE PENSION ARRANGEMENTS

Reform options for current age pension arrangements are difficult to ‘sell’ unless they involve (i) increased pension levels, and (ii) a reduced ‘taper rate’ for the withdrawal of the pension as own-incomes and assets increase.

However:

- Increasing the level of the retirement income ‘social safety net’ reduces incentives for individuals to provide for their own retirement income and increases Budget pressures as the population ages.
- Reducing the age pension ‘taper rate’, on the other hand, has two effects. First, for those already in the old ‘taper range’ of own-income, it reduces disincentives to own-provide for retirement. Second, the reduced ‘taper rate’ means that any given pension benefit level is abated over a larger own-income range, catching a new cohort of people in the (albeit lower) ‘taper rate’ effective marginal tax rate (EMTR) disincentive trap. The net effect of these, from a Budget sustainability perspective, is an empirical question.
- On balance, neither is likely to help much in net terms, and, whatever its equity merits, the former is likely to hurt, from a Budget sustainability perspective.

5.1 BROAD STRUCTURAL REFORMS TO CURRENT AGE PENSION ARRANGEMENTS

The difficulties notwithstanding, a brief review of structural reforms to current age pension arrangements that would (i) contribute to greater workforce participation, (ii) deliver greater incentives to own-provide for retirement income, and (iii) reduce looming Budget pressures associated with an ageing population, is useful.

Age pension age

As the population ages, it is also living longer, and living longer *productively*.

One direct policy response to longevity risk is to defer the draw down of superannuation saving and access to the age pension, and extend working lives.

This would require an increase in the age pension age – and, ideally, a simultaneous closing of the current gap between the superannuation preservation age and the age pension age.

There is a strong case for such reforms.

But, as the current efforts in this area attest, these reforms must be delivered via a very long term program to avoid politically-charged accusations of ‘retrospectivity’. For example:

- For men, the age pension age is 65 years.
- For women, the age pension age was 63 years for those born before 30 June 1944 (ie, they last became eligible for the age pension at 63 as recently as June 2007). But it will be 2014 before those eligible for the age pension will only be able to access the age pension at age 65.

Given improvements in longevity, the quality of life for older people, and their longer period of productivity, there is much to be said for increasing the age pension age – and, even more so, the preservation age for superannuation savings.

Announcing such a reform is only practical with a long lead-in period.

Pension benefit levels

Measured against the ‘absolute’ or ‘community standards’ benchmarks of income adequacy covered in section 3 above, the current age pension is arguably too low.

Reflecting these concerns, there are current demands for an increase in the level of the age pension.

However, from Budget sustainability, workforce participation and longevity risk perspectives, it could be argued that a lower age pension level has desirable consequences as well. These are the more significant if, as is the case, the age pension age and the superannuation preservation age are too low.

Pension indexation arrangements

The age pension is currently indexed either to (i) 25% of total male average weekly earnings (MTAWE), or (ii) the CPI, whichever increases most.

This ensures that, whatever their levels for any period of time, age pensions increase at least as fast as community standards (or, where real wages decline, even faster).

Some other indexed benefits – including some public sector superannuation benefits – are indexed to the CPI. Over time, therefore, benefit levels in such schemes are likely to fall relative to the age pension as real growth translates into real income increases.

Whatever the merits of current indexation arrangements for the age pension from an equity perspective, they may also, at the margin, undermine incentives to own-provide for retirement income.

Naturally, reducing or weakening current pension indexation arrangements would be regarded as politically ‘courageous’.

Pension means tests and benefit abatement rates

The current assets and income means tests for the age pension involve pension reductions when either test threshold is breached (with the test determining the larger pension reduction being the test that is applied).

The current age pension abatements rates are:

- For the assets test, the age pension is reduced by \$1.50 per fortnight for every \$1,000 above the applicable assets threshold. The assets thresholds for the full pension depend on whether the recipient is single or partnered, and homeowners or not. The full pension assets test thresholds range from \$171,750 up to \$368,000. The corresponding part-pension assets test thresholds range from \$550,500 up to \$1,125,500.
- The part pension assets test thresholds, especially, cover a large proportion of the Australian population.
- For the income test, the age pension is reduced by 40 cents for every \$1 above the applicable assets threshold for single pensioners, and 20 cents for every \$1 above the applicable threshold (each) for couples. The income thresholds for the full pension depend on whether the recipient is single or partnered, and with children or not. The full pension thresholds range from \$138 plus \$24.60 per child, per fortnight, up to \$240 plus \$24.60 per child, per fortnight. The corresponding part-pension thresholds range from \$1,558.25 plus \$24.60 per child, per fortnight, up to \$3,080.50 plus \$24.60 per child, per fortnight (these figures can be higher for those receiving rent assistance).
- Expressed in annual rate terms, these income test thresholds (for access to the full age pension) range from almost \$3,600 to almost \$6,900 or more, and (for access to a part pension), from over \$40,600 to over \$80,900 or more.
- The part pension income test thresholds cover a large proportion of the Australian population.

In short, the assets and income test ‘taper ranges’ cover asset and income levels within which a large proportion of the Australian population would fit. Accordingly, the Budget pressure arising from the

age pension entitlement (especially after the policy changes introduced by the previous Government¹²) has increased.

Reducing that pressure, other things being equal, would require increased pension abatement rates, either for the assets test, and/or (especially?) for the income test.

Access to pension and part-pension related benefits

Those qualifying for a full- or part-age pension may also qualify for other benefits, including:

- Pharmaceutical allowance
- Rent assistance
- Telephone allowance
- Utilities allowance
- Remote area allowance
- A Pension Concession card

These benefits can provide substantial additional financial assistance, and in some cases are fully available to people that only just qualify for a few dollars of pension because of the means test. That is, their value is not reduced by application of means testing, except at the point where those concerned lose entitlement to the age pension completely.

Accordingly, these additional benefits provide a powerful additional incentive to access at least a few dollars of the age pension, rather than own-providing to the point where access to the age pension is completely lost.

Ideally, providing these pension-related benefits in proportion to the recipients' access to the age pension would reduce this problem. However, operationalising this proportioning would be administratively difficult, at best.

