Submission to Tax White Paper Task Force

Retirement Income and the Interactions of the Age Pension, Superannuation and Income Tax

by James Bonham

Table of Contents

1 List of recommendations

Recommendation 1: Determine comprehensive objectives for government support of retirement, treating superannuation, the Age Pension and income tax as a coherent system

Recommendation 2: Stabilise the rules and eliminate legislative risk, on a long term basis**.**

Recommendation 3: Regard the Age Pension as a dividend on people's contributions to society, not as welfare.

Recommendation 4: Abandon or drastically modify means testing for the Age Pension so as to remove arbitrary and unfair discrimination.

Recommendation 5: Define the purpose of superannuation as "to build and manage assets so as to create financial security for the individual in retirement by providing present and future income together with a resilient buffer against financial shocks"

Recommendation 6: Restructure the rules for the Age Pension and Income Tax for the over 65s so as to remove both income and asset poverty traps

Recommendation 7: Make the effective marginal tax rate for over 65s progressive, so that it only increases with increasing income.

Recommendation 8: Evaluate the concept of a universal taxed Age Pension in depth with particular regard to the benefits of simplicity, stability, efficiency, fairness, and pensioner behaviour.

Recommendation 9: Abolish the minimum drawdown rules for superannuation pensions.

Recommendation 10: Introduce a 5-year bring-forward rule for concessional and non-concessional contributions

Recommendation 11: Remove the age based restrictions on superannuation contributions for people over 65.

Recommendation 12: Re-introduce indexation of the cost base for CGT, at least as an option

Recommendation 13: Retain dividend imputation.

Recommendation 14: Retain the tax free status of superannuation accounts in the retirement phase

2 Introduction

This submission deals entirely with the three major government influences on retirement income: the Age Pension, Account-based or other superannuation pensions, and personal income tax.

Each of these influences is individually complex, and together they create an environment which is poorly understood by most, which is unfair in many cases and seriously dysfunctional in others, and which is very expensive to administer.

Constructive debate is hampered by the lack of a coherent philosophy and objectives, and by the widespread use of inappropriate terminology which tends to frame discussion in ways that inhibit clear analysis.

Partly as a consequence of the lack of coherent philosophy and objectives, the entire system is extremely complex and subject to very high legislative risk. Rule changes are frequent and can be very damaging to individuals affected. Most people older than mid 50s have become very concerned about these matters, and nervous about their ability to fund their retirement adequately.

The body of this submission consists of the following:

Section 3 is concerned with the objectives of superannuation, and with clarifying the nature of the Age Pension and superannuation (in short: the former provides income; the latter is a vehicle for developing and maintaining assets which provide financial security). Some fundamental problems are discussed.

Section 4 is a detailed account of how the superannuation, the age pension and income tax rules interact in a typical case, revealing bafflingly inconsistent government support of retirement incomes, the existence of some highly restrictive rules that serve no purpose, and two types of serious poverty traps.

Section 5 develops the concept of a universal taxable pension

Section 6 discusses a number of current rules which are arbitrary, unfair or pointless and can be addressed immediately. It also discusses some changes to current rules which have been prominently advocated in public debate, and if enacted would fall into the same category of being arbitrary, unfair or pointless.

Section 7 presents some concluding remarks

3 Rethinking the system

The proportion of retirees in Australian society is increasing rapidly as the baby boomers age, yet the superannuation system has not been in place for long enough to become mature, and it remains quite unstable legislatively.

Work patterns are also changing with many retirees continuing in some form of paid employment – whether it be occasional part-time work or a resumption of their previous career The many parameters defining the Age Pension rules are (necessarily) adjusted regularly, and from time to time structural changes are made.

All this is unfolding without any overarching philosophy, or clear statement of objectives.

Public debate is often made acrimonious or is misdirected by the use of language which tends to frame discussion in emotional terms ("welfare", "safety net", "tax concession", "means test", "wealthy", "millionaire", "less welfare, lower taxes", "tax burden on future generations" etc.)

There is an urgent need to design a coherent system. This requires beginning with a clear understanding of the purpose and nature of the Age Pension and Superannuation in retirement, and of how they interact with income tax.

Only when that is clear can the quantitative aspects of the system be redesigned from scratch to avoid the sort of problems outlined above.

Recommendation 1: Determine comprehensive objectives for government support of retirement, treating superannuation, the Age Pension and income tax as a coherent system

Recommendation 2: Stabilise the rules and eliminate legislative risk, on a long term basis**.**

3.1 The nature of the Age Pension

The Age Pension has been with us since soon after Federation, far longer than superannuation. It is usually described as "welfare" or a "safety net" for those with few other resources to support themselves in retirement.

It is also usually described as being funded entirely from current tax receipts, which means that provision of the Age Pension is often seen simply as a cost to the public purse, to be minimised if possible.

While it is obviously true that Age Pension payments must be paid from current tax receipts, it is also true that those tax receipts are what they are, to a large extent, because of the taxes paid and the work done (whether remunerated or not) by the retirees during their younger more productive years. Under the latter view, the Age Pension is simply a return on their investment in the country in previous years – a dividend paid out of current cash flow. This is a far more constructive concept than "welfare".

Many people echo this philosophy, expressing opinions (usually quite strongly felt) along the lines "I have worked hard, saved hard and paid a lot of tax for many years, and I deserve a return on that in retirement". Or, in a similar vein, "Our children are in a position to help support us only because we worked hard to give them a good education and keep them healthy".

The truth (across the community if not in every individual case) of these common sayings is self-evident and it shows the intellectual poverty of regarding the Age Pension simply as welfare.

Recommendation 3: Regard the Age Pension as a dividend on people's contributions to society, not as welfare.

3.2 Means testing of the Age Pension

Means testing is a consequence of regarding the Age Pension as welfare. It has been a feature of the Age Pension in various forms almost since inception, apart from a brief period in the 1970s. The desire for means testing is driven partly from a desire to save costs, and partly from a political reaction to jealousy of "wealthy people receiving welfare". These are weak motivations which follow from viewing the Age Pension as welfare rather than as a social dividend, as was discussed in Section 3.1.

As will be shown in detail in Section 4, means testing (unless handled very carefully) can be arbitrarily discriminatory and can lead to poverty traps which drive self-defeating behaviour by retirees – a serious social problem which entrenches dependence on the pension.

Here are just a few well-known problems:

> Assets, other than the home, which produce no income are counted for the assets test. The implication is that they should be monetised in some way, presumably by sale. This is just chopping up the furniture for firewood - a perfect mechanism for destroying people's financial security.
>
> A retiree living in two $400,000 units in separate towns to facilitate looking after two sets of grandchildren is severely treated compared to a retiree in an $800,000 house.
>
> Married couples are treated differently from other individuals who share a house.
>
> Homeowners are treated differently from those who rent.
>
> Means testing of financial assets (held inside or outside of superannuation) applies not just to the asset value but also to the deemed income they "earn". It is a tax on holding assets, even assets held within superannuation which are otherwise not taxed. In this case, one part of the retirement support system subverts the intentions of another – a sure sign of a system in trouble.
>
> Worse, the deeming calculation is a fiction, and it has a pernicious aspect: people are led to think that the deemed return, which is low, is an acceptable return from a long term investment.

Means tests, as currently implemented, should be abandoned or drastically modified but obviously that can only be achieved in a completely restructured system. Some ideas on how this can be achieved are presented in Section 5.

Recommendation 4: Abandon or drastically modify means testing for the Age Pension so as to remove arbitrary and unfair discrimination.

3.3 The objectives of superannuation

Superannuation has grown to be a very complex beast, and the basis for a major industry. Its importance to Australia's retirement funding system and general economy is undeniable, but there is a lack of clarity about the precise formulation of its philosophy and objectives. As a result, we end up with rules that lack a clear foundation in principle, and can therefore be inconsistent and self-defeating.

This point was made by the Financial System Inquiry, as discussed in more detail below.

Most public debate about retirement funding is based on the view that the purpose of superannuation in retirement is to provide income, and that the purpose of the Age Pension is to provide a safety net for those with inadequate superannuation, or other income. This view, although commonly held, is dangerously simplistic and a far more nuanced understanding is necessary to avoid on-going dysfunction and acrimonious debate.

3.3.1 The Financial System Inquiry

The *Financial System Inquiry*'s Recommendation No 9 states: *Seek broad political agreement for, and enshrine in legislation, the objectives of the superannuation system and report publicly on how policy proposals are consistent with achieving these objectives over the long term.*

The FSI is certainly right in observing that the lack of clarity about the purpose of superannuation is a major obstacle to constructive debate. Their Recommendation 9 seems to imply an open mind as to exactly what the purpose of superannuation should be, and a desire to resolve this through public discussion. But the commentary immediately after the Recommendation makes it clear that the FSI has already decided that the objective should be *to provide income in retirement to substitute or supplement the Age Pension.*

This simple statement seems at first sight to be self-evident. It has been widely accepted without question, and vigorously promoted. But a closer investigation reveals serious deficiencies, which are discussed below.

3.3.2 The Sole Purpose test and death benefits

The Sole Purpose Test in the SIS Act (section 62) is the nearest thing we currently have to a formal statement of the purpose of superannuation. It permits just two purposes: provision of income in retirement and provision of death benefits. The latter is important.

Inexplicably the rule is not mentioned in the FSI report, although it is taken very seriously indeed by the ATO, auditors, advisors, accountants and superannuation fund trustees.

For purely administrative reasons, superannuation funds must be able to pay death benefits to a retiree's beneficiaries, in order to dispose of the remaining balance of their investment.

Furthermore, since the age of death is usually unpredictable, every retiree who wants to remain independent of (or minimally dependent on) the Age Pension must plan to hold sufficient funds in superannuation to provide a desired level of income to a very old age although few will actually reach that age. In most cases, there will therefore be substantial funds to distribute to beneficiaries.

Although there seems to be a widely held view that it is unethical to use the superannuation environment to accumulate wealth for the specific purpose of providing an inheritance, there is nothing in the Sole Purpose rule which would prevent this.

