

Towards a “Win-Win” Solution on Super Tax

9 October 2015

Reports of last week’s ‘mini summit’ chaired by the Prime Minister, if indicative that various interest groups are prepared to recognise that everyone can win from a ‘whole-of-economy’ approach, are very exciting for the future of superannuation.

The idea that economic growth and improvements in productivity can benefit everyone should also extend to the idea that a more efficient savings tax system can benefit everyone.

In particular, a more efficient superannuation tax system would result in the Government being more able to raise Age Pensions per person; and changes in the income tax scales can allow the introduction of a fairer progressive taxation of superannuation contributions.

Any serious review should recognise the following facts:

1. Age Pensions cost more than super tax concessions and so a better and more efficient super system can lead to budget savings in Age Pensions and so put the Government in a better position to raise the Age Pension for those who need it;
2. A more efficient tax system for super savings will give better results per dollar of tax concession;
3. Adding a new tax or otherwise penalising super earnings in pension phase does not improve the tax efficiency of super nor help more people save adequately in super; and
4. Our income tax scale is currently one of the world’s most progressive, but improving this situation would better allow the Government to make some super taxes progressive and thus improve super effectiveness for those on lower incomes.

Is there really a problem?

Criticism of the current system has been exaggerated and a rational debate has been distorted by the widespread misunderstanding and misuse of the apparently large scale of the so-called “\$32 billion” superannuation tax concessions. (See our 28 February 2015 media release [“Finally it’s official – focus on \\$32 billion cost of superannuation is misleading”](#))

Rob Heferen of Treasury and former Assistant Treasurer Josh Frydenberg have clearly stated that this “\$32 billion” figure should not be relied upon and this is not the amount of tax the Government would receive if it eliminated tax concessions on super. Serious economists agree. A Parliamentary Standing Committee is currently undertaking an inquiry into the Treasury reporting of superannuation and other tax concessions which we hope will lead to more meaningful figures being published in future.

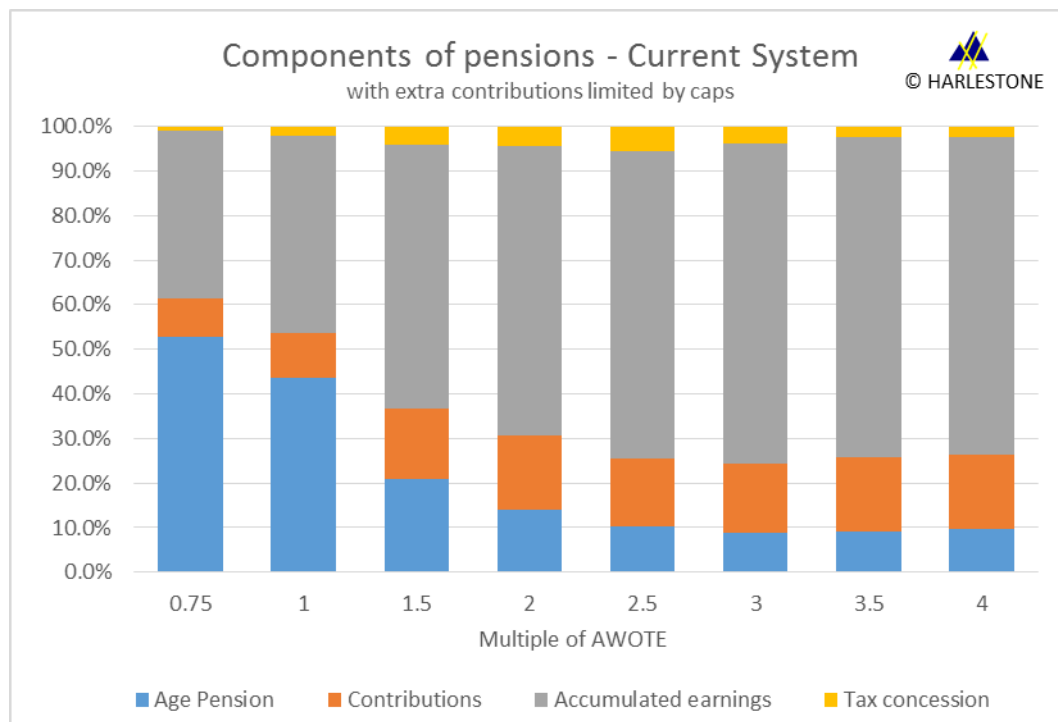
However, although the current system is not yet mature, we agree there are improvements that could be made as part of an overhaul of the tax system that would lead to the super system being more effective for more Australians. We canvassed these issues in our submission to the “Re:Think” tax White Paper review process in May 2015 ([May 2015 SMSFOA submission](#)) and analysed in detail suggested improvements to the tax efficiency of the super system.

A significant point that some lobbyists ignore is that providing a tax incentive to encourage Australians to save is a much more effective use of Government budget than the Age Pension cost. With a superannuation-based retirement system, most of the funds that provide the pension are derived from an individual’s income that they have saved rather than spent during their working lives. The tax concessions just provide the incentive and compensation for saving rather than spending and comprise much less than 10% of the funding of all pensions.

