

Superannuation: don't kill the goose that lays the golden egg

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Abstract: The taxation of superannuation arrangements in Australia has undergone many changes, particularly since 1983. In the lead-up to the federal Budget in May 2013 and the federal election in September 2013, there are rumours of further changes to come. This article examines some of the policy considerations underlying changes which may be considered by the government. The article considers the policy context, the place of superannuation as a component of household wealth, the fiscal context, superannuation as a “cash cow” for government, and the tax expenditures argument. The author argues against any further changes being made to the superannuation rules and presents reasons which support this position.

Introduction

It is a constant source of amusement, surprise and frustration to me — as I am sure it is for many practitioners and their clients — as to why governments in Australia cannot seem to leave the taxation arrangements which apply to superannuation alone for any period of time.

In the course of writing this article, I had occasion to examine various chronologies of superannuation and retirement incomes in Australia and I was astounded at the number of changes that have occurred to the superannuation rules in Australia.¹ If one were to print a chronology — and then limited it only to changes that have occurred since 1983 when lump sum taxes were introduced — it would run to several pages and, while these changes are too numerous to detail here, some of the “highlights” include the introduction of lump sum taxes in 1983, the imposition of a 15% tax on superannuation contributions by employers and on superannuation earnings in 1988 through to my favourite — the so-called “Simpler Super” reforms of 2006, which some would regard as an oxymoron! These reforms included exemption from tax on end benefits for Australians aged 60 or over and the abolition of reasonable benefit limits accompanied by the introduction of superannuation contribution caps or limits.

The contribution caps have proved to be a sting in the tail of the Simpler Super reforms because a person who has concessional contributions in excess of the annual cap amount is liable to pay

“excess contributions tax”,² with the effect that the excessive amounts are subject to total tax of 46.5% (15% + 31.5% excess contributions tax). More people are likely to be subject to excess contributions tax given that, in recent times, there has been a large reduction in the concessional superannuation contributions caps, down from \$50,000 (and as much as \$100,000) to only \$25,000 from 1 July 2012.³

In February 2013, consulting group Mercer released a report (the Mercer report) which compared Australia's superannuation tax rules with those applicable to retirement savings in eight other countries with world-class retirement savings.⁴ The report concluded that the current Australian contribution caps fall significantly short of all other countries included in the report's comparison and this issue will be explored further below.

In the lead up to 2013 federal election which is to be held on 14 September 2013, rumours of further changes to superannuation are gathering momentum ahead of the federal Budget in May 2013. It is therefore timely to examine some of the policy considerations of why such changes may be considered by the government. This article argues against any further changes being made to the superannuation rules and will present reasons which support this position.

Policy context

Since Federation, superannuation has been an important theme for the Commonwealth Government and this importance has

intensified with the ageing population in Australia and the expected slowing in the growth of the workforce in Australia that flows from an ageing population.

In common with many other countries, the retirement income system in Australia consists of three pillars:

- (1) the age pension which is provided by the Commonwealth Government;
- (2) compulsory superannuation contributions under the superannuation guarantee regime;⁵ and
- (3) additional savings via voluntary superannuation contributions.

Consistent with these three pillars, superannuation has always been a preferentially taxed savings vehicle in order to encourage Australian taxpayers to invest in and save for their own future retirement. This in turn is designed to reduce the burden on the government to provide pensions for taxpayers when they retire.

Put another way, superannuation involves a trade-off. Taxpayers are encouraged and induced to put away their savings until retirement and forgo consumption today in return for concessional tax treatment. The benefit for the government is the financial independence of taxpayers once they retire and consequently the lower the demand on the government-funded age pension system.

It is important to appreciate this trade-off and to understand the delicate policy context in which superannuation exists as it is easy for this balance to become disrupted which can result in detrimental consequences for both retirees and the government.

Funds held in superannuation

Over the years, superannuation has become an increasingly important part of household wealth. As at December 2012, the total estimated superannuation assets under management is a staggering \$1.51t (up from \$1.31t in December 2011)⁶ — that is about the same as Australia's annual gross domestic product.