In fact, if funds saved in superannuation pass to beneficiaries, those funds will continue to serve the government's purposes in helping those people build sufficient wealth to provide for their retirement.

SMSF trustees are *required* (not just permitted) to consider the provision of life insurance, which is necessarily purely a death benefit. This is inconsistent with any antipathy to death benefits and estate planning *per se* within the superannuation environment.

The provision of death benefits, and the importance of maintaining a substantial superannuation balance throughout life are thus fundamental to any comprehensive statement of the objectives of superannuation.

By excluding these issues from their statement of the objective of superannuation, the FSI has encouraged a short-term approach concentrating only on the immediate provision of income, which is extremely damaging to the country in the long term.

3.3.3 The value of investment assets

More concerning even than the subject of death benefits is the failure of the FSI, and consequently the failure of most politicians and public commentators, to acknowledge that the function of invested capital is not just to provide a routine income to cover normal living expenses.

It is easy to determine the current value of an asset as a producer of income: depending on the asset type this will be determined by the dividend yield, interest rate, rent etc. But superannuation is a very long term investment, and the ability of that asset to produce income in future years is just as important.

Someone retiring at 65 who does not wish to depend on the Age Pension may well have 30 or more years of retirement which must be funded by her superannuation (and other savings if any). During that 30 years, very large and unpredictable changes may occur in the investment landscape as well as in her personal need for regular income and for occasional significant capital drawdowns.

Changes in the financial environment may come about rapidly, as in the 2008 global financial crisis where share prices fell sharply, dividends were reduced, some companies and funds collapsed, and some funds froze income payments.

Or the changes may be relatively gradual as in the decrease of 12 month term deposit rates from 7.15% in May 2008 to 2.5% in May 2015 – a 70% drop, after adjusting for inflation, in the purchasing power of the interest payments in just 7 years.

At some stage in the decades to come, the government of the day may lose control of inflation which could easily revert back to the high teens we saw not very long ago, rather than the 3% or so we have enjoyed in recent years.

On the personal side, during 30 years of retirement every household appliance and the family car will need replacing at least once (probably more: computers and smart phones which are essential for modern communication last only a few years), significant house maintenance will be essential, medical emergencies will happen and these may have serious on-going financial implications. There are many more examples of common situations where retirees will need access to funds beyond what is required for day to day living.

Retirees who are in a sound financial position are also much better placed to assist the younger generation – something most older people are strongly motivated to do.

The value of financial assets in providing a buffer against all these contingencies is at least as important as their immediate income-producing power. It is critically important both to the individual and to the government (which will otherwise have to pick up the pieces) that assets be grown during retirement, and not simply be consumed.

An environment which facilitates the growth of one's resources in retirement can also help retirees improve their financial situation, as well as defend it against shocks. Life does not have to be all downhill after retirement (in a financial sense).

Conversely, aspects of the superannuation system which militate against growing assets in retirement seriously weaken the system to the long term detriment of the country.

3.4 Superannuation: what's in it for the government?

It is common to view superannuation as simply representing a cost to the government, in the form of tax foregone because of the various discounted tax rates for superannuation funds. Quantitative assessments then typically compare this cost over a lifetime with savings in Age Pension outlays (necessarily subject to some strong simplifying assumptions about future returns, taxes, pension rules and inflation).

This is essentially a cost accounting view, and it often has the unfortunate effect of framing superannuation as "welfare for the rich", with the same pejorative overtones as when the Age Pension is framed as a "safety net". Such framing invites condescension towards those who have less and envy of those who have more – destructive notions which distort the public debate.

A better, more strategic approach (which does not invalidate the cost calculation, but rather gives it a context) views superannuation tax concessions as an investment for the future. The government empowers individuals to invest on its behalf (in both accumulation and retirement phases) so as to achieve a better rate of return - and hence a wealthier population in retirement - than it can achieve through the normal processes by which the government strengthens the community over time: infrastructure, health support etc.

This empowerment leads to other benefits for the community as a whole, since superannuation creates economic activity:

- through administration fees (administration of large and small superannuation funds is a huge industry which did not exist a few decades ago),
- by providing a capital pool for companies by direct investment, bonds, bank deposits etc.
- by incentivising those who become engaged with the subject to become more skilled in the discipline of money management and long term investing
- through the injection of money into the economy as retirees spend their superannuation and/or Age pensions

These benefits lead to a wealthier community in the future, which is both better able to fund the Age Pension, and less reliant on it.

This is the full mechanism by which superannuation reduces pension costs, and it has far greater scope than the rather simplistic concepts behind the conventional picture.

3.5 Formulation of the purpose of superannuation

To summarise the arguments above, the purpose of superannuation can be expressed in two parts, so as to emphasise that both the individual and the government gain benefits:

- from the individual's point of view: to manage invested assets so as to provide ***financial security*** in retirement, in the form of income plus a buffer against financial shocks
- from the Government's point of view: to ***invest*** in the capability of empowered individuals to achieve better financial security in their retirement than could be provided by the government through the Age Pension alone, leading to long term secondary benefits to society

The term *financial security* is critical; it embodies the notion that assets must provide resilience against future financial contingencies as well as provide immediate income.

Defining superannuation as a government *investment* draws attention to the importance of the government acting to protect and enhance that investment.

Recommendation 5: Define the purpose of superannuation as "to build and manage assets so as to create financial security for the individual in retirement by providing present and future income together with a resilient buffer against financial shocks"

This is a far richer statement of purpose than the FSI's *to substitute or supplement the Age Pension.*

3.6 A coherent view of the Age Pension and superannuation

To sum up the discussion in this Section: the focus of the Age Pension is different from that of superannuation pensions.

The Age Pension is a direct contribution to the individual of ***income***, best viewed as a dividend on past taxes and other contributions to society.

Superannuation is a partly compulsory vehicle for building and nurturing the ***assets*** which can support someone through retirement, by providing income for daily living and a resource to cope with financial shocks.

4 Interactions of the Age Pension, Account-based Pensions and income tax

4.1 Introduction

Many retirees, especially in the first decade of retirement, undertake some paid work, receive income from an Account-based Pension in a superannuation fund or from investments outside superannuation, and also receive at least a part Age Pension.

Each of these sources contributes to the individual's net income, and they should all be considered together. Unfortunately this is a complex problem, and a good top-down description of the entire system is not easy to come by – it is certainly not available on the Centrelink or ATO websites, where one would expect to find it.

In this section, a number of scenarios will be explored quantitatively. A simple model is assumed, but the principles apply more widely. This is not an examination of what may happen over a retiree's lifetime, but is a detailed look at what is happening now or in the immediate future under current rules.

4.2 Model assumptions

- The model used throughout Section 4 assumes a single retired homeowner, age 65.
- His only asset assessable under the assets test for the Age Pension is an investment which returns 5% per annum after fees, unless stated otherwise. To put this in context: ASIC's Money Smart website suggests a typical "balanced" fund would return 5.7% *before* fees, and a "growth" fund 6.2%.
- The deemed return from that investment is assessed under the income test for the Age Pension.
- The investment may be held in a superannuation pension account, in which case the returns are not taxable, or outside superannuation in which case the actual return is taxable as income.
- In addition, the retiree may undertake some paid work which will be subject to income tax.
- Current income tax rates are used, including the Medicare levy and the low-income and seniors and pensioners offsets, but excluding the temporary "budget repair levy" in the top tax bracket.
- Current Age Pension rules are applied, except that two versions of the asset test taper rate are used.

Changing these assumptions won't generally change the qualitative nature of the conclusions drawn, just the precise quantitative results.

4.3 Definitions

- The term “old (low) taper” is used to describe the taper rate of $1.50 per $1000 of assets which applies to the Age Pension assets test until 1 Jan 17.
- “New (high) taper” refers to the taper rate of $3.00 per $1000, together with minor changes to the threshold, which will apply after 1 Jan 17.
- “Income” is used to refer to income earned from employment and from investments held outside superannuation, before tax but ignoring superannuation guarantee payments.
- “Net income” consists of any or all of: Age Pension plus superannuation pension plus income less income tax.

4.4 Net income

The retiree’s main concern is his total net income. This is what determines his quality of life, and the actual source of the money is of secondary concern – basically a dollar is a dollar.

Fig 1 shows the retiree’s annual net income as a function of earned income for various amounts of assets in the superannuation account, assuming the new (high) taper rate.

If the assets are high enough (orange and blue curves), the retiree receives no pension; total net income rises steadily with the amount of earned income, the rate decreasing beyond the threshold for the next tax bracket.

The grey curve ($500,000 of assets) exhibits a range between about $35,000 and $40,000 of earned income where the curve is horizontal. This is an income poverty trap, to be discussed in more detail in Section 4.5.1. Similar, but wider, income poverty traps exist in the yellow and green curves corresponding to lower superannuation assets.

In addition, the cross-over of the yellow and grey curves ($250,000 and $500,000 of assets) at low earned incomes indicates an asset poverty trap, discussed in detail in Section 4.5.2.

For comparison, Fig 2 is the same graph calculated using the old (low) taper rate.

Despite all the simplifying assumptions, drawing these graphs still required consideration of the following, each with its own set of parameters and rules:

- Basic income tax
- Medicare levy
- Low income tax offset (LITO)
- Seniors & Pensioners tax offset (SAPTO)
- Age Pension assets test
- Age Pension income test including deeming.
- Work bonus

It is no wonder that ordinary people, and many commentators, find it impossible to grasp the whole system and how it works.

