

**A better super system:
Assessing the 2016 tax reforms**

Grattan Institute Working Paper

John Daley, Brendan Coates and William Young

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Overview

Winding back superannuation tax breaks will be an acid test of our political system. Not because our major political parties are at loggerheads, but because they largely agree on both ends and means. If we cannot get reform in this situation, then there is little hope for either budget repair or wider economic reform.

Better targeting of superannuation tax breaks should be one of the first items of business in the new Federal Parliament. The government proposes to legislate that the aim of the \$2 trillion superannuation system is to encourage savings to supplement or substitute for the Age Pension. Tax breaks should only be available when they serve this policy aim. Yet as our 2015 *Super Tax Targeting* report shows, current super tax breaks go well beyond this purpose and their costs are unsustainable.

This paper analyses the impact of proposed changes to super tax breaks announced in the May Budget by the Coalition Government, and the ALP's subsequent policy response. They largely agree on a new 15 per cent tax on super earnings in retirement for those with super account balances of more than \$1.6 million; a lower annual cap of \$25,000 on pre-tax contributions; a lower income threshold of \$250,000 at which tax on super contributions will rise from 15 to 30 per cent; a \$500,000 lifetime cap on post-tax contributions; taxing earnings while in transition to retirement; and removing tax breaks on inheritance.

These would be big steps towards aligning super tax breaks more closely with their purpose. They would trim the generous super tax breaks enjoyed by the top 20 per cent of income earners – people wealthy enough to be comfortable in retirement and unlikely to qualify for the Age Pension.

Claims that the Budget changes will affect many low- and middle-income earners are wrong. The changes will affect about 4 per cent of superannuants, nearly all of them high-income earners who are unlikely to access the Age Pension. Nor are the proposed changes retrospective. Many reforms affect investments made in the past, and no-one suggests they are retrospective. Rather, the changes will affect taxes paid on future super earnings, and entitlements to make future contributions to super.

The major parties disagree about relatively little in this reform debate. The ALP would not count post-tax contributions between 2007 and the present. On the other hand it would adopt a number of other policies that would contribute even more to budget repair. Any combination of the packages on offer would improve the current system overall.

The changes are electorally popular. Electorates more likely to be adversely affected by the super changes – that is, those with more old and wealthy voters – tended to swing *less* to the ALP at the last election than other electorates. A survey before the election showed that the proposals had more support amongst those most likely to be adversely affected.

The proposed changes to super tax are built on principle, supported by the electorate, and largely supported by all three main political parties. If common ground cannot be found in this situation, then our system of government is irredeemably flawed.

Even after the reforms, super tax breaks will still mostly flow to high-income earners who do not need them. The budgetary costs of super tax breaks will remain unsustainable in the long term. Further changes to super tax breaks will be needed in the future.

Table 1: Government proposed reforms to superannuation tax breaks, ALP positions, and Grattan recommendations

	Government policy		ALP position	Grattan view	
	Proposed policy change	Budget impact (2019-20\$m)	additional Budget impact, 2019-20\$m	additional Budget impact, 2019-20\$m	Rationale
Pre-tax super contributions	• Lower annual cap on pre-tax contributions to \$25,000 a year	+950	✓	✓	• Reduces tax breaks for those unlikely to access the Age Pension in retirement.
	• Allow carry forward of unused pre-tax contribution cap	-250	+250 (no carry-forward)	+250 (No carry-forward)	• Does little to help low- and middle-income earners to make catch-up contributions.
	• Lower income threshold for 30% Division 293 tax on super contributions to \$250,000	+200	+500 (lower threshold further to \$200,000)	✓	• Reduces tax breaks for those unlikely to access Age Pension in retirement.
	• Maintain the LISC (renamed 'Low Income Superannuation Tax Offset')	-800	✓	?	• Unclear how this maximises boost to retirement incomes of low income earners per budget dollar
	• Permit all workers to make personal pre-tax super contributions	-750	+750 (no expansion)	✓	• Enables those with a mix of employment and self-employment to access super tax breaks.
	• Remove anti-detriment provisions in respect of death benefits from super	+245	✓	✓	• No reason to refund contributions tax paid by deceased estate.
Total super contributions	• Introduce \$500,000 lifetime cap on post-tax contributions, counting contributions since 2007	+250	-230 (no backdating)	✓	• Reduces tax breaks for those unlikely to access the Age Pension in retirement. • Little impact on genuine retirement savings.
	• Abolish the work test for 65 to 74 year olds to make contributions	-50	+50 (retain work test)	+50 (retain work test)	• Work test does not seem to prevent genuine retirement saving. Limits tax planning strategies.
	• Increase income threshold for low income spouse tax offset to \$37,000	-5	✓	+5 (no change threshold)	• Poorly targeted way to boost retirement incomes.
Earnings post-retirement	• Introduce 15% tax on super earnings in retirement for super account balances exceeding \$1.6 million	+750	✓	✓	• No rationale for tax-free super earnings in retirement. • Big long-term budgetary savings.
	• 15% earnings tax for super accounts for transition to retirement pensions	+230	✓	✓	• Closes tax-planning loophole allowing people to reduce tax on super earnings before retirement
Total budget impact / year		+770	+1,320 extra savings (+2,090 total savings)	+305 extra savings (+1,075 total savings)	

Note: Budget impacts reflect Treasury figures for 2019-20 when all measures are fully implemented. Breakdown of budgetary impact of \$25,000 cap on pre-tax super contributions and \$250,000 threshold for Division 293 tax are Grattan estimates.

Source: Treasury (2016c); ATO (2016b); Australian Labor Party (2016); Grattan analysis.

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1 Introduction

1.1 Aims for the superannuation system

Despite accumulating more than \$2 trillion in assets under management, our superannuation system has never had legislated aims.¹ This is changing.

The 2014 Financial System Inquiry recommended that superannuation should provide 'income in retirement to substitute or supplement the Age Pension.'² The Coalition endorsed this view in the May 2016 Budget.³ The ALP also backed legislating an objective for superannuation although it has not yet committed to the objective proposed by the Financial System Inquiry.⁴

As our recent *Super Tax Targeting* report shows, if the objective of super is to provide retirement income to substitute for or supplement the Age Pension, then the system should avoid supporting those whose wealth makes them unlikely to receive even a part Age Pension. This objective also implies that superannuation should not support savings at a high cost to the budget if it only reduces Age Pension liabilities a little. The benefits of higher retirement incomes must be balanced against the costs of achieving them.⁵

¹ APRA (2016a)

² Financial System Inquiry (2015). See also Daley, *et al.* (2015)

³ Treasury (2016b), p.5; Morrison (2016c).

⁴ Bowen (2016b). In a speech in 2015, the Shadow Treasurer Chris Bowen proposed 'our superannuation system should 'ensure that as many Australians as possible have access to the resources for a dignified retirement without recourse to the full age pension' Bowen (2015).

⁵ Daley, *et al.* (2015), p.16

Yet current superannuation tax breaks often go well beyond this purpose and their costs are unsustainable. The tax breaks reduce income tax collections by more than \$25 billion a year.⁶ More than half the benefits flow to the wealthiest 20 per cent of households who already have enough resources to fund their own retirement, and whose savings choices aren't affected much by tax rates. The current system is expensive and unfair. Reforms, such as those proposed by the major parties, are sorely needed.

1.2 Contributing to budget repair, and restoring the intergenerational bargain

Apart from being needed to align super with its policy rationale, reforms are also needed to contribute to budget repair, and to restore the intergenerational bargain.

The Commonwealth budget has a serious structural deficit. Actual deficits have been about 2 to 3 per cent of GDP for eight years.⁷ The Government is yet to respond to the scale of this challenge. In office, both major political parties have hoped that bracket creep and favourable economic conditions would produce a

⁶ As noted in *Super Tax Targeting*, this estimate accounts for behavioral change, where people would put less money into superannuation and more into other vehicles where they pay less tax than their marginal rate of income tax. See *ibid.*, pp.23-24. The value of superannuation tax breaks is calculated against a comprehensive income tax benchmark. While some commentators argue that an expenditure tax approach is a desirable structural feature of the tax system, arguments about the best policy for taxing savings should not be confused with questions about how to measure their cost. The income tax benchmark remains the best measure of how much tax breaks cost. Absent superannuation, savings would be taxed at rates of personal income tax. See *ibid.*, Box 1.

⁷ Daley and Wood (2015), p.4

surplus. Yet over seven years, outcomes have consistently been worse than these projections.⁸ Age-based spending and tax breaks are major contributors to structural deficits.

