

Tax and super – unfinished business

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On superannuation taxes the government's main response to the Henry review has been to lift the compulsory contribution rate, from 9 to 12 per cent of wages by 2020. This would eventually rectify the continuing inadequacy of most superannuation balances at retirement. Unlike the government, Henry acknowledges the adverse-selection and supply-side problems stunting the Australian market for longevity insurance. We propose a resolution that would give workers a choice between either or both of two kinds of super account, one taxed under the current arrangements (or those proposed in the Henry review) and the other only in retirement and at the marginal rate of the retiree. The new accounts would be reserved for the purchase of lifetime annuities.

1. Introduction and summary

The Henry review of Australia's tax system reported to the government in December 2009 (AFTS 2010a,b,c). So far as superannuation is concerned, it proposes taxing employer and employee contributions progressively while halving the 15 percent tax on investment earnings.¹ The review envisages a rate scale for taxing contributions set at an offset to the marginal rate faced by the worker on her personal income. The rate of the offset for a worker on the 'standard' marginal tax rate would be set at a level that resulted in her effective tax rate on contributions remaining at 15 per cent. The review floats 20 per cent as a possible value for the offset.

The review proposes that the compulsory contribution rate be raised from the current effective rate of $(1 - 0.15) \times 9 = 7.65$ per cent to the current headline rate of 9 per cent. This would be achieved by abolishing the tax on superannuation contributions in the fund. Instead, employer contributions would be taxed at the personal income tax rate less the offset.

There would be a new uniform tax of 7.5 per cent on the investment income and capital gains of superannuation assets before retirement. The tax would also fall on 'assets supporting income streams', notwithstanding a term of reference stipulating the continuation of tax-free retirement benefits to those aged at least 60.² The resulting regime would be more progressive overall than the present one but less progressive than the personal income tax, owing to the 7.5 per cent flat tax on fund earnings before and after retirement. Apart from these flat taxes and the absence of any requirement to convert retirement benefits into income streams, the resulting regime would resemble the one governing Roth retirement accounts in the United States. The proposed system can be summarised by the acronym Ttt, where an upper-case letter signifies a comparatively large

¹ Capital gains are currently taxed at 10 per cent rather than 15 per cent. Interest income is effectively taxed at more than 15 per cent whenever inflation is positive, as recognised by the Henry review (AFTS 2010a,b,c) and Sorenson and Johnson (2009).

² Strictly speaking, there actually are some taxes on super benefits paid to the over-60s, in particular, on shortfalls in age-dependent minimum annual drawdowns from allocated pensions, death benefits paid to non-dependents out of pre-tax contributions, and retirement benefits from untaxed funds. See Bateman and Kingston (2007).

tax and the positioning of the letters corresponds to taxed contributions, taxed fund earnings before retirement, and taxed benefits after retirement.

One group of winners from Henry's proposals would be young workers at the lower end of the income distribution. Another group would be those able to take advantage of new contribution-splitting opportunities enabled by the post-Henry system. One group of losers would be fast-trackers on high wages. Fast trackers would need to give serious consideration to non superannuation strategies for long-term saving such as negative gearing.³ Another group of losers would be elderly people exposed to the new tax of 7.5 per cent on assets supporting income streams after retirement. They too would need to give serious consideration to moving their retirement savings out of the super system.

Overall, the Henry proposals would improve the equity of the superannuation system. The government's main response to the Henry review thus far has been to propose a lift the headline compulsory contribution rate from 9 to 12 per cent of wages, by 2020. This would eventually go a long way towards rectifying the continuing inadequacy of most superannuation balances at retirement. The government also came up with with what is in effect a two-step scale for taxes on employer contributions, setting rates at zero and 15 per cent (Australian Treasury 2010).⁴

Neither Henry nor the government comes up with a solution to the adverse-selection problems (or the supply side issues) that stunt the Australian market for longevity insurance.⁵ To overcome an adverse-selection problem you need outright compulsion or a compelling tax preference.⁶ We propose a combination of the two. Workers should be given a choice between either or both of two kinds of super account, one taxed under the current arrangements (or those proposed by the Henry review) and the other only in retirement and at the marginal tax rate of the retiree. The new accounts would be reserved for the

³ Apart from those able to make good use of the Henry-inspired lift from \$A25,000 pa to \$A50,000 pa in the cap on employer contributions on behalf of workers aged over 50 and with less than \$A500,000 in super.

⁴ Strictly speaking this is not a zero tax rate. It is framed as a 15% contribution towards tax paid on concessional contributions up to a maximum of \$A500 per annum (non-indexed), and will therefore lose its impact over time.

⁵ Although the Final Report on Australia's Future Tax System (2010a,b,c) does advocate policies to address the lack of longevity products through supply-side measures including, requiring that the government issue long term securities and through public provision of immediate and deferred annuity products (Evans and Sherris 2010).

⁶ And to address the supply-side problem requires intervention to assist providers deal with interest rate risk, inflation risk and mortality risk (Purcal 2006, Evans and Sherris 2010).

purchase of lifetime annuities. They would kick-start the market for longevity insurance and ease the cost to taxpayers of population ageing.

