Fairness and flexibility:

Making superannuation work for low and middle income-earners

Submission to the Senate Select Committee on Superannuation's inquiry into Superannuation and standards of living in retirement

May 2002

ACOSS Paper No 123

- Although the Superannuation Guarantee fails to achieve comparable levels of income replacement for high income-earners, this is not an appropriate role for a compulsory savings regime. The Superannuation Guarantee nevertheless provides high income-earners with a decent absolute living standard in retirement, and they are in a strong position to save voluntarily to improve income replacement levels after retirement.

- It would be impractical to set different Superannuation Guarantee contribution rates for different groups in the population. The foregoing points suggest that the compulsory retirement savings requirement should be somewhat less than 9% of earnings.

- There is a strong case for broadening the scope of compulsory saving, and taxation support for saving, to long-term savings needs other than retirement. These long-term savings needs include home purchase, income maintenance while a parent withdraws from the paid workforce to care for a child, further education and training, and for low wage-earners the purchase of necessary assets such as cars and refrigerators (to help them avoid excessive debt levels).

- If an more broadly-based system of compulsory long-term saving were established along these lines, there would be case for raising the Superannuation Guarantee level above 9%, *provided the proportion of earnings required to be set aside for retirement purposes does not exceed 9%* (indeed, it should be less than this, at least for low income-earners).

- On the other hand, those savings still earmarked for retirement purposes should be more strictly preserved for that purpose. The present system inappropriately encourages early retirement and allows large lump sum retirement benefits. A more rapid increase in the preservation age, and tighter restrictions on lump sum retirement benefits are likely to be resisted by many people approaching retirement age. Allowing people to withdraw a part of their compulsory savings for purposes other than retirement (within in a carefully structured long-term savings system) could ease that resistance.

An integrated Lifelong Savings System

ACOSS proposes broadening the present superannuation system to embrace a wider range of long-term savings needs. This integrated *Lifelong Savings System* would include:

- compulsory long-term saving;

- taxation support for compulsory saving, and a modest level of additional voluntary saving, through the proposed Long-term Savings Rebate.

The proposed system would have following key features. It should be noted that the amounts used below (the Superannuation Guarantee level, and the ceilings on pre-retirement and post-retirement lump sum benefits) are illustrative only:

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[9] In respect of middle income-earners, this assessment is based on a presumption that a reasonable retirement income target for the *compulsory* savings system would imply a modest reduction in living standards after retirement. Those who wish to maintain *exactly the same* living standards after retirement as those enjoyed during working life (or more) can still save voluntarily to that end.

Low income-earners are disadvantaged by the present superannuation system in three ways: they are forced to set aside an excessive proportion of their limited earnings for retirement, they receive little taxation support for this, and a large part of the resulting increase in their retirement income is clawed back under the Age Pension income test.

Part 1: The taxation treatment of superannuation

1.1 On what basis should superannuation be taxed?

There are two alternative approaches that can be taken to taxing retirement savings: expenditure tax treatment or income tax treatment.

Some argue that *expenditure* (or consumption) tax treatment should apply.[13] Under "pure" expenditure tax treatment:

- existing taxes would be removed from *contributions* and personal contributions would be tax deductible;
- existing taxes would be removed from *fund earnings;*
- *benefits* would be taxed at standard personal income tax rates.

This is akin to taxing consumption rather than income.

The alternative approach is income tax treatment. Under "pure" income tax treatment:

- *contributions* would be made from after-tax earnings (so that employer contributions would be taxed in the hands of the employer at the appropriate marginal tax rate rather than a flat rate of 15% in the hands of the fund);
- *fund earnings* would be taxed at the appropriate marginal tax rate for each investor;
- *benefits* would not be taxed, at least until they are re-invested to yield an income stream.

This is akin to the current tax treatment of investments in bank savings accounts.

The present superannuation tax system is a hybrid in which tax applies at each of the three stages listed above[14]:

- Employer *contributions* are taxed at the flat rate of 15% in the hands of the fund, while other contributions made from after-tax income attract various tax concessions, and a 15% surcharge applies to contributions made on behalf of high income-earners;
- *Fund earnings* are generally taxed at the flat rate of 15%;
- *Benefits* are taxed at a range of different tax rates, depending on the mix of contributions from which they are derived, the form of benefit paid (lump sum or pension), and the overall level of the benefit.

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[13] Knox (1996), Fitzgerald (1996), ASFA (1998).

[14] For a more detailed description of the present system, see Attachment B.

1.2 Existing tax concessions for superannuation generally

The annual cost of superannuation tax concessions, based on an income tax benchmark, was estimated by the Treasury to be $9.5 billion in 2001-02[15] (Table 1). This is equivalent to around 60% of expenditure on Age Pensions, or all Federal Government expenditure on hospitals and ancillary health care services.

Table 1:

Tax concessions for superannuation in 2001-02

Contributions:	
flat 15% tax on employer contributions *	$4,530m
deduction for self employed/un-supported	$190m
10% rebate for low income earners	$15m
18% rebate for contributions on behalf of low income spouse	$10m
Sub-total:	$4,745m
Fund earnings:	
flat 15% tax on fund earnings *	$4,340m
Capital Gains Tax concessions	$370m
Sub-total:	$4,710m
Benefits:	
Under-taxation of un-funded lump sums (minus tax on funded benefits)	$30m
Total:	**$9,485m**

Source: Treasury, Tax Expenditure Statement (2001)

*Compared with a benchmark income tax at the marginal rate of each fund member, plus Medicare Levy.

Table 1 shows that the flat 15% taxes on employer *contributions* and fund *earnings* are the largest of these tax concessions. As we argue below, these flat taxes mean a large tax saving to individuals on the highest marginal income tax rates, but offer little relief from taxation for those on lower marginal tax rates. They are therefore highly regressive.