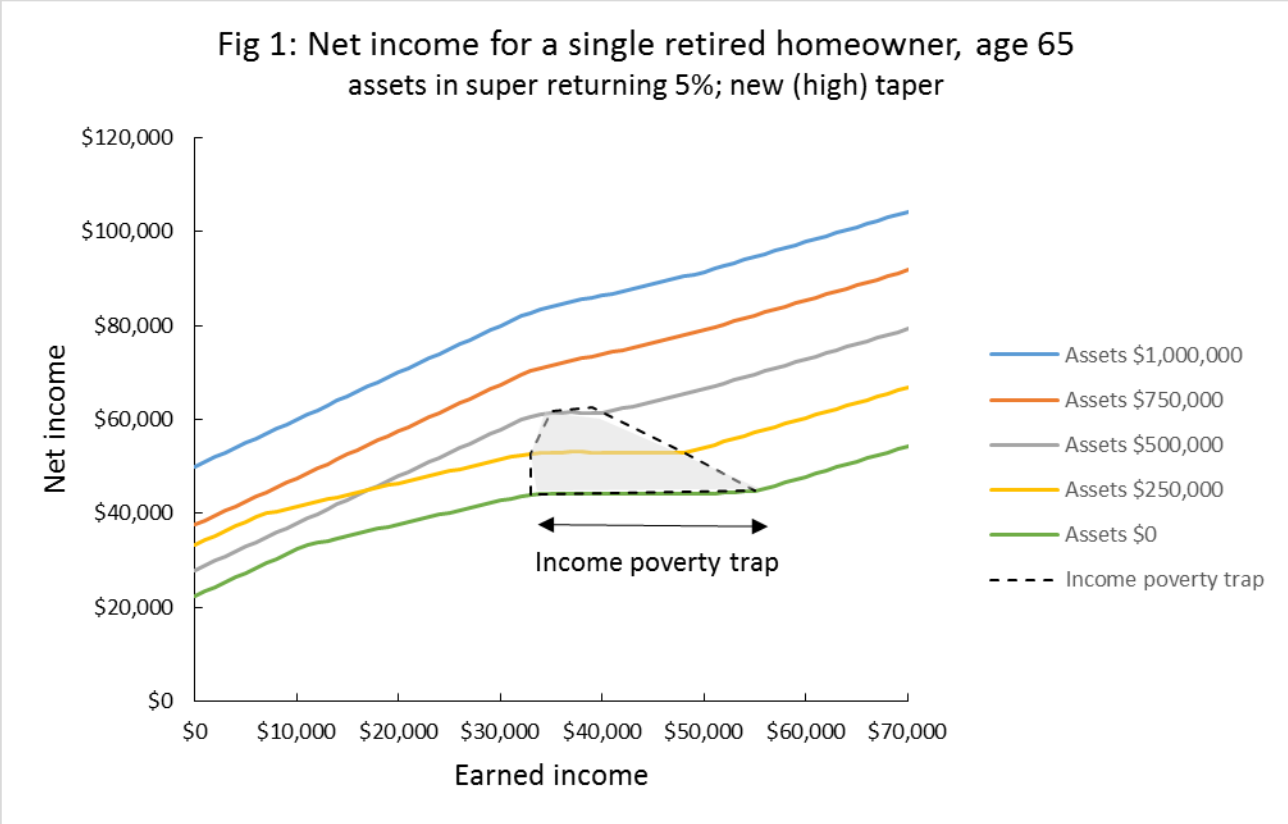
Fig 1: Net income for a single retired homeowner, age 65
assets in super returning 5%; new (high) taper
$120,000
$100,000
$80,000
$60,000
$40,000
$20,000
$0
Net income
$0
$10,000
$20,000
$30,000
$40,000
$50,000
$60,000
$70,000
Earned income
Income poverty trap
Assets $1,000,000
Assets $750,000
Assets $500,000
Assets $250,000
Assets $0
Income poverty trap

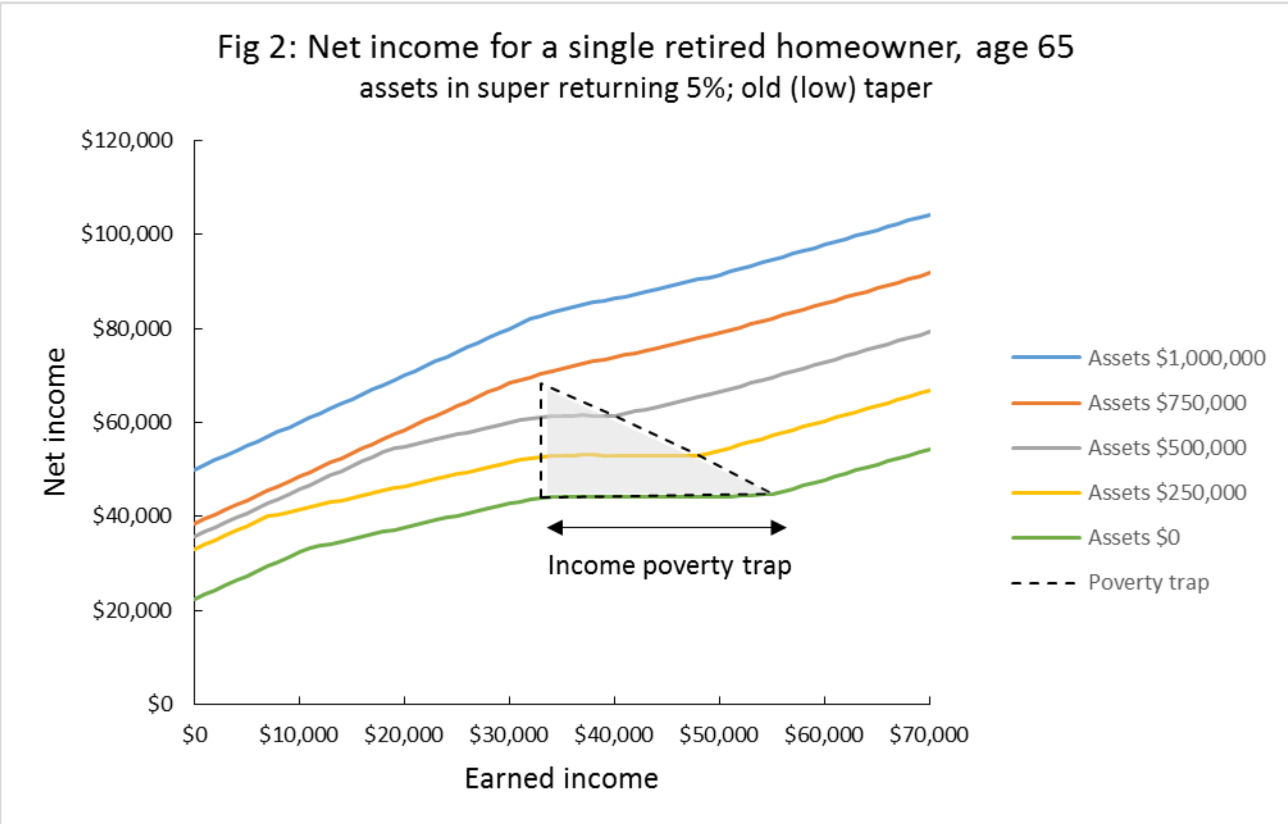
Fig 2: Net income for a single retired homeowner, age 65
assets in super returning 5%; old (low) taper
$120,000
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$50,000
$60,000
$70,000
Earned income
Income poverty trap
Assets $1,000,000
Assets $750,000
Assets $500,000
Assets $250,000
Assets $0
Poverty trap

4.5 Poverty traps

The term "poverty trap" was coined in the 1970s to describe the situation where taking steps to improve wealth (such as earning more income or saving to grow assets) results in no increase in net income. This can be an insurmountable obstacle, forcing a person to remain in a state of poverty even though they wish to escape it. It is a well-known problem.

From a systems design viewpoint, it is hard to avoid poverty traps when means testing is involved.

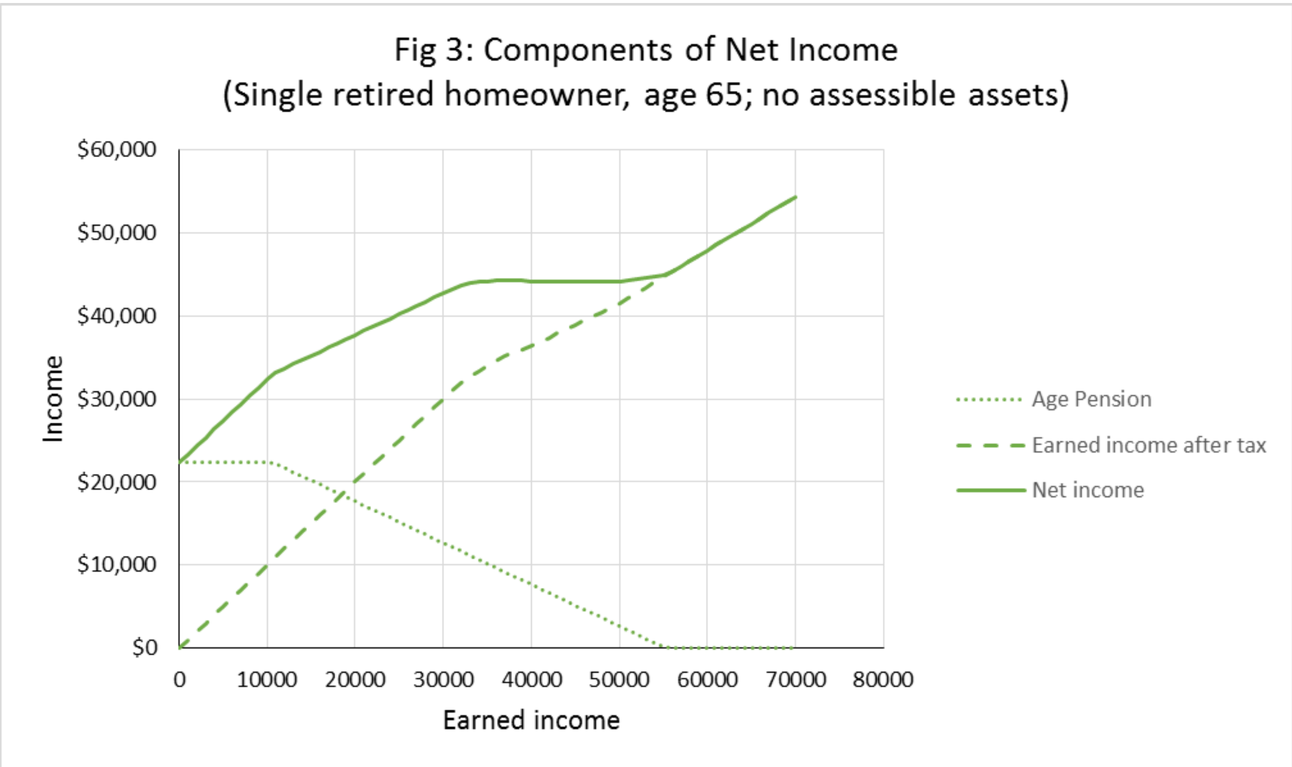
4.5.1 Income poverty traps

Both Figs 1 & 2 exhibit a very wide poverty trap (the shaded, roughly triangular area) which exists between earned incomes of about $35,000 and $50,000 for people with low to moderate superannuation account balances: within this range the curve is horizontal, meaning the pensioner gets no net benefit from earning extra income.