The resulting regime would resemble that faced by US workers⁷. They can contribute to either or both of 'traditional' (back-end-taxed) 401ks or Investment Retirement Accounts (IRAs), or Roth (front-end-taxed) accounts. That is, US workers saving for retirement can choose either or both an EET account and a TEE account. Both account types are subject to an account-specific contribution limit and a global contribution limit, to protect the revenue. (Key features of traditional and Roth 401ks and IRAs are summarised in Appendix 1.) In contrast to the US system, retirement benefits from the new EET accounts suggested by us for Australia would be confined to lifetime annuities, as distinct from the life-expectancy annuities also permitted under the US rules. Retirement benefits from the old TTE (or Henry recommended Ttt) accounts could continue to be untaxed (ignoring returns on underlying assets) and lump-sum in form. Workers and retirees disinclined to familiarise themselves with yet another new set of super rules could largely continue with their existing arrangements.⁸

Our proposal accommodates the needs of retirees for both longevity insurance and lump-sum resources. By eliminating all flat-rate taxes on investment earnings, the new accounts would bring the progressivity of super taxes fully into line with that of personal income taxes. The new accounts would go close to eliminating double-dipping, in contrast to the current regime and the Henry proposal, which both appear to envisage continued heavy reliance on the Age Pension by at least half of the income distribution.⁹ The new accounts would generate a major revenue stream for the government in two to three decades time, when tax revenues will be scarcer than today. Back-end taxes would promote the competitiveness of voluntary contributions to super with long-term savings plans based on negative gearing strategies, as the lifetime tax efficiency of negative gearing is broadly comparable to what the lifetime tax efficiency of superannuation would be in the absence

⁷ And Canadians who can opt for tax deferred Tax Free Savings Accounts (TFSA) or front-end taxed Registered Retirement Savings Plans (RRSPs) (Government of Canada 2009).

⁸ The qualification 'largely' is necessary because there would need to be a gradual squeeze on the contribution limits applying to old accounts in order to accommodate rising tax expenditures on the new accounts.

⁹ A broad definition of double dipping is accessing public benefits in old age despite having had adequate opportunities to arrange a self-funded retirement during one's working years, including access to tax-concessional super. See AFTS (2009b) on the extent to which Treasury foresees continued take-up of the Age Pension in 2050.

of a contributions tax. Back-end taxes confer a tax-deferral benefit to workers on the cusp of retirement who chose to delay it.¹⁰ This would promote labour-force participation by the elderly, which is low relative to our labour-force participation a few decades ago and participation rates in countries such as the US. Finally, progressive taxes at the back end serve to cushion members of poorly-performed defined-contribution plans, by easing them into a low tax bracket in retirement.

Winners from our proposals would include young workers at the lower end of the income distribution, and fast-trackers. Those facing the prospect of supporting government-funded retirees in two to three decades time would be better off; one group of losers would be workers planning to double-dip in retirement. Retirees planning to use the super system to leave a large bequest would lose too. Finally, long-lived retirees would obviously do better out of life annuities than those not so favoured.

In the next two sections we provide context by outlining the evolution the tax and transfer arrangements for superannuation and retirement benefits. We then discuss the recommendations of the Henry review as it applies to superannuation and summarise the minimal response by the government. Overall, the Henry proposals would improve the equity and reduce the complexity of the superannuation system as well as improving the supply side of Australia's life annuity market. We conclude with a proposal for superannuation taxation, based on the US experience, which allows choice of front- or back-end taxation of retirement saving and provides a mechanism to revive the demand side of Australia's life annuity market.

2. Evolution of superannuation taxes

Prior to the release of the Henry review (AFTS 2009a, 2010a,b,c) and the measures proposed in the government's response (Australian Treasury 2010), Australian superannuation was taxed under a comprehensive income tax regime (TTE). Superannuation contributions were subject to tax (T) at different rates depending the source or quantum of the contributions, superannuation fund earnings were subject to tax (T) at different rates by type of income, and superannuation benefits were free of tax (E) for

¹⁰ For more details see Kingston (2007).

persons age 60 and above¹¹. Where the benefits satisfied certain design features the earnings on the underlying assets were also free of tax.

These arrangements were the result of two decades of evolution from an expenditure tax regime prior to 1988 (EET, where contributions and superannuation fund earnings were exempt from tax and benefits taxed), to a hybrid regime between 1988 and 2007 (TTT, where contributions, fund earnings and benefits were all taxed, albeit at concessional rates) and finally to the TTE regime since July 2007.¹²

This evolution is summarised in column 1 of Appendix 2, while the broad features of the pre-Henry review tax treatment of superannuation contributions, fund earnings and benefits are summarized in Table 1.

Table 1: Taxation of superannuation, pre Henry review^a

Contributions	Superannuation fund earnings	Benefits
Tax treatment differs by type of contribution and amount	Tax treatment differs by type of income and retirement phase	Tax treatment differs by age and benefit type.
<p>Employer contributions: Tax deductible to employer.</p> <p>Employee contributions: Paid out of after-tax income OR 'salary sacrificed' - to effectively become employer contributions (Excess contribution tax applied above cap).</p> <p>Low/middle income earners eligible for a government co-contribution.</p> <p>Self employed contributions: Tax deductible. Eligible for government co-contribution.</p> <p>Spouse, child contributions: Tax rebates available.</p>	<p>Concessional contributions^b: Taxed at 15%. (Excess contributions tax applied above cap).</p> <p>Interest income: Taxed at 15%.</p> <p>Dividend income: Taxed at 15%, eligible for imputation credits.</p> <p>Foreign source income: Taxed at 15%, with credits for foreign tax paid.</p> <p>Realised capital gains: Taxed at 15% or 10%, depending on date of acquisition.</p> <p>Retirement benefits: Income on underlying assets tax free if minimum drawdown requirements are satisfied.</p>	<p>Benefits taken between age 55-59 Lump sum: Taxed at 15% above threshold. Income stream: Taxed at marginal income tax rates, 15% tax rebate.</p> <p>Benefits taken from age 60 Lump sum: Tax free. Income stream: Tax free.</p>

Source: Bateman and Kingston (2007), Treasury (2009).

- a. A small minority of superannuation funds are 'tax exempt'. No taxes apply to fund income and higher taxes apply to benefits.
- b. Concessional contributions are contributions which have received a tax deduction – employer and self-employed contributions.