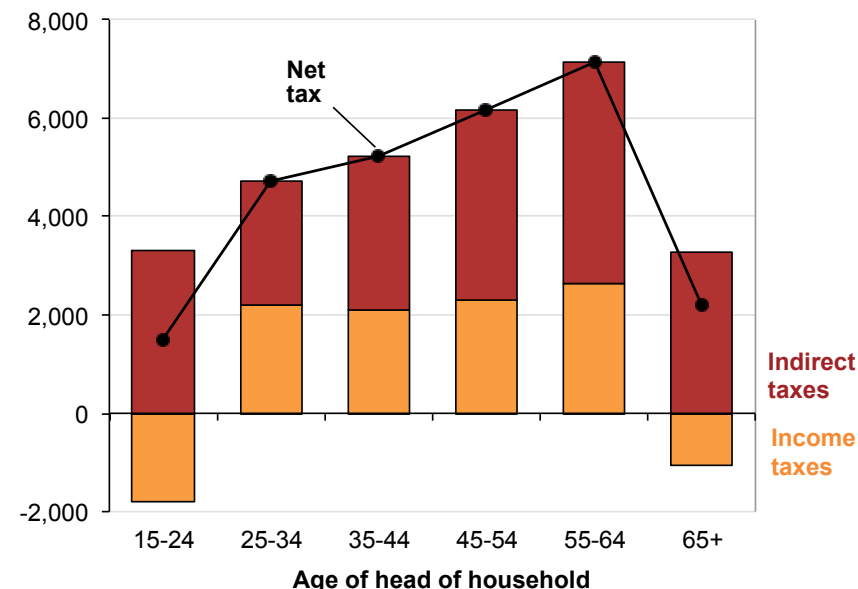
Net government transfers per household are calculated as health, education and welfare spending, less income and consumption taxes. Between 2004 and 2010, average net government transfers to households over the age of 65 increased in real terms from \$23,000 to \$32,000.⁹ The increase in net transfers to older households has worsened Australian government budgets by \$22 billion a year.¹⁰

For more than a decade, superannuation tax breaks have been absurdly generous to older people on high incomes. They are one of the major reasons why households over the age of 65 (unlike households aged between 25 and 64) are paying less income tax in real terms today than they did 20 years ago, even though their workforce participation rates and real wages have jumped (Figure 1).¹¹

In particular, the decision by the former Coalition Government to abolish taxes on superannuation withdrawals for those aged over 60 years in 2007 - without introducing taxes on super fund earnings in retirement - dramatically reduced the income tax bills of older Australians.¹²

Figure 1: Older households are paying less income tax because of the super tax breaks

Change in taxes per household, 1988-89 to 2009-10, \$2010



Source: Daley, Wood, Weidmann et al. (2014), Figure 3.6.

⁸ Daley and Wood (2016)

⁹ Daley, et al. (2015), p.22

¹⁰ Daley, et al. (2014), p.22

¹¹ Ibid., p.27

¹² Tax-free super withdrawals for over 60s were introduced by the former Howard Government as part of the *Simpler Super* reforms. Prior to that, super income streams were taxed at marginal rates of personal income tax less a 15 per cent rebate, whereas lump sums were taxed at different rates depending

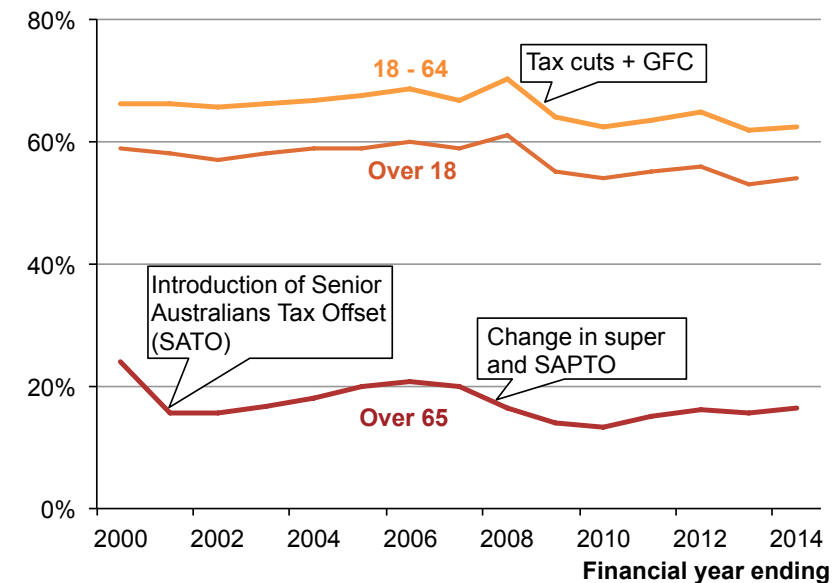
on whether they exceeded reasonable benefit limits (Treasury (2008)). Superannuation schemes where contributions are not taxed, such as public-service defined benefit pensions, still have taxes applied to withdrawals.

Super tax changes introduced in 2008 materially increased the number of income “taxed nots”¹³ aged over 65 (Figure 2). The introduction of tax-free super benefits provided an enormous windfall to high-income earners who had already amassed large super account balances that were no longer liable for taxes on either fund earnings or benefits withdrawn.¹⁴ These overly generous super tax breaks have been funded by deficits. The accumulating debt burden will disproportionately fall on younger households.

Making a transition to a fairer set of policies requires careful thought. Younger generations, on the wrong side of the drawbridge after the policies change, lose out when they pay for benefits for older generations that they do not receive themselves. Exempting older households from the costs of policy changes – by grandfathering existing benefits and tax breaks, for example – simply magnifies the costs shifted onto younger generations.

Figure 2: Older Australians account for a large share of the “taxed-nots”

Proportion of population paying personal income tax by age



Notes: Number of individuals paying some income tax based on taxable income as identified by the ATO at the time the late statistics for the financial year were released. Late taxpayers are probably about another 5 per cent of the population, but the bias is likely to be constant across the time series. Population data are for March quarter of each financial year. SATO and the Pensioner Tax Offset were amalgamated into the Senior Australian and Pensioners Tax Offset (SAPTO) in 2012-13.

Source: ATO (multiple years); ABS (2016); Grattan analysis.

¹³ This expression was introduced in Morrison (2016d). We interpret it here as the number of people paying income tax. Of course, virtually all households pay indirect taxes, and about half of all households receive more in benefits and services than they pay in taxes, because total government spending on welfare and services is similar to income and indirect taxes paid. Jericho (2016).

¹⁴ Prior to 2007, there were “reasonable benefit limits” on the amount of superannuation benefits that a person could receive over their lifetime at concessionally taxed rates. The system was complex to administer and affected few taxpayers. It aimed to levy additional taxes on those with very large super balances when they made large super withdrawals. Recent ASFA estimates suggested that 475 people with super account balances greater than \$10 million are now drawing tax-free income streams at an average of \$1.5 million annually: see Parliamentary Library (2005), p.10; Select Committee on Superannuation (2002), p.106; Clare (2015), p.4.

1.3 Political recognition of the need for reform

In the recent Federal election campaign, both major parties proposed rolling back superannuation tax breaks. The Turnbull Government announced a super reform package in the May 2016 Budget.¹⁵ The ALP had announced its own reforms to super tax breaks in April 2015,¹⁶ and committed to reviewing the Coalition's proposed changes after the Federal election.¹⁷ In August 2016 the ALP released a revised super package, which would save \$1.7 billion more over four years than the government's plan.¹⁸

There is little evidence for the claim that the Government's proposals reduced support for the Coalition in the 2016 Commonwealth election.¹⁹ The ten electorates most affected by the Coalition's proposed changes swung less to the ALP than the national average – indeed some swung towards the Coalition.²⁰ Polling suggests that support for the changes is highest amongst older people on high incomes²¹ – perhaps because they understand that the current system is unsustainable. In the face of these facts, some arguments against the superannuation proposals seem to amount to a claim that they should not proceed

¹⁵ Morrison (2016a)

¹⁶ Australian Labor Party (2015)

¹⁷ Chalmers (2016)

¹⁸ Bowen (2016a)

¹⁹ Vinales and Smiley (2016)

²⁰ Mather (2016). Bowe (2016) shows that electorates with a greater proportion of older people with higher median incomes – those most affected by the Coalition's super changes – swung less against the Coalition Government than the national average after accounting for other factors.

²¹ Those most likely to approve of the \$1.6 million cap on tax-free super earnings in retirement were Liberal/National voters (57 per cent), full-time workers (53 per cent), those earning \$1,500-2,000 per week (57 per cent) and those making after-tax super contributions (60 per cent): Essential Media (2016).

simply because Coalition party donors oppose them,²² which is not usually considered a relevant consideration for policy decisions.

Reforms to super tax breaks represent a rare opportunity to make much-needed progress on budget repair, while better aligning super tax breaks with their policy purpose. Both major parties agree on many measures. The risk is that these disagreements will derail reform. Good politics is always the art of compromise.

1.4 This paper's analysis of 2016 Budget reforms and opposition proposals

The remainder of this paper analyses the impact of proposals made by the major parties to wind back super tax breaks. It considers who would be affected and by how much. More importantly, it examines whether the proposals would better align super tax breaks with the newly articulated purpose of super.

Chapter 2 evaluates the proposed changes to **contribution tax breaks** announced in the 2016 Budget. Chapter 3 evaluates the proposed changes to **earnings tax breaks**. Chapter 4 considers changes to **how much in total people can contribute to superannuation**, including from their post-tax income, and the rules governing when they can make contributions.

Chapter 5 considers **how many people in total will be adversely affected** by the proposed changes. Chapter 6 **analyses their budgetary impact**. Chapter 7 asks **whether the proposed changes go far enough** to align super with its new purpose.

²² Markson and Martin (2016).

2 Proposed reforms to contributions tax breaks

2.1 Targeting pre-tax contribution tax breaks where they are needed

People can contribute to superannuation from their pre-tax income. These “concessional” contributions are taxed at just 15 per cent, rather than the person’s marginal income tax rate.

