SUBMISSION ON LEGISLATING THE OBJECTIVE OF SUPERANNUATION

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This submission has been prepared in response to the Consultation paper issued by The Treasury on 20 February 2023. While focusing on the proposed objective for superannuation and the four questions in the Consultation paper, it also canvasses some related issues concerning the appropriate tax treatment of superannuation and the relationship between superannuation and the age pension.

1. **What do you see as the practical benefits or risks associated with legislating an objective of Australia's superannuation system?**

We believe it is important to clarify in legislation the purpose of Australia's superannuation system which involves mandating employer contributions, limiting voluntary contributions, constraining access to the funds, regulating the management of superannuation accounts and applying different taxation rules to those applying to other savings. The absence of a clear objective leads to uncertainty about future policies adding sovereign risk to the risks individuals and funds must manage. Addressing such sovereign risks may take attention away from the management of the key risks the system is meant to be assisting with – longevity and the life cycle, market risks and inflation. The sovereign risk in the absence of a clear objective may also have unintended consequences including to government revenue and to the overall equity of the system.

While legislating an objective would not prohibit the Parliament changing the objective sometime in the future, it would place a considerable hurdle before significant policy changes and provide much more policy certainty for individuals and funds. It could also constructively draw attention to the reforms still needed to improve the system's efficiency and effectiveness and move on from unnecessary and diversionary (even misleading) debates.

2. **Does the proposed objective meet your understanding of the objective of the superannuation system in Australia?**

It is important to appreciate the history behind the Australian system, and the alternative approaches other developed countries have taken to supporting retirement incomes.

Since 1909, Australia has relied on flat-rate, means-tested age pensions financed from general revenue to provide people with income protection in old age. Over the following seven decades, governments of both political persuasions explored alternative or complementary ways that would provide more generous benefits in old age which not only protected people from poverty (the first objective of retirement income systems) but offered the opportunity to maintain their pre-retirement living standards (the second objective). These proposed schemes involved compulsory contributions paid to the government which would in turn pay benefits linked to those contributions. The most recent such proposal was made by the Hancock Inquiry in 1976 but it was rejected by the Fraser Government which instead focused on reform of occupational superannuation to address the second (income maintenance) objective through mostly voluntary arrangements, the reforms being aimed to ensure occupational superannuation was used for genuine retirement purposes, was more firmly owned by the members and was more portable on changing jobs. This approach was initially continued by the Hawke Government in the mid-1980s.

the main focus was income maintenance with social assistance commonly addressing poverty alleviation for those with limited contributions. But during the 1980s, the risks to government and future generations from this approach were highlighted as life expectancy increased, fertility rates dropped and the political obstacles to constraining entitlements became apparent.

It was in this context that Australia's superannuation system emerged. It was an alternative way of providing more generous benefits to everyone in retirement and old age that had the advantage of being based on real funds thus limiting the risks to government and future taxpayers.

Importantly, like the age pension and overseas national superannuation systems, the Australian superannuation system is intended to provide benefits in retirement. Just because it is more firmly funded does not mean it should be accessible before retirement or be used for other purposes. Nor would it be expected to fund inheritances other than that which individuals might choose to retain from their spending in retirement.

That said, the Australian system does offer more choices than other systems and, subject to it focusing on being used to provide income and to facilitate consumption in retirement, such choices may be seen as an advantage so long as people are well informed to make the choices. It is in this area we believe future reform must focus.

Accordingly, we favour an objective that is anchored on building and preserving savings to retirement and delivering income in retirement. 'Income' here needs to include resources used for lump sum consumption such as holidays and resources set aside for contingencies in later life such as aged care as well as regular income such as from annuities; moreover, retirees may want to allocate some funds to inheritances even though inheritance funding is not the objective. Broadly, the system is about facilitating the spreading of lifetime incomes to allow the smoothing of consumption and the maintenance of living standards in retirement.