A universal age pension?

One way of eliminating any pension withdrawal disincentive effects (due to EMTRs) on own-provision for retirement income and/or on workforce participation would be to make the pension universally available.

This would eliminate pension withdrawal rates (40% for single pensioners and 20% each for couples) as a contributor to current EMTRs.

However:

- This is inconsistent with a targeted approach to provision of retirement 'social safety net' (see principle #1 in section 2 above).
- It would add, rather than reduce, Budget pressure as the population ages (even though a large proportion of the retirement age population is currently eligible for a part pension, this initiative would provide a full pension to all pension age people).
- It may well raise concerns about vertical equity.

This report does not pursue this matter further.

¹²

See, for example, *Better Super: Australia's worked hard for it. A simple guide to the biggest reform to Australia's superannuation ever*, Australian Government, undated (2007?), pages 14-15.

5.2 ARE THESE REFORMS LIKELY TO BE POLITICALLY ACCEPTABLE?

This question is something on which GCA is not qualified to make a judgment. The sorts of reforms implied by the brief review in section 5.1 (except for the universal age pension option) would more tightly target the age pension and related benefits. However, they would do so by withdrawing currently available benefits to a group in the community whose current pension entitlements are under challenge as being inadequate.

We conclude that attempting to introduce such better targeting of the age pension and related benefits at this time is unlikely to be acceptable.

However, this does not mean that nothing can be done to improve age pension targeting (and targeting for other lower income benefits).

Sections 5.3 and 5.4 deal with possible reforms in this area.

5.3 CORRECTING A WORK DISINCENTIVE ANOMALY WITH LONGEVITY RISK IMPLICATIONS

The introduction by the previous Government of tax-free superannuation benefits has produced an anomaly that, ironically:

- provides an incentive, when retirement age is reached, for pensioners or part-pensioners to supplement their income by drawing down **first** (and faster?) on their superannuation savings rather than other forms of income; and
- at the same time, provides an incentive **not** to continue working part-time (or full time) while there is an opportunity to use superannuation savings; and
- given existing low-income tax offsets (notably the Low Income Tax Offset – LITO – and the Senior Australians Tax Offset – SATO), this anomaly operates most strongly on people most likely to be able to save more for their own retirement and reduce – even eliminate – their reliance on the age pension.

This anomaly seems to be an ‘unintended consequence’ of so-called ‘tax-free super’ introduced by the previous Government. How does ‘tax free super’ cause this problem?

The basic anomaly

The current tax-free treatment of superannuation benefits affects the way means tests – specifically income tests – operate. For example, access to the age pension, SATO and LITO are all subject to an assessable income or taxable income means test.

(There are other targeted benefits as well, such as access to the Medicare levy low income exemption, but concentrating on the age pension, SATO and LITO will be sufficient to make the point.)

In the case of tax-free superannuation, the various means tests appear to include superannuation income in the definition of assessable income or taxable income, even though, technically, tax-free superannuation benefits are neither assessable nor taxable.¹³ However:

- For non-superannuation sources of income, the income definition is applied gross of personal income tax payable on that income.
- For superannuation sources of income, in contrast, no personal income tax is payable by people receiving benefits and aged 60 or more.
- The income definition effectively applies to such income on a net-of-tax basis.

Table 5.1 below illustrates the problem and one relatively simple solution.

¹³ See, for example, the definition of assessable income presented by the Australian Government on the Centrelink website (www.centrelink.gov.au/internet/internet.nsf/factors/income.htm).

Table 5.1. Illustrative retirement income cameos: non-super and super income sources

Own-income cameos (annual assessable income)	Non-super own-income	Super own-income only	Super own-income ('grossed-up' basis)
Single age pensioner homeowner			
Cameo 1	\$4,843	\$4,843	\$4,843
Cameo 2	\$22,000	\$21,804	\$22,000
Cameo 3	\$28,869	\$26,557	\$28,869
Cameo 4	\$34,000	\$29,448	\$34,000
Cameo 5	\$40,000	\$32,658	\$40,000
Cameo 6	\$46,500	\$39,116	\$39,116
Cameo 1			
Pension entitlement	\$14,157	\$14,157	\$14,157
SATO entitlement ('notional' for super own-income)	\$2,230	\$2,230	\$2,230
LITO entitlement ('notional' for super own-income)	\$1,200	\$1,200	\$1,200
Pre-tax income	\$19,000	\$19,000	\$19,000
After-tax income	\$19,000	\$19,000	\$19,000
Cameo 2			
Pension entitlement	\$7,294	\$7,373	\$7,294
SATO entitlement ('notional' for super own-income)	\$2,177	\$2,191	\$2,177
LITO entitlement ('notional' for super own-income)	\$1,200	\$1,200	\$1,200
Pre-tax income (b)	\$29,294	\$29,177	\$29,294
After-tax income	\$29,177	\$29,177	\$29,177
Cameo 3			
Pension entitlement	\$4,547	\$5,471	\$4,547
SATO entitlement ('notional' for super own-income)	\$1,661	\$1,835	\$1,661
LITO entitlement ('notional' for super own-income)	\$1,063	\$1,119	\$1,063
Pre-tax income (b)	\$33,416	\$32,028	\$33,416
After-tax income	\$32,028	\$32,028	\$32,028
Cameo 4			
Pension entitlement	\$2,494	\$4,315	\$2,494
SATO entitlement ('notional' for super own-income)	\$1,277	\$1,618	\$1,277
LITO entitlement ('notional' for super own-income)	\$940	\$1,049	\$940
Pre-tax income (b)	\$36,494	\$33,763	\$36,494
After-tax income	\$33,763	\$33,763	\$33,763
Cameo 5			
Pension entitlement	\$94	\$3,031	\$94
SATO entitlement ('notional' for super own-income)	\$827	\$1,377	\$827
LITO entitlement ('notional' for super own-income)	\$796	\$972	\$796
Pre-tax income (b)	\$40,094	\$35,689	\$40,094
After-tax income	\$35,689	\$35,689	\$35,689
Cameo 6			
Pension entitlement	\$0	\$0	\$0
SATO entitlement ('notional' for super own-income)	\$26	\$949	\$949
LITO entitlement ('notional' for super own-income)	\$540	\$835	\$835
Pre-tax income	\$46,500	\$39,116	\$39,116
After-tax income	\$39,116	\$39,116	\$39,116

Notes: Cameos are based on current standard income tax rate scale.