The major problem with the tax treatment of *benefits* is the excessively generous Reasonable Benefit Limits (RBLs), especially for lump sums. The present RBLs are $529,000 for lump sums and $1,058,742 for pensions.

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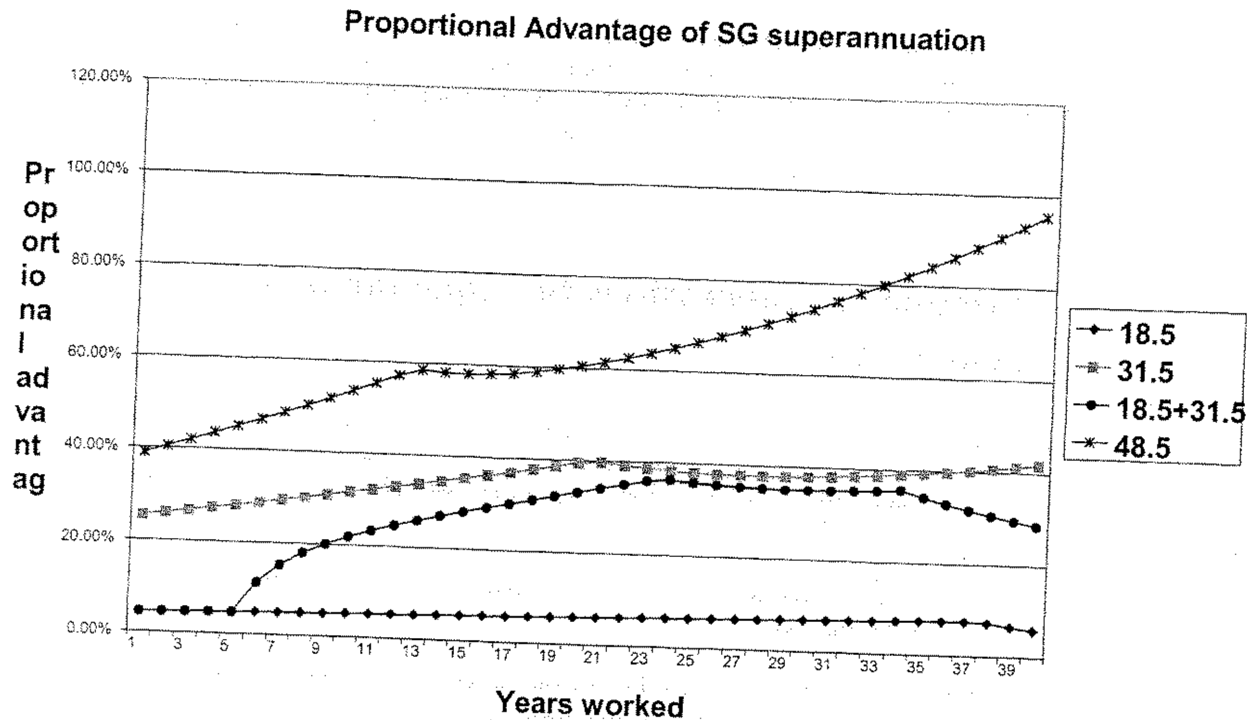
[15] Treasury, *Tax Expenditure Statement* (2001). Note that this is the estimated cost in a single year only. The cost over time is somewhat less than this, since tax concessions increase the value of superannuation assets, thereby boosting the future stream of fund earnings and benefits subject to taxation. For the purpose of tax expenditure analysis, it is not appropriate to take into account future Age Pension savings brought about by superannuation tax concessions, as some commentators have. This should be calculated separately as a future saving in Government expenses.

Graph 1



Source: Rothman G, Assessing the taxation advantages of superannuation. Retirement Income Modelling Group (2000).[16]

Graph 1 shows that:

- an individual on the top marginal tax rate throughout working life doubles his or her retirement benefit, due to the tax advantages of investing in superannuation;
- an individual on the lowest tax rate for the first five years, and the 30% rate thereafter, boosts his or her retirement benefit by about 30%;

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[16] This graph shows the relative tax advantage associated with employer superannuation contributions. It compares the retirement benefits obtained by individuals on different marginal tax rates from compulsory employer superannuation contributions (at the maximum superannuation guarantee level of 9% throughout working life) with those obtained from an alternative investment strategy in which the same amounts are invested (after tax) in a balanced portfolio that achieves the same rate of return (before tax). The graph shows the *net increase* in retirement benefits arising from investment in superannuation, compared with the alternative investment strategy.

It is assumed that all cases are within age contribution and RBL limits, and that all benefits are taken as a post-preservation age ETP and that the full 16.5% tax rate applies above the ETP tax free threshold (where the threshold applies). This under-estimates the relative tax benefits of superannuation. All taxes applying to superannuation and the alternative investment strategy are modelled, including taxes on contributions, investment income, and benefits.

The various lines refer to the marginal personal income tax rate of the person , with say, 31.5, meaning this marginal tax rate applies throughout the persons working life. The 48.5 line has the person paying this marginal tax rate and the full surcharge throughout their working life. The 18.5+31.5 case has the person on the 18.5% marginal personal tax rate for the first 5 years of their working life, followed by 30 years of work at 31.5%, and the rest of working life at 18.5%.

- an individual on the lowest marginal tax rate throughout working life rate boosts his or her retirement benefit by less than 10%.

The greater proportional advantage accruing to high income-earners is not due to the fact that high income-earners invest more dollars in superannuation.[17] Rather, it reflects the regressive character of the tax subsidies for superannuation. The principal culprits are the flat 15% taxes on employer contributions and fund earnings, which account for over 90% of the total cost to revenue of all superannuation tax concessions.

