



The good, the bad and the likely

The 2016 Federal Budget is only a few months away. While tax reform is likely to be on the menu for Budget night, there are also other areas that are likely to be included, such as changes to retirement income streams. With no tax white paper set to be released prior to the release of the budget, we look at what topics are likely to be included in the Budget – and what areas of the economy the Government could reform.

Helping women back to work

Women have longer life expectancies than men, but lag behind in terms of retirement savings. The traditional role of women as the primary carer of the family is a key factor in lengthy career breaks. A lengthy career break affects earning power, and in turn the ability for many women to set aside funds for retirement. Inadequate retirement savings then lead to the need to rely on the Government for the Age Pension and subsidised aged care costs.

This will place a considerable burden on the Government in the coming years. One of the ways to help Australian retirees become self-funded – and less reliant on the Government, is by increasing workforce participation. It therefore makes sense that last year, the Government introduced its childcare reform package with the aim of increasing primary carers' participation in the workforce. While the package is gender neutral, in practice more women are likely to utilise the package.

The proposed childcare package will increase the cost to the Budget, as it is designed to provide a higher level of maximum childcare subsidy per child (\$10,000 per child as compared to \$7,500 today). It is also intended to provide more assistance to vulnerable children, children in disadvantaged communities and children with special needs.

The difficulty lies with how the package will be funded. The bulk of the costs require funding to be achieved by cuts to Government family payments. The Government has introduced legislation to reduce Family Tax Benefit B, and gradual phasing out of Family Tax Benefit Part A and B Supplements. While the legislation has passed the House of Representatives it is unclear whether the Bill will pass the Senate. Labor has been a staunch opponent of the proposed cuts and had successfully blocked past attempts to pass the changes to family payments. This means that the Government may not be able to deliver its childcare package.

A double dissolution may be a possibility if the Government continues to fail to pass key legislation, such as the childcare reform package. Although increasing workforce participation of secondary income earners through childcare is a worthwhile idea, the Government could also look at other measures.

The Government could consider introducing a tax offset for secondary income earners, linked to an activity test designed to encourage increased workforce participation. The offset is needed because the cost of childcare increases significantly when there is more than one child in childcare. The combination of current marginal tax rates and increasing childcare costs encourages secondary earners to reduce their working hours, as for some reducing their work hours actually result in a better financial outcome.

The table below provides a simple example of how the combination of tax and child care costs can negatively influence workforce participation. In this example, a woman with two children under the age of five in childcare and working full time earns \$70,000 before tax. Her net income after tax and



Medicare levy, childcare costs of \$100 per day for 48 weeks, and the child care rebate, is \$21,303. If she reduces her working days to 3 days per week, her net income after tax and childcare costs will be \$21,563. This means that there is no real difference between working five days or working three days. This type of outcome has led many women working fewer days per week, as working additional days does not improve their net position.

| Difference in net income based on the number of days worked | | | | | |
|--|------------------------|------------|--------------------------|-----------------------------------|--------------------------------------|
| No of days worked | Before tax salary (\$) | Tax and ML | Childcare net of subsidy | Net income after child care costs | Amount of foregone before Tax income |
| 5 | 70,000 | 15,697 | 33,000 | 21,303 | 0 |
| 4 | 56,000 | 10,867 | 23,400 | 21,733 | 14,000 |
| 3 | 42,000 | 6,037 | 14,400 | 21,563 | 28,000 |
| 2 | 28,000 | 2,422 | 9,600 | 15,978 | 42,000 |
| 1 | 14,000 | 0 | 4,800 | 9,200 | 56,000 |

The Government needs to consider the opportunity cost of foregone pre-tax income from secondary income earners reducing employment from five days to three. Using the earlier example, foregone income in this case is about \$28,000. That is the amount of income from which the Government could have derived some tax revenue. This can be used to help make up for revenue lost as a result of introducing the tax offset.