According to figures released by the Australian Prudential Regulation Authority (APRA),⁶ self-managed superannuation funds (SMSFs) held the largest proportion of superannuation assets, accounting for 31.5% of assets, followed by retail funds with 26.4% of total assets. Industry funds accounted for 19.5% of total assets, public sector funds 15.7% and corporate funds 3.8%. Small APRA funds held 0.1% of total assets.

The fiscal context

With the government now well underway with its 2013 Budget preparations, some of the initiatives with large funding costs that need to be factored in as part of this process include the National Disability and Insurance Scheme (NDIS), with estimates ranging from \$15b gross to \$22b gross,⁷ the National Broadband Network (NBN) which was initially estimated to cost \$36.9b to construct over a 10-year period (including a federal government investment of \$27.5b),⁸ and the Gonski education reforms with an estimated cost of \$6.5b.⁹ Just considering these three announced initiatives gives some context to the magnitude of “structural savings” that the government will need to achieve if it is to successfully fund and implement these measures. Apart from significant capital obligations, they of course also carry large recurrent funding obligations.

Against the background of the high cost of these initiatives, the government is facing a shortage in tax revenues in many areas. The much publicised case of the minerals resource rent tax — where the government recently announced it has only collected \$126m against a revenue forecast of \$2b — is a case in point.

The Treasurer conceded in an economic note released on 24 February 2013 that at the centre of the challenges that the government faces in this year's Budget is the huge hit to government revenues that has occurred since the global financial crisis.¹⁰ Tax-to-GDP has dropped from around 24% before the global financial crisis to around 20%, and further massive write-downs in revenues have

been brought about by dramatic falls in commodity prices in the second half of 2012, together with the high Australian dollar.¹⁰ With revenues coming in lower than expected, this partly explains why the Budget will not return to surplus in 2012-13 and, in this context, many have questioned whether the government should be pursuing high-cost spending measures like the NBN, the NDIS and the Gonski reforms which will need to be funded in a very tight fiscal environment.

Cash cow ripe for the picking?

Given the substantial amount of money tied up in superannuation, it is perhaps no surprise that governments could be tempted to cast their eyes on it and view it as a ready source of revenue to either fund its initiatives or to use it as a cash cow to address its growing Budget shortfalls.

When considering possible areas where the government may focus on increasing its tax revenues, one needs to consider the current taxing points for superannuation in Australia. Broadly, taxation of superannuation can occur at three points:

- (1) when contributions are made to a superannuation fund;
- (2) on the investment earnings of a superannuation fund; and
- (3) on end benefits (for example, lump sums on retirement)

Since 2007, when the Simpler Super reforms were introduced, Australia has operated on what is commonly known as a “TTE” basis (where T denotes a taxed superannuation point and E denotes a tax-exempt superannuation point) under which taxes are applied on assessable contributions (which include those made by an employer on behalf of an employee and personal contributions for which the contributor is entitled to a deduction) and investment earnings but end benefits are exempt for those aged 60 and above.

By contrast, many countries (including Canada, Chile, the Netherlands, the UK and the US) have adopted an EET system, where contributions and investment earnings are exempt from tax, while benefits are normally subject to full taxation, when received.¹¹ Many fear that the Australian government could remove the exemption for end benefits in the forthcoming May 2013 federal Budget, but under growing political and community pressure, in February 2013, the Prime Minister ruled out taxing withdrawals from

superannuation for people aged 60 and over.

While the Prime Minister ruled this out, the government might now consider changes to the 15% concessional tax rate on assessable superannuation contributions and the 15% tax on investment earnings which some in the government believe favours the wealthy. Indeed, increasing these taxes would be the easiest expedient for the government, especially given that the bulk of what would be taxed is already there (“a sitting duck”). In terms of future contributions, these are largely compulsory and are now rising to 12% of earnings, which would give the government a “double whammy” if it increased taxes on contributions as well, that is, a higher tax rate to apply on contributions which are planned to rise from 9% to 12%.