1.3 Existing tax concessions for superannuation contributions

We focus in the remainder of this part on tax concessions for *contributions* on the grounds that:

- These tax subsidies are among the most inequitable, wasteful and complex of all superannuation tax concessions.
- They cost $4.7 Billion per annum in 2000-01, roughly half the overall cost of superannuation tax concessions in that year.
- They undermine the integrity of the Pay As You Go personal income tax system by encouraging tax avoidance through salary sacrifice arrangements.
- It is possible to replace them with a more equitable system without increasing the complexity of the system.[18] In particular, there would be no need for grand-fathering arrangements.

There are currently five different tax treatments for superannuation *contributions*, depending on the source and destination of the contributions:

1. *Employer* contributions are generally made from *before-tax* earnings and taxed at the flat rate of 15% in the hands of the fund.
2. *Employee* contributions are generally made from *after-tax* earnings and attract a small rebate of 10% of contributions up to $1,000 annually for employees with incomes below $31,000 per annum.
3. Contributions by *self employed* people (and employees who receive minimal employer superannuation support) are generally made from after-tax earnings and attract a full tax deduction for contributions of up to $3,000 per annum, and a 75% tax deduction for additional deductions up to the *Maximum Deductible Contribution* limits described below.
4. Contributions made on behalf of a *low-income spouse* are generally made from the after-tax income of a higher-income partner, who is entitled to a tax rebate of 18% for contributions of up to $3,000 per annum.

[17] The higher absolute level of saving by high income-earners is not measured in the Graph.

[18] The proposed reforms would greatly simplify the tax treatment of superannuation contributions and render the public subsidies involved more transparent.

5. Contributions made by or on behalf of an *individual on a very high income* attract a maximum additional surcharge of 15% (where the individual has an income above $104,000 per annum) or a lesser proportion where his or her income falls between $85,000 and $104,000 per annum.

In addition, employer contributions up to the following annual *Maximum Deductible Contribution* limits are treated as a business expense and therefore attract a tax deduction in the hands of the employer [19]:

- for individuals up to 35 years old, $11,912
- for individuals from 35-49 years old, $33,087
- for individuals 50 years or over, $82,054.

By far the most costly of these five tax concessions is the flat 15% tax on employer contributions. This costs the Federal Budget $4.5 Billion in 2000-01, out of a total of $4.7 Billion for all tax concessions for superannuation contributions. In the following discussion of the equity, adequacy, efficiency, and complexity of existing tax subsidies for superannuation contributions, we focus mainly on the flat 15% tax on employer contributions.

Equity

The present flat rate tax on employer contributions is an upside-down tax subsidy. Due to the way in which it interacts with our progressive personal income tax system, it provides up to fifteen times the level of public support for superannuation saving (per dollar contributed) for high income-earners, than for low income-earners.

The effect is akin to replacing the present progressive tax system with a flat 15% tax.

This is illustrated in **Table 2**. Although the superannuation surcharge claws back some of this tax subsidy for individuals on very high incomes (above $85,242), it only reaches its peak level of 15% once a tax-payer earns more than $103,507. In 1998, less than 3% of wage-earning tax-payers earned more than $85,000 and less than 2% earned more than $103,507. [20]

Even where the surcharge applies at its maximum rate of 15%, the tax subsidy is higher per-dollar invested than that available to either low or middle income-earners.

[19] Further, FBT does not apply to superannuation contributions.

[20] Taxation Statistics (1998-99).

Table 2

Effective tax subsidy per dollar of employer contributions

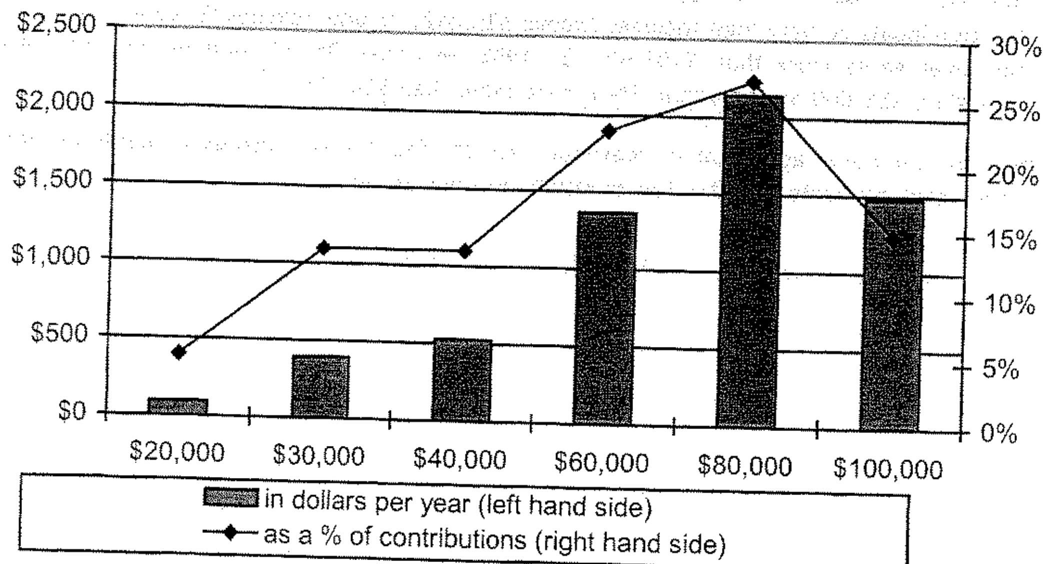
Income	$6,001-$20,000	$20,001- $50,000	$50,001- $60,000	$60,001- $85,242	$103,507+
Marginal tax rate[21]	17-18.5%	31.5%	43.5%	48.5%	48.5%
Tax subsidy per dollar contributed	2-3.5 cents	16.5 cents	28.5 cents	33.5 cents	18.5 cents

Graph 2 shows the distributional effects of two of the current tax concessions for superannuation contributions:

- the flat 15% tax on employer contributions; and
- the 10% rebate for personal contributions by low income-earners.