Turning to the specific wording of the proposed objective, we suggest some minor amendments and clarifications:

- Replace 'preserve savings' with 'build and preserve savings', reflecting in particular the mandated employer contributions which facilitate the spreading of lifetime incomes. We support the inclusion of the word 'preserve' to make it clear the system is not intended to support consumption before retirement.
- Clarify that 'deliver income' does not exclude the use of accumulated savings for consumption in retirement other than through regular income. While it is likely that most retirees should be encouraged to direct at least some of their savings into annuities, the appropriate mix of retirement income products will vary with individuals' circumstances. The proposed 'covenant' requiring funds to offer retirement income products that they consider to be in their members' best interests is likely to lead to a range of preferred products with varying proportions devoted to annuities (or similar forms of regular income with longevity risk cover), to lump sum purchases and for contingencies such as aged care.
- Clarify that 'dignified' focuses on both financial security (as mentioned in the Consultation paper) and adequacy, in conjunction with the age pension providing not only protection from poverty but also the maintenance of living standards at and through retirement. We are not sure that 'wellbeing', the term mentioned in the Consultation paper, conveys this understanding of adequacy. Financial security is an essential component of 'dignity' as a

central role of superannuation is to help people manage key risks including how long they will live and market and inflation risks.

- The achievement of both adequacy and security might be made clearer if the reference to ‘alongside government support’, came after ‘deliver income’ rather than after ‘dignified retirement’. We would also prefer to be more specific about the age pension here, recognising (as does the Consultation paper) that many retirees will not be eligible for any age pension.
- We are uncomfortable about the term, ‘sustainable’ which seems to be loosely defined in the Consultation paper suggesting that it could include actions not in the best interests of superannuation fund members. As discussed further below, we also think the costs of superannuation tax concessions have been greatly exaggerated and their distribution misrepresented, adding to the danger that the term ‘sustainable’ will be misinterpreted. Our strong preference is that the objective refer to ‘in an effective, efficient and equitable way’.

In summary, we support the following objective:

> ‘The objective of superannuation is to build and preserve savings to deliver income, alongside the age pension, for a dignified retirement in an effective, efficient and equitable way.’

3. Is the proposed approach to enshrining the objective in legislation appropriate? Are there any alternative ways the objective could be enshrined?

We support having the objective in legislation. A policy statement by the Treasurer or Prime Minister would not have any standing beyond the term of the elected government and would not provide any longer-term certainty. While legislation can always be amended, a statutory objective represents the will of the Parliament that is not so easily changed.

The objective could also be enshrined in funds’ regulations and the obligations of trustees, but in the absence of a statutory objective, funds and their trustees may find it difficult to interpret their obligations to members.

Previous reviews (e.g. the Callaghan Review) have canvassed the option of an objective for the retirement income system as a whole. This has some advantages as such an objective could embrace more firmly the two key purposes (poverty protection and income maintenance). But the downside is the failure to specify exactly what each component of the system (particularly the age pension and superannuation) is intended to do.

4. What are the practical costs and benefits of any alternative accountability mechanisms to the one proposed?

We agree that the objective would provide a useful basis for parliamentary scrutiny of any new policy proposals affecting superannuation. It would also assist scrutiny of proposals affecting the other pillars of the retirement system, focusing more attention on the coherence of the system as a whole, an issue rightly highlighted by the Callaghan Review.

Accountability could be taken further if the Government presented regular (perhaps biennial) reports on how well the system is meeting its statutory objective, helping to ensure more attention is given to remaining challenges such as appropriate guidance in the pensions phase on the best use of accumulated savings to address risks and ensure adequacy, and achieving coherence with the age pension means tests.

We suggest therefore that the Government commit to a biennial report to the Parliament on how well the system is meeting its objective. Such a report should be by independent experts.

5. **Other Related Issues**
   a. **Superannuation Tax Concessions**

Treasury's calculations of superannuation 'tax expenditures', drawn upon by the Treasurer and Prime Minister in recent speeches and statements, are in our firm view misleading. They are measured against a benchmark that has never been officially endorsed as appropriate for savings, let alone long-term savings much of which are mandated. While it is true that increasing savings through superannuation does reduce revenues (particularly in the short-term), that does not mean that the tax regime for superannuation should be benchmarked against the way wages are taxed.