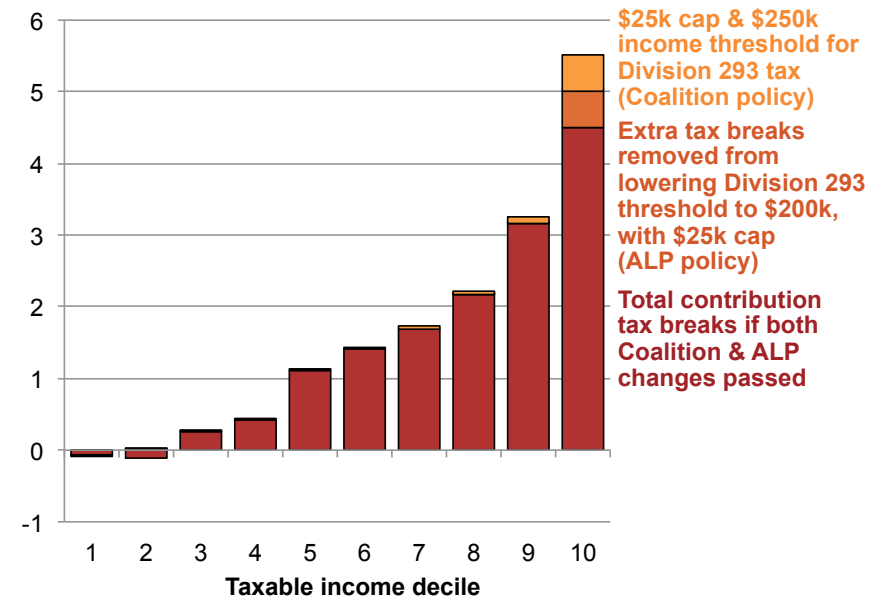
Tightening access to contributions tax breaks

The Government’s super package will reduce how much a person can contribute to superannuation from their pre-tax income. The limit will be reduced from \$30,000 (or \$35,000 for over 50s) to \$25,000 a year. Furthermore, contributions will be taxed at 30 per cent rather than 15 per cent if a person earns more than \$250,000 – down from the current threshold of \$300,000.²³ Treasury expects the changes will bring in an extra \$1.2 billion a year by 2019-20.²⁴

These changes will better align superannuation tax breaks with their policy purpose by reducing tax breaks for those who don’t need them as a substitute for the Age Pension. In 2017-18, the changes will affect about 550,000 people – overwhelmingly high-income earners who are unlikely to access the Age Pension in retirement.²⁵ Three quarters of the people affected are in the top fifth of income earners (Figure 3).

Figure 3: Trimming pre-tax contribution tax breaks will mainly affect the wealthiest Australians

Total superannuation contributions tax breaks by taxable income decile, \$ billions, 2017-18



Notes: The value of tax break is calculated against a comprehensive income tax benchmark, income deciles are for taxable incomes for 2013-14; only includes taxpayers that made a pre-tax contribution in that year. Does not include the impact of the Low Income Superannuation Tax Offset (LISTO).
Source: ATO (2016a); Grattan analysis.

²³ ATO (2016e)

²⁴ Treasury (2016c), p.28

²⁵ Grattan analysis of ATO (2016a).

The Government will also remove the anti-detriment provision that effectively refunds the taxes paid on super contributions if a member dies and the beneficiary is their dependent. There is no justification for boosting the value of inherited super balances – super is not a taxpayer-funded inheritance scheme. Treasury expects this change will raise \$245 million a year by 2019-20.

The ALP supports the Government's moves to tighten access to contributions tax breaks, accepting the government's moves to tighten the annual cap on pre-tax super contributions to \$25,000 a year and the removal of anti-detriment provisions.²⁶

Labor also proposes that the new income threshold for the 30 per cent tax rate on pre-tax super contributions be lowered further to \$200,000, which would save an additional \$500 million a year by 2019-20 compared to the Government's plan. In practice this more or less aligns with the top marginal income tax rate of \$180,000 because the income threshold for pre-tax super contributions includes both income and super contributions. It would mean that overall the system would broadly provide all taxpayers with a discount from their marginal income tax rate for superannuation contributions of between 15 and 22 per cent.

Lowering the income threshold even further for the 30 per cent tax rate to \$180,000 would save the budget a further \$350 million a year.²⁷

²⁶ Bowen (2016a); Daley and Coates (2016b).

²⁷ Grattan analysis of ATO (2016a).

Boosting contributions tax breaks for low-income workers

The Government will also boost super tax breaks for low-income earners by retaining the Low Income Superannuation Contribution (LISC), now renamed the Low Income Superannuation Tax Offset (LISTO) and paid through the tax system. The LISC is due to be abolished from 2017-18 onwards.

The LISTO removes a tax penalty on some low-income people who pay more tax on their super contributions than on their take-home pay. In 2017-18 it will provide \$800 million²⁸ to 3.3 million²⁹ people who earn less than \$37,000 a year. The ALP also supports this proposal.³⁰

Yet it remains unclear whether the best way to improve retirement incomes for low-income earners is to provide extra super tax breaks such as the LISTO, or additional Age Pension support. Of course, this trade-off assumes that money saved by not proceeding with the LISTO is re-directed towards additional Age Pension support. While such cross-portfolio budgetary transfers are uncommon, there are precedents, particularly for such a large strategic shift.

On the one hand, the LISTO is well-targeted to boost the super balances of low-income workers. Boosting individuals' superannuation balances, particularly women's, may improve their economic independence.³¹ The LISTO also arguably

²⁸ Treasury (2016c), p.28

²⁹ Treasury (2016a), p.12

³⁰ Bowen (2016a)

³¹ For example, see Senate Economics Committee (2016), pp.90-91.

compensates low-income earners for being compelled to lock up their savings in superannuation in retirement.³²

On the other hand, government may be able to deliver more effective and targeted assistance to low-income groups through income support payments rather than through superannuation. Boosting the retirement incomes of low-income earners through the tax and superannuation system is inherently less well targeted than increasing income support payments, which take into account the resources of the entire household.

For example, government makes additional co-contributions when people with low incomes make voluntary post-tax super contributions. But it is likely that many of the people who benefit from these provisions are the partners of high-income earners.³³ Therefore boosting retirement incomes through superannuation may produce a less progressive tax system overall.

Further, the LISTO may provide only a limited boost per budgetary dollar to the retirement incomes of low-income earners. Low-income earners accumulate less super, and so fees can erode a larger portion of their contributions.³⁴ More evidence is needed to test how much of the LISTO will ultimately benefit low-income retirees, and how much will be eroded in fees. Super funds could calculate this based on member records, or the Treasury could derive it from longitudinal analysis of individual tax

³² Daley, *et al.* (2015), p.17

³³ Daley, *et al.* (2016), p.4

³⁴ Rice Warner (2012) estimated that super fees for low-balance accounts can be much larger than the industry average. Account administration fees are typically charged at a flat rate irrespective of the super account balance, as are default insurance premiums provided by super funds (ASIC (2016); Canstar (2016)). Minifie, *et al.* (2014) (p.8) showed that small increases in fees can have a significant effect on final super account balances at retirement.

records that include both superannuation contributions and balances.

Expanding access to contributions tax breaks to all workers

Finally, the 2016 Budget proposes to make it easier for people to make voluntary pre-tax contributions directly to their superannuation fund. Under the changes, all taxpayers will be able to contribute directly to their super fund and claim a tax deduction on their personal income tax return. At present, only people who earn most of their income from non-employment activities (usually people who are self-employed or drawing most of their income from investments) can contribute directly,³⁵ employees and those with a mixture of part-time work and self-employment can only make pre-tax voluntary contributions if their employer provides a facility for salary sacrifice contributions.

The change improves system flexibility and levels the playing field so that some people do not miss out on super tax breaks simply because of their employment circumstances. In particular, the bulk of workers denied access to salary sacrifice arrangements are likely to work for small employers earning lower wages.³⁶

Treasury expects 850,000 working Australians to use these new arrangements. By 2019-20 they will receive a further \$750 million of super tax breaks a year, at the expense of the Commonwealth Treasury.³⁷

³⁵ ATO (2016d).

³⁶ ABS (2015a), Table 13.

³⁷ Treasury (2016a). The full budgetary cost of allowing all taxpayers to make pre-tax contributions only becomes apparent from 2019-20 because of delays between when tax is collected on those extra contributions and when taxpayers claim deductions for those contributions on their personal income tax returns.

The ALP does not support this proposal.³⁸ It argues that those using the new arrangements are likely to be mainly high-income earners, and providing them with additional support should not be a priority given budgetary constraints.

But the government’s proposal does promote consistency. If pre-tax contributions are allowed at all, there is no reason in principle to lock out people with employers who have less sophisticated payroll systems. One of the overall reform objectives should be to make superannuation policy more stable by aligning the system with its purpose.

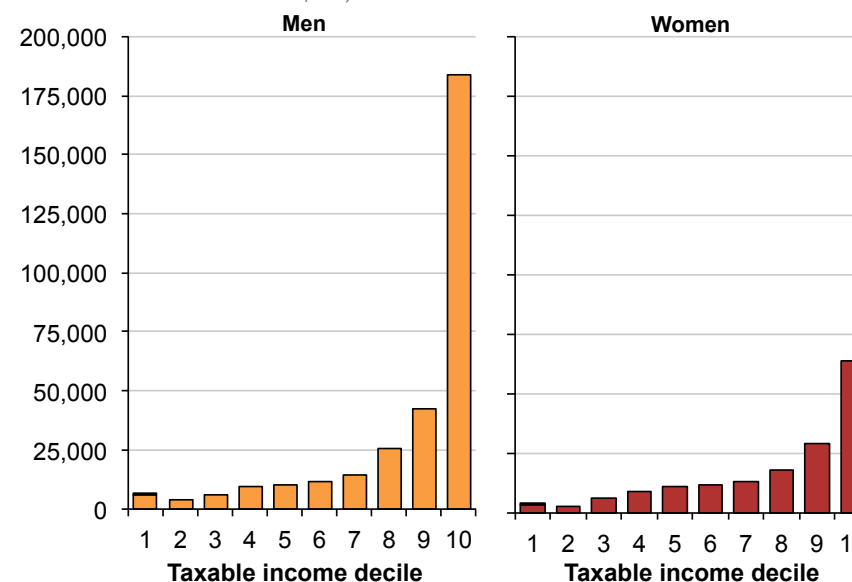
2.2 Pre-tax contribution limits are sufficient for those with broken work histories

Some have suggested that the lower \$25,000 annual cap on pre-tax super contributions will make it harder for those with broken work histories – particularly women and carers – to make catch-up super contributions.³⁹ Such concerns are overblown. All the evidence shows that very few middle-income earners, and even fewer women, make large catch-up contributions to their super funds.⁴⁰

At present, just 2 per cent of women are on course to contribute more than \$25,000 in 2017-18, compared to 4 per cent of men.⁴¹ Of those that make such large contributions, around two-thirds are among the top 20 per cent of income earners, most of whom are unlikely to ever qualify for an Age Pension (Figure 4).