The graph is based on the hypothetical example of individuals on different income levels who receive 8% of earnings in employer contributions and contribute another 2% themselves. It understates tax concessions for superannuation - especially for high income-earners - since it ignores the benefits of the flat 15% tax rate on fund earnings.

Graph 2



Source: ACOSS calculations[22]

[21] Includes Medicare levy. Many tax-payers on the lowest marginal tax rate are exempted from the levy.

The outcomes are that:

- A tax-payer on $20,000 saves just $96 per annum in tax, or 5% of contributions;
- A tax-payer on $40,000 saves $528 per annum in tax, or 13% of contributions;
- A tax-payer on $80,000 saves $2,144 per annum in tax, or 27% of contributions;
- A tax-payer on $100,000 saves $1,480 per annum in tax, or 15% of contributions.

The flat 15% tax on employer contributions skews the tax subsidies per-dollar-contributed towards those on higher incomes. The surcharge injects an element of equity into the system, but it only effects the top 3% of wage-earners. Moreover, even a high income-earner paying the full 15% surcharge is likely to receive a greater public subsidy per-dollar-contributed than an individual on an average full-time wage.

We estimate that roughly half the $4.7 billion of annual tax concessions for contributions accrues to high income-earners:

- More than half accrue to tax-payers on incomes of $50,000 or more (the top one sixth of employees and self employed people receiving superannuation contributions).
- More than one third accrue to those on $60,000 or more (the top one tenth).

The present system of tax subsidies for superannuation contributions has other inequitable features:

- There is a strong tax bias in favour of salary sacrifice arrangements (in which earnings ordinarily taxed at the appropriate marginal rate are converted into employer superannuation contributions taxed at a flat 15 or 30%). This favours high income-earners since relatively few people on low to middle-incomes have access to salary sacrifice arrangements. It also disadvantages self-employed people, except those who restructure their affairs through private companies to pay themselves a salary.
- The rebate for spouse contributions mainly benefits men on high incomes who can afford to make contributions on behalf of their partner. It is of no benefit to the majority of married women on low incomes because their partners usually have modest incomes.[23] Encouraging contributions from spouses cannot resolve the inequities associated with the disadvantaged position of women in the paid workforce. This problem is best resolved by increasing women's earnings over the life cycle, improving tax support for superannuation saving by low paid workers generally, and improving the Age Pension.

On equity grounds, tax subsidies for superannuation should offer *at least the same level of support per dollar contributed* to people on low incomes as that available to those on higher incomes.

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[22] Assumptions: All tax-payers receive 8% contributions from employers and contribute an additional 2% themselves. Current income tax scale applies.
Current tax treatment of contributions: Employer contributions taxed at 15% (30% for incomes above about $100,000). Employee contributions attract a rebate of 10% up to $1,000 of contributions, restricted to tax-payers on less than $31,000.
Note: This graph does not take account of the tax concessions for superannuation fund earnings or benefits, which are also very generous for high income-earners. For example, there is a flat rate tax of 15% on fund earnings instead of the much higher marginal tax rate that would otherwise apply to high income-earners. It therefore considerably under-states the overall tax subsidies available to high income-earners.

[23] Richardson S (1998).

Indeed, equity principles suggest that in overall terms, public retirement income subsidies should be:

- *higher as a proportion to income for low income-earners*, to help them achieve a minimum income level after retirement that is consistent with a decent standard of living;
- *capped in the case of high income-earners* so that the public purse does not subsidise luxurious levels of retirement income, or large bequests.

Some argue that it is the function of the Age Pension, not superannuation tax concessions, to inject equity into public support for retirement incomes. According to this view, these two elements of the of the retirement income support system have different functions. The Age Pension is designed to place a floor under retirement incomes. It is therefore targeted towards those with the lowest retirement incomes. Tax concessions cannot replicate this function since their purpose is to support compulsory saving and encourage voluntary saving. Therefore, these two elements of the system should be targeted differently.

This argument makes sense. However, it does not logically follow that superannuation tax concessions do not have to be equitable, or that the Age Pension alone should shoulder the responsibility for ensuring that retirement income subsidies are fairly distributed. Each element of the retirement income support system should be designed in an equitable way. Moreover, as we argue below, it is also economically efficient to target superannuation tax concessions towards low and middle-earners.

There is no sound policy reason to offer large tax subsidies to high income-earners to save through superannuation, as we presently do.

Adequacy

We comment in more detail on retirement income adequacy in the Part 2 of this submission. Here we briefly examine the role of Maximum Deductible Contribution limits and Reasonable Benefit Limits and in capping the overall annual and lifetime value of superannuation tax concessions

The Maximum Deductible Contribution limits cap the value of annual tax deductions for employers making contributions on behalf of each of their employees, and those for self employed people making personal contributions. In theory, they cap the value of tax concessions in order to ensure that luxurious retirement living standards are not publicly subsidised. However, in practice they are well in excess of the benefits or contributions required to achieve a decent retirement income.

The present maximum contribution limits for persons aged less than 35, 35-49, and 50 or above are equivalent to 28%, 78%, and 193% (respectively) of average ordinary-time earnings.

The maximum contribution limit for a person aged 35-49 years would (over a period of 40 years) yield a retirement income of well over twice average earnings - an income level only attained by the top 5% of wage-earning tax-payers.

The Reasonable Benefit Limits (RBLs) for lump sums and pensions were described above. These limits do little to constrain the overall level of tax subsidies for superannuation. The RBL for pensions - $1,058,742 - would yield a retirement income above average earnings for a single male.

The generosity of the present tax subsidies available to high income-earners cannot be justified on the grounds that they are needed to ensure an adequate income in retirement. In particular, tax subsidies for superannuation contributions should be capped at a much lower level.