This particular poverty trap occurs because, through most of its range, every dollar of earned income is decreased by the following:

Basic Income tax	$0.325
Medicare levy shade-in	$0.100
SAPTO shade out	$0.125
Pension income test taper	<u>$0.500</u>
	$1.050

Fig 3 shows graphically how the rate at which after tax income increases balances the rate at which the pension decreases through the poverty trap zone, giving rise to a constant net income:



Because the Age Pension is a contribution to retiree's net income, a change in pension payments has exactly the same effect on the cash flows of both retiree and government as does a change in income tax charges. Thus it is reasonable to define "effective marginal tax rate" in relation to net income (in the same way that "marginal tax rate" is defined in relation to after tax income). Its effect on the retiree is the same as the effect of marginal tax rate on a pre-retirement employee.

As detailed above, the effective marginal tax rate through the poverty trap is around 100%. Fig 4 shows this graphically for the case of a retiree with no assessable assets.

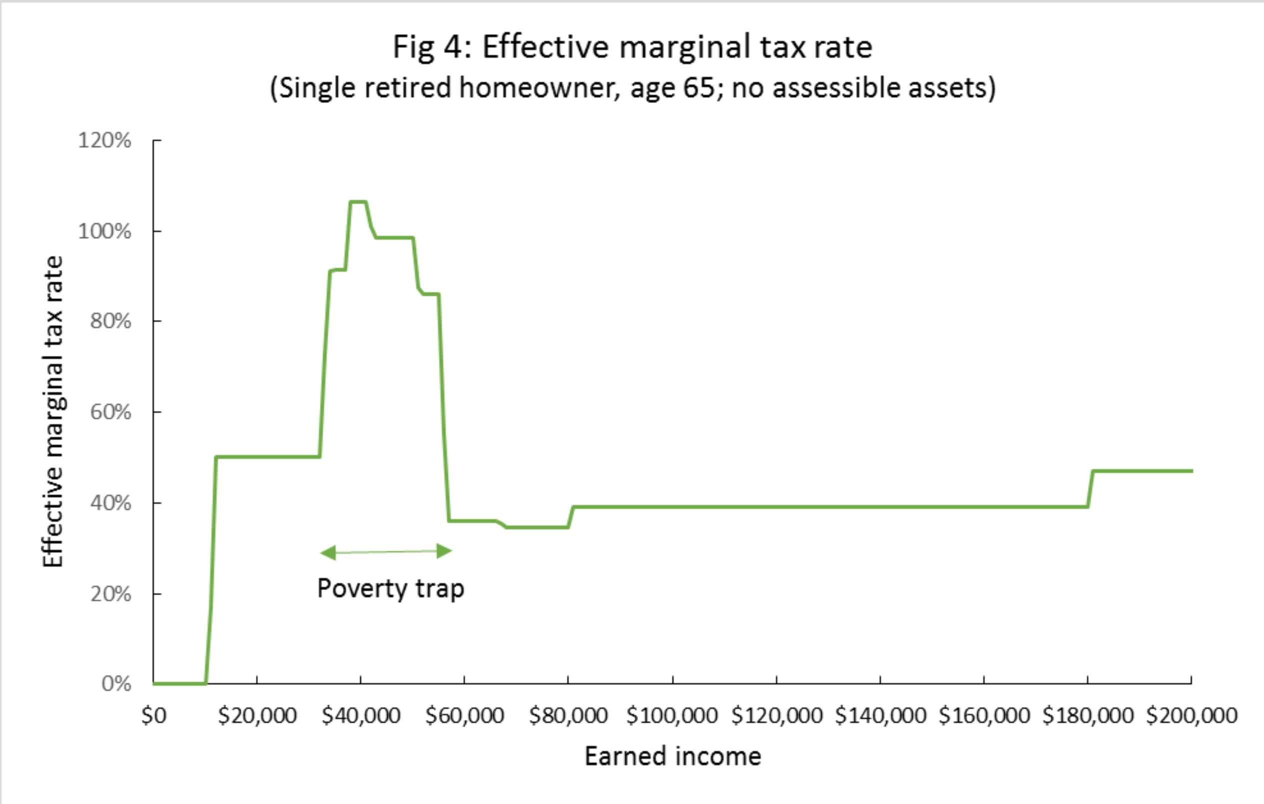


Fig 4 has been run out to quite high incomes, to contrast the very high effective marginal tax rate applying to pensioners earning a modest additional income with the much lower marginal tax rate applying to those in the top tax bracket.

In fact there are 8 separate effective marginal tax rates for earned incomes below $80,000 and all but the lowest (0%, for very low earned income) are higher than the marginal rates applied for incomes above $80,000. This is the antithesis of a progressive tax system.

This poverty trap is the disastrous result of the combined effect of numerous rules, each of which no doubt is soundly justified but only in isolation. Means tests can be terribly destructive.

While the big picture can be hard to see, people affected know the problem well, if only by experience: it is not uncommon to hear retirees say "There is no point taking on more work because Centrelink and the ATO will take all the extra income". They are trapped!

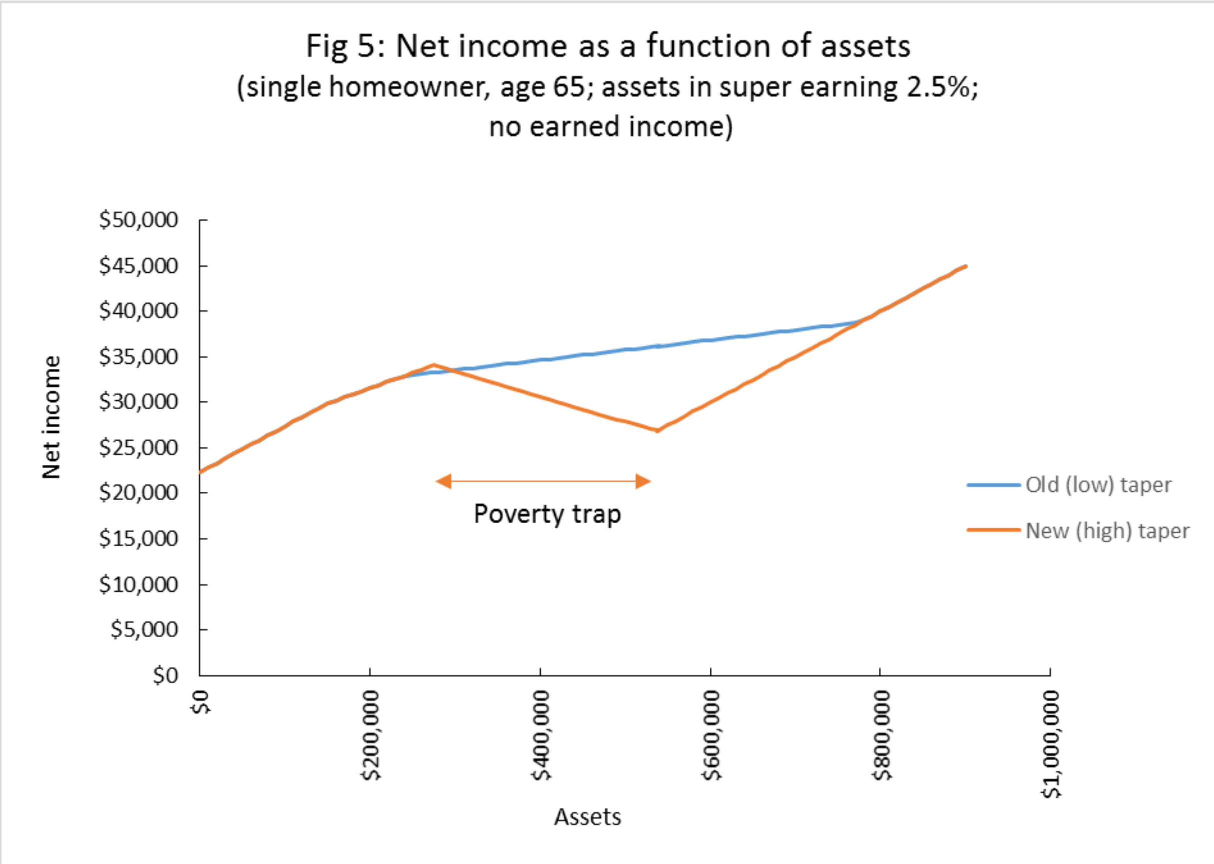
4.5.2 Asset poverty traps

As well as the income poverty trap, Fig 1 also includes an asset-related poverty trap although it is less obvious. Fig 5 makes it clearer by plotting net income as function of assets, assuming no earned income. Fig 5 also shows the curve for the previous low-taper regime for comparison.

This graph shows a pronounced poverty trap in the high taper case, where the incremental benefit of owning more assets (other than the family home) is negative between $275,000 and $538,000. The slope of the high-taper curve through the poverty trap, -2.8%, represents the effective earning rate of any increase in assets. In other words, the higher taper rate subtracts 7.8 percentage points from the 5% earning rate of the fund.

If the assets earn more than 7.8% (very hard to sustain), the slope through the poverty trap becomes positive and the poverty trap vanishes, although the incentive to grow assets remains weak for any conceivable sustainable investment return.

This poverty trap has been commented on in the public debate from various viewpoints, although the term "poverty trap" seems to have vanished from the Australian public lexicon.