Encouraging (and mandating) the spreading of lifetime income as intended (according to the proposed superannuation objective), requires a tax regime that is neutral as to the timing of consumption. The orthodox approach (used in most OECD countries) to achieve this is to exempt both contributions and earnings from tax, and to impose tax in full when the accumulated savings are consumed. This form of expenditure tax is very different to the comprehensive income tax approach Treasury uses as its benchmark for calculating superannuation tax expenditures. Such a benchmark, if used for superannuation savings, would impose a very large burden on those saving for retirement.

The benchmark used by Treasury leads not only to hugely different estimates of the tax expenditures (and implied tax concessions) involved, but also greatly distorts their distribution. A simple example illustrates this: using that benchmark a high income earner with a marginal tax rate of 47% gains a concession of 32% on his fund earnings way more than the 'concession' for those on modest or middle incomes; but no-one would seriously suggest a tax of 47% on fund earnings over 40 years or more as that would impose a huge penalty on such savings, totally at odds with the objective of the superannuation system.

Australia's superannuation tax regime is complex, and after thirty years it is now impossible to change to the orthodox approach identified above. But unpublished work by a former Treasury officer, Phil Gallagher, a few years ago suggested strongly that the current Australian regime is remarkably similar in its overall impact (on retirement incomes and on revenues in the long run) to the orthodox approach. The 'concessional' taxes on contributions and earnings with no tax on retirement incomes is similar, at nearly all income levels, to having no tax at all on contributions or earnings but full tax on retirement incomes. That is, the regime broadly provides the neutrality required for postponing consumption to retirement and does not involve excessive concessions for high income earners.

It would be good if the Government and the Treasury clarified that this is the case. The current regime, following the changes introduced by the Turnbull Government, bears considerable similarity to the regime advocated by the Henry Review (involving taxes on contributions 15 percentage points below individuals' marginal tax rates and a standard 15% tax on fund earnings). This does not deny the need to ensure that contributions and accumulated savings must be used for genuine retirement income purposes and not for tax minimisation purposes including to provide more generous inheritances; hence some caps are justified or other tinkering to improve the effectiveness, efficiency and equity of the system (or changes elsewhere in the tax system). But clarification that the tax regime is generally appropriate for genuine retirement savings might help to remove constant speculation of possible tax changes driven by spurious figures on the level of ‘concessions’ now involved.

A more detailed analysis of the appropriate way to tax retirement savings is attached.

b. The relationship between superannuation and the age pension

A key issue raised by the Callaghan Review was the need to improve cohesion between superannuation and the age pension. Unfortunately, that Review did not provide much useful guidance on how to do so.

As funds are being asked to offer retired members products that are in their best interests (a reform we strongly support which in itself should reduce the extent to which retirees underutilise their savings and leave more in inheritance than they planned), they are confronted with the very different approaches in the design of the superannuation pillar and the age pension pillar: one is individual-based while the other is based on the income unit, most commonly a couple. For the most part, retirees will perceive their ‘dignified retirement’ as couples, and funds will need to assess products that are in their joint best interest.

But this challenge is made more difficult by the complexity of the age pension means tests. Australia seems to be alone in applying two separate tests, one on income and the other on assets. The distinction was magnified by changes to the assets test in 2017. Various reviews (including the Henry Report) have suggested a more standard approach involving a single test, effectively converting assets into the income stream they could finance and adding this to other income with a test on the aggregate. Such a merged means test, appropriately designed to ensure there are rewards at all income levels from the superannuation pillar, would help the funds to design appropriate products for different groups of retirees (specifically, those still eligible for a full pension, those eligible for a part pension and those not eligible for any pension).

The exemption of the home from the current assets test may also distort behaviour away from the optimal use of total resources in retirement income, but we accept that this is a politically difficult issue that will require more careful exploration over time.