Figure 4: Pre-tax super contributions of more than \$25,000 a year will mainly be made by wealthy men

Number of individuals in each income decile projected to make pre-tax contributions of at least \$25,000 in 2017-18



Note: Pre-tax super contributions made by individuals in the ATO 2 per cent sample file for 2013-14 are adjusted to reflect total pre-tax contributions reported in ATO Taxation Statistics for superannuation funds, such as by estimating Super Guarantee contributions for taxpayers with salary income but who report no pre-tax contributions from their employer and accounting for people who do not lodge their tax return on time. Contributions are then projected forward to 2017-18 to account for increases in nominal incomes and growth in the working population. The range of taxable incomes included in each decile is the same for men and women.

Source: ATO (2016a); Grattan analysis.

³⁸ Bowen (2016a)

³⁹ SMSF Association (2016); Tanton, *et al.* (2016).

⁴⁰ Daley, *et al.* (2016)

⁴¹ Grattan analysis of ATO (2016a), projected forward to 2017-18.

Instead, most of those who contribute more than \$25,000, and thus benefit from the existing tax breaks, are men with higher incomes. Few others have enough disposable income to make such a large contribution to super.⁴² The cost of providing a tax break on contributions over \$25,000 is ultimately paid across the general income tax base. Therefore the winners from the proposed limits will be those who do not make such large contributions. These people will generally have lower incomes than those who are affected. And more of them will be women.

2.3 “Carry forward” provisions are not needed

While most of the Government’s proposed changes will better target contributions tax breaks, the “carry forward” provisions are a step backwards. The Government proposes that taxpayers with a super balance of less than \$500,000 will be able to draw on unused pre-tax caps from the previous five years to make “catch-up” contributions. In theory, these provisions are supposed to help people with broken work histories, particularly women and carers. The ALP does not support this change.⁴³

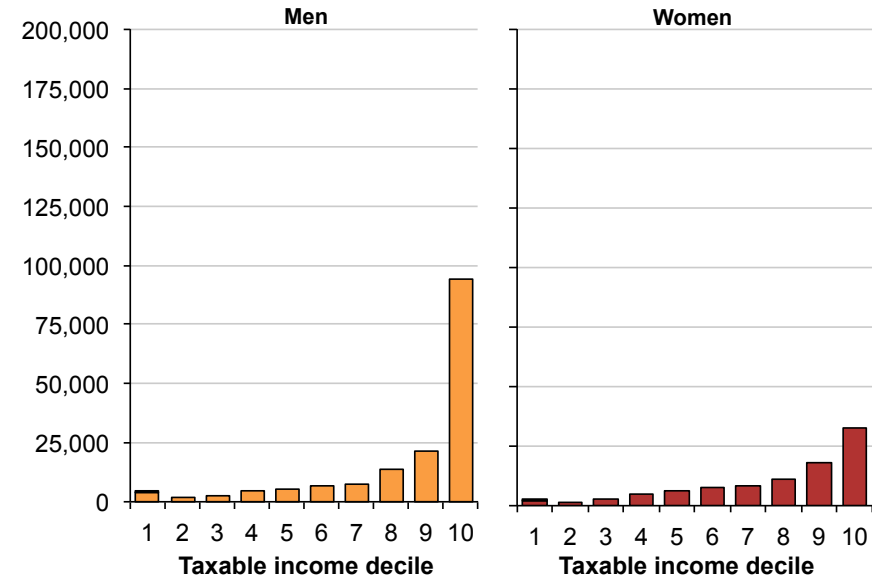
Restricting the catch-up allowance to those with a balance of less than \$500,000 would exclude some people. But it does not materially improve the targeting: those likely to use the catch-up allowance will still mostly be men on higher incomes. Only 11 per cent of those who would benefit are women aged below 50. A mere 2 per cent of women with superannuation balances of less than \$500,000 – around 100,000 people – are expected to make pre-tax contributions of \$25,000 or more in 2017-18. Most of them are among the top 20 per cent of income earners (Figure 5)

⁴² Daley and Coates (2015)

⁴³ Bowen (2016a)

Figure 5: Allowing taxpayers to carry forward unused caps will mainly help wealthier men

Number of individuals in each income decile with super balances of less than \$500,000 projected to make pre-tax contributions of at least \$25,000 in 2017-18



Note: As per Figure 4.

Source: ATO (2016a); Grattan analysis.

The primary beneficiaries of these “catch up” provisions are likely to be younger high-income earners, overwhelmingly men. Typically, only high-income earners have enough disposable income to be able to afford to save more than the new \$25,000 cap on pre-tax super contributions. As incomes rise in the middle of a continuous career, high-income earners will be able to start saving more than \$25,000 a year. Provisions designed to help women and others with broken work histories would primarily help men with secure careers to get even further ahead.

If the carry-forward provisions nevertheless remain, they should be more tightly targeted to those with broken careers. For example, they might be limited to those who have worked part-time in the previous five years and restricted to those with lower super balances, such as \$300,000.⁴⁴

⁴⁴ Daley and Coates (2016a)

3 Proposed reforms to earnings tax breaks

3.1 The \$1.6 million cap on tax-free super earnings improves targeting

For most people, income earned by their superannuation account is taxed at 15 per cent, and capital gains earned by the account at 10 per cent. Once a person turns 60 and retires, they can move their superannuation account into pension phase, and then pay *no* tax on the earnings.⁴⁵ The tax-free status of super earnings in retirement is a carry-over from a world in which most superannuation withdrawals were taxed.⁴⁶

The Government's 2016 Budget proposes to tax some of the earnings of very large superannuation accounts in pension phase. The proposal would only allow retirees to transfer \$1.6 million into tax-free pension accounts.⁴⁷ Any superannuation balance above this threshold would remain in the "accumulation phase" where 15 per cent tax is paid on earnings. The proposal is expected to save \$750 million a year by 2019-20, and much more going forward.⁴⁸ The ALP also supports this change,⁴⁹ having previously proposed a variant of this policy that would tax annual super earnings in excess of \$75,000 at 15 per cent.⁵⁰

The \$1.6 million cap on tax-free super balances in retirement would better align earnings tax breaks with the purpose of the superannuation system. Tax-free super earnings are a poor way

to boost the retirement incomes of low- and middle-income Australians. Previous research by Grattan Institute shows that tax breaks for superannuation fund earnings are especially poorly targeted. Two thirds of superannuation earnings tax concessions for those aged over 60 go to the 20 per cent whose annual incomes are above \$87,000.⁵¹ The cost of tax-free super earnings for retirees is \$2.7 billion a year, and will grow as more people retire with larger super balances.

The change affects only 60,000 people, all of who are among the wealthiest 10 per cent of people aged over 60.⁵² This group typically has more assets outside than inside super. Their assets disqualify them from getting a pension as \$1.6 million in super exceeds the asset limit that will apply from 2017 for a part Age Pension – \$541,250 for a single, or \$814,250 for a home-owning couple.⁵³

⁴⁵ Daley, *et al.* (2015), p.13

⁴⁶ See footnote 15.

⁴⁷ Treasury (2016c). p.25

⁴⁸ *Ibid.*, p.25

⁴⁹ Bowen (2016a)

⁵⁰ Australian Labor Party (2015)

⁵¹ Daley, *et al.* (2015), p.60

⁵² Grattan analysis of ABS (2013a), as per Figure 6. This estimate accords with that made by PBO (2015) suggesting that 60,000 people would be affected by a proposal to tax super earnings in retirement exceeding \$75,000 a year at 15 per cent in 2017-18, which would affect super accounts exceeding \$1.5 million assuming a 5 per cent rate of return. ATO data suggest that up to 98,000 taxpayers aged 60 years and over report super balances exceeding \$1.6 million in 2013-14. Of these, around one-third have not yet retired and would therefore not be affected by the proposed cap on tax-free super earnings of \$1.6 million. While there might be some self-funded retirees who do not submit a personal income tax return since super withdrawals are tax free, most retirees with balances exceeding \$1.6 million have significant other savings outside of super, and are therefore likely to submit returns. Daley, *et al.* (2015), p.28.

⁵³ Reflects new Age Pension assets test, which takes effect from 1 January 2017. DHS (2016).

Some argue that a \$1.6 million cap on tax-free super earnings will be too low to provide adequate income in retirement.⁵⁴ But the \$1.6 million cap is not a restriction on the amount of super that can be accumulated, but rather a limit on the amount a retiree can have before paying *any tax* on their super earnings. People affected would pay only a fraction of their total income in tax (Figure 6). For example, someone with \$2 million of assets in super would only pay \$3,000 a year in tax.