Efficiency

By "efficiency" we mean the cost-effectiveness of tax concessions in boosting private saving (including consideration of transaction costs), and the avoidance of undesirable distortions to business and investment decisions.[24]

Those features which make the present tax concessions inequitable - especially their targeting in favour of high income-earners - also render them inefficient.

The flat 15% tax on employer contributions is inefficient and wasteful as a subsidy to support and encourage retirement saving because (as noted above):

- Most high income-earners are likely to save for retirement and achieve an adequate post-retirement income without tax incentives.[25]
- They are unlikely to be entitled to an age pension on retirement.

Indeed, many of the current generation of self-styled "independent" or "self funded" retirees have received more in superannuation tax subsidies over their lifetime than they would have received in retirement on the maximum rate age pension. This is due to the generosity of the current tax concessions for high income-earners and the even more generous arrangements that applied before 1983.[26]

It might be argued that tax incentives for superannuation contributions are not needed at all since 9% of earnings will soon be compulsorily saved for retirement purposes. We do not agree. It would not be fair to force employees to forego a significant part of their past and future wage increases[27], in the absence of public subsidies for saving through superannuation. Under these circumstances, public support for the Superannuation Guarantee would be jeopardised, despite the fact that a higher level of compulsory saving would be required to achieve the same retirement income target in the absence of tax subsidies.

Therefore, the tax system should support compulsory long-term saving.

[24] The latter issues are addressed in the next section of this submission.

[25] High income-earners are very likely to save to achieve an adequate income in retirement in the absence of these concessions, whether through superannuation or otherwise. Their main effect on private saving decisions is likely to be to shift the savings of high income-earners from other vehicles to superannuation. See Edey & Britten-Jones (1990), Fitzgerald & Harper (1992), Gravelle (1991).

[26] This tax treatment still extends to benefits arising from pre-1983 contributions. Only 5% of such benefits are normally taxed, a far more generous system than the present tax treatment of benefits.

[27] Although Superannuation Guarantee contributions are nominally paid by employers, most of this cost is probably borne ultimately by employees in the form of lower wage increases. See Freebairn (1997).

It should also modestly support voluntary saving beyond compulsory saving requirements. This is also controversial. As argued above, voluntary savings incentives are likely to have little impact on aggregate private saving levels. Instead, they mainly encourage people to shift their savings into the most tax-preferred vehicles. This is especially so among high income-earners.

Nevertheless, tax incentives have a modest role to play in encouraging voluntary saving, provided they are properly targeted to those with the lowest propensity to save: low and middle income-earners.

As we have shown, the present system targets tax subsidies towards high income-earners. However, an optimal tax incentive to boost saving for retirement (or long-term saving generally) is one that:

- offers a higher subsidy per-dollar-invested for low and middle income earners than for high income-earners;
- is capped to prevent wasteage of public revenue on excessive subsidies for high income-earners (who are more likely to save anyway);
- supports compulsory saving;
- treats contributions from different sources consistently;
- is paid into the fund rather than being returned to the tax-payer each year, so that it directly boosts long-term saving.[28]

Simplicity and transparency

The present system of tax subsidies for superannuation contributions is extraordinarily complex, with five different tax treatments according to the source and beneficiary of the contributions.

The ultimate source of this complexity is the fact that employer contributions can be made from pre-tax income while other contributions are generally made from after-tax income. As long as this inconsistency remains, it is not possible to equalise the tax treatment of different contributions without allowing full income tax deductability for non-employer contributions (which would be very costly and mainly benefit high income-earners).

This inconsistent tax treatment of contributions means that:

- Employees have strong incentives to enter into salary sacrifice arrangements;
- Self employed people have strong incentives to incorporate so that they can pay themselves a wage and sacrifice part of this for superannuation contributions.

Business structures and decisions are thereby distorted by the tax treatment of superannuation, to the detriment of economic efficiency. Moreover, these distortions (such as salary sacrifice arrangements) add to transaction costs.

A more serious problem is that the majority of superannuation fund members do not understand how superannuation tax concessions work, or the extent to which they benefit from them.

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[28] A further problem with the present tax treatment of superannuation from an efficiency perspective relates to the treatment of lump sum benefits. The high Reasonable Benefit Limit for lump sum retirement benefits (currently $529,000) encourages the "leakage" of retirement saving through large lump sum payments.

There would be few examples of social programs on which the Government spends almost $5 billion per annum, yet most of the beneficiaries are unaware of it.

A simpler and more transparent system of tax concessions for superannuation contributions would improve public understanding and debate on their design and distribution, reveal any excessive subsidies to the well-off, strengthen public support for compulsory superannuation contributions, and encourage more low and middle income-earners to contribute voluntarily. It is also likely to attract broad popular support

1.4 A Long-term Savings Rebate

ACOSS proposes a restructure of the present tax treatment of superannuation contributions along the following lines. The key feature of the proposed system is the introduction of a Long-term Savings Rebate to replace all existing tax concessions for contributions:

1. Employer contributions would attract personal income tax in the hands of employers (through the Pay As You Go system) before they are transferred to the fund. Existing taxes on these contributions in the hands of the fund (the 15% contributions tax and the superannuation surcharge) would be abolished.

2. A new *Long-term Savings Rebate* would be introduced to replace all existing tax concessions for superannuation contributions. This would be paid into the relevant superannuation fund at the end of every tax year.

3. Contributions would attract the same annual rebate of tax regardless of their source, the income level of the individual concerned, and whether they are compulsory or voluntary.[29] The existing low-income employee contributions rebate, deductions for self employed people, and spouse contributions rebate, would be abolished.

4. The new rebate would be a percentage of contributions rather than a flat rate. The percentage would be high enough to support compulsory superannuation saving and encourage voluntary contributions, without raising the overall cost of tax concessions.