Age pension (\$14,655 per year) is assumed to be fully available up to annual own-income of \$3,598, and is fully withdrawn (40% abatement rate) when annual own-income reaches \$40,626.

Full SATO benefit (\$2,230) is available for own-incomes of up to \$28,867 per year, and is fully withdrawn (12.5% abatement rate) when own-income reaches \$46,707 per year). 'Notional' benefit for super own-income.

Full LITO benefit (\$1,200) is available for own-incomes of up to \$30,000 per year, and is fully withdrawn (4% abatement rate) when own-income reaches \$60,000 per year). 'Notional' benefit for super own-income.

'Grossing up' of super income (fourth column) based on current income tax rate scale, but excludes Medicare Levy to simplify exposition. There is no point in 'grossing up' in cameo 6: access to the age pension has been exhausted.

Table 5.1 deals only with the example of a single, home-owning, person of age pension age.

The cameos require some explanation:

- The six cameos cover own-income levels ranging from an example where no tax is payable and almost 100% access to the age pension applies, up to a level where the age pension has been fully withdrawn.

- The cameos cover three circumstances: (i) retirees with own-income only from non-super sources; (ii) retirees with own-income only from (tax-free) super benefits; and (iii) retirees with own-income only from (tax-free) super benefits, where those benefits have been 'grossed up' using the current income tax rate scale (excluding Medicare Levy) for purposes of eligibility for the age pension, and ('notionally') SATO and LITO.
- The 'super own-income' only cameos (third column) have own-income set at levels that produce the same (untaxed) total income levels as after-tax total income for the 'non-super own-income' cameos (second column). This result is seen in the highlighted rows in cameos 1 – 5. (For cameo 6, this restriction does not apply – see below.)
- The 'super own-income ('grossed up basis')' examples presented in the fourth column of table 5.1 show how the solution to the anomaly caused by tax-free super benefits can be addressed without violating the retention of tax-free super as a constraint on the Henry Review.

Cameos 2 – 5 illustrate the anomaly described above. Cameo 1 and cameo 6 do not.

For cameo 1, taxable income, regardless of source, falls below the relevant tax-free threshold.

For cameo 6, access to the age pension has been exhausted. Here, an anomaly remains – in the form of a larger gap between after-tax income from different sources – but it cannot be addressed by the proposed 'grossing up' option if super benefits are to remain tax-free. The only indirect and at best partial way to address the anomaly here (ie, for higher income groups) is to adopt some variant of the reform options presented in section 4 of this report.

These cameos – specifically cameos 2 – 5 – illustrate several points:

- The required (tax-free) superannuation draw-down to secure any given level of after-tax total retirement income, for many retirees, will be significantly less than if they access non-superannuation income sources – including paid work (compare columns two and three, cameos 2 – 5, at the top of table 5.1).
- Those accessing superannuation income to supplement the age pension will be able to claim (i) larger part-age pensions; and (ii) larger 'notional' SATO benefits; and (iii) larger 'notional' LITO benefits, than those accessing non-super incomes (compare columns two and three in Table 5.1).
- These 'notional' SATO and LITO benefits only produce cash benefits where such retirees still have some access to the age pension. Otherwise, they produce no cash benefit because super benefits are tax-free anyway.
- The Budget cost of greater access to these targeted benefits is higher (see also Table 5.2 below).

This problem is relatively easily addressed in a way that is consistent with the Henry Review terms of reference.

The solution (see column four in Table 5.1 above) is to 'gross up' superannuation draw downs to levels that would apply if they were both assessable and taxable income under the current income tax rate scale.

This is not to suggest that such income should actually be taxed.

Rather, the proposal is to apply the relevant income tests for the age pension, SATO and LITO *as if* such income was fully taxed.

'Grossing up' and 'deeming' practices are familiar elements of the Australian taxation system (eg, for franked company dividends, FBT benefits, and retiree interest income).

Using the current income tax rate scale, the retiree and Budget effects of 'grossing up' of tax-free super benefits are summarised in Table 5.2 below.

Table 5.2. ‘Grossing-up’, reduced benefits and Budget saving effects of proposed reform*

	Grossing-up amount (ie, notional income tax)	Actual reduced benefits (ie, reduced age pension)	Actual Budget benefit
Cameo 1	\$0	\$0	\$0
Cameo 2	\$118	-\$78	\$78
Cameo 3	\$1,387	-\$925	\$925
Cameo 4	\$2,731	-\$1,821	\$1,821
Cameo 5	\$4,405	-\$2,937	\$2,937
Cameo 6	\$7,384	\$0	\$0

*Assuming no change in taxpayer behaviour. Excludes Medicare Levy.

What happens if ‘grossing up’ is not adopted?

The anomaly described above is a cause for concern, especially under the fourth adequacy definition presented in section 3.4 above:

- It undermines government efforts to increase workforce participation rates and extend working lives for older people.
- It undermines peoples’ ability to accumulate adequate superannuation savings (on any definition of adequacy).
- It also undermines any attempts to ensure people preserve their superannuation savings (whatever their level) for their full retirement period, especially as the population lives longer.
- As a result, this anomaly may add materially to ‘longevity risk’ and longer term Budget pressure.

In short, this anomaly works both from the demand and supply sides (i) to increase longer term Budget pressures as the population ages, and (ii) to increase longevity risk:

- On the super income demand side, it makes accessing tax-free superannuation a preferred option relative to income from working.
- On the super income supply side, it makes accumulating superannuation (by saving and continuing paid employment) less preferable. Drawing down existing superannuation balances becomes tax-preferred.

At least in terms of accessing targeted government benefits such as the age pension, SATO and LITO, a policy designed to minimise longer term Budget pressure and longevity risk should be based on neutrality of tax treatment.