Given the tax-free threshold outside of super, a single retiree can have a combined \$2.2 million in assets in and outside the superannuation system before they pay a cent of tax.⁵⁵ The super industry itself believes that a \$545,000 asset balance is enough to provide a home-owning single person with a comfortable retirement, or \$640,000 for a couple.⁵⁶

Nor can the Government’s proposed changes be labelled retrospective.⁵⁷ Retrospectivity is a legal concept that applies if government changes legal liabilities for things that happened in the past.⁵⁸ The proposed \$1.6 million cap on tax-free super earnings in retirement does not change the tax treatment of past super earnings. Rather, the change will only affect the taxes paid on future super earnings.

⁵⁴ McCrann (2016)

⁵⁵ Accounting for the tax-free threshold, low-income tax offset and the Senior Australian and Pensioner Tax Offset only available to Australians aged 65 years and over.

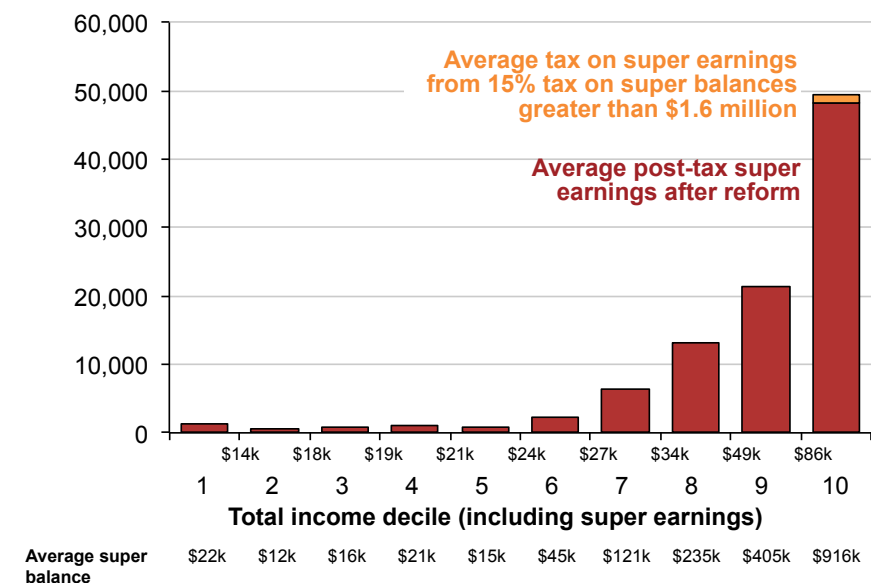
⁵⁶ ASFA (2015)

⁵⁷ For example, see ABC (2016); Stewart and Ingles (2016); Creighton (2016); Hutchens (2016).

⁵⁸ For example, Pearce (2014) (p.399) notes that legislation is only retrospective in effect if rights and obligations are changed with effect prior to the commencement of the legislation. None of the changes to superannuation tax breaks announced in the 2016-17 Budget alter tax law in this way.

Figure 6: The 15 per cent earnings tax on super balances of more than \$1.6 million will only affect high-income earners

Superannuation earnings for 60+ year old in drawdown phase, \$2017-18



Notes: Total income includes estimated earnings on super account balances but excludes withdrawals. Around 70 per cent of those with super balances aged over 60 are in pension phase, and therefore benefit from tax-free super earnings. The impact of super earnings tax in pension phase is calculated on the basis that taxing earnings would lead to a net increase in the effective tax rate on super earnings of 14 per cent, from a small negative effective tax rate (given refundable imputation credits and the capital gains tax discount), to an effective tax rate of between 8 and 10 per cent. Individual super account balances from the ABS Survey of Income and Housing 2011-12 are inflated to reflect the total value of Australian superannuation fund assets as of March 2016, while maintaining the same distribution of super account balances by age and income reported in the ABS Survey of Income and Housing 2011-12. Source: ABS (2013a), Grattan analysis.

Lots of changes affect investments made in the past, and no-one suggests they are retrospective. For instance, taxpayers purchasing shares today expect the future earnings will be subject to marginal rates of personal income tax. But if marginal rates of income tax change, they do not expect the old rates to be grandfathered to apply to all future earnings on those shares. Rather, they expect the earnings to be taxed at the prevailing marginal tax rate that applies at the time the income is earned.⁵⁹

This is the appropriate analogy for proposed changes to the tax treatment of earnings of superannuation accounts in excess of \$1.6 million. The mere fact that no tax was paid on earnings in the past does not imply that earnings in the future are entitled to be tax free.

Grandfathering the tax-free status of accounts for existing retirees might be politically expedient, but it is neither prudent nor fair. It would mean that the reform would contribute little to the budget for many years. It would also exacerbate the intergenerational transfers of the existing tax breaks – younger generations would continue to fund generous tax benefits for which they will not be eligible.⁶⁰

3.2 Taxing earnings while in Transition to Retirement improves targeting

Transition to Retirement (TTR) pensions allow a person to move their superannuation into the “pension phase” even though they are still working. They can then start withdrawing from their superannuation, and they also cease to pay tax on the earnings.

⁵⁹ Daley (2016).

⁶⁰ Daley, *et al.* (2014), p.47

The Government plans to start taxing the earnings on super for those drawing TTR pensions. Those withdrawing money from their superannuation, but also working and contributing to superannuation, will pay 15 per cent tax on the earnings of their super fund – just like everyone else who is still working.

TTR pensions, introduced in 2005, were supposed to encourage people to keep working part-time rather than stopping work entirely. Yet in practice mainly high-wealth individuals use these pensions to reduce their tax bills while they continue to work full-time.⁶¹ TTR pensions enable people to stop paying tax on the earnings of accumulated super balances from a younger age while still working. An older Australian with a superannuation balance of \$500,000 can use a TTR pension to reduce their tax bill by up to \$40,000 over five years.⁶² If their superannuation balance is higher, the tax benefit is proportionately larger.

TTR pensions bear little resemblance to the new explicit objective of superannuation. These pensions and their tax breaks don't encourage additional saving, and do little in practice to delay retirement. Instead they are part of an age-based tax system that allows older Australians to pay less income tax than younger Australians with similar incomes.⁶³

The lack of any coherent purpose for TTR pensions is reflected in the confusion about how many people will be affected by the Government's changes.

⁶¹ Productivity Commission (2015)

⁶² Daley and Coates (2016c)

⁶³ Other age-based provisions in our personal income tax system provide those aged over 65 with a higher income tax-free threshold (through the Senior Australians and Pensioners Tax Offset), a higher threshold free of Medicare Levy, and a larger private health insurance rebate.

The Government argues that the change to TTR pensions will affect 115,000 people.⁶⁴ It cites Productivity Commission analysis showing that just 5 per cent of superannuants aged between 55 and 64 were drawing on their superannuation while still working.⁶⁵

In contrast, the Association of Superannuation Funds of Australia (ASFA) has suggested that the change to TTR pensions could affect up to 550,000 people.⁶⁶

Yet the Association's estimate is misleading in several ways. First, it relied on APRA data that overstated the number of APRA-regulated superannuation accounts in TTR phase. APRA has since revised its data and now reports that only 148,000 APRA-regulated super fund accounts were in TTR phase as at June 2015.⁶⁷ Together with an estimated 80,000 self-managed super fund accounts in TTR phase,⁶⁸ no more than 230,000 super accounts could be affected by the proposed change to TTR pensions, not the 550,000 suggested by the Association.

Second, the Association's estimate confuses the number of TTR *accounts* with the much lower number of *people* affected. Australians on average have two superannuation accounts.⁶⁹ Further, as is well known in the super industry, many people using

TTR pensions have many more than two accounts in order to maximize the tax advantages.⁷⁰ Therefore the estimated 230,000 super accounts affected belong to far fewer than 230,000 people.

Third, many of these accounts belong to people who have fully retired but haven't told their super fund to reclassify their pension. They have little incentive to get their paperwork up to date, because the TTR pension already provides all the benefits of tax-free super earnings to which retirees are entitled.

Identifying the number of *people* actually using TTR pensions, and excluding those who would not be affected by the changes because they are fully retired, we estimate that the proposed changes to the tax treatment of super fund earnings for TTR pensioners would affect 115,000 people,⁷¹ in line with the Government's estimate.

⁶⁴ Morrison (2016b)

⁶⁵ Productivity Commission (2015) Vol. 2 p.144

⁶⁶ ASFA (2016). Although ASFA noted that the number of people affected might be less than the number of accounts, this disclaimer was not reflected in its headline numbers, and was unsurprisingly not reflected in media reporting: see e.g. Carney (2016); Rose, *et al.* (2016).

⁶⁷ APRA (2016b)

⁶⁸ Grattan analysis of ATO (2015); ATO (2014). Our estimate of 80,000 SMSF account holders affected by the TTR pension change accords with Government estimates cited in Crowe (2016).

⁶⁹ Minifie, *et al.* (2015), p.13

⁷⁰ For example see Superfund Wholesale (2015); Superfund Partners (2016): an older worker can minimise the tax paid on the earnings of contributions made while in TTR by rolling the newly contributed balance into a new account each year.

⁷¹ We identify the number of people aged 56 to 64 (accounting for the lift in the preservation age to 56 by 2017-18) that are drawing a super income stream while still reporting wage income, projecting forward population growth among this cohort to 2017-18 when the change will take effect. Grattan analysis of ABS (2015b).

4 Proposed reforms to total super contributions

A person can contribute to super from “after tax” as well as pre-tax income. Such contributions can be made from other assets accumulated outside super.