By comparison, the Government provides 100% of the cost of Age Pensions. Under the “three-pillar” architecture of our retirement system, the Age Pension is intended to just be a “back-stop” to support those Australians who, for whatever reason, have not saved enough via the superannuation system.

The following graph shows, for individuals at different income levels, the percentages of their retirement incomes provided by the Age Pension, their own savings (contributions), accumulated earnings on those savings and tax concessions.

Graph 1:



The two main messages from Graph 1 are the small size of the tax concessions and the large size of the “accumulated earnings” component. Without superannuation, all the bars would be blue! At every level of earned income the savings in Age Pension as a result of the availability of superannuation are greater than the tax concessions.

So it makes fiscal sense to provide adequate superannuation incentives and compensation so the greatest number of people will save and be independent in retirement.

As the number of people needing to be on the Age Pension reduces, so the ability of the Government to provide a better level of Age Pension support per person increases.

Is there a more efficient superannuation tax system?

The next issue is whether there is a better way of targeting the tax concessions to provide the maximum encouragement to save and better utilise every \$1 of tax concessions to make the retirement savings system most efficient. The answer is yes. The solution lies in better structuring the tax that applies to superannuation to benefit all rather than penalise some.

It is indisputable that to introduce a new tax on superannuation in pension phase would be unfair to those Australians who have saved rather than spent during their working life and paid all taxes legitimately under the tax regime at the time. Attacks on the small number of high balances again ignores that these were legitimately accumulated under the rules at the time and such large balances cannot be accumulated from concessional contributions under the current rules. However, the main point is that neither of these measures help make super more efficient and better for more Australians.

Originally, our retirement savings system used to have no taxes on contributions nor on superannuation earnings with only pensions being taxed. This system (known as EET) is recognised globally as the most

efficient with one of the key features being tax-free superannuation earnings. Dr Henry (in his 2009 report “Australia’s Future Tax System”) and other economists around the world generally agree that for a retirement savings system to be most efficient, taxes and other imposts on earnings should be as low as possible. Dr Henry emphasised the significance of the cumulative impact of earnings on resultant pensions and our analysis supports this.

Graph 1 illustrates this and we strongly endorse the Financial System Inquiry’s view that any action the Government could take to reduce the cost of financial advice and products would have a substantial compounding effect on superannuation earnings.

The introduction of a new tax on contributions and on (pre-retirement) earnings in the early 1990s (TTE) therefore reduced the efficiency of the super tax system. However, it is now very difficult to remove the tax on contributions because of the budget impact, but we believe that the tax on earnings could be removed without a negative budget impact. Our modelling reported in our submission to the Tax White Paper Taskforce referred to above illustrates the significant impact this can have on the efficiency of taxes.

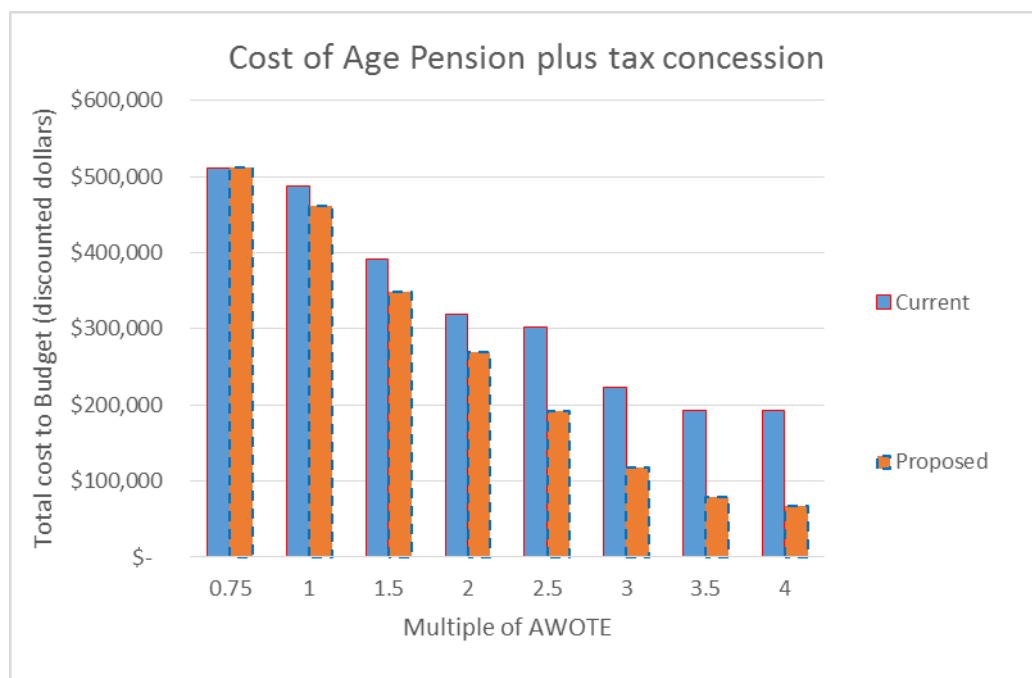
How to make super better for more Australians?