That is, the (notional) pre-tax and after-tax taxable income received by those accessing superannuation benefits and targeted benefits such as the three mentioned above should be the same.

‘Grossing up’ of tax-free super benefits as proposed in this report would deliver that outcome.

‘Grossing up’: is this effectively taxing superannuation at the benefit stage?

It should be emphasised that the ‘grossing up’ proposal does not entail actually taxing what currently are tax-free super benefits for people aged 60 over.

The proposal is not intended to violate this constraint on the Henry review.

Instead, the proposal is designed to improve the targeting of existing targeted benefits such as the age pension to those most in need, without increasing general EMTRs, and in a way that generates both longer term Budget savings and greater incentives to continue working.

‘Grandfathering’ issues

The ‘grossing up’ proposal raises questions about ‘grandfathering’ – itself a source of system complexity.

We judge that there are several possible options for adopting a ‘grossing up’ approach to super benefits as proposed above. For example, the Government might opt for one of the following courses:

- I.** Ignore the ‘grandfathering’ problem, and apply the proposal universally.
- II.** Apply the ‘grossing up’ proposal only to people currently not accessing the age pension.
- III.** Apply the ‘grossing up’ proposal only to people currently not accessing superannuation benefits.
- IV.** Apply the ‘grossing up’ proposal only to superannuation contributions made after the announcement of the ‘grossing up’ policy.

On balance, we judge that course I might be difficult to ‘sell’. Course IV seems far too generous and complex. In practice, either course II or course III seem more realistic.

We are inclined to support course II, both because this provides a little more incentive to continue superannuation saving (and working) than course III, and because, as a result, it helps a bit more to reduce longevity risk.

That said, course III would be a useful policy improvement too.

5.4 IS THIS REFORM LIKELY TO BE POLITICALLY ACCEPTABLE?

This question is something on which GCA is not qualified to make a judgment.

However:

- The ‘grossing up’ proposal does not violate the ‘tax-free super’ constraint on the Henry Review.
- It better targets ‘social safety net’ benefits intended to go to those most in need.
- As a result it is fairer.
- It does not increase general EMTRs.
- At least at the margin, it reduces longer term Budget pressures associated with population ageing.
- At least at the margin, it reduces disincentives for those of age pension age to continue paid employment.
- At least at the margin, it contributes to reduced longevity risk.

If all of these effects are valued in the political calculus, the ‘grossing up’ proposal might be politically acceptable.

6. COSTING SUPERANNUATION REFORM OPTIONS

The 24 superannuation reform options set out in section 4 of this report have been costed in a separate report prepared for Challenger Financial Services by Access Economics.¹⁴

This report does not duplicate the very detailed material provided by Access Economics in that report. However, to convey the flavour of the costing results, the following extracts from that report are reproduced here.

The summary charts presented below show changes attributable to each of the 24 reform options, as at 2040-41, to:

- retiree incomes and superannuation assets (shown as a % of GDP);
- the cost to the Federal Government (also shown as a % of GDP);
- the redistribution in favour of (or against) those with lower lifetime incomes (measured here as the difference in impacts between the second and the eighth lifetime income deciles arising from the specific option). In turn, these are measured against the 'modest but adequate' retiree income yardstick.¹⁵

Most options shift money between the Government and retirees, with the potential for some timing changes that therefore either add to or subtract from the aggregate size of assets held inside the super system. They also shift money between retirees (such as across deciles, or generations).

The results are illustrated in Charts 6.1 and 6.2 below. Some general observations can be made on the costings.

In brief, the 24 option costings lead to a relatively consistent set of results against several different 'groups' of these options.

Options 1, 9, 11, 13, 15, 19 and 21

Several themes run through the simulation results. Options 9, 11, 13 and 15 allow for various forms of super contribution discounts to the standard income tax rate while retaining the earnings tax rate at 15%. This set of options provides a relatively consistent hit to aggregate retiree incomes at around half a percentage point of GDP. They add close to one percentage point of GDP to government coffers, with the difference between those two levels mostly a matter of timing.

In turn, that timing affects the level of assets held within the superannuation system. For example, these options (which, as at 2040-41 add more to Government coffers than they have added to retiree incomes) are therefore consistent with smaller balances held in the superannuation system.

Options 1, 19 and 21 are also broadly similar to this group. The nature of the income tax discounts allowed for introduces a degree of progressivity, such that the resulting losses to retirement income adequacy measured on a 'modest to adequate' standard of retirement living fall more heavily on those with higher lifetime incomes than those with lower lifetime incomes.

Options 2, 5, 10, 12, 14, 16, 17, 20 and 22

Options 10, 12, 14, 16, 20 and 22 are a second group of options that also result in a broadly consistent set of outcomes. These options are similar to the earlier set (9, 11, 13, 15, 19 and 21), with the exception that the earnings tax rate falls to zero.

¹⁴ *Retirement Incomes Policy: Income Tax Simulations Paper* Report by Access Economics Pty Limited for Challenger Financial Services, 26 February 2009. See especially section 3.

¹⁵ The 'modest but adequate' measure compares incomes in retirement with the Westpac/ASFA Retirement Living Standard, which measures the cost of a fixed standard of living relative to that of the wider Australian community.

The abolition of earnings tax shifts retiree incomes from the red to the black, and the related cost to government flattens out to be near zero. Accordingly, there is relatively little impact on the size of the superannuation system.

However, whereas the variable tax discounts improve the relative fairness of retirement incomes, that is mostly undone by the abolition of the earnings tax – the first move is deliberately engineered to be of relative assistance to those at the bottom end, whereas the abolition of earnings tax helps those with higher retirement income balances, which thereby swings the redistributive affects back again.

Options 2, 5 and 17 are also broadly similar to this group.

Options 6, 18, 23 and 24

Another set of options which share broad outcome characteristics are options 6, 18, 23 and 24. Other things equal, a 30 percentage point rebate on contributions tax notably boosts retiree incomes, and the same is true of the combination of the abolition of the co-distribution alongside the abolition of earnings taxes (simulation 18).