Another area that the government could focus on is particular segments and aspects of the superannuation system, including SMSFs and capital gains tax concessions, for example. As noted earlier, given that SMSFs held the largest proportion of superannuation assets (accounting for 31.5% of assets as at December 2012), this represents a sizable potential target for the government to seek to tax more heavily. One area that has received attention in relation to SMSFs is their use of CGT exemptions. Critics of SMSFs believe that they use these exemptions more aggressively than other superannuation funds, given that they usually have one or two members who can quickly buy and sell investment properties, whereas bigger funds hold large portfolios which are typically held over longer terms with the benefits shared among many members.¹² When considering the government's appetite for changes in this area, it must be remembered that Treasury commenced examining options to scale back tax concessions for SMSFs during the second half of 2012, but the government did not proceed with these cuts in the mid-year economic and fiscal outlook in October 2012.¹²

A final area that the government might continue to target is the contribution caps. As noted in the introduction to this article, the cap in Australia from 1 July 2012 has already been reduced to \$25,000, which is down from \$50,000 and as much as \$100,000 previously. This downward trend, I would argue, represents bad policy. The Mercer report concludes that the current Australian arrangements, in respect of

contributions caps, clearly falls short on an international basis.¹³ The report found that the existing cap of AU\$25,000 per annum is the lowest of any country (when expressed as a percentage of average earnings) and, in most cases, the difference is considerable, for example, the contribution cap in the UK is GB£40,000 and in the US it is US\$51,000.¹⁴

Many commentators have noted that the imposition of a \$25,000 per annum cap on contributions to superannuation will have the effect of preventing many people (for example, parents in their late 50s and 60s who have a better capacity to save once their children have left home) from accumulating enough superannuation to sustain them through what could be 30 or more years in retirement (given rising life expectancies).¹⁵ This in turn could put greater pressure on the government-provided age pension, as many would not have been able to adequately provide for their own retirement.

My view is that a limit of at least \$50,000 (which is indexed) should be reintroduced as this is well within the reach of many Australians and will allow Australians the opportunity of accumulating funds for their own retirement (which will reduce their dependency on the age pension when they retire).

The tax expenditures argument

A “tax expenditure” is a provision of the tax law that provides a benefit to a specified activity or class of taxpayer that is concessional when compared to the “standard” tax treatment that would apply.¹⁶

Tax expenditures can include tax exemptions, tax deductions, tax offsets, concessional tax rates or deferrals of tax liability.

The *Tax expenditures statement 2012* (TES 2012) shows that the largest tax expenditures in 2011-12 were for superannuation (which amounts to around 25% of all tax expenditures) and owner-occupied housing, followed by tax concessions relating to the GST.¹⁷ The TES 2012 estimates that expenditures relating to superannuation will rise from just under \$32b in 2012-13 to just under \$45b by 2015-16. The largest measured tax expenditure is the concessional taxation of superannuation entity earnings of around \$17.1b in 2012-13 and the concessional taxation of employer contributions to superannuation amounts to approximately \$13.2b in 2012-13. Interestingly, deductions for superannuation contributions and the

concessional taxation of certain personal contributions only amount to a mere \$1.05b in 2012-13.

These are big numbers in anyone’s language and it is therefore no surprise that it has received attention from the government which might take the view that this rising trend in revenue foregone should mean that superannuation should be taxed more than it currently is. In other words, it may be contended by the government that the current superannuation system is too generous.

I do not subscribe to this view and, although some might argue that superannuation tax concessions are a big cost to government, this does not take account of the benefits and future financial savings for the government as a result of people being more self-sufficient in their retirement and not depending on the age pension.