5. The rebate would be capped on a flat dollar basis (not in proportion to individual earnings), to limit tax subsidies for high income-earners. The cap should be high enough to encourage low and middle income-earners to make voluntary contributions (beyond Superannuation Guarantee levels). It should be low enough to sharply reduce the generous tax subsidies for high income-earners, in order to ensure that the changes are revenue neutral in overall terms.

6. The proposed rebate would have two tiers. At low contribution levels it would be a co-contribution. Above that, a rebate would apply up to the cap described above. For example, the Rebate could be 100% of contributions up to 0.5% of average weekly ordinary time earnings (AWOTE), plus 20% of additional contributions up to 11% of average earnings.[30]

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[29] In the case of defined benefit funds, a similar actuarial methodology to that which is currently used to calculate superannuation surcharge amounts could apply.

[30] Since AWOTE was approximately $43,000 in February 2002, these contribution levels are currently $215 and $4,730 respectively. The 11% of average earnings is based on the 8% Superannuation Guarantee plus 3% to encourage voluntary saving. On his basis, the cap would rise to 12% of AWOTE once the Superannuation Guarantee requirement reaches 9% of earnings.

7. The present tax treatment of fund earnings and benefits could remain in place. *This means that the tax treatment of superannuation would still be highly concessional for high income-earners, due mainly to the flat 15% tax on fund earnings.*[31]

8. The current tax treatment of benefits would also remain in place, except that lump sum retirement benefits above the level of the tax-free threshold for such benefits (currently $106,000) would either be prohibited or taxed at a penal rate. This would reduce "leakage" of retirement savings and encourage greater use of complying pensions.

The example of a Long-term Savings Rebate described in point 6 above is only illustrative. The rebate could be targeted differently. By increasing the percentage and reducing the cap, it could be targeted more towards low income-earners. By lowering the percentage and raising the cap it could be targeted more towards higher income-earners.

Significantly, the new arrangements would only apply to contributions made after the date of their implementation. There would be no need for any grand-fathering arrangements.

A reform in which the present tax concessions for contributions were replaced by the illustrative Long-term Savings Rebate described above would be broadly revenue-neutral.

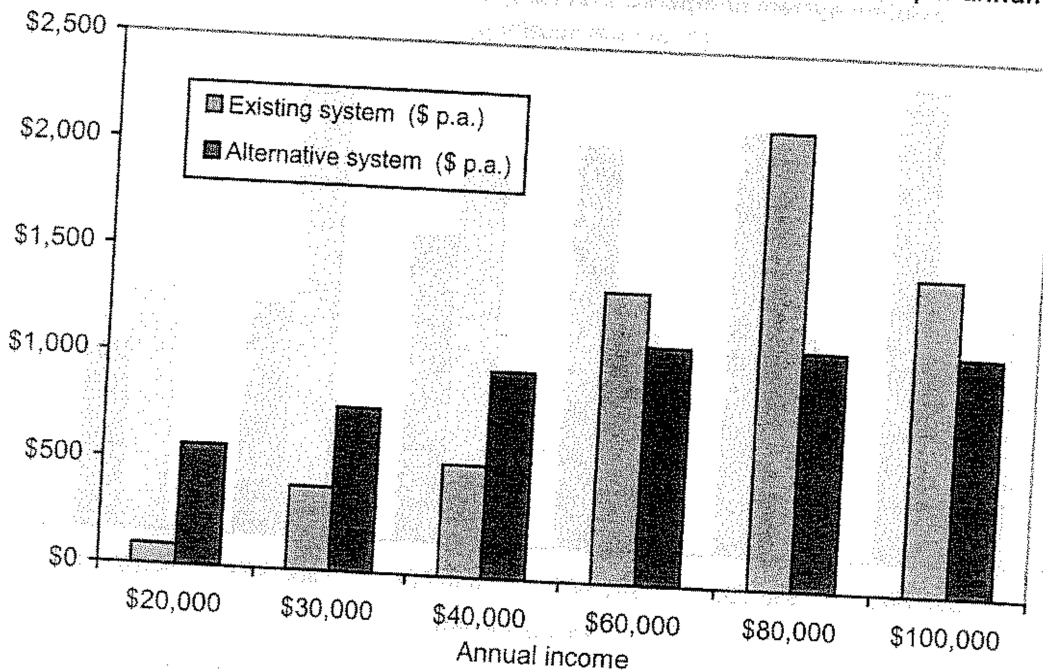
Equity effects of the proposed system

Graph 3 compares the annual dollar value of the illustrative Long-term Savings Rebate with the tax concessions for contributions available under the present system. The underlying assumptions are the same as for Graph 2 above.[32] *It should be noted that this understates the value of superannuation tax concessions - especially for high income-earners- since it ignores the highly concessional tax treatment of fund earnings.*

[31] Its cost to revenue is equivalent to that of the concessional 15% tax rate on employer contributions.

[32] That is, each tax-payer receives 8% of earnings in employer contributions and makes voluntary contributions of 2% of earnings.