The boost to retiree incomes comes at a broadly similar cost to government finances of around one percentage point of GDP for option 18, rising to 1.3 percentage points of GDP for option 6.

Both these options swing the distribution of improved retiree incomes notably to the top end of lifetime incomes.

These patterns across the options may be discerned more clearly in Chart 6.1. It ranks the options by their impact on the size of the super system (change in assets, shown as dollar figures in today's dollars), and shows that:

- Retiree incomes and Government costs (also seen here in today's dollars) move inversely – when incomes to retirees rise, costs to Government rise.
- As retiree incomes are typically less affected than Government costs (because there is a lag between the revenue costs to Government and the ultimate effect on retiree incomes), there is also a close relationship between retiree incomes and the overall size of the super system (that is, 'funds under management').

CHART 6.1: THE 24 TAX REFORM OPTIONS: SUMMARY TRENDS

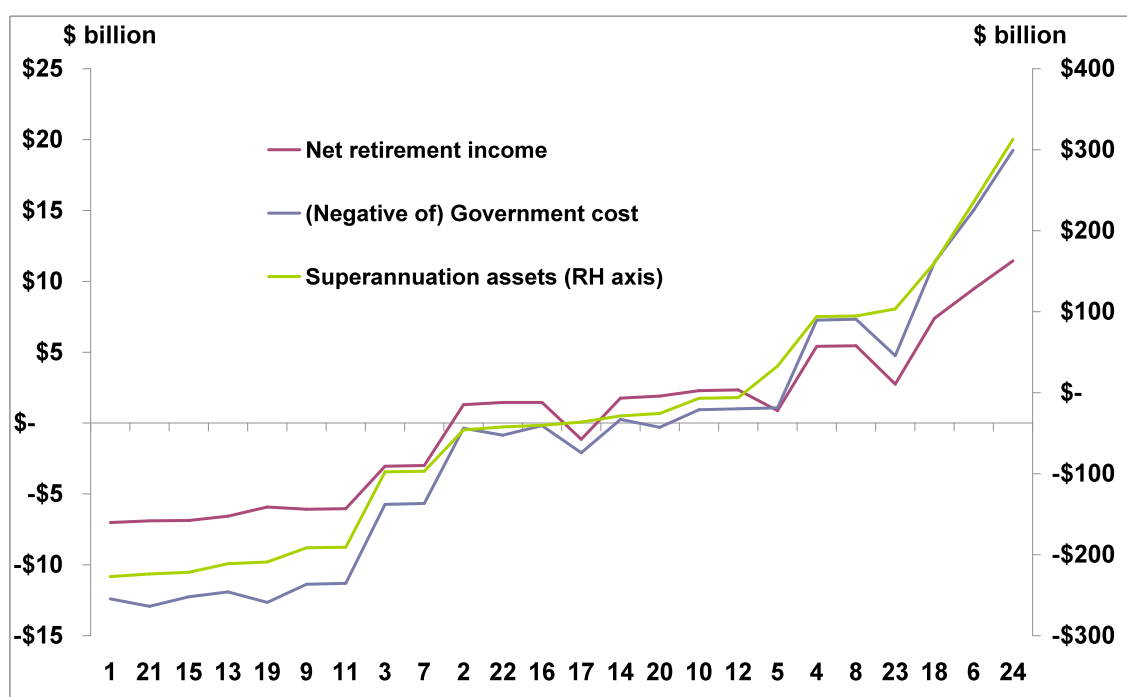
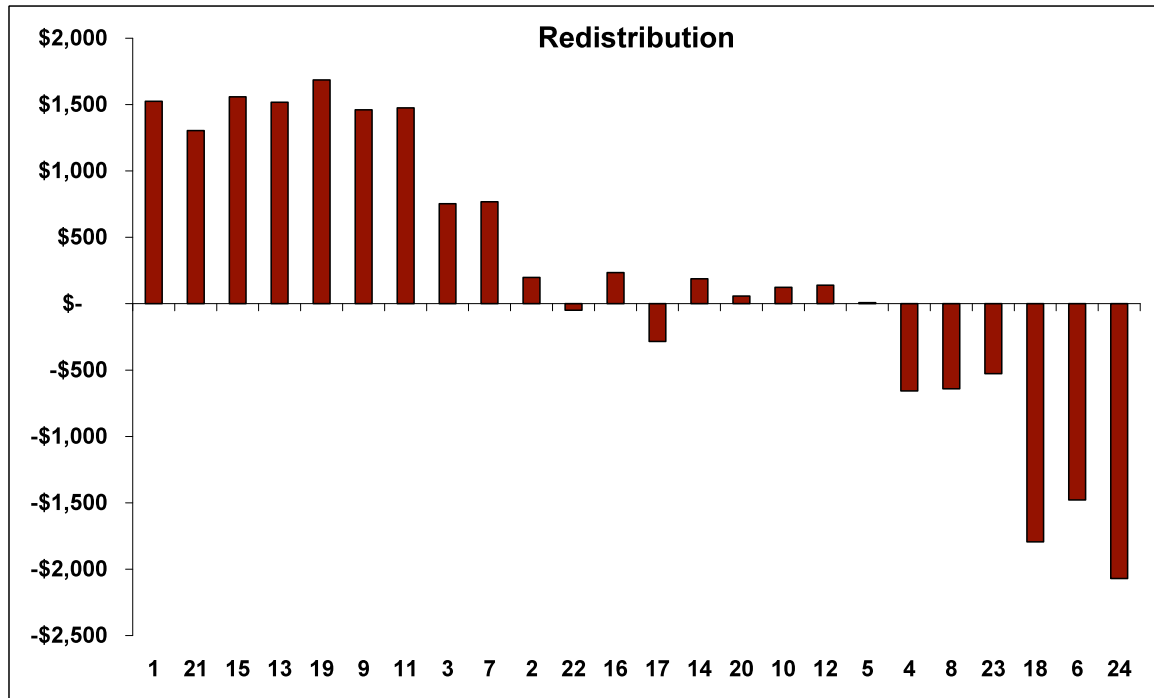


Chart 6.2 below includes the same scenarios (ordered the same way) but shows their redistributive effects (the difference in dollars going to the eighth and second lifetime income deciles). These show the opposite pattern to Chart 6.1. That is, savings to Government, reductions in retiree incomes, and reductions in the stock of assets in the superannuation system tend to improve relative adequacy, and vice versa.