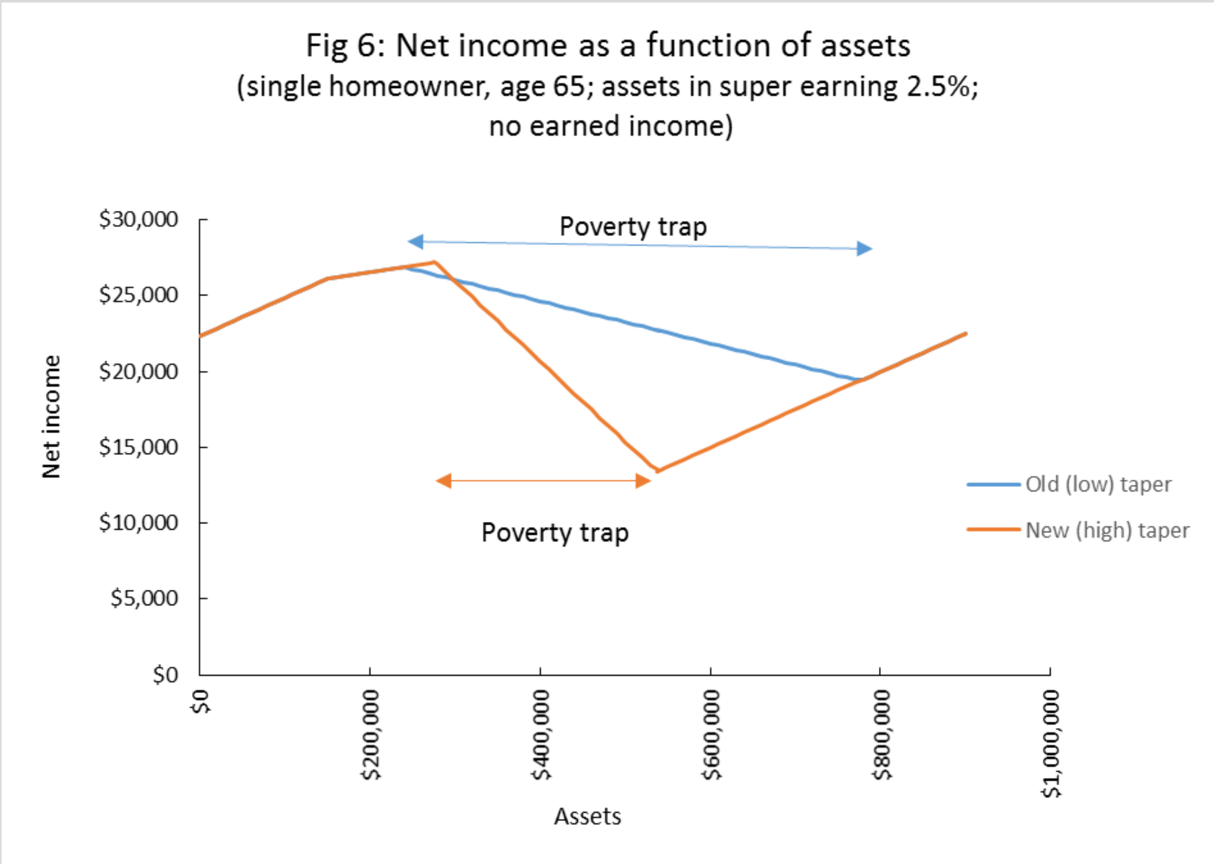


For lower returns on assets, both the low and high taper regimes create poverty traps, as shown in Fig 6 where the current 12 month term deposit rate of 2.5% has been assumed.

If a single retiree with no earned income holds more than about $300,000 in a term deposit there is a strong disincentive to save (i.e. an incentive to consume savings) unless the amount saved exceeds about $500,000 in the current system, or $800,000 in the previous system.

The government proposed the new higher taper rate as a deliberate cost-saving measure. However, those savings may well be illusory if many people then succumb to the substantial incentive to consume assets so as to increase their pension, thereby increasing their total net income. (This is not to say that such consumption would be reckless – people are likely to spend the money on otherwise unaffordable surgery, or significant house maintenance, for example).

The government has actually suggested that affected people consume some capital, at least to the extent of drawing down sufficient to restore any lost pension. It seems naïve to assume they won't go further.



The asset poverty traps illustrated in Figs 5 and 6 persist if the retiree earns some income from paid employment, although the range shrinks.

4.5.3 Poverty traps – concluding remarks

The poverty traps described above indicate a severely dysfunctional system of government support for retirement income. Rather than helping people become independent of the Age Pension, they entrench dependence. Over the long term, they therefore add to government costs while encouraging people to live an unnecessarily impoverished life in retirement. This is in no one's interest.

There is probably no solution to this problem based on simply fiddling with the parameters, although the higher taper rate clearly exacerbates the problem and such changes should be avoided. Rather, a complete re-think and redesign of the entire system of Government support for retirement is required. This subject is developed further in Section 5.

Recommendation 6: Restructure the rules for the Age Pension and Income Tax for the over 65s so as to remove both income and asset poverty traps

Recommendation 7: Make the effective marginal tax rate for over 65s progressive, so that it only increases with increasing income.

4.6 Benefits to the individual of superannuation in retirement

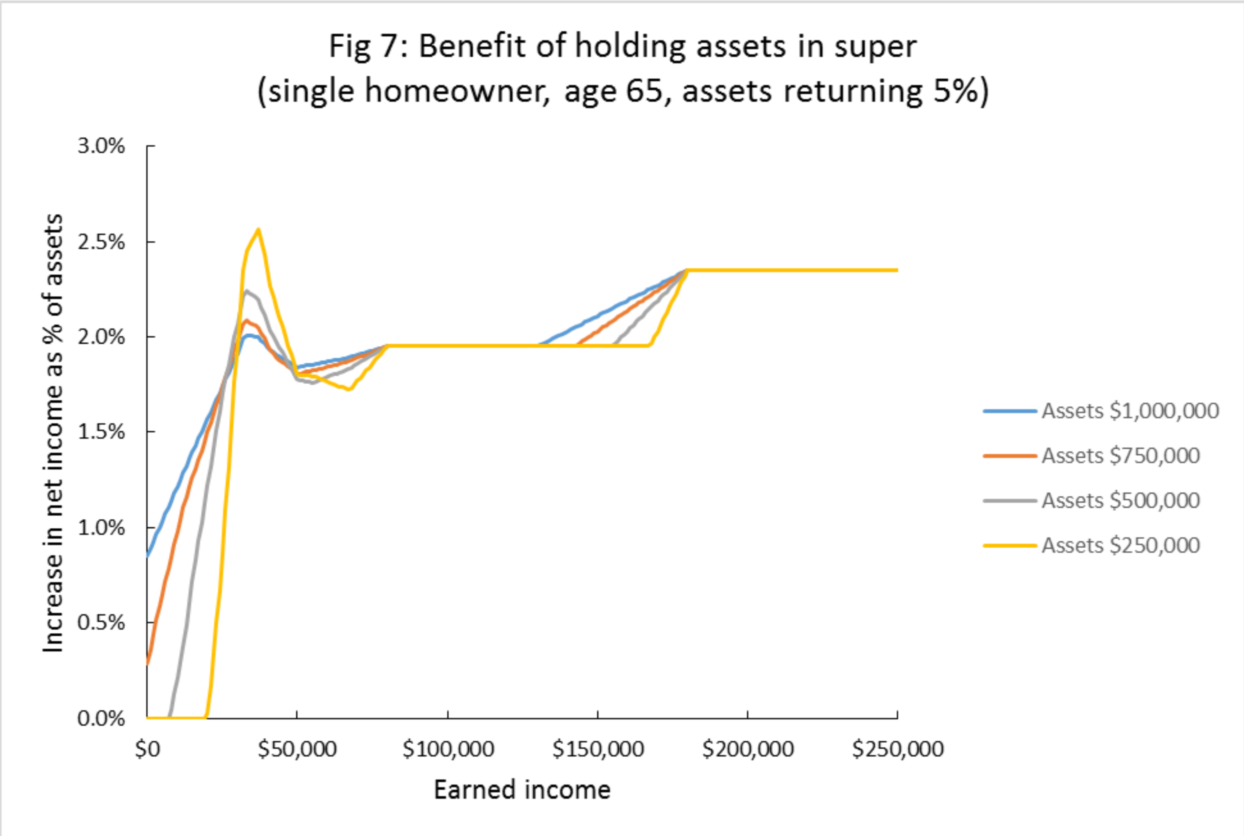
Fig 1 can be recalculated on the assumption that the same investments are held outside of super. This changes the retiree's taxable income because the 5% return on assets becomes taxable.

Subtracting the original from the recalculated graphs gives the benefit to the individual of holding the assets in superannuation – except that administration costs will be significantly less outside superannuation, so the return after costs from the investment will be better, but we will ignore that.

Fig 7 shows the difference in net income between holding the assets in superannuation and holding them outside super, for the same retiree considered above. The difference is expressed as a percentage of assets, because it has the same effect as a change in the return on assets.

This graph is unaffected by the asset test taper rate. Nor is it particularly sensitive to asset returns, although if a fund returns significantly more than 5% some of the return is likely to be realised or unrealised capital gains and a more complex model is needed.

(Note: Fig 7 and the graphs to follow only refer to assets already in superannuation. Further additions via superannuation guarantee payments are not considered.)



This is a complicated graph, especially for earned incomes below $80,000 (although it is not affected by changes to the asset test taper rate).

Clearly there is no simple answer to the question "Is it worth keeping assets in super during retirement?" except that for someone with modest assets and income the answer is clearly "No".

In situations where there is little benefit to the retiree, there is also correspondingly little cost to the government, so there is no point in deliberately forcing retirees with assets below, say, $750,000 (which includes a large proportion of retirees) to withdraw money from super, yet that is the express purpose of the minimum withdrawal rules for superannuation pensions.

Nor is there any point in making it impossible for retirees with modest assets who are not working to continue contributing to their superannuation beyond age 65.

Both these considerations are discussed further in Section 6.