The opposite view is also supported by many commentators. Stammer, for example, contends that Treasury’s calculations made inadequate allowance for the front-ended taxation of superannuation (for example, by ignoring many contributions that are now taxed at 30%); rather, he contends that they assume the \$1.5t of assets currently held in superannuation funds would be invested elsewhere with all earnings taxed at marginal rates, not to mention that they ignore future tax collections (for example, when someone dies and the taxable component of their superannuation benefit is not paid to a dependent spouse or minor child, then tax at 16.5% applies).¹⁵

For someone who is paying 46.5c in the dollar in income tax at the margin, Treasury calculates that the person is receiving a tax concession of 31.5% (assuming a 15% rate on contributions for those earning less than \$300,000 a year) on their superannuation contributions. Many economists, including Henry Ergas, argue that this should not be regarded as a “concession” because taxing superannuation as ordinary income would yield ludicrously high effective tax rates on retirement savings.¹⁸ Ergas uses the following example to illustrate his point:¹⁸

“Consider a taxpayer facing a 46.5 per cent marginal tax rate. Assuming a nominal return of 8 per cent and a real return of 5 per cent due to 3 per cent inflation, taxing that income earner’s superannuation as ordinary income would imply an effective tax rate of about 70 per cent, in part because taxes would remove income that was simply compensation for inflation.

Indeed, for super held for 40 years, the effective tax rate would be 95 per cent, meaning that each dollar saved would fund 5c in future consumption. In other words, to pay for \$1 in retirement consumption, a young person today would need to save \$20, with 19 of those 20 dollars being removed as tax.”

This is clearly an inequitable and inefficient outcome which would likely encourage people to divert their voluntary contributions into other assets, including the tax-sheltered family home, or turn to investments in negatively geared property and shares which is costly to government revenue.

Ergas goes on to note that, in relation to compulsory superannuation contributions, imposing higher rates would be equivalent to increasing the income tax, as the superannuation payment that has to be made on each dollar earned attracts penal levels of taxation.¹⁸ This would have detrimental impacts on the labour market, including discouraging and reducing labour market participation and decreasing output. In turn, instead of rising, the tax take could paradoxically reduce.

Finally on this point, the Mercer report found that the current tax concessions on superannuation in Australia are not generous when compared to the retirement systems in eight other countries (Canada, Chile, Denmark, the Netherlands, Sweden, Switzerland, the UK and the US) which are considered to have world-class retirement systems.¹⁹

The research undertaken by Mercer modelled the effect of different tax systems, showing the present value of the after-tax retirement benefit for an individual on average earnings, with a 9% employer contribution over 40 years, and benchmarked these results against the Australian superannuation system. This analysis revealed that the net retirement benefits in Australia are lower than five of the eight countries that were part of the research. For example, an average British worker would be 16.4% or \$43,534 higher, while an American worker would be 11% or \$29,273 higher than their Australian counterpart. Only Denmark and Sweden had lower benefits, but OECD figures reveal that, in both of these countries, public expenditure on old-age taxpayers is higher than in Australia because of a universal pension in Denmark and an earning-related scheme in Sweden.²⁰

The above analysis led Mercer to the conclusion that “on the global stage, the

taxation of Australia's retirement savings is *not* overly generous" (emphasis added).²¹

Conclusion

This article has examined some of the areas in the superannuation system that the government might target to increase its revenues in the lead up to the federal election in September 2013. Against the background of possible areas the government might target, it is somewhat ironic that taxes on superannuation are already budgeted to be one of the fastest growing revenue sources over the coming years. Prominent economists, including Henry Ergas, have observed in this regard that "the 2012-13 budget already list taxes on super as the government's fastest growing revenue source over the next three years".²¹ According to the 2012 Budget papers, receipts from superannuation funds are budgeted to increase by 11.9% (\$960m) in 2013-14, 19.9% (\$1.8b) in 2014-15, and 17.7% (\$1.9b) in 2015-16.²² The acceleration in growth in superannuation tax over these years reflects stronger capital gains growth as asset markets recover, the effect of crisis-related losses on tax positions unwinds, the phased increase in the superannuation guarantee charge to 12%, and the measure which was announced in the 2012-13 Budget to reduce the tax concession which very high income earners receive on their concessional contributions.²²

As noted earlier in this article, Australia's three pillar system of retirement income includes the age pension, the compulsory superannuation guarantee system and voluntary superannuation contributions. Reducing future superannuation benefits through higher taxation or reduced concessions will simply mean a greater reliance on the age pension when people get to retirement age, which will be a detrimental outcome for Australia, especially given the ageing of its population.