¹¹ The overall taxation of superannuation differs depending on the tax status of the superannuation fund. This summary refers to 'taxed' superannuation funds, which is the most common case. There is also a very small category of tax exempt public sector superannuation schemes for which contributions and fund earnings are untaxed, and benefits are taxed.

¹² Following the introduction of Simpler Superannuation announced in the 2006-07 Budget (Australian Treasury 2006).

The taxation of superannuation had been long criticized on the grounds of complexity and its inequity. These criticisms were highlighted in the many submissions Australia's Future Tax System and were emphasised in preliminary recommendations of the Henry review panel (AFTS 2009b).

The lack of alignment of superannuation taxes with the personal income tax system had resulted in the flat rate superannuation tax rates becoming more nearly regressive as they had failed to benefit from the substantial falls in personal income tax rates over the previous two decades. As well, the reduced visibility of superannuation taxes as compared with personal income taxes has jeopardised the political insulation offered by private retirement income provision.¹³

3. The failed market for life annuities¹⁴

Despite introducing mandatory retirement saving, Australian policymakers have always fallen short of mandatory retirement benefit purchase. In the years prior to the release of the Henry review the tax-transfer treatment of retirement benefits had become neutral across alternative benefit types. As with the taxation of superannuation and retirement benefits, this treatment was the result of several decades of reform and change.

Throughout the 1980s and early 1990s, in conjunction with the introduction of mandatory defined contributions (DC) arrangements (productivity award superannuation followed by the superannuation guarantee), tax-transfer reforms were introduced to encourage lifetime annuities. Measures included tax exemption for income on the underlying assets; offering a 15 per cent tax rebate, which, when compared with the 15 per cent tax then imposed on lump sums, gave a 30 per cent advantage to life annuity purchase;¹⁵ and a doubling of the retirement accumulation eligible for tax concessions (known as the Reasonable Benefit Limit) as compared with lump sums. Life annuities were later afforded concessional treatment under the Age Pension income and assets tests. (These and later measures are summarised in columns 2 and 3 of Appendix 2).

¹³ See Bateman and Kingston (2007).

¹⁴ The material in this section is drawn from Bateman and Piggott, forthcoming 2010.

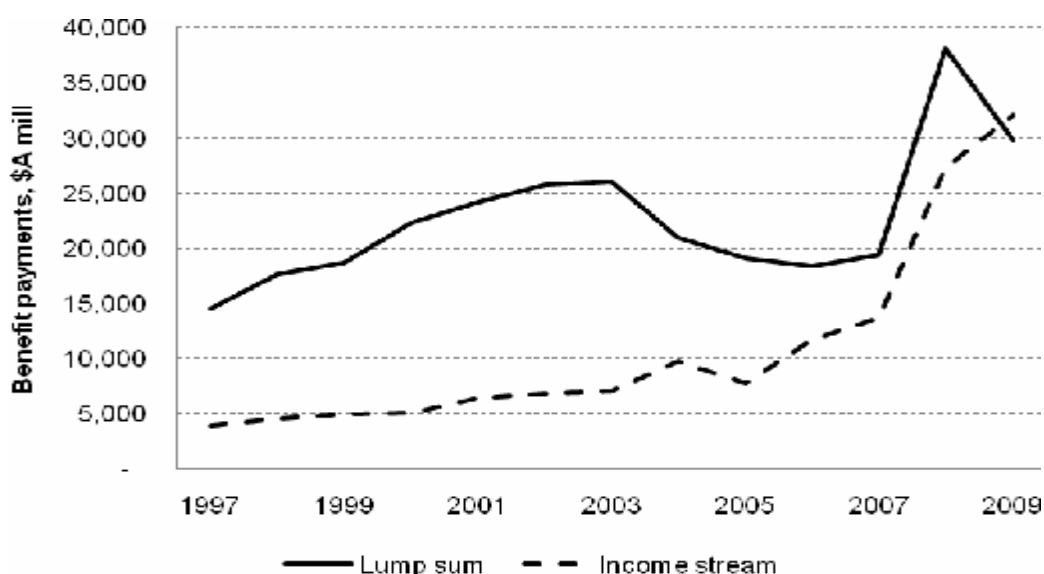
¹⁵ However, the treatment of the principal repayment component of life annuities purchased with tax-preferred accumulations nullified this advantage (Bateman et al 1993).

However, almost as soon as they were introduced, the tax-transfer incentives for life annuities were progressively extended to non-longevity insured products, including phased withdrawals (ie, initially known in Australia as allocated pensions) from 1994, life expectancy term annuities from 1998, term allocated pensions in 2004 and transition to retirement pensions in 2005. The Simpler Super reforms of 2006-07 resulted in the removal of all tax-transfer preference by benefit type (Treasury 2006).

The withdrawal of tax-transfer preference for life annuities, coupled with adverse selection deriving from the small and voluntary nature of the life annuity market in Australia and supply side constraints such as a lack of products to hedge the long term liabilities and uncertainty surrounding mortality risk, has resulted in just about no demand for life annuities and the reluctance of providers to promote life annuities as a retirement benefit option (Purcal 2006, Evans and Sherris 2010).