Graph 3:



Source: ACOSS calculations. [33]

Graph 4 makes the same comparison. However, here the annual tax subsidy is expressed as a proportion of contributions. Since in this hypothetical scenario contributions are 11% of income in all cases, this graph measures the *progressivity* of the existing system and the illustrative Long-term Savings Rebate:

- Under a *progressive* tax treatment of superannuation contributions, the tax subsidy would fall (in proportion to income) as income rises. *The ACOSS illustrative proposal is progressive.*
- Under a *regressive* tax treatment of superannuation contributions, the tax subsidy would rise (in proportion to income) as income rises. *The existing system is regressive.*

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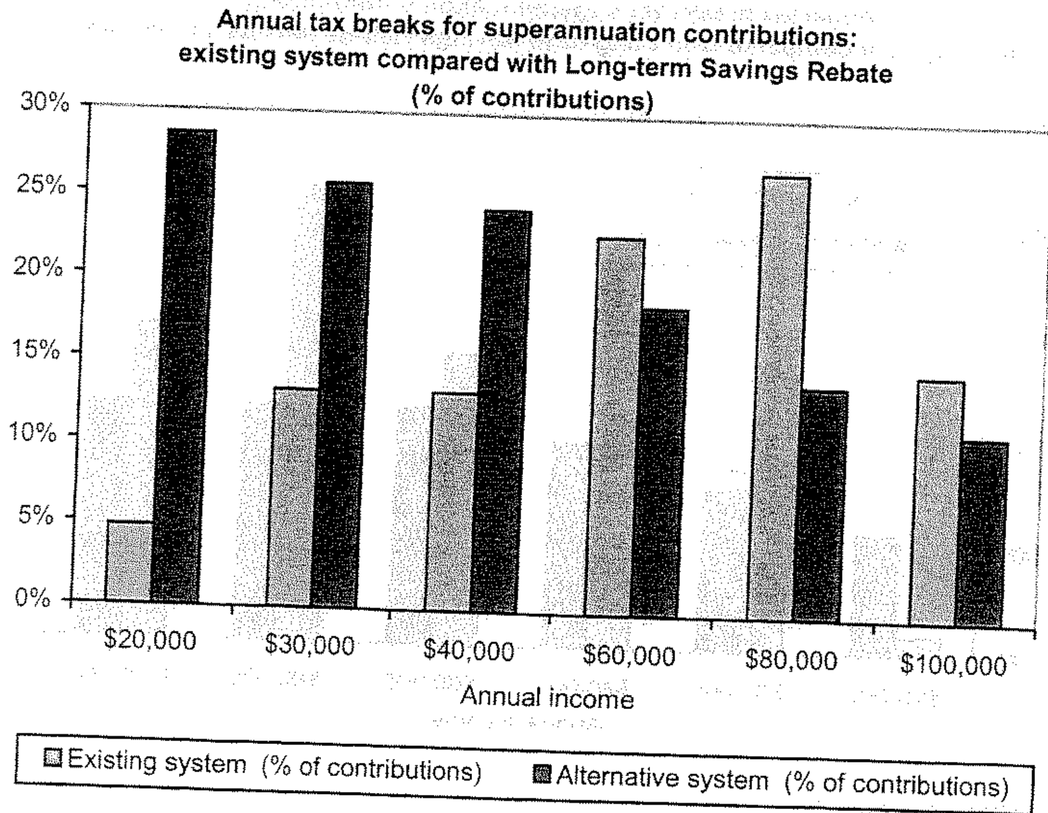
[33] Assumptions: All tax-payers receive 8% contributions from employers and contribute an additional 2% themselves. Current income tax scale applies. AWE was $43,000 in February 2002.
Current tax treatment of contributions: Employer contributions taxed at 15% (or 30% for incomes above about $100,000). Employee contributions attract a rebate of 10% up to $1,000 of contributions, restricted to tax-payers on less than $31,000.
Proposed tax rebate: The proposed rebate is set at 100% of all contributions up to 0.5% of average full-time earnings ($215 in 2002), plus 20% of additional contributions up to an annual limit of 11% of average earnings ($4730 in 2002). It replaces the above tax concessions for contributions (employer contributions are taxed through the PAYG system at the relevant marginal rate of income tax).
Note: This graph does not take account of the tax concessions for superannuation fund earnings or benefits, which are also particularly generous for high income-earners. For example, there is a flat rate tax of 15% on fund earnings instead of the much higher marginal tax rate that would otherwise apply. This means that although the proposed system would reduce tax concessions for high income-earners significantly, it would still offer them substantial incentives to save.

Graph 4



Source: ACOSS calculations

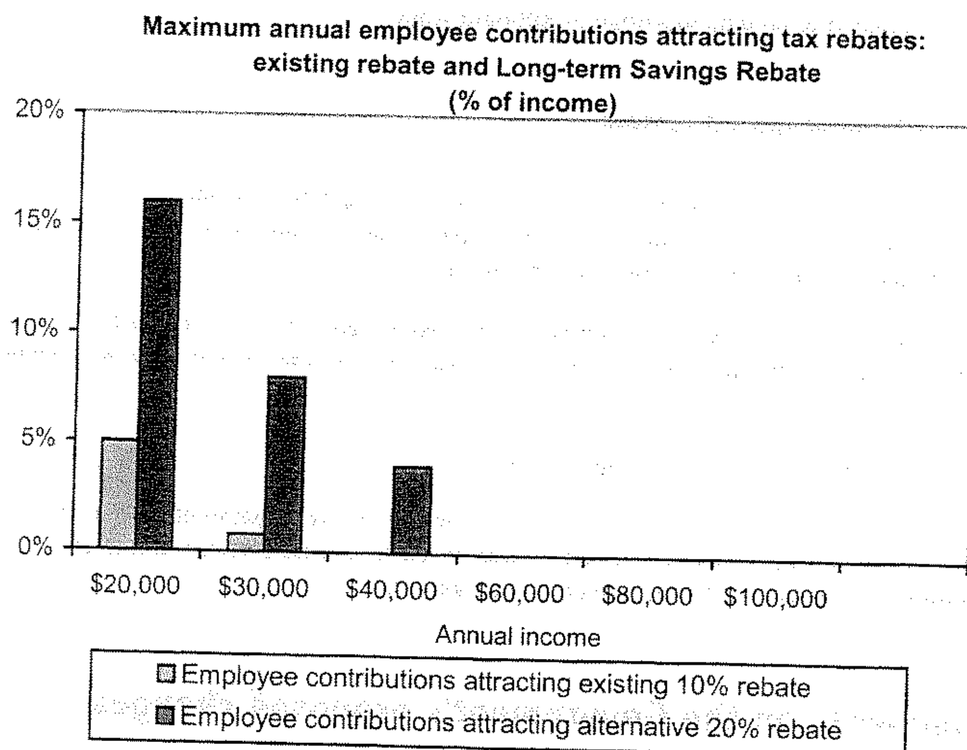
Incentive effects of the proposed system

Graph 5 gives an indication of the effect of the present system[34] and the illustrative Long-term Savings rebate on incentives for voluntary saving by employees. It shows the maximum level of *voluntary* contributions[35] that would attract the current 10% rebate for employee contributions and the proposed 20% Long-term Savings Rebate. These maximum contribution levels are expressed as a percentage of gross earnings.