CHART 6.2: THE 24 TAX REFORM OPTIONS: SUMMARY REDISTRIBUTIVE EFFECTS VERSUS THE 'MODEST BUT ADEQUATE' STANDARD



7. COSTING AGE PENSION REFORM OPTIONS

This report does not provide comprehensive costings of the 'grossing up' proposal presented in section 5 above:

- There are far too many retirement income situations to cover. For example:
 - There are single pensioners and couples, with or without children.
 - There are homeowners and non-homeowners.
 - There are groups with particular health/disability problems.

The main purpose of section 5 was to present a reform option that would:

- Reduce immediate and longer-term calls on the Budget funding for the age pension.
- Improve incentives favouring longer workforce participation and own-provision for retirement.
- Help contribute to addressing longevity risk.

The 'cost' of the proposal to the Commonwealth Budget should be significantly negative.

The 'grossing up' of incomes from superannuation presented in section 5 can, alternatively, be expressed as an increase in the *effective* taper rate for the age pension income test. On the basis of data provided to Challenger Financial Services by Towers Perrin, Table 7.1 below illustrates the effect of 'grossing up' on effective taper rates under the age pension income test.

Table 7.1. 'Grossing-up' effects on age pension income test taper rates

Assessable annual income band	% effective taper rate
Up to \$21,999	40.0
\$22,000 - \$22,999	40.6
\$23,000 - \$23,999	41.5
\$24,000 - \$24,999	42.3
\$25,000 - \$25,999	43.1
\$26,000 - \$26,999	43.8
\$27,000 - \$27,999	44.4
\$28,000 - \$28,999	45.0
\$29,000 - \$29,999	45.6
\$30,000 - \$30,999	46.1
\$31,000 - \$31,999	46.9
\$32,000 - \$32,999	47.7
\$33,000 - \$33,999	48.3
\$34,000 or over	48.8

8. SOME OBSERVATIONS ON HOW THE PROPOSED REFORMS AFFECT LONGEVITY RISK

The Henry Review is obviously concerned *inter alia* about longevity risk (see question Q4.2 noted in section 2.1 above), the solutions to which involve, in part, better retirement saving arrangements.

8.1 BETTER TARGETING AS A CONTRIBUTION TO BETTER LONGEVITY RISK OUTCOMES

The reforms proposed earlier in this report:

- better targeting of superannuation tax concessions; and
- better targeting of access to the age pension

both contribute to improved longevity risk outcomes, based on Budget-relevant definitions of retirement income adequacy.

The definitions of adequacy covered in section 3 above, and especially the first and fourth of these, (absolute income adequacy and adequacy in terms of longer term Budget sustainability) seem most appropriate based on the retirement income policy design principles set out in Box 2.1 in section 2, and especially the first three of those principles, viz:

- I. Governments should be less concerned about adequacy of retirement incomes for well-off people than for lower income people. This is the rationale for the age pension as a safety net, and the current government co-contribution, for example. This is a policy objective that is both targeted and, potentially, sustainable.
- II. Governments must be concerned about the pressures on the Commonwealth Budget over time, including those arising from the ageing of the Australian population. Policy settings – including for retirement income policy – must have regard for the sustainability of the Budget costs thereof.
- III. Tax concessions and other incentives to undertake voluntary saving for retirement should be targeted to reflect propositions I. and II. This ensures that they are best used to deliver adequacy (as defined above) in a sustainable way.

The reforms proposed in this report work to improve longevity risk outcomes by working both on the demand and supply sides of own-provision of retirement incomes:

- On the demand side, the proposed reforms work to reduce and/or delay demand for superannuation benefits. Better targeting of the age pension will remove current tax-based distortions favouring earlier (and larger?) access to superannuation savings in preference to longer participation in the workforce. This helps support workforce participation rates and reduces demands on the age pension as well.
- This contributes to reduced longevity risk and more sustainable Budget outcomes.
- On the supply side, superannuation savings are likely to be increased and/or held in the accumulation phase for longer. Better targeting of superannuation concessions allows Budget costs to be concentrated more on those (i) most able to save for their retirement and (ii) most likely to be eligible for a part-age pension. As noted above, the proposed 'grossing up' reforms in relation to access to the age pension improve incentives to increase superannuation saving and/or defer moving to the benefit stage by the affected groups. Better targeting therefore improves the size of the superannuation 'nest egg' for those otherwise most likely to have to rely on the taxpayer-funded age pension. A larger superannuation 'nest egg' improves prospects that a reasonable retirement income can be provided across the full retirement period with less, or no, access to the age pension.
- This contributes to reduced longevity risk and more sustainable Budget outcomes as well.

8.2 TOWERS PERRIN & ACCESS ECONOMICS REPORTS ON ANNUITISATION AND LONGEVITY RISK

Towers Perrin has produced a report for Challenger Financial Services on the impact of compulsion

on annuitant mortality as a response to longevity risk.¹⁶

A draft of this has been provided to GCA.

The key points made by Towers Perrin are:

- In the UK, there is some evidence of 'adverse selection', in that the mortality of voluntary purchasers of lifetime annuities is lower than the population in general.
- There is similar evidence in Australia, but it is based on more dated and less extensive data. The evidence here is therefore regarded as less credible by Towers Perrin.
- Compulsory purchase of lifetime annuities would reduce individuals' capacity to engage in 'adverse selection' behaviour, and so could reduce the insurer's pricing risk.

Another report from Towers Perrin¹⁷ concludes that:

- The average mortality of compulsory annuitants should be higher than voluntary annuitants.
- Compulsory annuitants will tend to be drawn from the subset of the population that has larger accumulated assets. This subset is likely to be wealthier and healthier, and therefore have lower mortality than the population as a whole. This is supported by UK evidence.
- Introduction of compulsory lifetime annuities in Australia should allow insurers to offer better annuity rates because average mortality would be higher than is the case for voluntary purchasers of lifetime annuities. The exact amount of any reduction in rates would depend upon rules relating to compulsion, emerging experience and the extent of competition in the market.