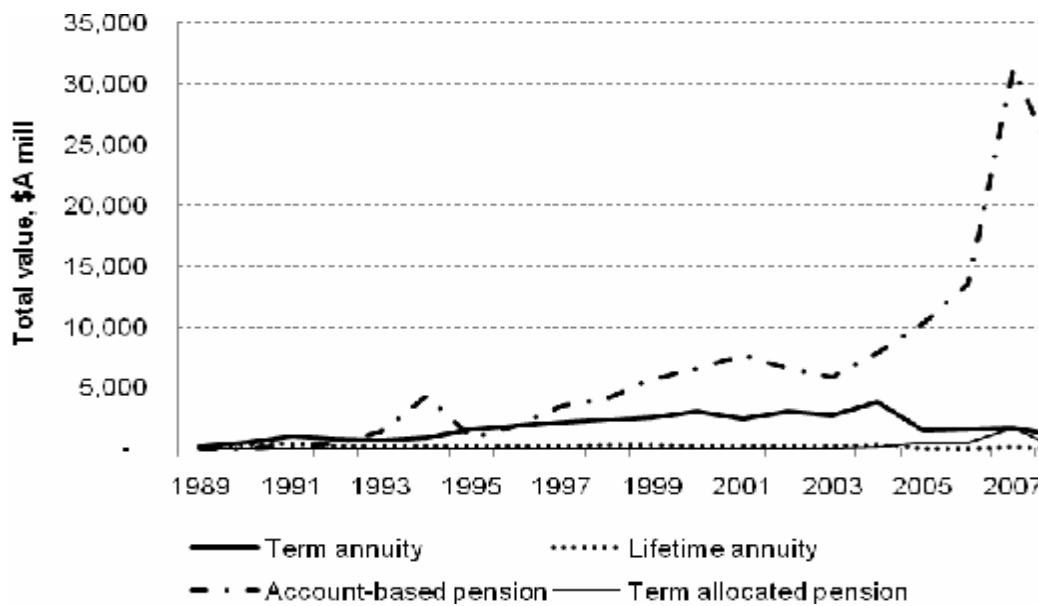
As a result, few Australian retirees are covered for longevity risk by virtue of their private retirement saving. Figures 1 and 2 summarise trends in the take-up of retirement income products purchased over this period. Figure 1 focuses on the split between lump sums and retirement income streams, while Figure 2 reports on trends in the market for income stream products, specifically life annuities, term annuities, account-based pensions and term allocated pensions.

Figure 1: Value of retirement benefits – lump sum and income stream, 1997-2009



Source: APRA (2007, 2010).

Figure 2: Value of private retirement income streams, 1989-2009



Note: Account-based pensions include transition to retirement pensions. Account-based pensions were previously known as allocated pensions.

Source: Plan for Life (2010).

A number of trends are evident. The switch in preference from lump sums to retirement income streams, the sharp increase in the demand for phased withdrawal-type products (allocated pensions, account-based pensions and transition to retirement pensions), the growth in, and then decline, of the market for term annuities, and finally, the disappearance of the market for life annuities.

Figure 1 plots the value of retirement benefits taken from superannuation funds each year from 1997 as either lump sums or income streams. Traditionally Australian retirees had a preference for non-annuitized benefits, and particularly lump sums. However, this began to change with the introduction of phased withdrawal products, initially in the form of allocated pensions, and later as 'transition to retirement pensions' and 'account-based pensions'. By 2009, income streams dominated lump-sums and these income streams are mostly account-based pensions.

Trends in the demand for account-based pensions (and the previous allocated pensions) are reported in Figure 2. A spike in sales is evident in 1994 with the extension of the 15 per cent annuity rebate to allocated pensions and a dip prior to 2004 as retirees switched to

term annuities in anticipation of reduced Age Pension means test preference for these products from September 2004. However, the market for phased withdrawal alternatives expanded rapidly from the mid 2000s due to the introduction of the 'Transition to retirement' legislation of 2005 and the Simpler Super reforms of 2006-07 (Treasury 2006).

'Transition to retirement' pensions allow individuals to simultaneously contribute to a superannuation fund, continue to work, and draw down benefits taken as an income stream. This allows additional contributions to be made from before-tax income (taxed at 15 per cent in the hands of the fund), and simultaneous tax-free withdrawals. The Simpler Super reforms, announced in the May 2006 Budget and implemented in 2006 and 2007, abolished taxes on all retirement benefits taken after age 60, simplified the Age Pension means tests by removing differences by benefit type and exempted tax on the underlying assets of retirement income streams which satisfied minimum age-based drawdown requirements. As a result, in the pre Henry review period there were incentives to keep retirement assets in the superannuation system as retirement income benefits, rather than take them out of the superannuation system as a lump sum. In Australia this translated into a rapid increase in the demand for account-based pensions.

A small market for life annuities emerged in the 1980s and grew slowly in the early 1990s in line with the advantageous tax arrangements. It reached its peak after the introduction of Age Pension means test incentives in the form of full asset test exemption and income test concessions in 1990. Life annuities then held a small niche in the retirement product marketplace until 2004, when their exemption under the assets test was cut to 50 per cent. Tax concessions remained, and supported a very small number of sales. However, after the removal of benefits taxation to retirees over the age of 60 in 2007, all incentives towards life annuities ceased, other than for those retiring before 60. Between 2007 and 2008, the market declined by 90 percent in value, and by two thirds in number of sales. In 2009, only 29 life annuity policies were sold in Australia. A similar pattern is seen for term annuities.

The disappearance of Australia's life annuity market is illustrated in Table 2. Of 32,722 immediate annuity policies sold in 2001, 1,927 were life annuities (which corresponds to purchase by only 2 per cent of Australians retiring that year). By 2009 only 29 life annuity policies were sold out of a total of only 4,202 immediate annuity policies.

Table 2: Patterns of annuity purchase in Australia: 2001 – 2010

Year	Term certain annuities (without RCV)		Term certain annuities (with RCV)		Lifetime annuities	
	No.	Average value (\$A)	No.	Average value (\$A)	No.	Average value (\$A)
2001	11,072	71,677	19,725	82,798	1,927	86,227
2002	15,004	73,065	20,326	93,296	1,750	88,349
2003	18,606	72,893	12,530	107,925	1,477	135,674
2004	37,296	73,951	9,159	116,731	2,801	99,886
2005	7,233	75,746	7,664	114,307	293	93,072
2006	6,566	80,810	7,187	131,588	341	88,446
2007	7,355	107,353	6,010	145,749	403	92,184
2008	999	110,951	5,496	182,997	61	195,082
2009	685	110,657	3,517	185,036	29	203,793
2010*	283	115,194	893	205,622	19	68,421

*Note: Data for 2009 covers the year to the end of March only.