4.1 \$500,000 lifetime cap on post-tax contributions improves targeting

The Government proposes to cap post-tax contributions at \$500,000 over a lifetime. The cap will include any post-tax contributions made since 2007-08.⁷² At present post-tax contributions are capped at \$180,000 a year – or \$540,000 over any three year period. This change is expected to improve the budget by \$250 million a year by 2019-20, and these savings will grow significantly over time.⁷³ The ALP supports a \$500,000 lifetime cap on post-tax contributions but only including post-tax contributions made since Budget night 2016, on the basis that a backdated cap is “retrospective”. This more modest change would save \$500 million less over four years than the Government’s plan.⁷⁴

Post-tax super contributions are designed to allow individuals to make top-up payments to a fund. Australians made \$33.6 billion in

post-tax super contributions in 2012-13, about three quarters of all voluntary contributions.⁷⁵

In reality, after-tax contributions do little to increase retirement savings. Instead most people who make after-tax contributions already have large super balances and typically contribute from existing pools of savings in order to minimise their tax (Figure 7). Only 1 per cent of taxpayers have total super account balances of more than \$1 million, yet this tiny cohort makes a quarter of all post-tax contributions.

⁷² Treasury (2016c). The Australian Taxation Office only has reliable records on post-tax contributions made from 1 July 2007.

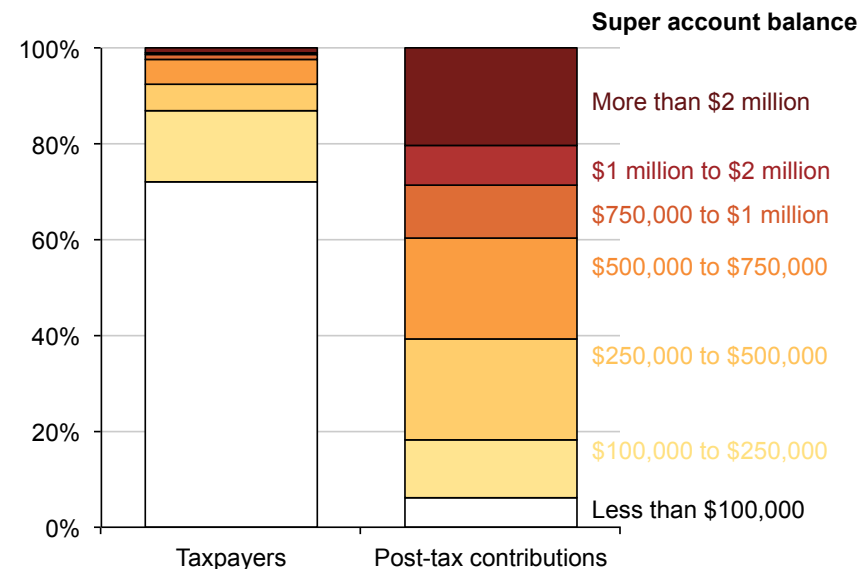
⁷³ For example Coorey (2016a) cites unpublished PBO costings that suggest the \$500,000 lifetime cap on post-tax contributions would raise \$5.7 billion over a decade.

⁷⁴ The PBO estimates the ALP proposal would save only \$50 million over four years: Australian Labor Party (2016).

⁷⁵ Daley, *et al.* (2015), p.54

Figure 7: Voluntary post-tax contributions are mostly made by those who already have high superannuation balances

Share of taxpayers and post-tax contributions, by existing superannuation balance, 2013-14, per cent



Notes: Excludes people who do not lodge tax returns.
Source: ATO (2016a); Grattan analysis.

A \$500,000 lifetime cap on post-tax contributions would go a long way to aligning super tax breaks with the purpose of superannuation. Those who have contributed more than \$500,000 after tax before the cap was introduced would be prevented from contributing any more. These people are unlikely to qualify for an Age Pension given how much they have already accumulated in super from post-tax contributions, and taking into account that they probably also have substantial pre-tax contributions, savings outside of super, and in many cases, the super balance of a second income earner if they are a dual-income household.

As well as cutting back earnings tax breaks for high-income earners, a lifetime cap would restrict so-called ‘re-contribution strategies’ that allow people to minimise the tax paid on superannuation fund balances that are ultimately passed on as inheritances.⁷⁶

Critics have argued the \$500,000 lifetime cap is both retrospective and too low.⁷⁷ Both these claims are incorrect.

The proposed lifetime cap is not retrospective

Contrary to the position of the ALP, a lifetime cap is not retrospective for the same reasons that the \$1.6 million cap on tax-free super earnings in retirement is not retrospective (see Section 3.1). Both changes ultimately depend on a person’s circumstances in the future, and attach liabilities to these circumstances.

The cap on post-tax contributions only applies to additional post-tax contributions in the future. The Budget explicitly states

⁷⁶ Ibid., pp.54-55.

⁷⁷ Chartered Accountants Australia and New Zealand (2016); McCrann (2016).

that contributions made before the announcement are not affected, even where they exceed \$500,000.⁷⁸ True, the limits take into account the amount that has already been contributed, but no adverse consequence flows from historic contributions; the change merely limits future contributions. To draw an analogy, legislation is not retrospective if it changes how to take into account assets accumulated in the past in order to assess future Age Pension payments.

A \$500,000 lifetime cap is not too low

A \$500,000 lifetime cap will not lead to a mass movement onto the Age Pension. Some might think that a \$500,000 super balance doesn't sound like much. But it is larger than the super balance of 19 in 20 taxpayers today. A man aged 60 to 64 years today can expect to retire with average superannuation savings of \$292,000, and a woman with \$138,000. Even in a mature super system, where workers make compulsory super contributions of at least 9 per cent for their working lives, most people will retire with less than \$500,000 in super.

In any case, total retirement assets are likely to be much larger than post-tax contributions to super. A person who makes \$500,000 of post-tax contributions to super will usually also make large pre-tax contributions, and have substantial savings outside superannuation. Most people affected by the lifetime cap will be high-income earners with retirement assets much larger than \$500,000, and so unlikely to qualify for the Age Pension.

The proposed lifetime cap of \$500,000 does not affect the ability of the self-employed to accrue much larger superannuation balances: no change is proposed to provisions that allow small

⁷⁸ Treasury (2016c); Stewart and Ingles (2016).

business owners to transfer business assets of up to \$1.4 million into their superannuation fund.⁷⁹

Finally, the benefits of the current arrangements must be balanced against the costs. The current rules allow a very small number of people with limited assets to make catch-up contributions to super. There are few in this category: those with broken work histories are unlikely to start earning so much towards the end of their lives that they can afford to contribute both \$25,000 a year before tax, and more than \$500,000 after tax within a few years. And the improvement in their retirement incomes needs to be balanced against the much larger tax leakage that happens when many more well off taxpayers unlikely to qualify for an Age Pension make additional post-tax contributions to minimise their tax.

Some Coalition backbenchers have signalled their opposition to the \$500,000 lifetime cap, suggesting instead a higher \$750,000 or \$1 million cap.⁸⁰ Such an increase is unjustified. Further, increasing the lifetime cap beyond \$500,000 may cost the budget more than the current \$180,000 annual cap on post-tax super contributions. Where the lifetime cap is set above the \$540,000 bring-forward rule, total post-tax contributions are likely to increase. Additional one-off contributions are likely to be more than the reduced contributions from those making regular post-tax super contributions year after year.⁸¹

⁷⁹ Daley, *et al.* (2015), p.57

⁸⁰ Coorey (2016b)

⁸¹ The PBO estimates that of those aged 55 and over in 2013-14, just 12 per cent of post-tax contributions were made by people who had contributed more than \$500,000, and only 6 per cent were made by people who had contributed more than \$800,000. PBO (2016).

Any exemptions to the lifetime cap should be limited

Some have called for exemptions to the \$500,000 lifetime cap on post-tax contributions in cases of divorce, or other major life events.⁸² Yet any exemptions to the lifetime cap should be applied sparingly, if at all, to avoid creating further tax-planning loopholes.

The existing superannuation rules already allow superannuation fund balances to be split between a couple who get divorced, and these transfers are not classified as super contributions by the receiving spouse.⁸³

A more valid concern is where a super fund member, having made substantial post-tax contributions, splits their super balance with their spouse and is then unable to make additional post-tax super contributions to top up their super account balance. Where at least one member of a household has made post-tax contributions and super fund balances are split as part of a divorce settlement, any post-tax super contributions should be split in line with the split in super balances, also counting towards the lifetime cap of the spouse receiving the super balance. Any exemptions for divorce should not permit two members of a couple being able to contribute more after tax if they divorce than if they stay together.

Another justifiable exemption to the lifetime cap would be post-tax contributions funded by workers' compensation payouts. Such an exemption would recognise that workers' compensation is made on the grounds of economic loss, reducing recipients' future earnings and capacity to make pre-tax contributions in later years.

⁸² Frost (2016)

⁸³ For instance, see Attorney General's Department (2016); ATO (2016h); ATO (2016i).

In contrast, there is no case for allowing inheritances put into super to be exempted from the lifetime cap on post-tax contributions. The existing super rules already permit superannuation benefits to be transferred from a deceased super fund member to a surviving spouse, and such funds are not counted towards pre- and post-tax contributions caps.⁸⁴ Those receiving a windfall inheritance should not expect an extra bonus supported by other taxpayers through the superannuation system.

A lifetime cap would be administratively straightforward

Introducing a lifetime cap is administratively straightforward. The ATO already administers a lifetime cap, called the CGT cap, on some post-tax contributions by small business owners.⁸⁵ The Coalition's backdated cap would only apply to contributions made since 2007 – the point where information on post-tax contributions was accurately collected. The ATO should consider sending annual notices to taxpayers to update them on their entitlements to make post-tax contributions.