[34] Specifically, the existing 10% rebate for employee contributions.

[35] Beyond Superannuation Guarantee levels, that is 8% of earnings.

Graph 5



Source: ACOSS calculations[36]

This graph shows that the proposed rebate would provide much more generous support for voluntary contributions made by low income-earners than the present system:

- In the case of a person on $20,000 voluntary contributions of up to 16% of income would attract the Long-term Savings Rebate, compared with 5% under the present system.
- In the case of a person on $30,000 voluntary contributions of up to 8% of income would attract the proposed rebate, compared with 1% under the present system.
- In the case of a person on $40,000 voluntary contributions of up to 4% of income would attract the proposed rebate, compared with no support at all from the present system.
- In the case of a person on $60,000 or more, no voluntary contributions would attract the proposed rebate, as is the case under the present system.

In theory, the present system offers additional support for voluntary contributions under salary sacrifice arrangements. In practice, as argued above, this is largely confined to high income-earners.

As Graph 5 shows, the proposed Rebate would efficiently target incentives for voluntary saving to people on low and middle incomes - the groups with the lowest propensity to save in the absence of tax incentives. This is the outcome of applying a flat dollar contributions cap to the proposed rebate. As income rises, compulsory superannuation guarantee contributions would make up a

[36] Assumptions are the same as for Graph 3 above. Note that compulsory superannuation guarantee contributions are also subsidied by the proposed Rebate, though this is not shown here.

higher proportion of rebateable contributions (100% in the case of a person on $60,000 or more). This would leave less scope for the subsidisation of voluntary saving. Of course, the level of the cap could be varied to target this savings incentive in different ways.

Overall effects of the proposed system

In overall terms, the proposed Long-term Savings Rebate would target tax subsidies more equitably and efficiently (towards people on lower incomes), reduce waste, and inject an element of simplicity and transparency into the superannuation system.

The illustrative Long-term Savings Rebate described above would leave the vast majority of people earning less than $60,000 better off[37], without any additional cost to Government since it is broadly revenue-neutral.

However, it could be targeted in different ways, if desired.

It is important to note that in the above graphs, we only model the tax treatment of contributions. *Since the flat 15% tax on fund earnings would remain in place, superannuation would still be an attractive long-term savings vehicle for many high income-earners.*

1.5 Comments on the Government's proposed changes

We comment briefly here on four of the Government's proposed changes to the tax treatment of superannuation:

- to reduce the superannuation surcharge for high income earners;
- to allow couples to split superannuation contributions;
- to replace the rebate for contributions by low income employees;
- to require employers to make quarterly superannuation guarantee payments based on quarterly earnings.

Superannuation surcharge reduction

The Government proposes to reduce the superannuation surcharge for contributions made on behalf of high income-earners (those on more than $85,000 per year) from a maximum of 15% down to 10.5% over the next 3 years, at a cost to revenue of $200 million annually by 2005-06.

This proposal is simply a tax cut for high income-earners. Only the 5% of wage-earning tax-payers on more than $85,000 would benefit.

The proposal does not resolve the inequities of the present tax treatment of superannuation, or the complexity and high administration costs associated with the surcharge.

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[37] See Graph 3 above.

We do not support alternative proposals to reduce the tax rate on employer contributions generally, as this would neither improve equity nor reduce revenue wasteage within the present tax treatment of superannuation.

Either the system should be fundamentally reformed along the lines proposed above, or the 15% surcharge should remain in place.

Splitting of superannuation contributions

The Government proposes that superannuation fund members be allowed to split their contributions with their spouse, thereby potentially doubling their Reasonable Benefit Limits (RBL).

This would mainly benefit high income-earners who are in the best position to afford to split their contributions and have the strongest incentive to do so (as they approach RBLs).

ACOSS opposes this proposal. Instead, a two-tier Long-term Savings Rebate along the lines proposed above would substantially benefit low wage-earners, the majority of whom are women. It would also assist more women to achieve a greater degree of financial independence from their partners.

Replacement of rebate for low income-earners

The Government proposes to replace the present 10% rebate for personal contributions of up to $1,000 per year by individuals earning less than $31,000 with a matching co-contribution of $1,000 for those earning less than $20,000 (falling to zero at an income of $32,500).

Although a co-contribution of up to $1,000 is much more generous than the present 10% rebate the maximum amount will apply to much fewer employees so that the Government anticipates saving $10 million per year as a result of this change.

If a co-contribution is to be introduced, it should extend higher up the income scale, and should be fully funded by reducing tax concessions for high income-earners.

Quarterly Superannuation Guarantee contributions

The Government proposes that employers make superannuation guarantee contributions on a quarterly rather than an annual basis, but that the income threshold above which these must be made be liberalised. Instead of a threshold of $450 per month, a threshold of $1,350 per quarter would apply.

This has the potential to disenfranchise large numbers of part time and casual workers, as employers could manipulate rosters to avoid their superannuation guarantee obligations.

On the other hand, a system of quarterly payments based on monthly income is supported, as this would help improve compliance with superannuation guarantee obligations.