Source: Plan for Life Research (2010), Immediate Annuity Report, March 2010.

4. The Henry review on superannuation taxes

In its preliminary report on strategic issues (on Australia's retirement income system) released in conjunction with the 2009-10 budget, the Henry review panel made two important observations. First, that the access and take-up of superannuation tax concessions was uneven, with around 2.5 million individuals receiving little or no personal income tax benefit from their superannuation contributions, while around 200,000 taxpayers earning more than \$A180,000 received a concession on their superannuation contributions of 31.5 per cent (AFTS 2009a,b; 2010a). And second, that there were insufficient products to insure against a person outliving their assets. In response, the panel then recommended:

- Maintaining tax assistance to superannuation but improving the fairness of concessions for contributions, including broadening access to superannuation concessions and limiting generous salary-sacrifice concessions; and
- Improving the ability of people to use their superannuation to manage longevity risk.

The Henry review, formally entitled *Australia's future tax system*, was delivered to the Treasurer on 21 December 2009 (but reserved until 2 May 2010 for public release) – see

2010a,b,c. The parts of it most relevant to this paper are the terms of reference relating to super, and Appendix A2, entitled 'Retirement incomes' (AFTS 2010b). The key recommendations of the Henry review as they apply to the taxation of superannuation and retirement benefits are summarised in Table 3.

Table 3: Taxation of Superannuation, recommended by the Henry review^a

Contributions	Superannuation fund earnings	Benefits
All superannuation contributions included in individual's taxable income and taxed at marginal rates (subject to an offset for low income earners).	All income (including capital gains) of superannuation funds and earnings on assets supporting superannuation income streams) of superannuation funds taxed at 7.5%..	All benefits taken from age 60 tax free.
The offset would be provided for all superannuation contributions up to an annual cap of \$A25,000 (indexed) and set so the majority of taxpayers do not pay more than 15 per cent tax on their contributions. The govt co-contribution and the spouse contribution tax offset would be abolished. Contributions cap doubled to \$A50,000 pa for people aged 50 or older.	Tax on superannuation contributions within fund abolished.	Review also recommended. The development of longevity insurance products should be encouraged. The government should issue long-dated bonds - to help product providers manage the investment risk associated with longevity insurance - and remove rules that restrict the development of income stream products. The government should consider offering annuity products itself.

Source: AFTS (2010a, b, c).

Terms of reference

One term of reference enjoined the review to 'preserve tax-free superannuation payments for the over 60s'. The review's interpretation is puzzling. On the one hand, it invokes this term of reference to rule out hybrids of the kind described earlier whereby workers get a choice between two kinds of super account, one taxed under the current arrangements and the other only in retirement: 'The terms of reference of this Review preclude it from considering the tax-free status of superannuation payments for the over-60s' (p97). On the other hand, the review proposes: 'The 7.5 per cent should also apply to capital gains

(without a discount) and the earnings from assets supporting superannuation income streams' (Recommendation 19, p106.)

Another term of reference was to 'incorporate consideration of all relevant tax expenditures.' As tax expenditures are measured on an annual time frame, this can be interpreted as a restriction on reforms that would reduce federal revenue in the short term while reducing social security outlays in the long term. The review reports little in the way of numeric estimates of the cost to tax expenditures of alternative proposals. In qualitative terms, however, the review is timid rather than bold when contemplating fresh tax expenditures. The word 'sustainable' crops up whenever the review signals concerns; unsurprisingly, it crops up as a justification for the proposed tax on the assets supporting superannuation income streams. In such ways the review places more emphasis on restraining tax expenditures than restraining Age Pension outlays.

Retirement incomes

Appendix A2, entitled 'retirement incomes', details the review's proposals. It is diffuse at times.¹⁶ Here is an instance from its recommendations on transitional arrangements: 'the changes could be implemented as part of the broader plans to reform the tax system. Another option would be to start with a higher offset that would gradually phase down to the ongoing offset rate over a transition period' (p106). Our education of financial planners is primarily by way of detailed numeric examples—'John and Joan are a couple aged 60. John earns \$A60,000 per year and Joan is retired', etc. Whatever finally emerges for superannuation taxes from the official family in the wake of the Henry review and the government's response will need to enable the construction of such examples.

The review recommends that contributions be taxed at the marginal rate of the contributor less a capped offset. Earnings should be taxed but at a 'very low' rate. This pair of recommendations is viewed as serving three objectives:

- progressivity would be greater than that of the existing flat-tax regime,

¹⁶ Yet the superannuation recommendations of the review were about two years in the making.

- super would remain preferable to some alternative saving plan whereby investment income is taxed at full marginal rates, even in the case of after-tax contributions, and the case of low-paid workers,
- reasonable (ie, not excessive) tax expenditures.

The review was particularly concerned with the current lack of incentives for voluntary contributions in the case of low-paid individuals, eg, those on half Average Weekly Ordinary Time Earnings. Indeed, the review may underestimate the lack of incentives in the case of the low paid, as it does not examine prospective losses of social security benefits. In this way, the review may exaggerate the appeal of voluntary contributions to the low-paid, were its proposals adopted. The review notes that current arrangements are not always equitable even in the case of the well paid. In particular, it is currently at the discretion of employers whether they offer salary sacrifice arrangements.