9 March 2023

ATTACHMENT

The Economic Theory and Policy of Pension (Superannuation) Taxation

Introduction

This discussion sets out the economic case for an expenditure tax treatment of pension saving. The arguments and analysis are not new. But policy debate on the topic in Australia does not appear to be grounded in a consistent framework, so it seems worthwhile bringing the elements of analysis and policy together. We conclude that while the Australian taxation of the important channels of life-cycle saving is somewhat clumsy, it approximates an expenditure tax treatment. As argued in the body of the submission, we believe that this is appropriate for a developed country and is indeed approximately observed across the OECD.[1]

Some relevant theory

The economic analysis of taxation begins from the idea that the price system, with notable exceptions, allocates resources efficiently, in the sense that profit-maximising suppliers, and utility maximising consumers, will be induced through responding to prices to choose such that resources cannot be re-allocated to make someone better off without making someone else worse off. There are well-documented and significant circumstances in which this will not hold – in which markets fail. Government interventions of various kinds are then considered and frequently implemented. Nevertheless, the allocative role of markets remains at the heart of normative public finance analysis, and at the heart of economic policy formulation in a mixed economy such as Australia's.

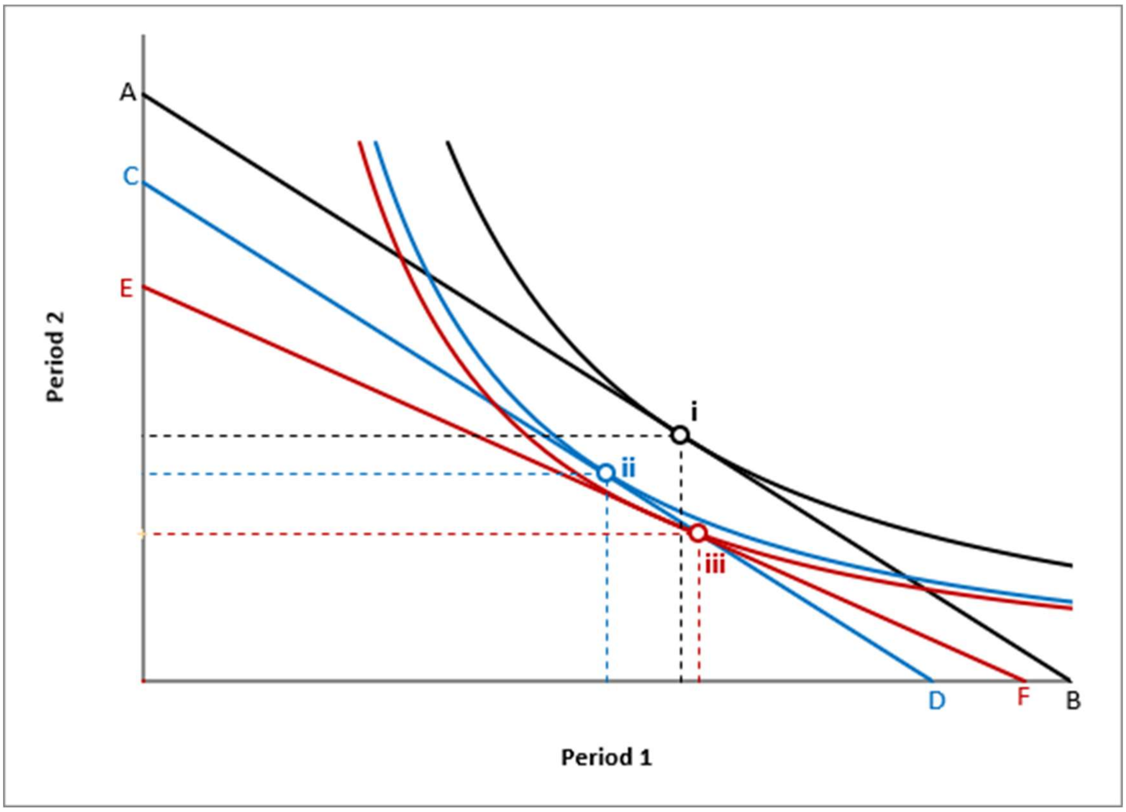
Here we consider the simplest possible textbook treatment of the question. We imagine a two-period model, in which the relative impacts of an income tax and an expenditure tax on consumption in working life vis-à-vis consumption in retirement can be represented. Labour is assumed to be inelastically supplied. In Figure 1, the line AB gives the pre-tax budget line. The slope is given by (1+r), where r is the compounded rate of interest between working life and retirement. But AB may also be interpreted as the marginal rate of transformation between present and future consumption bundles. The equivalence between the marginal rate of substitution (MRS) and marginal rate of transformation (MRT) generates point *i* as the efficient choice point in this diagram.