Based on the evidence presented, these findings by Towers Perrin seem unexceptional to GCA.

Overseas experience suggests a wide variety of practices in relation to dealing with longevity risk.¹⁸

In summary (as concluded in the overview paper just noted):

Pension schemes have a strong institutional position in many countries, particularly those where they may be state run or where superannuation arrangements have had a strong occupational link. However in many jurisdictions, like Australia, there has been a profound shift from defined benefit to defined contribution arrangements and with that a broadening of benefit arrangements. This has been associated with a significant transfer of risk from pension providers to retirees.

Annuities remain a significant, indeed in some jurisdictions the principal, means of delivering retirement incomes with their capacity to be used to manage the rate of withdrawal as well as investment, inflation and longevity risks. A number of countries report making purchase of an annuity compulsory either on retirement, by a specified later age (the UK requires this by age 75), or in combination with other retirement benefits such as lump sums or income stream with different risk characteristics. Some countries reported stipulating the indexation arrangements for annuities, in some cases requiring that they replicate the adjustments of state run pension schemes.

Deferred annuities are a feature of a small number of mandatory arrangements in the Americas. In these jurisdictions they are compulsory to deal with longevity risk if a retiree does not elect to buy an immediate life annuity on retirement and instead opts for programmed withdrawals from an individual

¹⁶ Letter to Tony Bofinger, Chief Financial Officer and Appointed Actuary, Challenger Life No. 2 Limited, February 2009.

¹⁷ *Actuarial analysis of longevity and market risk*, comments on *Retirees' Longevity Risk*, Duncan Rawlinson and Michelle Cater, 2 May 2008, paper presented to the Institute of Actuaries of Australia, 19-20 May 2008.

¹⁸ *Benefit arrangements in other jurisdictions*, summary paper provided to GCA by Challenger Financial Services.

account. Deferred annuities are a cost effective means of using pooling to deal with longevity risk while allowing a substantial proportion of benefits to remain subject to market risk.

Programmed withdrawals or account-based pensions have been particularly attractive to retirees since the early 1990s because they provided the benefit of substantial exposure to a rising market. The global financial crisis is currently providing a demonstration of market risk and the limitations of these arrangements as the sole means of delivering retirement incomes.

Countries report a variety of rules for programmed withdrawals and account based pensions, including; periodic payments to exhaustion over a relatively short period of years and minimum and maximum ranges based on an actuarial assessment of what the account balance would support as an annuity. Australia's pension rules impose only a minimum schedule of withdrawals increasing with age with no maximum rate, which means that early exhaustion and longevity risk are largely unattended.

By contrast, the mandatory schemes in the Americas require the amount available to be withdrawn to be recalculated each year on the basis of expected investment performance and an actuarial assessment of the life expectancy of the retiree at that age. It should be noted that this recalculation targets life expectancy and cannot deal with longevity risk, hence the accompanying requirement for a deferred annuity.

Allowing partial lump sums allows retirees to deal with some capital requirements or to provide a pool of savings for emergencies.

Allowing full lump sums are the laissez-faire solution to delivering retirement incomes.

Access Economics has provided modelling of the costs and benefits of some compulsory annuitisation options (30%, 50% and 100% of superannuation savings) including a 30% deferred annuity option.¹⁹

The conclusions from this modelling seem in line with our *a priori* expectations:

- Net benefits at retirement are little affected (the compulsory annuitisation options deal with the retirement phase, not the accumulation phase).
- Initial age pension cost increases to the government as retirees shift away from lump-sum draw-downs of their superannuation savings towards purchases of annuities, are reversed over time, with age pension costs to the Budget falling below baseline.
- Consumption-based measures of retirement income adequacy improve, and do so a little more for most lower income deciles. In contrast 'modest but adequate' measures of adequacy also improve, but more so for higher income deciles (reflecting their larger superannuation savings).
- Overall, compulsory purchase of annuities is more beneficial for longer-lived, higher income groups.
- The modelling of the compulsory 30% 10-year deferred annuity option, as expected, shows different results because of the different timing of the annuity income stream.
 - There is an initial fall in retirement incomes as the scheme commences, but, as the superannuation system matures, this is outweighed by higher (deferred) income streams paid to retirees.
 - A larger initial cost to the Budget in terms of age pension outlays relative to baseline is ultimately replaced by a similarly larger age pension cost saving as income from the deferred annuities is received.
 - There are broadly similar effects on benefit patterns for the two 'adequacy' benchmarks by income decile as reported above (albeit smaller in absolute amount).

¹⁹

Retirement incomes policy: annuities simulation paper, Report by Access Economics for Challenger Financial Services, 25 February 2009.

Taken together, the material provided by Towers Perrin and Access Economics suggests that compulsory annuitisation options would:

- Increase the size of the 'pool' through which more retirees insure against longevity risk, rather than leaving that to governments.
- A larger 'pool' would also allow better pricing of the products, also improving adequacy of the resulting income streams given the available amount of superannuation savings.
- Over time, this shifting of longevity risk to retirees would underwrite lower age pension Budget costs relative to baseline, and help improve retirement income adequacy.

The logic of compulsion, and the gains it can deliver, rely heavily on its insurance 'pooling' advantages (ie, the effective reduction in scope for 'adverse selection').

Should such measures be introduced, it will be important that the rules relating to compulsory annuity products are designed to preserve this longevity risk insurance 'pooling' effect and the cost saving/cost spreading that comes with it.

9. CONCLUDING COMMENTS AND POLICY RECOMMENDATIONS

9.1 CONCLUDING COMMENTS

This report has argued that current tax concessions for superannuation, and access to the age pension by recipients of tax-free superannuation, could and should be better targeted.