Similarly, the recent reductions in contributions caps in Australia to \$25,000 will affect the confidence of people in superannuation as a long-term investment and creates uncertainty and confusion. As Anderson has observed:²³

"In June 2008, 34% of working Australians considered super to be tax effective. By June 2010, this had dropped to 20% and is likely to be even lower now. One in five weren't even sure about the tax effectiveness."

The reduction in this limit also removes the opportunity for many baby boomers to

catch up and provide for their retirement, so rather than reducing this limit, as the Mercer report concluded: "Increasing these caps, particularly for those aged over 45, should be a priority for the government."²⁴ In light of the international experience in this area, I suggest that the caps should be restored to at least \$50,000, which should be indexed over time.

In conclusion, it must be remembered that the Henry Review concluded that superannuation's sole purpose is to provide a lifetime savings vehicle and as such should receive preferential income tax treatment compared to other savings.²⁵ Given the healthy and increasing rate of growth in tax revenues from superannuation, the government needs to be careful not to "kill the goose that lays the golden egg" by trying to squeeze even more tax revenue from the lemon that is already being squeezed very hard. It should therefore resist targeting superannuation — which is a long-term investment — as a convenient expedient to meet the government's short-term needs to balance its books.

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- 2 The rules on excess contributions tax are set out in Subdiv 292-B (s 292-10 to s 292-25) of the *Income Tax Assessment Act 1997* (Cth) (ITAA97).
- 3 The cap amount is indexed annually to average weekly ordinary time earnings, in increments of \$5,000 rounded down: s 960-285 ITAA97. The government announced that, effective from 1 July 2014 (originally to apply from 1 July 2012 when first announced), individuals aged 50 and over with superannuation balances below \$500,000 would have a concessional contributions cap that is \$25,000 more than the general concessional contributions cap.
- 4 Mercer Consulting, *Tax & superannuation: benchmarking Australia against the world's best retirement savings systems* (the Mercer report). The eight countries covered by the report were Canada, Chile, Denmark, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States.
- 5 The *Superannuation Guarantee Charge Act 1992* (Cth) and *Superannuation Guarantee (Administration) Act 1992* (Cth) came into effect from 1 July 1992,

mandating a minimum level of employer contributions, with a charge imposed for failures to meet that minimum.

- 6 APRA, *Quarterly superannuation performance December 2012*, issued 21 February 2013.
- 7 The Productivity Commission took a "snapshot" approach to estimating the cost of the NDIS — and the result was a \$15b a year NDIS in 2009-10. The problem with this estimate is that the NDIS will not be fully operational at least until 2018-19, meaning that the Commission's \$15b estimate does not take into account the intervening years of wage growth, price inflation, and population growth to 2018-19. The alternate figure of \$22b comes from a report by the Australian Government Actuary which was released under a freedom of information request by The Centre for Independent Studies.
- 8 NBN, *Corporate plan 2011-2013*, available at www.nbnco.com.au/assets/documents/nbn-co-3-year-gbe-corporate-plan-final-17-dec-10.pdf. Much debate and discussion have since ensued over whether this estimate should be higher than stated but this is outside the scope of this article.
- 9 The original figure according to the Gonski report (*Review of funding for schooling* available at <http://foi.deewr.gov.au/node/30439/>) was \$5b, which was based on 2009 figures. It is believed that the extra money required in 2013-14 dollars is calculated at about \$6.5bn.
- 10 The Hon. Wayne Swan, MP, *Treasurer's economic note*, 24 February 2013, available at www.treasurer.gov.au.
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- 25 Commonwealth of Australia, *Australia's future tax system: report to the Treasurer*, December 2009, Pt 2, p 98.