We believe that the taxation of contributions proposed by Dr Henry in his report on Australia’s Future Tax System provides a solution to the better distribution of tax concessions.

He proposed that contributions be included in an individual’s taxable income - and therefore taxed at marginal income tax rates – but with a fixed percentage credit/rebate to provide a flat incentive across all income bands. He proposed a 20% rebate but we have proposed reducing this to 15% to compensate the Government budget for removing the taxation of superannuation earnings. This modification to Dr Henry’s proposal is similar to one also being proposed by Professor Freebairn of Melbourne University.

The following shows that under the current system, contrary to popular perception, the cost burden per person on the Government Budget of the Age Pension plus super tax concessions falls as income increases. However, it also shows that the cost falls more dramatically with income under our proposal. The cost is also lower at every income level than the current system.

Graph 2



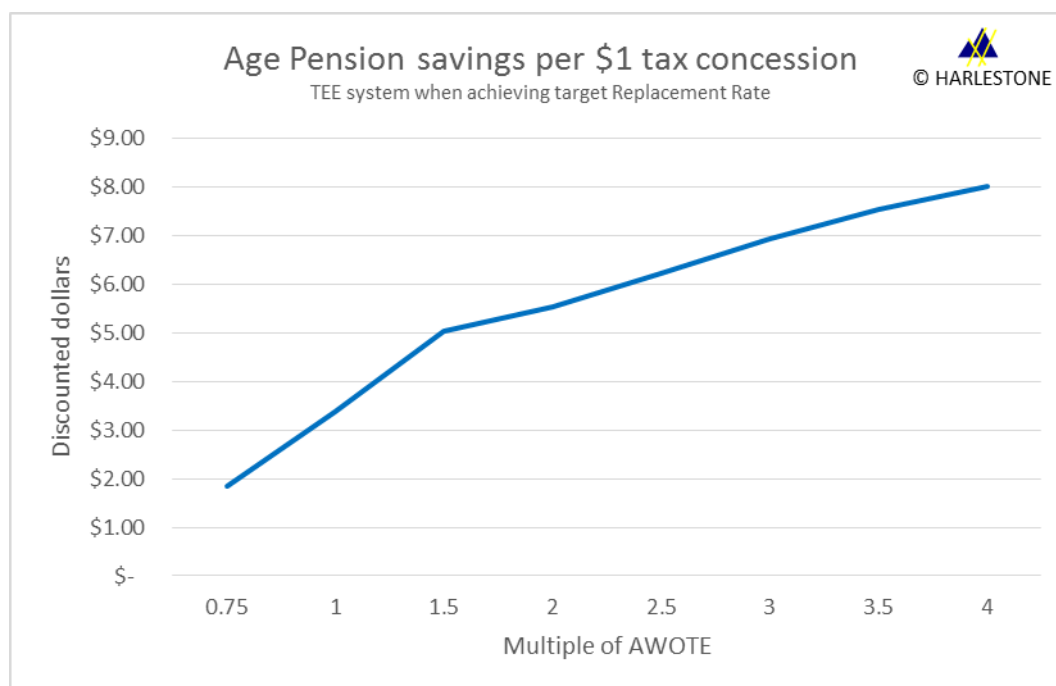
In theory, it seems ‘fair’ for contributions to be taxed at some progressive scale. However, this ignores the fact that— even after super contributions – our income tax system is one of the most progressive in the world. Introducing more progressive taxation of contributions would make this situation even worse and further impede the depressing effect of our income tax system on productivity.

At present, although 20% of taxpayers benefit from 57% of tax concessions (in dollars), these same taxpayers pay 64% of all income taxes. So their tax concessions are actually lower as a percentage of the taxes they pay.

So what is the solution?

Our proposal has a lower budget cost, is more tax efficient and could be introduced concurrently with an improvement to the income tax scales. Its efficiency is illustrated by the following graph which shows the savings in Age Pension costs for every \$1 of tax concession. It is evident from Graph 3 that at every level of income the 'return' on the Government's 'investment' is multiples of the cost of the tax concession.

Graph 3



We support the view that making our income tax system less progressive should encourage productivity.

As part of an overhaul of the tax system, we propose that progressive taxation of contributions be introduced as described above at the same time as reducing the progressivity of the income tax scale and removing taxation of superannuation earnings (TEE).

The restoration of the original system with tax-exempt superannuation earnings both pre and post retirement does not only have a dramatic impact on the accumulation of earnings but dramatically simplifies super fund administration leading to further improvements in super returns. Some argue that the introduction of Dr Henry's ideas as modified by us/Professor Freebairn is too difficult. We do not agree but suggest that this should be the challenge for the Government, with all its resources in policy analysis, to address with the support of industry and community groups. Let's see real reform that will improve the system for everyone, not just adding more taxes and making super even more complicated.

Our proposal would improve the efficiency of the superannuation tax system and, in the broader context of a fairer income tax system, improve the value of superannuation to more Australians and increase their engagement with the superannuation system.

Contact:

Duncan Fairweather
Executive Director
SMSF Owners' Alliance
dfairweather@smsfoa.org.au

0412 256 200