What constitutes ‘better’ targeting requires a framework of principles for ‘good’ retirement income policy design. This report suggests four principles, of which the most important are the first three:

- I. Governments should be less concerned about adequacy of retirement incomes for well-off people than for lower income people. This is the rationale for the age pension as a safety net, and the current government co-contribution, for example. This is a policy objective that is both targeted and, potentially, sustainable.
- II. Governments must be concerned about the pressures on the Commonwealth Budget over time, including those arising from the ageing of the Australian population. Policy settings – including for retirement income policy – must have regard for the sustainability of the Budget costs thereof.
- III. Tax concessions and other incentives to undertake voluntary saving for retirement should be targeted to reflect propositions I. and II. This ensures that they are best used to deliver adequacy (as defined above) in a sustainable way.
- IV. Where there are clear and unavoidable trade-offs and/or conflicts between policy objectives, these should be made explicit and so dealt with in designing policy responses. For example, raising the level of the age pension, and introducing looser means tests for eligibility, might be seen as boosting the adequacy of the age pension (albeit at a cost to the Budget over time). However, that initiative, at the margin at least, (a) reduces incentives for individuals to save to provide for their own retirement incomes, and possibly (b) also affects their incentives to work more generally.

Given this framework, defining an *adequate* retirement income benchmark is also important. This report suggests that there are four possible definitions or benchmarks:

- An absolute retirement income adequacy benchmark.
- A ‘community standards’ retirement income adequacy benchmark.
- A ‘relative to pre-retirement income’ adequacy benchmark.
- A long term Budget sustainability adequacy benchmark.

There is some tension between these benchmarks, especially between the third and fourth definitions.

Given the design principles for retirement income policy noted above, the tension can be resolved by concentrating primarily on the first and fourth of these adequacy benchmarks (with, possibly, some attention being given to the second benchmark).

Given this framework, built from design principles and adequacy benchmarks based on these principles, we conclude that:

- Reducing current taxation concessions for superannuation saving by higher income earners, and/or increasing such concessions for middle and lower income earners, would be a better way to target such concessions.
- Access to the age pension should be better targeted to deliver a more ‘level playing field’, in terms of age pension access, as between people of pension age relying on non-superannuation income (especially from continued paid employment) and people enjoying tax-free superannuation benefits.

- Both of these reforms will help deliver useful benefits:
 - They will help improve incentives to own-provide for retirement income by those most likely otherwise to be able to access the age pension.
 - They will help to encourage preservation of superannuation for longer, and extend paid workforce participation.
 - They will help to reduce looming Budget pressures associated with an ageing population.
 - They will help to reduce longevity risk.

9.2 POLICY RECOMMENDATIONS

This report concludes that the Henry Review should consider making the following recommendations for structural reforms to the current Australian retirement income policy.

Superannuation concessions

For superannuation, better targeting of superannuation concessions and incentives, including:

- I.** Shifting all contributions taxation out of superannuation funds and back to employers, the self-employed, or individual contributors.
- II.** As a result of this reform, it becomes feasible to introduce a more progressive (and better-targeted) contributions tax rate scale. This is recommended.
- III.** There are many possible variants of such a progressive contributions tax rate scale, ranging from the standard income tax rate scale through to substantial targeted tax discounts (including refundable credits paid by the Government into the contributors' superannuation funds).
- IV.** As part of this restructuring, consideration should be given to abolition of the current Government co-contribution, especially where lower-income contributions tax discounts are introduced, because the latter are potentially better targeted and involve no EMTR problems.
- V.** Ideally, abolition of the superannuation fund earnings tax. This maximises the dollar impact of the accumulation process, improving retirement income adequacy, reduces super fund administration costs (the benefits of which should be passed on to contributors), reduces longer-term Budget pressures, and reduces longevity risk.
- VI.** In declining markets, reducing or suspending minimum annual draw-downs in the pension phase to provide some relief for those not needing to crystallise losses, thereby preserving superannuation balances, contributing to lower longer-term Budget pressures and reducing longevity risk (in part, this recommendation has already been implemented).
- VII.** As quickly as possible, closing the current gap between the superannuation preservation age and the age pension age.
- VIII.** Making annual tax-free superannuation drawings above a specified dollar amount assessable (but not taxable) for income tax purposes. This would help to preserve superannuation balances, contributing to lower longer-term Budget pressures and reducing longevity risk.

Superannuation benefit recipient access to the age pension

For access to the age pension, especially by those in the superannuation benefit phase, better targeting of such access, including:

- I.** Considering a longer-term program for raising the age pension age above 65 years, especially if, as seems likely, pension benefit levels are to be increased.

- II.** For the purposes of the age pension means test, reviewing the application of that test to income taken in the pension phase of superannuation.
- III.** Specifically, where tax-free superannuation is included in assessable income for purposes of applying income tests related to the age pension, the Medicare Levy exemption, SATO and LITO, that income should be 'grossed up' to place it on the same footing as income from non-superannuation sources, (and especially income from working).
- IV.** In addition, where tax-free superannuation is included *on a concessional or part-exempt basis* in assessable income for purposes of applying income tests related to the age pension, the Medicare Levy exemption, SATO and LITO, that income also should be fully 'grossed up' (offsetting both the concessional treatment under the means test and the tax-free nature of such benefits) to place it on the same footing as income from non-superannuation sources, (and especially income from working).
- V.** As to 'grandfathering' of these reforms, we suggest that they should be applied only to people not currently accessing the age pension. Alternatively, they may be applied only to people aged 60 or over not currently accessing superannuation benefits.

Compulsory annuitisation as a response to longevity risk

The evidence provided by Towers Perrin and Access Economics suggests that compulsory annuitisation options would:

- Increase the size of the 'pool' through which more retirees insure against longevity risk, rather than leaving that to governments.
- A larger 'pool' would also allow better pricing of the products, also improving adequacy of the resulting income streams given the available amount of superannuation savings.
- Over time, this shifting of longevity risk to retirees would underwrite lower age pension Budget costs relative to baseline, and also help improve retirement income adequacy.

The logic of compulsion, and the gains it can deliver, rely heavily on its insurance 'pooling' advantages (ie, the effective reduction in scope for 'adverse selection').

Should such measures be introduced, it will be important that the rules relating to compulsory annuity products are designed to preserve this longevity risk insurance 'pooling' effect and the cost saving/cost spreading that comes with it.