Increase saving and investing capacity by making housing affordable

While tax reform is an important factor in encouraging workforce participation, another important social and economic issue is the increasing cost of housing. If most of net household income is taken up by the cost of housing, then it does not leave much for savings and investment. Over the long term, this can reduce a person's ability to save for their retirement. According to ratings agency Moody's, Australians with two income earners spent an average of 29.3% of monthly income on mortgage repayments in October 2015, up from 28.2% from the previous year. The proportion of net income taken up by the cost of housing is worse in areas such as Sydney, where the average mortgage repayment takes up to 39.2% of a couple's monthly income

Factors that have been identified as leading to the deterioration of housing affordability range from lack of housing supply, increasing foreign ownership, to tax laws that favour property ownership. The Government has increased supply of land in high demand capital cities in the past few years, but this does not seem to have improved the issue. In capital cities such as Sydney, new land releases are far from centres of employment and lack transport infrastructure. This had led to more people entering the rental market, exacerbating the affordability problem.

A potential alternative to increase housing stock is to introduce measures that encourage senior Australians to downsize. Last year, reports by the Senate Economics References Committee and the Productivity Commission discussed the issue that many senior Australians are asset rich but income poor, with most of their wealth locked up in their principal homes. The Productivity Commission report



also noted that many senior Australians practice precautionary savings, where they spend very little of their retirement savings and Age Pension to save for a 'rainy day'. According to the data they collected, Senior Australians with smaller retirement savings spend the least (proportion wise) in comparison with those with more retirement savings. The concern raised is that this affects their standard of living. The report also noted that if more senior Australians decide to sell their homes and move to suitable alternative housing and release the equity in their homes, they can improve their standard of living.

If that is the case, why have Senior Australians refrained from downsizing? A key factor identified by both reports is the lack of suitable alternative accommodation in the area that they are living in. Senior Australians prefer to age in place, as they wish to retain access to family, friends and services. Other factors that may influence senior Australians against downsizing include an underdeveloped home equity release market, stamp duty as well as tax and social security policies as factors that favour staying at home.

The Government could work with the states and territories to find new, and novel, ways to improve housing affordability. Simply increasing the supply of land for housing may not be enough to promote housing affordability, as it does not necessarily result in the creation of the right kind of housing.

To create the right kind of housing, the Government could consider a pilot project where senior Australians living in high demand areas receive preferential tax and/or social security treatment on proceeds from the sale of their former home, provided that the home is sold to purchasers who will redevelop the land for suitable housing. Suitable housing can be housing for retirees, or housing schemes for low to medium income households. An example of such a scheme is the one currently operated by City West Housing, where eligible tenants (low to medium income households) have their rents capped to a certain percentage of household income.

Another alternative solution to improve housing affordability is reforming tenancy laws to allow for longer term tenancies. The Senate committee report highlighted that housing affordability is not merely about home ownership but also encompasses rental affordability. The observation was made that in Australia the system favours landlords rather than renters. Arguably in Australia there is a lack of security of tenure due to short fixed tenancy periods and the relative ease in which leases may be terminated by landlords. This is in contrast to some European countries such as Germany, where long term leases (such as 20 years or longer) are the norm. This, along with laws that provide better protection for renters, have helped to reduce the German populace's desire to own a home.

If the Government does not wish to change current tenancy laws, it could consider taking a more active role in public housing schemes. An example of a country where the Government has successfully done so is Singapore, where more than 80% of its residents are housed in Government public housing. In conjunction with the earlier idea of providing incentives to senior Australians to sell their homes to be redeveloped into suitable housing stock, the housing stock can be leased on a long-term basis to eligible groups such as first home buyers, low to medium income families, particularly households with critical occupations such as police and health workers. If successful, a way to help fund more projects in the future could be by collateralising the long term leases. Similar to a mortgage fund, the long term nature of the leases could be suitable for investors who prefer stable sources of income.

Reforms to retirement income streams



As super balances grow, more and more Australians are expecting super to be their main source of income in retirement. However, with Australians today expected to live well into their 80s, very few super balances will be able to support a full retirement. Government changes restricting Centrelink payments – such as the 1 January 2017 asset test changes – will only put more emphasis, and pressure, on retirees to fund their own retirement. It is vital that the Government implements measures to help retirees better manage their retirement savings.

The government has indicated (via their response to the Financial System Inquiry) that they support the development of a more comprehensive income stream. A comprehensive income stream offers not only the flexibility of present day account based pensions, but it will also offer better protection against longevity risk. This may involve pairing an account based pension with another income stream that restricts access to capital in exchange for income payable over the person's lifetime. This amount may be pooled with funds sourced from others (similar to how insurance funds work) and if the Government allows for lower minimum pension requirement, then the income stream will help to manage longevity risk.