There may be a benefit in the retiree's remaining in superannuation even if it makes little difference to his net income, in that there is a wide range of easily accessible funds to choose from in the superannuation environment. Selecting a suitable investment outside superannuation may be difficult for some. Also, the retiree may have established a trusting and productive relationship with the fund during the accumulation years, and wish to retain that.

Finally, it should be noted that Fig 7 assumes that the taxable earnings from the assets contribute directly to net income. This may not be the case outside superannuation if, for example, the taxable income includes a significant realised taxable gain which is reinvested rather than consumed as income. This can occur simply as part of routine rebalancing of a share portfolio, or as the consequence of a company takeover.

In fact, for most people the single compelling reason to keep assets in superannuation during retirement is to avoid capital gains tax. Significant issues concerning this tax are discussed later in Section 6.

If Labor's proposal to tax the earnings of Account-based Pension funds above $75,000 goes ahead in the future, the advantage of avoiding CGT will be diminished.

4.7 Total government support of retirement income

The benefit to the individual of keeping assets in superannuation during retirement (Fig 7) derives entirely from tax savings, so it also represents the cost to the government of that individual staying in super (assuming the same assets are managed the same way whether in or out of super, and ignoring the less easily quantifiable benefits to the government discussed in Section 3.4)).

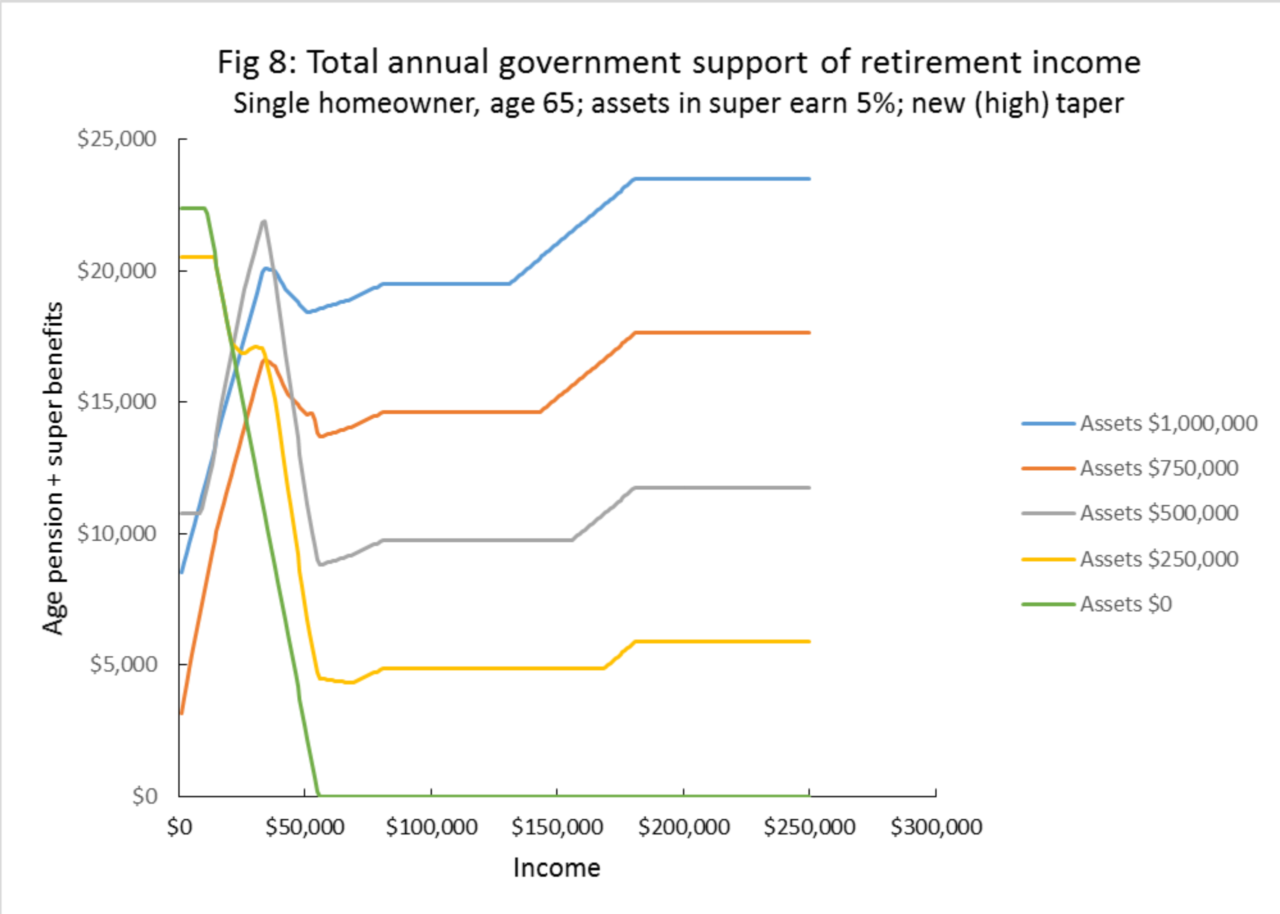
Adding Age Pension payments (if any) to the curves of Fig 7 (after converting those curves back to cash) gives the total annual government support for the retiree as shown in Fig 8, which is based on the new (higher) asset taper rate.

Fig 8 sums up what a complex inconsistent mess the system of government support for retirement incomes really is, especially for retirees earning less than about $80,000.

For those earning more than this, the level of support is strongly dependent on the amount of assets held in superannuation and is not very sensitive to income (since it only depends on the marginal tax rate applied to the investment earnings outside super).

Government support of superannuation, by not taxing earnings of assets in superannuation pension accounts, is entirely consistent with the notion, developed in Section 3, that superannuation is an investment by the government. Applying taxes would simply erode that investment.

Interestingly, in this example, a single retiree with $1,000,000 of invested assets who earns more than about $37,000 from paid employment and investments outside superannuation receives government support (superannuation tax concessions) roughly equal to a full Age Pension.



5 Food for thought: a universal taxed pension?

Unfortunately it is beyond the resources of a private individual such as myself to fully analyse a system as complex as Australia's retirement support. Even apparently straightforward analysis, such as determining the "cost" to the government, or benefit to the individual, of superannuation (as in Fig 7) is seriously oversimplified. It ignores behavioural questions, and fails to consider how effects will develop over time. In fact the question is not even the right one: we should be asking "where would the country be now had we not had compulsory superannuation, and where would we be in 30 years if we abandoned it?"

Similarly, it easy to calculate a "cost" of making changes to the Age Pension but if they do not accurately take into account behavioural consequences the answer is of dubious relevance.

If the new asset test taper rate and threshold are introduced on 1 Jan 17, and there are no other significant changes in the next few years, there is a terrific opportunity for the ABS or other expert statisticians to study in detail how people respond to those changes, in particular the poverty trap they introduce. In fact such a study should already be underway, because some people are shedding assets already, or planning to.

With the caveat that this is a simplistic analysis, I would like to make a suggestion for a complete restructure of the Age Pension, in conjunction with the income tax system.

In Sections 3 and 4 I have made the following points, among others, about the Age Pension:

- It is better thought of as a "dividend" than as simply welfare.
- Discrimination against various groups is unfair.
- The assets test creates a serious poverty trap, especially in its latest incarnation.
- The income test in conjunction with income tax also creates a serious poverty trap.

And I have made the following relevant recommendations (abbreviated here):

4: Abandon or drastically modify means testing.
6: Restructure Age Pension and income tax rules to remove poverty traps.
7: Make the effective marginal tax rate progressive for over 65s.

So far, I have not discussed how these might be achieved. Whatever way it is done, it will involve radical changes. Here is a suggestion:

Step 1: Remove the distinctions between homeowners and others and between couples and singles so that there is only one full pension. Removing the associated arbitrariness and unfairness of the current system is sufficient justification in my view, although there is obviously a cost involved.

Step 2: Remove the assets test and associated deeming of income. This test is arbitrary and unfair, and it is also the cause of a serious poverty trap. There is obviously a cost involved here too, because many more people will be entitled to a full pension. There are behavioural benefits also, because of removal of the poverty trap.

Step 3: Remove the income test. The intention here is primarily to remove the income poverty trap, and to go at least part of the way to making the effective tax rate progressive.

In aggregate these three changes make the Age Pension universal: everyone over 65 is entitled to it. Such a proposal would be anathema to those who believe the Age Pension is strictly welfare for the poor, but it is perfectly consistent with the view that the Age Pension is a dividend. Obviously such an enlarged scope entails costs, but ways to offset these are discussed below.

> Step 4: To take the dividend analogy one step further, if the Age Pension is a dividend then it is income and as such should be subject to income tax. The progressive nature of the income tax scale then fulfils the role of the current Age Pension income test, although it is fairer.

Fig 9 shows how a universal taxed Age Pension (assumed here to be the same as the current single homeowner pension) would interact with taxable income. This is analogous to Fig 3, and the current actual (untaxed) Age Pension is also shown for comparison.