Such considerations motivate this passage from Recommendation 18: 'The tax on superannuation contributions in the fund should be abolished. Employer contributions should be treated as income in the hands of the individual, taxed at marginal personal income tax rates and receive a flat-rate refundable offset' (p100). As a consequence of the offset, mooted at 20 per cent, a worker with income under the tax-free threshold, envisaged as \$A25,000 pa by the review, would pay no tax on their superannuation contributions. Contributions eligible for the offset would be capped at \$A25,000 pa. Someone on AWOTE and on the average marginal rate of 35 per cent envisaged by the review would pay $35 - 20 = 15$ per cent. Someone on three times AWOTE and on the top marginal rate of 45 per cent envisaged by the review would pay $45 - 20 = 25$ per cent.

Recommendation 18 sounds a defensive note on the implications for voluntary contributions at the mooted top marginal rate, namely 25 per cent: 'Although concessions for high income earners would decrease under the recommendation the offset would still provide a substantial incentive for them to make voluntary superannuation contributions.' The problem with this argument is that the seriously competitive savings strategy outside super is not simply accepting a marginal rate of 45 per cent plus, but negative gearing,

which enables an investor to gain access to something like a EET tax regime along with superior flexibility in managing assets .¹⁷

Recommendation 19 is to cut the tax on superannuation fund earnings to 7.5 per cent. This rate would apply to investment income and capital gains alike,¹⁸ and also to assets supporting income streams. The review says: 'This would mean that the tax paid on the earnings of an average superannuation fund would be close to zero after allowing for the effect of imputation credits' (p107). Moreover: 'In the event that dividend imputation is abolished in the future, the earnings tax on superannuation should be reduced to zero'. This estimate of zero tax paid is predicated on the average fund continuing to allocate about 60 per cent of its assets to equities. Indeed, our average equity weighting appears to be the highest in the OECD (OECD 2009). There is a case, however, strengthened by the crash of 2008, for reducing the weight we place on equities, especially in the case of baby-boom fund members.¹⁹ By rendering domestic equities more tax-efficient than investments in interest-bearing securities our unusual practice of taxing the earnings of accounts in accumulation mode has probably exacerbated our unusually and questionably high allocation to equities. Moreover, there is no technical obstacle to refunding company tax effectively paid by members with accounts in accumulation mode as this already takes place smoothly for members with accounts in drawdown mode. Because of the company tax we ordinarily describe the tax on accounts in drawdown mode as zero even though there is proximately a cash flow to such accounts from the Australian Tax Office.

Even with inflation at just 2 per cent pa, a headline rate of 7.5 per cent on income from a deposit carrying an interest rate of 5 per cent corresponds to an effective rate of $100 \times 0.075 \times 5 / (5 - 2) = 12.5$ per cent. As a consequence, this tax is not necessarily 'very small'. Extended to assets supporting income streams, it could reinforce the pre-existing tendency to excessively risky asset allocations recommended by advisers to prospective self-funded retirees.²⁰ The review notes that halving the earnings tax to 7.5 per cent 'would significantly increase superannuation assets' (p114). Indeed, the effect on balances is found to be 'more

¹⁷ See Kingston (2006).

¹⁸ Capital gains would still be favoured over interest income under this change because an investor often has the option of delaying the realisation of a capital gain.

¹⁹ See Kingston (2009).

²⁰ See Kingston (2009). Advisers and managers tend to charge bigger fees for growth assets than interest-bearing ones.

than an increase in the superannuation guarantee to zero under the current tax arrangements.' The review is silent, however, on the effect on balances in drawdown mode of introducing a 7.5 per cent tax on assets supporting income streams.

The review notes the unpopularity of lifetime annuities in Australia and the supply-side constraints facing providers. It reports persuasive evidence that adverse selection is a major problem here. Other problems reported are unduly restrictive rules for providers of life annuities, ongoing increases in longevity, and an incomplete market for long term securities in Australia. Recommendation 21 says in part: 'The government should issue long-term securities, but only where this is consistent with its fiscal obligations, to help product providers manage the investment risk associated with longevity insurance' (p121). The clause on fiscal obligations probably alludes to the fact that the yield curve for nonindexed securities ordinarily slopes upwards, with the consequence that the interest costs of long term securities are comparatively high. However, the experience of Australia and the United Kingdom with indexed bonds is that their associated yield curves ordinarily slope downwards. Hence, there is more scope than the review suggests for improving the range of available maturities for index bonds.²¹ The review floats the possibility of government-provided lifetime annuities (Evans and Sherris 2010).

Appendix A2 (of the Henry review) proceeds to recommend a superannuation portal where people can interact with government agencies. It concludes by reiterating a recommendation in its earlier report on retirement incomes that the preservation age for super be raised to 67, so as to align it with the Age Pension age.

Not mentioned in Appendix A2 is that taxing super at the benefits stage could be expected to encourage late retirement, as continuing to work would then enable people to defer taxes. This omission is in contrast to Appendix A1 on the personal income tax, which is much exercised with the desirability of increasing the participation rate.

Overall, the Henry review proposes a Ttt regime for the taxation of superannuation, resulting in an improvement in the equity of the superannuation arrangements. The lack of

²¹ The likely explanation is that long-term index bonds are a better way of financing a consumption stream than short-term index bonds because the investor faces less reinvestment risk. In this connection, note that yield curves for nominal government bonds typically sloped downwards under the gold standard, suggesting that inflation risk explains most of the typical upward slope of government-bond yields in recent times.

longevity products would be addressed through support to develop a private annuity market and/or government provision of longevity products.