The Government may introduce changes that could require superannuation trustees to offer a pre-selection option. This would involve trustees pre-selecting a comprehensive income stream for members, however the member has the option not to take it up and access their funds in alternate ways. A pre-selection option may be desirable for those with low levels of knowledge or interest.

The Government has indicated that legislation for consultation will be developed by the end of 2016.

Negative gearing

After increasing the GST was eliminated as an option to fund personal and company tax cuts ahead of the next election, the Government indicated that it is likely to limit the tax benefits of negative gearing where the level of benefit is considered excessive. No details have been released on what would be considered as excessive, or how they will trim back the concessions. Most of the discussion to date has been limited to negative gearing of real estate, as the Global Financial Crisis and recent global volatility dampened investors' appetite for gearing share portfolios.

The Labor party has announced that if elected, from 1 July 2017, they will limit the ability to deduct net rental losses against other income (such as wages), but only if losses arise from newly constructed housing. Existing property investments will be grandfathered.

Similarly, the Government may choose to limit changes to negative gearing to real estate investments. Alternatively the changes can be extended to all asset classes. Negative gearing can be limited by putting a cap on the number of properties eligible to benefit, by not allowing rental deductions to reduce non rental income, by putting a cap on the total amount of investment losses able to reduce non-investment income, or by limiting the amount of investment income subject to tax to 60% (as recommended in the Cooper review).

What is interesting is that the construction sector is a large employer, and any significant changes that impact this sector may lead to significant job losses. The Government has stated that one of the objectives of tax reform is to increase jobs. While it is likely that the Government will propose some changes to negative gearing, it is unlikely to target one specific area such as property.

Reduction of the CGT discount

Many have commented that the combination of negative gearing and the Capital Gains Tax (CGT) discount have distorted investment decisions to favour Australian property. What is the CGT discount?



It halves the amount of capital gains subject to tax, when incurred by individuals, partnerships or trusts.

Past Government reviews such as the Cooper Review have suggested reducing the discount to 40%. Despite these suggestions, the Government does not seem inclined towards changing the CGT discount.

Work related deductions

Similar to the negative gearing discussion, this is an area that has been flagged as one that is likely to change. The Henry review recommended that taxpayers be given a choice of a standard deduction to cover work-related expenses and the cost of managing tax affairs or full substantiation to claim actual expenses exceeding the limit. The standard deduction will also simplify tax reporting for most taxpayers.

The previous Labor Government had proposed to impose a cap of \$2,000 per annum on self-education expenses, but the subsequent Coalition Government chose not to implement the proposal. Electing to bundle all work related deductions into a standard cap would be less contentious than targeting specific types of expenses. What is unclear is whether the Government will mandate a standard deduction or allow higher claims provided that they are fully substantiated.

Increasing superannuation contributions and earnings tax

Super concessions have also been flagged as an area to be targeted. One idea involves increasing the rate of tax levied on pre-tax superannuation contributions. Currently, super contributions from pre-tax earnings such as Superannuation Guarantee and salary sacrifice contributions are subject to a concessional tax rate of 15% (or effectively 30% for high income earners earning over \$300,000).

It has been argued that a flat rate approach favours the wealthier end of town, and a more equitable method is to apply tax at the individuals' marginal tax rate and then reduce it by 15%. While this would be a boon for low income earners who would pay just 6 per cent tax on super, it would also see those on the highest marginal tax rate of 49 per cent pay 34 per cent tax on their super.

The issue with this approach is that there may be alternative investments that may be more attractive tax wise, and those investments are not subject to the same accessibility rules that apply to super funds. Benefits from negative gearing, dividend imputation and the CGT discount mean that investing in shares, managed funds or property may result in effective lower tax rates than the proposed taxation of super funds. Even insurance bonds are currently taxed at 30%, which is lower than the proposed 34% that will be paid by high-income earners.