4.2 Abolishing work test for super contributions encourages tax planning

The 2016 Budget also proposed removing the work test, a change that would allow more people aged over 65 to contribute to super even if they are not working and saving for their retirement. Currently, people aged 65 to 74 can only contribute to super if they pass a work test of working 40 hours over 30 consecutive

⁸⁴ For example, see ATO (2016c); ATO (2016g).

⁸⁵ ATO (2016f)

days in the financial year.⁸⁶ The ALP does not support abolishing the work test.⁸⁷

This change is undesirable because it does not serve the purpose of superannuation. Removing the work test for older Australians will do little to support genuine retirement savings, but will turbocharge tax planning for wealthy retirees.

The existing work test is not onerous. It requires someone to work 40 hours over 30 consecutive days in the financial year. If people are not passing this minimal test they are unlikely to be working in order to build up savings for retirement.

If a person is not working, but is contributing to super, then most of these contributions are probably sourced from retirement savings outside of superannuation – such as shares or investment property. Allowing such contributions substantially reduces their tax liability because investment income can be washed through the superannuation fund at a tax rate of just 15 per cent, rather than at marginal tax rates. Such strategies do little to boost retirement savings while imposing costs on the budget and other taxpayers. Abolishing the work test will open up additional tax breaks for wealthier older Australians who are already retired.

Consider the example of a retired 70-year old earning \$150,000 a year just from an investment portfolio. They do not work and therefore cannot contribute to superannuation under current arrangements. If the proposed change takes effect, they will be able to contribute \$25,000 (the new pre-tax contribution cap) into superannuation. On this contribution – which is really just investment income – they would pay contribution tax of

15 per cent instead of their marginal rate of 39 per cent. This would reduce their total tax bill by \$6,000. Future earnings on the \$25,000 contributed would be tax-free.

In addition, those not working would be able to transfer other savings as post-tax contributions into superannuation, where future earnings are either untaxed, or only taxed at 15 per cent. This will be a particularly attractive tax-planning opportunity if the lifetime cap on post-tax contributions is not legislated.

⁸⁶ ATO (2016k)

⁸⁷ Australian Labor Party (2016)

5 Number of people adversely affected by changes

The Coalition has stated that the 2016 Budget super changes will adversely affect 4 per cent of super account holders.⁸⁸ The Association of Superannuation Funds of Australia (ASFA), by contrast, maintains that up to twice as many super account holders – or 1.26 million people – will be worse off under the changes (Table 2).⁸⁹ Our independent analysis is in line with the Government figures, while those of the Association appear unreliable.

First, as Section 3.2 notes, the Association overestimates the number affected by changes to TTR pensions by confusing the number of TTR accounts (more than 500,000) with the number of people affected (most likely 115,000). And many of the people affected may be eligible for tax-free super earnings anyway.

Second, adding up the number of people separately affected by each measure, as the Association does, double counts people affected by more than one change. There are many overlaps. About a fifth of post-tax contributions are made by those with a super balance over \$2 million, and they are therefore likely to be affected by the cap on tax-free super balances over \$1.6 million (Figure 7). People who make large post-tax contributions also tend to make large pre-tax contributions,⁹⁰ and so will be affected by both the \$500,000 lifetime cap on post-tax contributions and the \$25,000 cap on pre-tax contributions.

We estimate that about 40,000 people will be affected by both the change to the TTR pensions and the changes to the pre-tax contribution cap or the Division 293 income threshold.⁹¹ But a lack of publicly available data means we are unable to identify those that will be affected by more than one of: the \$1.6 million cap on tax-free super earnings in retirement; the \$500,000 lifetime cap on post-tax contributions; and the tighter rules governing pre-tax contributions.

The estimate for the number of people is based on figures from the ATO taxation statistics, which reconciles the approximately 30 million super accounts with the number of individuals with super. The estimated population includes only individuals with a Member Contribution Statement to avoid double counting and is adjusted to reflect population growth to 2017-18.⁹²

Overall, our analysis suggests that just over 4 per cent of superannuation account holders will be adversely affected by the Government's super changes – in line with the Coalition's estimate (Table 2). Even then, we probably overestimate the total number affected as we cannot account for all the people affected by more than one policy change. We also do not account for any positive impacts from other parts of the super package that may offset the adverse effects of other Budget changes.

⁸⁸ Treasury (2016c)

⁸⁹ ASFA (2016)

⁹⁰ Daley, *et al.* (2015), p.42

⁹¹ Grattan analysis of ABS (2015b).

⁹² We estimate that 18.75 million people will have a super account by 2017-18 compared to 17.5 million in 2013-14. APRA (2016a); ATO (2016j).

Table 2 – Estimates of the number of people adversely affected by the 2016 Budget super changes, 2017-18

Policy change	Number of people negatively affected	
	ASFA estimate	Grattan estimate
Contributions tax breaks		
\$25,000 pre-tax contribution cap and lower \$250,000 income threshold for Division 293 tax	500,000	550,000
Remove anti-detriment provision in respect of death benefits from superannuation	20,000	20,000
Earnings tax breaks		
\$1.6 million cap on tax-free earnings in retirement	110,000	60,000
Abolish tax-free super earnings for Transition to Retirement pensions	550,000	115,000
Rules governing total super contributions		
\$500,000 lifetime cap on post-tax contributions	80,000	80,000
Less those affected by more than one policy change	0	- 40,000
Total negatively affected by package	Up to 1,260,000	Up to 785,000
Number of people with a super account	14,000,000	18,750,000
Proportion of superannuants affected	Up to 9.0%	Up to 4.2%

Notes: We adopt ASFA's estimates of the number of people affected by the lifetime cap on post-tax contributions and abolition of anti-detriment provisions in the absence of publicly available data. Our estimate of those affected by reforms to TTR pensions is consistent with that of the Productivity Commission. Our estimate of the number of people affected by the cap on tax-free earnings in retirement is consistent with the PBO and Taxstats, as discussed above at footnote.52. Our estimate of the number of people affected by more than one policy change is likely to be an underestimate, and hence the total number affected by any one measure in the super package will be overestimated, due to data limitations. Our estimate of the number of superannuation accounts is based on ATO data on the number of people with a superannuation fund plus population growth using ABS population projections. It excludes individuals without a Member Contribution Statement to avoid double counting.

Source: ASFA (2016); Productivity Commission (2015), Vol. 2, p.144; Grattan analysis of ABS (2013a); ABS (2015b); ATO (2016a); ATO (2016j); ABS (2013b).

6 Contribution to budget repair

The government’s super package will make a significant contribution to budget repair, which will grow over time as the super system matures and the population ages. Measures that reduce the earnings tax breaks to high-income earners – especially the \$1.6 million cap on tax-free super earnings in retirement and the \$500,000 lifetime cap on post-tax contributions – will reduce the budgetary cost of super tax breaks in the long-term, which have become unsustainable. Importantly, these changes will have little or no impact on future Age Pension expenditures, since they overwhelmingly affect high-income earners who are unlikely to ever qualify for the Age Pension in retirement.⁹³

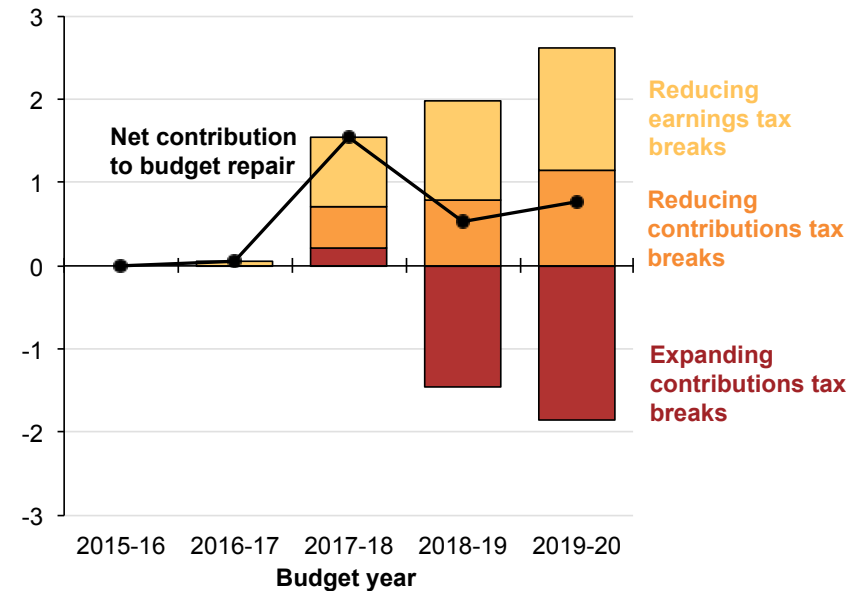
Yet despite including measures that reduce super tax breaks by \$2.6 billion a year by 2019-20, the annual budget savings from the Government’s super proposals only total \$775m in 2019-20 (Figure 8). This is because widely publicised cuts to super tax breaks for high-income earners are offset by measures that widen access to super tax breaks to other groups. Retaining the LISTO is expected to cost the Budget \$800 million a year by 2019-20. Permitting all taxpayers to contribute directly to their super fund and claim a deduction on their personal income tax return will cost a further \$750 million.

Other measures to expand contributions tax breaks – measures that should not proceed because they do little to support the purposes of super – reduce the budgetary savings from the Government’s super package by a further \$305 million a year (Table 1).