5. The government's response

A document issued by the Australian Government (Australian Treasury 2010) gives an interim response to the Henry review. It proposes a phased lift in the headline compulsory contribution rate from 9 to 12 per cent of wages and salaries (not recommended by the Henry review). These rises are scheduled to begin with ones of 0.25 per cent on 1 July 2013 and 2014, and be followed by ones of 0.5 per cent pa between 2015 and 2019 inclusive. In line with the review, the Superannuation Guarantee age limit would be raised from 70 to 75. From July 1 2012 a new superannuation contribution of up to \$A500 (non-indexed) is proposed to be made by the government on behalf of workers with incomes up to \$A37,000, in accord with the concerns of the review over the comparative lack of tax concessions available to the low paid. The idea is to return in effect the tax on superannuation guarantee contributions made to funds used by the low paid.

In addition (fleshing out an imprecise line of argument in the review) the government has foreshadowed that from 1 July 2012 people aged over 50 can direct employer contributions of up to \$A50,000 pa if their balance is less than \$A500,000. For others the employer contribution limit would remain at \$A25,000 pa, enforced by the pre-existing system of heavy taxation of excess contributions. Thus far there appears to be no plan to adopt the other changes to superannuation taxes recommended by the review.

In particular, neither the government's response to the Henry tax review or to the Harmer pension review (see Harmer 2009) advocated a reversal of the tax-transfer incentives for lifetime annuity purchase.

The overall government response is disappointing. The government did not address the inequities in the super taxes nor has it made concrete recommendations to revive the dormant market for life annuities.

6. Lessons from North America²²

The US has evolved a system for taxing superannuation which is settled, reasonably straightforward, and generally perceived as fair. It goes further than the Henry review and the government's response to ensure that superannuation taxes are progressive and aligned with the rules for taxing wages and salaries. It appears to avoid inordinate tax expenditures. It ensures sizeable revenue streams to the government both in the near term and in two to three decades time. It promotes labour force participation by the elderly, facilitates the needs of fast trackers, and eases members of badly-performed plans into a low tax bracket in retirement. It promotes voluntary contributions: at the turn of the century US private-sector voluntary contributions to pension plans were eight per cent of US wage earnings, or more than the 7.65 per cent after-tax contribution rate compelled by our superannuation guarantee (SG). In 2009 Canada emulated key features of the US system.

We do not say that Australia should copy all aspects of the US system. Notably, the US has thus far failed to enact compulsory pre-funded super of the SG variety, with the result that about half of the US workforce is not covered by pre-funded super. We do advocate emulation of the distinctive 'optionality' feature of the US system, as will be explained. We propose a tweak of the US model that would resolve the adverse selection problem bedevilling our market for life annuities.

1981 saw the introduction of 401k plans to the United States. They are EET vehicles for retirement saving by employees. The plans involve employer sponsorship; employers can contribute at up to half the rate of employees. 401k plans are of the defined contributions variety. Distributions received after age 59½ are generally taxed at the investor's marginal rate, and can take the form of periodic equal-size drawdowns apportioned in line with average life expectancy. Tax-deferred individual retirement saving takes place through Individual Retirement Accounts (IRAs), which do not require employer sponsorship, and are generally used as supplements to 401ks. Contributions to traditional IRAs come from after-tax income, but are generally deductible from federal income tax. Hence the tax efficiency of IRAs is the same as that of 401ks. These back-end-taxed vehicles quickly became a staple source of tax deductions for wage-earners in the upper half of the income distribution,

²² This section's explanation of the US system draws on Kingston (2006).

rather as negative gearing has become common for Australian wage-earners in the top two tax brackets for personal incomes. In 1998 the US introduced the Roth IRA alongside the standard IRA. These are TEE vehicles; contributions come out of your after-tax income but are tax free thereafter. Only if your marginal tax rate in retirement is the same as your rate at the time you contribute will the tax efficiency of the two kinds of IRA be the same. Yet members of pension plans do not rely exclusively on standard IRAs. One reason is a minority anticipating that their marginal tax rate in retirement will exceed their rate at the time of contribution into a pension fund. Another is that there are annual limits on what can be contributed to tax-favoured savings plans. Because contributions to Roth plans are taxed before they are counted towards the global limit, Roth plans give high-income earners an opportunity to squeeze more into tax-favoured savings plans. The year 2006 saw the introduction of Roth 401ks. Like standard IRAs they are employment related. Like Roth IRAs, tax is paid at the point of contribution rather than in retirement. Currently around 31 per cent of American households have traditional IRAs and around 15 per cent have Roth IRAs. (Traditional and Roth IRAs and 401ks are summarised in Appendix 1).

We propose an Australian version of this differential approach (ie back-end and front-end taxed arrangements operating simultaneously) that would be introduced by initially restrictive contribution limits, to moderate short-term tax expenditures. Over time we envisage more generous limits with the result that back-end-taxed accounts would eventually become Australia's primary vehicle for superannuation, as in the US. At retirement, and in contrast to the US, these accounts would be reserved for life annuities, which could be either offered by insurance companies (at preset prices) or tightly regulated tontines. These life annuities could be either fixed or variable. We suggest that variable annuities allocate no more than 50 per cent of their portfolio to growth assets. This cap would mitigate the moral-hazard problem for taxpayers of unlucky investors with risky allocations who end up falling back on the Age Pension.²³

We envisage that Australia's existing TTE (or the Ttt proposed in the Henry review) super accounts would eventually come to play an analogous secondary role in the Australian system. Contribution limits would gradually be tightened so as to limit tax expenditures

²³ As recently as 2008 we suffered this problem yet it has been disregarded by the Henry review and the government response.

while progressively working towards a system in which the new EET accounts hold most super assets. Investors in these new accounts are rewarded with a middle E rather than a middle T (or t) to compensate them for loss of Age Pension along with the liquidity advantages of retirement benefits in the form of lump sums, as they would be required to purchase lifetime indexed annuities.

7. Conclusion

The Henry review proposes to replace the pre-existing 15 per cent tax on employer contributions with a three-step scale. It flags zero, 15 and 30 per cent as one candidate set of rates. It proposes replacing the 15 per cent tax on fund earnings by one of 7.5 per cent. This flat rate would also apply to 'assets supporting income streams'.