If superannuation does not offer more attractive tax concessions than alternative investments, and the restrictions on accessing super remain, then it may no longer be an attractive vehicle to save for retirement. People may choose to divert their savings to alternative investments that can facilitate lower tax rates and allow them access to their investments. However, the super access rules were created for a reason, and that is to ensure that retirement savings are set aside until the person retires.

Any reform to taxation of super must consider any impact on investor behaviour and should not encourage an outcome that inadvertently promotes an over-reliance on the Age pension.

Superannuation concessional contributions cap



Another suggestion involves lowering the concessional contributions cap. Currently an annual cap of \$30,000 (\$35,000 for those turning age 50 or older) applies to contributions funded from pre-tax earnings. The idea involves lowering this annual cap to \$15,000 or even as low as \$11,000 per annum.

While these proposals have been projected to help the Government save approximately \$6 billion a year, it must be pointed out that the compulsory super system is relatively young. There are still many Australians approaching retirement who may need to 'catch up' on their super contributions.

A group that would be significantly affected by reducing the concessional cap is none other than women, particularly those who took on lengthy career breaks to assume the primary carer role. Statistics indicate that women tend to have less funds in retirement, but have longer life expectancy than men. Denying women the ability to catch up on superannuation contributions would appear contrary to the Government's desire for Australians to not rely on the Age pension.

Besides women, another group that would be disadvantaged by the reduction of the concessional cap would be the self-employed, whose work patterns tend to result in 'lumpy' patterns of contributions. Again, any changes to super contribution caps must not simply focus on funding tax reform, but also take into account the impact on social security and aged care.

Another idea that has been mentioned is a lifetime cap on superannuation contributions, rather than annual caps. A lifetime cap provides more flexibility for those with career breaks and lumpy contribution patterns. The challenge with a lifetime cap will be calculating an amount that works for both the Government and future retirees.

Tax on superannuation earnings

An alternative to increasing taxes on the way in, is to limit the tax concessions on superannuation earnings. The current system differentiates between earnings of superannuation funds while it is still in accumulation phase (not yet converted to a pension) and the earnings of superannuation when it has been converted to a pension. Superannuation pension earnings are exempt from tax, whereas superannuation funds in accumulation phase are taxed at a maximum of 15%.

The Cooper review recommended a 7.5% tax applying to earnings (including capital gains) of superannuation funds, regardless of whether the funds have been used to commence a pension. It also recommended removing the CGT discount for superannuation funds (currently superannuation funds in accumulation phase are only taxed on two thirds of capital gains when assets are held for 12 months or longer).

The final report resulting from the Financial System Inquiry (FSI) made observations that different tax treatment of superannuation during the accumulation phase and pension phase can result in sub-optimal investment behaviour, such as deferring investing until nearing retirement, rather than investing over the long term. An option considered in the report is aligning the earnings tax rate between the accumulation and retirement phases.

Another idea involves limiting the amount of tax concessions given to large superannuation pension balances. The previous Labor Government came up with the idea of taxing the earnings of super pensions once earnings exceed \$100,000. Again, the subsequent Coalition Government did not adopt this idea.

While this limits 'overly' generous tax concessions to those who arguably don't have as great need for it, in practice it would be quite difficult to administer, especially for large retail super funds. In addition,



fluctuating super balances due to market movements, and the ability for members to open multiple accounts to keep balances down may undermine the effectiveness of the proposal.

Applying the same tax rate to super funds regardless of the phase would certainly be simpler than trying to differentiate on the basis of super balances. The issue will be striking the right rate.

Increasing tax on superannuation payments

The Government may opt to increase tax on payments of super funds. The system at present is generous for those aged 60 and above, where no tax is levied on super payments from funds that have been subject to earnings tax. Some suggest that perhaps the time has come to review the generosity of this rule, and just as the qualifying age for the pension will progressively increase to age 67 for certain people, a similar progressive increase in relation to tax-free super payments could be considered.

For the time being, the treasurer has indicated that the Government is not seeking to impose tax on retirees accessing their superannuation funds.

The need for an integrated approach to tax reform

It is expected that the Budget will include changes to the taxation of super and investments. Whatever changes are proposed in the next months, there is little doubt that bold economic reform will be necessary eventually. The government should take the initiative to make innovative changes to help Australians save more for their retirement by making housing more affordable, and by helping women increase their workforce participation.