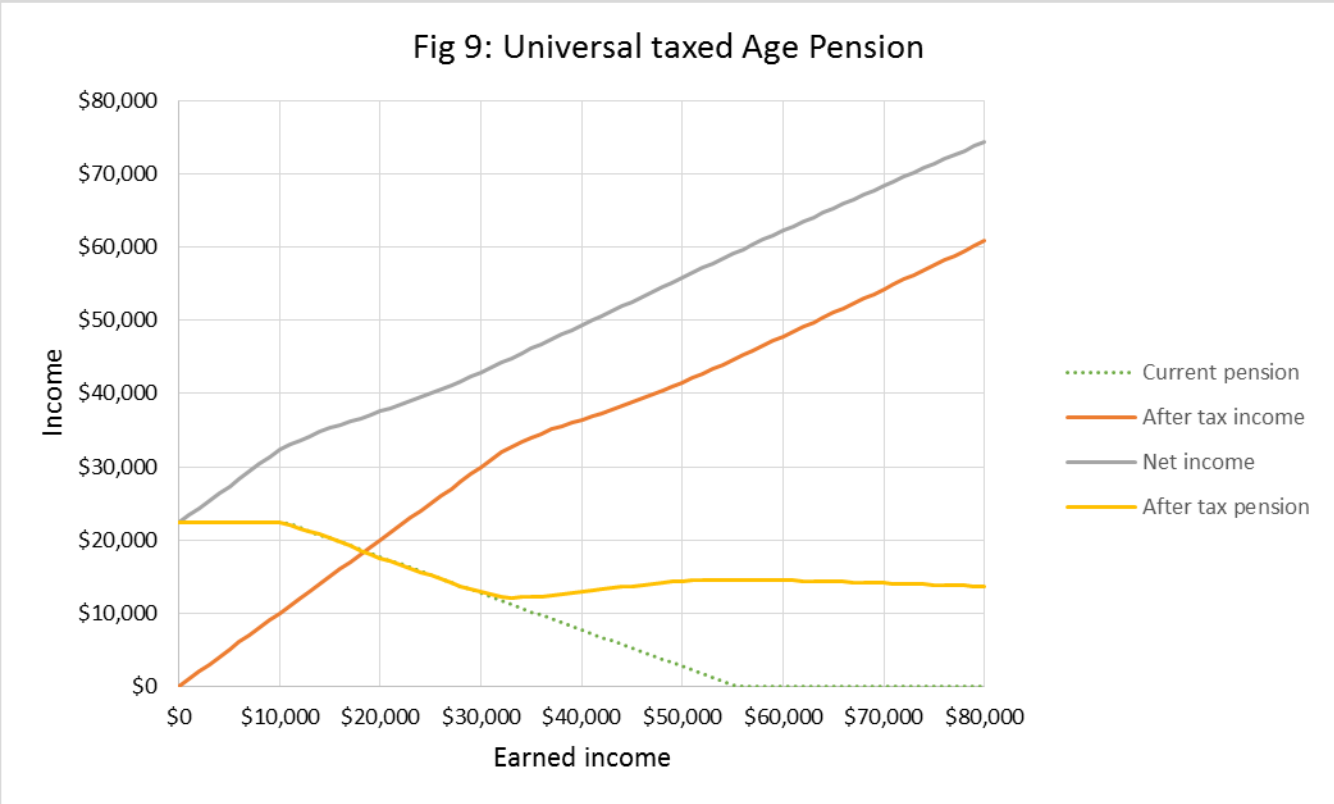
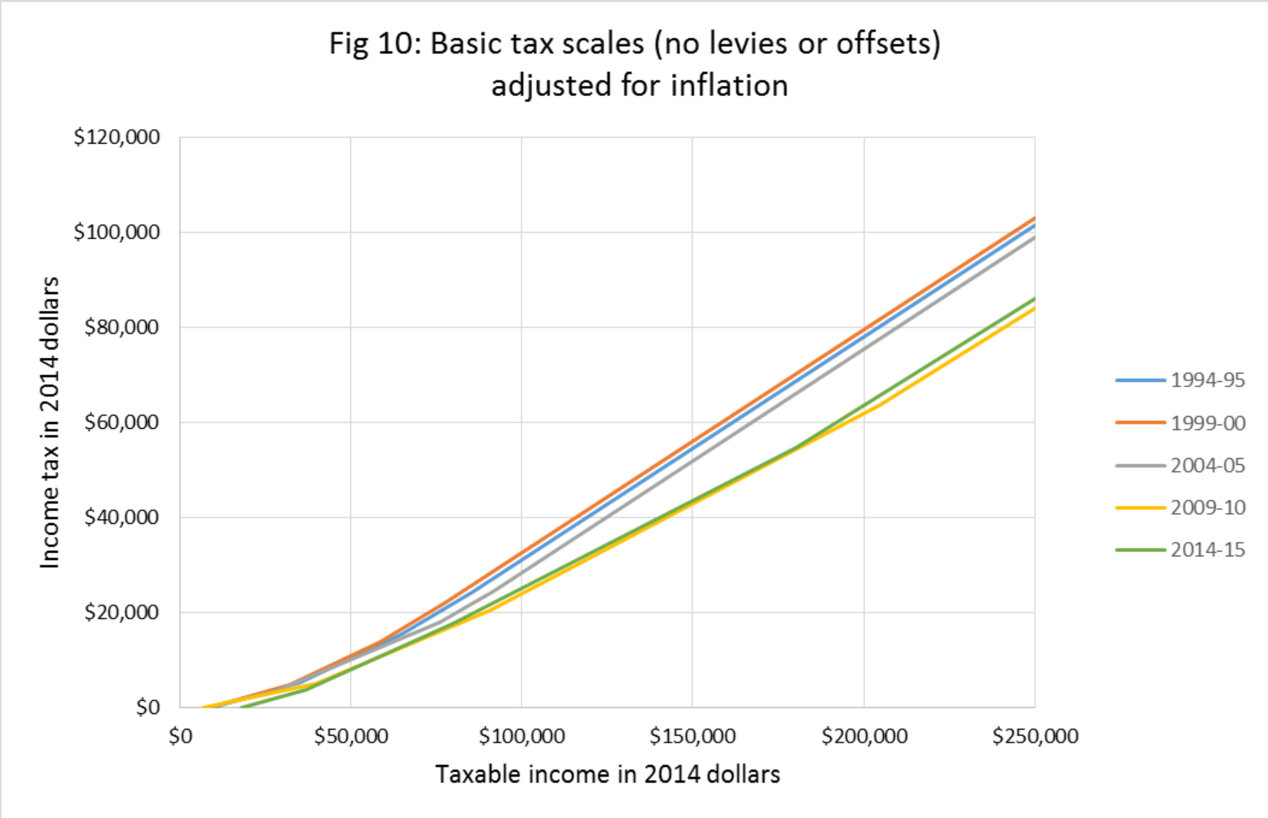


Fig 9 notes: "Current pension" is the Age Pension for a single homeowner under the present rules.
"After tax income" is earned income less the tax paid on it
"After tax pension" is the Universal Age Pension, less the additional tax paid on it
"Net income" is "After tax income" plus "After tax pension"

In contrast to the current system, the universal taxed pension would deliver a pension payment of $13,000 to $14,000 to retirees earning more than $40,000. This is apparently a radical departure from the present situation, but it needs to be seen in context. For example, it is similar to the benefit from the tax-free superannuation environment received by a retiree with $500,000 in assets returning 5% (see Fig 8).

A more relevant comparison is with the changes in income tax scales which occurred through the period 2004-5 to 2009-10 as shown in Fig 10:

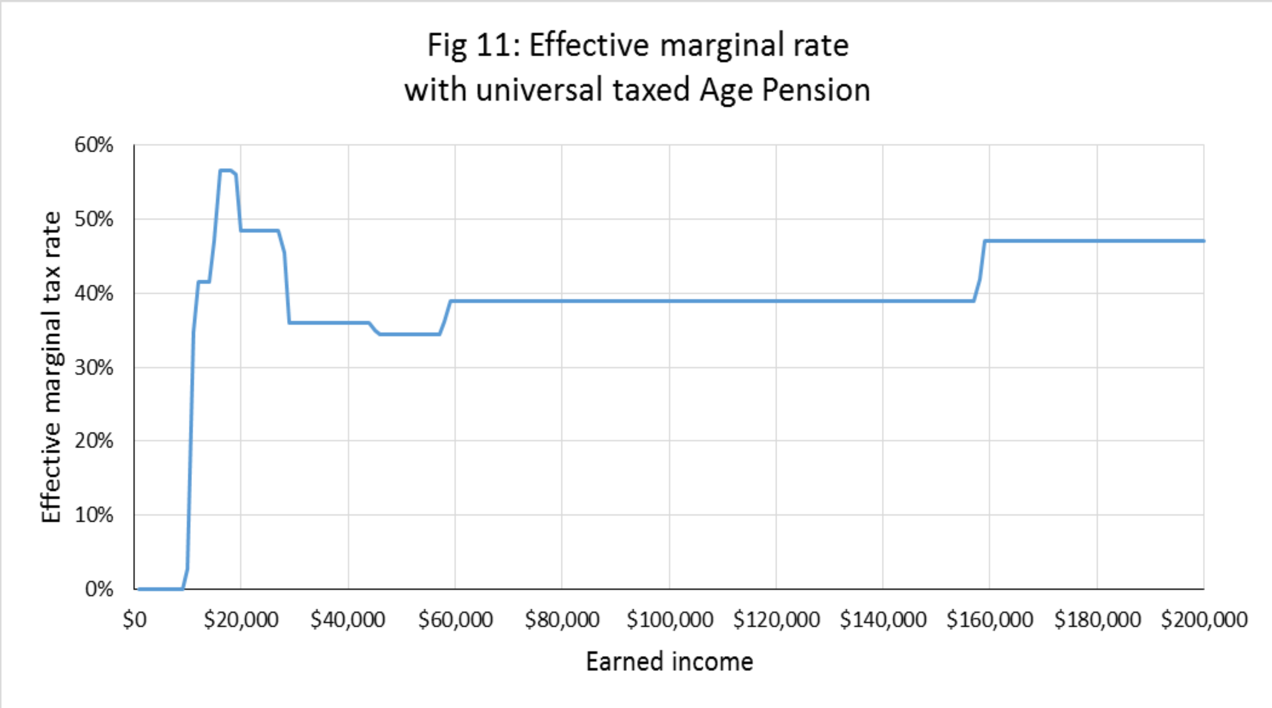


The changes (mainly an increase in the threshold for the top tax rate, and to a lesser extent the second top) gave everyone (not just retirees) in the current top tax bracket (over $180,000 income) an extra $15,000 *per annum* in 2014 dollars.

Extension of the Age Pension to those (relatively few) retirees earning higher incomes could therefore be presented as an alternative to a tax cut: those younger than 65 get a tax cut, those older get a pension without changing their tax rate, the net effect being similar. If there is no tax cut in the offing, the tax scales for over-65s can simply be modified to counter the effect of the pension for those on high incomes. (SAPTO already provides a precedent for an age-based component of income tax).