Now consider two alternative tax regimes raising the same revenue: an expenditure tax, in which working life and retirement consumption are taxed at the same rate; and an income tax, in which the interest income on saving is also included in the tax base. The tax rate in the latter case is lower,

[1] Holzmann and Piggott (2018) contains accounts of pension tax treatment across a range of countries, as well as an introductory analysis.

because the base is larger. But the interest tax leads the price line to swivel, breaking the MRT-MRS equivalence. As a result, the consumer can be expected to choose more consumption today relative to consumption in the future; and that under the comprehensive income tax they will be worse off as a result. That is, the indifference curve passing through point *ii* is higher than the indifference curve passing through point *iii*, even though the same present value of taxation is collected in both cases. This latter condition is guaranteed geometrically by the parallel lines AB and CD.

Figure 1.



The superiority of the expenditure tax regime does need to be qualified. A more sophisticated analysis would include labour supply choice. But nevertheless, it is widely accepted that a discounted rate of tax on life course saving is desirable.

In the context of pension taxation, it has become commonplace to designate alternative tax treatments according to the three points at which savings are taxed: the tax treatment of contributions, earnings, and benefits. A 'Haig-Simons' income tax treatment would be designated as TTE: contributions and earnings are taxed under the income tax schedule, and benefits are exempt. Most OECD countries treat pensions under an EET regime, where both pension saving and their lifetime returns are exempt.[2] An alternative might be TEE, in which contributions are taxed at the personal income rate, but no further tax is payable. Kingston and Piggott (1993) show that under a proportional tax regime, and absent uncertainty, TEE and EET are equivalent. Such equivalence is not possible where earnings are taxed because the duration of saving impacts overall returns.

The two most important channels of life-cycle saving, in Australia and throughout the developed world, are owner-occupied housing and pension saving. We focus here mainly on the taxation of pension saving, but it is important to note that the principle applies equally to the returns of holding the principal residence. Using the notation outlined above, Australian pension taxation is represented by ttE, where t represents a tax lower than the legislated income tax rate; and the tax treatment of the principal residence is given by TEE. This is important, because unless the taxation treatment of these life-course saving assets is broadly equivalent, inter-asset distortions will be introduced, and these can be very costly in terms of resource misallocation. Hamilton and Whalley (1985) demonstrate this clearly.

What constitutes relevant policy?

There is no evidence that legislative intent ever countenanced a Haig Simons[3] definition of income in introducing an income tax. In particular, long term saving assets have been excluded. When it was legislated in 1915, it specified tax preference to superannuation which persisted, in a very generous form, until the 1980s. Similarly, capital gains were not subject to tax for more than 70 years after the income tax was introduced. As well, owner-occupied housing has been given an expenditure tax treatment since 1923.[4] A search of Hansard shows only two references to Haig-Simons income, both in 2015, in the context of the Standing Committee on tax and revenue, specifically the Tax Expenditure statement.

References

Hamilton, B. and J. Whalley (1985). “Tax treatment of Housing in a Dynamic Sequenced General Equilibrium Model”, Journal of Public Economics, 27, 2, 157-175.

Holzmann, R. and J. Piggott (2018) (eds). The Taxation of Pensions. MIT Press.

Kingston, G. and J. Piggott (1993). "A Ricardian Equivalence Theorem for the Taxation of Pension Funds", Economics Letters, 42, 399-403.

[2] This is true even in those countries, such as Denmark, that have introduced a “dual income tax” structure, where income tax treatment of the returns from capital income from all sources is discounted.

[3] Or, more correctly, a Schanz-Haig-Simons definition of income.

[4] https://www.austaxpolicy.com/income-tax-at-100-years-a-little-history/