The Rudd government has responded with what is in effect a two-step scale with rates on contributions set at zero and 15 per cent. Thus far it leaves undisturbed the pre-existing 15 per cent tax on earnings and the zero tax on fund benefits. The government also announced a plan to raise the compulsory contribution rate from 9 to 12 per cent by 2020.

Combined with other recommendations, both the Henry review and the government response address equity concerns over superannuation taxes while neglecting efficiency concerns. In the case of the Henry review this neglect is at odds with its close attention to efficiency concerns in the design of taxes on personal and business incomes. Both sets of proposals hark back to the superannuation surcharge regime that was introduced in 1996 and abolished in 2005.²⁴

We proposed a hybrid of front-end and back-end taxes on superannuation, based on the successful hybrid regime for IRAs and 401ks in the United States. Our suggested Australian version addresses efficiency concerns as well as equity ones. Longevity risk, premature retirement, inadequate voluntary contributions, deficient risk sharing²⁵ and moral hazard²⁶ were on our list of efficiency issues. Our proposal also made provision for people who would prefer simply to stick with their pre-existing tax arrangements.

²⁴ The initial version of the surcharge saw employer contributions taxed at rates between 15 and 30 per cent.

²⁵ Arising from the interaction between investment risk and the absence of progressive back-end taxes.

²⁶ Arising from the interaction between comparatively high advice fees applicable to risky assets and the presence of a safety net in the form of the Age Pension.

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Appendix 1: Features of traditional and Roth 401ks and IRAs

Features	Traditional 401k	Roth 401k	Traditional IRA	Roth IRA
Tax treatment	Contributions tax deferred. Distributions taxed at normal personal income tax rates.	Contributions made post tax. No tax on distributions.	Contributions tax deferred. Distributions taxed at normal personal income tax rates.	Contributions made post tax. No tax on distributions.
Income limits	None, subject to rules for highly compensated employees.		Single: Full - \$US53,000 pa. Partial - \$US63,000 pa. Married: Full - \$US85,000 pa. Partial - \$US105,000 pa.	Single: Full - \$US105,000 pa. Partial - \$US120,000 pa. Married: Full - \$US167,000 pa. Partial - \$US177,000 pa.
Contribution limits	Global limits for traditional and Roth 401ks: < age 50, \$US16,500 pa > age 49, \$US22,000 pa		Global limits for traditional and Roth IRAs: < age 50, \$US5,000 pa > age 49, \$US6,000 pa	
Inside account	Capital gains, dividends and interest accumulate tax free.			
Take up	Na	Na	31.2% US households in 2009	14.5% US households in 2009

Source: Investment Company Institute (2009), Internal Revenue Service (2010).

Appendix 2: Evolution of the tax-transfer treatment of superannuation and retirement benefits

Period	Taxation of superannuation and retirement benefits	Age Pension means test treatment of retirement benefits	Retirement benefits product menu
Pre 1983	EET: Tax concessions for lump sums (5% lump sum amount taxed at personal tax rates). Full taxation of retirement income streams at personal tax rates.	Income and assets from superannuation benefits subject to full income and assets tests.	
1983	EET: Specific lump sum taxes introduced. (15%/30%)		First incentives for life annuities
1984	Exemption from tax on income of underlying assets of immediate annuities.		
1988	TTt: <ul style="list-style-type: none"> • Significant changes to the taxation of superannuation: • 15% tax on concessional (mainly employer) contributions and superannuation fund earnings. • Reduction in lump sum taxes (0%/15%), • 15% annuity rebate for immediate annuities. • Return of capital excluded from taxable income for immediate annuities. • Introduction of reasonable benefit limits (RBL), with greater (double) RBL for life annuities. 		
1990		Concessions introduced for lifetime annuities. <ul style="list-style-type: none"> • Full exemption from assets test. • Return of capital excluded from income assessed for income test. 	
1992			Allocated pension introduced (phased withdrawal with minimum and maximum drawdown requirements).
1994	15% annuity rebate extended to allocated pensions.		
1996	15% Superannuation surcharge introduced.		
1998		Age Pension means test concessions for lifetime annuities extended to life expectancy annuities.	Concept of a life expectancy term annuity introduced.
2003	Government co-contribution introduced.		

Appendix 2: (cont)

Period	Taxation of superannuation and retirement benefits	Age Pension means test treatment of retirement benefits	Retirement benefits product menu
2004		100% assets test exemption for lifetime annuities reduced to a 50% exemption and extended to the 'new' term allocated pension (TAP).	Term allocated pension (TAP) – a market-linked income stream introduced.
2005 2007	15% Superannuation surcharge abolished. TTE: Exemption from tax on all retirement benefits for those aged 60 and above (both lump sums and income streams). <ul style="list-style-type: none"> • Abolition of reasonable benefit limits. • Abolition of 15% annuity rebate. Age-based contribution limits replaced with dollar amount contribution caps.	Removal of assets test exemption for immediate annuities and TAPs. Full asset test applies to all retirement benefits.	Transition to retirement pension introduced. Account-based pension (a revised allocated pension with a minimum drawdown requirement only). TAPs no longer sold.
2009	Contribution caps for concessional contributions reduced to \$A25,000 pa. Temporary reduction in co-contribution.		
2010	TTE: Proposals in government response to the Henry review include: contribution caps for concessional contributions increased to \$A50,000 pa for those aged 50 and over with superannuation accounts of less than \$A500,000; \$A500 offset to contribution taxes for those on incomes less than \$A37,000.		Introduction of minimum payment guarantee products.

Source: Bateman and Piggott (forthcoming 2010), AFTS 2009a, Australian Treasury 2006, 2009, 2010.