It does not matter exactly how the integration of the Age Pension with income tax is achieved. In fact one thing this analysis highlights is that there is no difference in principle between a pension payment and a tax cut. Calls from some quarters for less welfare and lower taxes are therefore self-contradictory.

With a universal taxed pension, the income poverty trap disappears, because the influence of the Age Pension income test is gone. The effective marginal tax rate is not quite progressive (compare Fig 11 with Fig 4), but it is close because the effective marginal tax rate is well below 100%. Further fine tuning of the tax scale would fix the progressiveness if necessary.



Making the Age Pension universal and taxable would dramatically improve the efficiency of its delivery, providing very substantial cost savings.

Responsibility could pass from Centrelink to the ATO, since calculation of the pension entitlement only depends on age and it is easily automated. Tax on the Age Pension entitlement could easily be incorporated into PAYG deductions for those in regular employment.

Centrelink would then be freed up to concentrate its resources on the unemployed, the disabled and others who necessarily require individualised attention.

Finally, the universal taxed pension is a far simpler system than we have at present, and is nowhere near as susceptible to legislative and regulatory risk, so it should be much more stable.

Unfortunately, a full examination of this concept is beyond the resources of a private individual but it is worth deeper study, even if only as a benchmark by which other transformative proposals can be judged.

Recommendation 8: Evaluate the concept of a universal taxed Age Pension in depth with particular regard to the benefits of simplicity, stability, efficiency, fairness, and pensioner behaviour.

6 Current or potential rules which militate against the purposes of the Age Pension and superannuation in retirement

A number of aspects of the current system are at odds with the philosophy outlined in this submission. They also insult common sense, and they can easily be corrected immediately.

Also some aspects of the current system which are very sound are under sustained attack in the public debate.

This section deals with both.

6.1.1 Minimum super pension drawdowns

The minimum drawdown rules in the retirement phase of superannuation are specifically designed to force money to be taken out of superannuation. It may then be consumed as income or re-invested outside superannuation. The intention is to prevent the use of the tax free environment of an Account-based Pension as an estate planning tool.

The minimum drawdown rules impede the ability of the fund trustee to invest in a prudent way and in this respect probably contradict the trust deed of every superannuation fund, large or small.

Forcing assets to be removed from the superannuation environment is a pointless exercise in most cases (little or no tax advantage for the government), and it acts to defeat the objective of helping people build and maintain financial security throughout retirement.

I criticised this rule in some detail in my submissions to the *Financial System Inquiry* and to Treasury's *Review of retirement income stream regulation* on the basis that minimum drawdowns have the most severe effect on conservatively invested funds with relatively low returns after fees and inflation, quite independently of the size of the fund.

Such funds are unlikely to be a vehicle for amassing great wealth, and the most likely effect of the rules on them is to force too rapid a consumption of capital in the early years of retirement thus increasing reliance on the Age Pension (counter even to the FSI's limited view of the purpose of superannuation) in the later years and compromising the retiree's resilience against financial shock.

In the years following the Global Financial Crisis in 2008, it proved necessary to modify the drawdown limits, because of the damage being done to account balances when returns were negative. That should have been a clear sign that these rules do not operate as intended.

Further confirmation can be found in the Treasury discussion paper *Review of retirement income stream regulation* which canvassed adjustment of the minimum drawdown rates in response to fluctuating market conditions.

The minimum drawdown rules are simply not an effective or fair way to limit the total amount of money a retiree has in superannuation.

Nor are they necessary: that role is now filled by tight restrictions on the size of contributions during the accumulation phase.

Recommendation 9: Abolish the minimum drawdown rules for superannuation pensions.

6.1.2 Contribution limits

Contribution limits have been made significantly tighter than they were a few years ago, and thus have become the main mechanism for limiting the total amount of assets one can transfer to the superannuation environment. I support this approach in principle because it is straightforward, easy to administer and does not of itself hamper the ability of the individual to grow assets in either the accumulation or retirement phases.

However, contribution limits can also act in an unfair way to prevent people building up a superannuation balance sufficient to fund their retirement. This is especially the case for women whose career is interrupted by raising a family, for anyone else whose income is erratic, and for anyone who receives a significant sum such as an inheritance and wants to place it in a superannuation account.

A significant improvement for people in these categories would be to allow both concessional and non-concessional contributions to be spread over 5 years, as is currently done with non-concessional contributions (although they can only be brought forward 3 years, which I suggest is not enough).

The restrictions on contributions for people aged 65-70, however, are arbitrary, unfair and pointless. Thus, at age 64 one can use the bring-forward rule to make a non-concessional contribution of $540,000 but from age 65 the limit is only $180,000 if the work test is met and $0 otherwise.

The work test itself is also arbitrary. How is 40 hours of work in 30 consecutive days different from 40 hours evenly spread through the year, and why 40 hours? It is a trivial amount of work for anyone in regular employment, but those over 65 are not necessarily able to find any sort of work at all.

Beyond age the age of 70 the restrictions become even more severe. Yet even at 75 a retiree may need her superannuation for another 20 years or more, and she should be allowed to contribute further funds if she is able.

Limiting or preventing contributions from those who are retired, or partly retired, has the same effect as forcing them to withdraw money from superannuation. It is counter to the proposed purpose of superannuation, to common sense, and to the government's long term objectives for superannuation. In most cases, there is not even a significant tax advantage for the government.

Recommendation 10: Introduce a 5-year bring-forward rule for concessional and non-concessional contributions

Recommendation 11: Remove the age based restrictions on superannuation contributions for people over 65.

6.1.3 Capital gains tax

Generally, when assets are sold, the sale may create a capital gain which is taxed as income.

In retirement, this currently applies to assets held outside superannuation but not to those held inside a superannuation pension account. However, there is considerable public discussion about taxing superannuation earnings in the retirement phase, and this would include capital gains. The Labor party has proposed such a tax, and it may well be introduced by either party at some point in the future.

If this happens, it is extremely important that the way capital gains tax is calculated is fair. When assets are sold in retirement, they have often been held for a very long time. This means that a significant part of their growth in nominal value is simply due to inflation, and it is obviously not fair to tax inflationary gains.

Tax should reasonably apply to the growth in spending power between the cost of purchase and the proceeds of sale; in other words, the cost base of assets should be indexed for inflation before calculating the taxable gain.

This is the way capital gains were taxed until a few years ago, when it was decided to simplify the system by abandoning indexation and simply taxing 50% of the nominal gain (66.6% for assets in a superannuation in the accumulation phase) – a trade-off of fairness for simplicity.

The indexation method is fairer because it taxes only the gain in spending power. For example, under the present discount system an asset held outside superannuation which simply maintains a constant real value (so that the purchasing power of the sale proceeds is the same as the purchasing power of the money it cost) would generate a taxable capital gain of 29% of the sale price if sold after 30 years, assuming 3% inflation. Indexing the cost base would, correctly, lead to no taxable gain.

Recommendation 12: Re-introduce indexation of the cost base for CGT, at least as an option

6.1.4 Dividend imputation

There has been a lot of public commentary about getting rid of dividend imputation. Somehow, it is seen as an arbitrary benefit to share investors, which is nonsense.

Dividend imputation is based on the very sound concept that company profits should not be taxed twice, simply because they have been passed from the company to its owners.

It is often argued that we should not have dividend imputation because few other countries do. Similarly, presumably, we should not lead the world in any field because no one else does?

In reality, dividend imputation is a great benefit to Australia. It encourages companies to value the interests of their shareholders, provides a huge capital base for reinvestment in the country, and provides investors with excellent returns.

Dividend imputation is sometimes presented as something which benefits only those on low marginal tax rates, such as superannuation funds in retirement mode, but that is not true. In fact, the franking credits are simply income for all investors, and are taxed as such.

Recommendation 13: Retain dividend imputation.

6.1.5 Taxation of super in retirement phase

A number of participants in the public debate have advocated strongly against retaining the tax free status of superannuation accounts in the retirement phase.

The Labor party, in particular has said that if it gains office it will tax earnings in the retirement phase in excess of $75,000 in the same way as they are taxed in the accumulation phase. This would include capital gains tax (see Section 6.1.3), so routine portfolio rebalancing or liquidating a fund to transfer it to another fund could create a liability even for relatively small accounts. It is not proposed to index the $75,000 so the tax would eventually affect many funds.

This is a short sighted approach.

Government support for superannuation is best seen as an investment, and it is in the government's interest to nurture, not hobble, that investment. This is the fundamental reason why superannuation should not be taxed in the retirement phase: taxation depletes the government's investment.

Recommendation 14: Retain the tax free status of superannuation accounts in the retirement phase.

7 A closing comment

In compiling this submission, I have been mindful of the principle of obliquity: “our objectives are often best pursued indirectly” (see *Obliquity* by John Kay: Profile Books, 2010).

Kay describes numerous cases where the “right” objective is not necessarily the most obvious, for example: companies which have gone broke pursuing profits are contrasted with others pursuing customer satisfaction which are highly profitable.

Our present system is based on concepts of welfare, overlain with condescension and envy, and constrained by an overriding desire to keep government costs down. The result: a complex, unfair and capricious system for both the Age Pension and superannuation. Few understand it well, and it is characterised by expensive bureaucratic inefficiency, frequent changes, poverty traps and often acrimonious public debate. Clearly the objectives have been very badly chosen.

A clear understanding of the nature of the Age Pension and superannuation provides an unemotional basis for establishing why each should exist, and why the government should support them.

I have shown how, by focussing on fairness, consistency and simplicity, it is then possible to simplify the Age Pension to such a point that it can be incorporated as an automatic calculation within the tax system with potentially large improvements in efficiency and stability. Furthermore, poverty traps are removed.

With superannuation pensions too, insisting on fairness and consistency simplifies and improves the system in a way that is entirely consistent with government objectives to empower and assist people to invest for their retirement.

Properly constructed, with a firm philosophical base and an emphasis of fairness, efficiency and stability, the system of government support for retirement income need not cost more than what we have now, but in the long run should deliver much better results for retirees and for the economy as a whole.

Finally, it is essential to consider the Age Pension, superannuation and the income tax system as a coherent whole in any discussion of retirement incomes. A thorough formal review is long overdue.