⁹³ Daley, *et al.* (2015), p.29

Figure 8: The Government’s super package will save less than \$1 billion a year once fully implemented

Net budget impact of super package, 2015-16 to 2019-20, \$ billions



Notes: Fiscal savings are as reported in the 2016-17 Budget. Extending the income threshold for the low-income spouse tax offset is included in “expanding contribution tax breaks” series.

Source: Treasury (2016c); Grattan analysis.

In particular, allowing people to carry forward unused pre-tax contribution caps to future years is expected to cost \$250 million by 2019-20, and more over time.⁹⁴ If these changes do not proceed, the budgetary savings from the government's package would be boosted to about \$1 billion a year in total.

The ALP is proposing reforms that would do more to repair the budget than the Government's plan. The ALP's super package would raise \$2.1 billion a year, or \$1.3 billion a year more than the Government's proposal (Table 1). If the Government makes "concessions", they will mostly improve the budget position. In contrast, many amendments to the government's package advocated by industry groups, such as watering down the limits on super tax breaks for high income earners that don't need them, could easily result in a package that makes the budget position worse overall.

⁹⁴ The government estimates the measure will only cost \$350 million over the four years to 2019-20. However, since taxpayers will only be able to carry forward the unused portion of their contributions cap from 1 July 2017 onwards, the full cost of the policy change will only become apparent from 2021-22 onwards, when individuals have access to unused caps over the previous four years. Daley and Coates (2016a).

7 Future changes

Overall, both the Government’s and the ALP’s proposed changes are a big step in the right direction. Those affected are overwhelmingly high-income earners who are unlikely to ever qualify for the Age Pension in retirement. Yet the changes don’t go far enough.

7.1 Super tax breaks remain poorly targeted overall even after 2016 Budget reforms

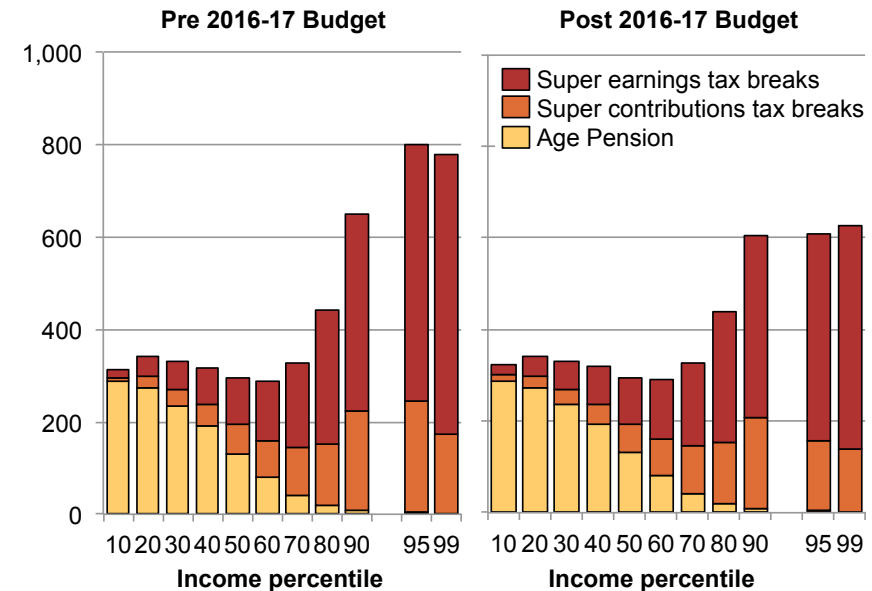
Even after the reforms, super tax breaks will overwhelmingly flow to high-income earners who do not need them. People in the top 20 per cent of income earners, who are unlikely to ever get a pension, will still receive about half of all super pre-tax contribution tax breaks.

Treasury projections in the 2016 Budget show that the lifetime value of tax breaks to high-income earners remains much higher than the value of the Age Pension for low-income earners, even after the Government’s Budget changes (Figure 9). These projections are likely to be conservative since they ignore post-tax super contributions, which are largely made by high-income earners, boosting the super earnings tax breaks they receive.⁹⁵

⁹⁵ Different assumptions about life expectancy and draw down rates can also result in much higher estimates of the lifetime benefits to high-income earners. For example, Industry Super Australia (2015) calculates that superannuation tax breaks for the top 5 per cent of income earners are worth more than \$2 million for men over their lifetimes. In contrast, a lower discount rate than 5 per cent would boost the net present value of government support provided to low-income earners via the Age Pension, and the value of earnings tax breaks to high income earners.

Figure 9: Lifetime income support will remain unequally distributed even after the Government’s changes

Net present value of total government support over a lifetime through the Age Pension and super tax breaks, \$2016, thousands



Note: Individuals are assumed to commence work in 2016 at age 30 and work until age 70, with a predicted life expectancy of 92. Accumulated superannuation benefits are invested in an account-based pension and individuals are assumed to draw down their assets at the current age-based minimum drawdown rates. The level of tax assistance and Age Pension entitlements are discounted by 5 per cent per annum to calculate a net present value in 2016 dollars. Annual incomes are calculated for each percentile based on the distribution of earners at each single year of age. Assumes no post-tax contributions. Source: Treasury (2016a), p.4; Grattan analysis.

Before the changes, someone in the top 1 per cent of income earners could expect to receive **two and a half times as much** in tax breaks from super over their lifetime as a retiree with no assets receives in pension. This is also two and a half times as much as the average income earner receives in pension and super tax breaks combined. The Budget changes merely trim the worst of these excesses: the top one per cent now receives **just twice as much** as low or average income earners.

There is no public consensus on how government support for people's retirement should be distributed. Yet when self-funded retirees receive twice as from government as the assistance provided by the pension, super tax breaks clearly need to be more aligned with their policy purpose.

7.2 Opportunities to improve targeting of super tax breaks

Changes to superannuation in the past have been too timid. The 2016 Budget changes will not end the need for reform. In 2019-20, the Government's package will trim \$775 million a year from super tax breaks, just 3 per cent of their overall value.

Even if the Budget reforms are implemented, a wide gap will remain between the purpose of the system and what it delivers. Decisive reform must target superannuation tax breaks at those who need them most.

Grattan Institute's recent *Super Tax Targeting* report identified three reforms to better align tax breaks with the goals of superannuation, and would go much further than the government's package.⁹⁶

⁹⁶ Daley, *et al.* (2015)

Contributions from pre-tax income should be limited to \$11,000 a year. Such a change to create a much more targeted system would primarily affect the top 20 per cent of income earners, but they would still have a comfortable retirement, mostly without an Age Pension. The change would improve budget balances by \$3.5 billion a year. If the income threshold for Division 293 tax were lowered to \$250,000 as the government proposes, or \$200,000 as proposed by the ALP, pre-tax super contributions could instead be capped at \$15,000 a year. This would ensure those on upper middle incomes would still make sufficient contributions – after paying any tax on those contributions – to be unlikely to qualify for an Age Pension in retirement.

Lifetime contributions from post-tax income should be limited to \$250,000. While a lifetime cap on post-tax contributions is a sensible step, the \$500,000 cap is too high. The cap might not sound like much to some, but it is more than what 95 per cent of taxpayers have in super right now. A lifetime limit of \$250,000 (in addition to pre-tax contributions) is likely to be more than most people with broken work histories can afford to contribute to super. Beyond this point, post-tax contributions are much more likely to be tax planning than catch-up.

All earnings in retirement should be taxed at 15 per cent, the same as superannuation earnings before retirement. The proposed \$1.6 million super balance cap, while a positive step, is far too high. Allowing retirees to amass four times the amount needed for a comfortable retirement and not pay a cent of tax is unacceptable. Even people affected by the cap will pay very little extra tax compared to their total income.

Imposing a 15 per cent tax on all superannuation earnings in retirement would have little impact on retirement incomes.⁹⁷ Those with super but on low and middle incomes could maintain a zero tax rate on earnings by moving savings out of super. Their total taxable earnings would be below the tax-free threshold, which is effectively around \$30,000 for those aged over 65 who qualify for the Senior Australian and Pensioner Tax Offset (SAPTO). A 15 per cent tax on all super earnings would improve budget balances by \$2.7 billion a year today, and much more in future.

These changes would help fix the budget without compromising the objectives of the superannuation system. They would also be fair. Low-income earners and younger people would pay less in other taxes if super tax breaks for the wealthy were wound back. Those already retired would pay some tax on their superannuation savings but they would pay much less tax than wage earners on similar incomes. For a small proportion of women with higher incomes later in life, the changes would reduce their catch-up contributions. Yet the changes would reduce the tax breaks far more for those with substantial means to save for their own retirement without government support.

7.3 Broader reforms to Australia's retirement incomes system are also needed

Many other features of Australia's retirement incomes system also need reform, and could contribute to the task of budget repair. Areas beyond the scope of this paper include:

- Increasing the age at which tax free withdrawals can be made from super to match the age of access to the pension,⁹⁸
- Better targeting the Age Pension by including owner-occupied housing in the Age Pension assets test;⁹⁹
- Reducing the value of superannuation tax breaks for small business owners, such as the lifetime CGT cap;
- Restricting the Senior Australians and Pensioners Tax Offset (SAPTO), which provides a much higher tax-free threshold for pensioners and other retirees.¹⁰⁰
- Better targeting government support for aged-care costs by tightening the means tests for home-based and residential aged care, and especially by including more of the value of the family home.

⁹⁷ Ibid., p.63

⁹⁸ See Daley, *et al.* (2013), p.29.

⁹⁹ See *ibid.*, p.37.

¹⁰⁰ ACOSS (2015), p.10.

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