Submission to Stage Three of the Productivity Commission's Review of Efficiency and Competitiveness of the Superannuation System

1. Main Points

- **A review of the efficiency of the superannuation system should be in the context of the social and economic objectives set for superannuation. However, such an analysis is hampered by the inadequate "substitute and supplement" definition of the purpose of superannuation (not yet passed by the Parliament);**
- **There is currently no overall performance benchmark for the superannuation system against which the efficiency of the system, and its component funds, can be measured. This is astonishing for a $2 trillion segment of the economy mandated by government policy;**
- **The share market is a proxy for the economy and a practical benchmark measure of performance would be the ASX Accumulation Index grossed up to include imputation credits, adjusted for CPI and measured over 5-10 year rolling periods;**
- **Analysis of the efficiency of superannuation needs to focus on very long-term outcomes, as superannuation is a life-time investment. However, there is a tendency by fund managers to focus on short-term performance on which their income is based;**
- **The current tax structure for superannuation still does not deliver the best long-term result in terms of adequate retirement incomes and return on tax incentives.**
- **Administrative and compliance costs, including government charges, to funds reduce the ultimate return to members and need to be minimised;**
- **The Government must always include a rigorous "efficiency impact statement" regarding any change that impacts superannuation covering both direct cost and indirect behavioural impacts;**
- **All investment "products" should include a clear upfront statement of all the fees and costs that reduce returns achievable from an investment portfolio in a form that allows comparison between products;**
- **In assessing the performance of segments of the superannuation system, the Commission should bear in mind that while it is useful to average the performance of managed funds, as collective investment vehicles, the performance of self-managed funds will vary according to the circumstances, risk appetite and expectations of members so averages are not so meaningful. What matters fundamentally is whether SMSFs are enabling their members to save enough to provide a reasonable income throughout their retirement and old age without recourse to the age pension;**

- **Encouraging the establishment of low management fee indexed funds. There is almost an argument for a government run fund because there is little incentive (profit) for the private sector to provide such products;**
- **Encouraging investment opportunities for self-managed funds beyond the traditional assets of shares, cash and property to include the facilitation of a market in non-listed investments and easier access to government, corporate and infrastructure bonds.**

2. About SISFA

The Self-managed Independent Superannuation Funds Association (SISFA) is Australia's original SMSF advocate, established in 1998 to represent the interests of trustees and industry to Government. SISFA's mission includes the encouragement of high professional standards through its professional membership and public education initiatives. In May 2017, SISFA merged with the SMSF Owners' Alliance which was established in 2012 to give the owners (trustees and beneficiaries) of SMSF's a direct voice on Government policies that affect them. SMSF Owners' primarily focussed on advocacy supported by comprehensive financial modelling to illustrate the impact of proposed and possible changes to the system.

Collectively, SISFA's membership represents over 10,000 SMSF trustees.

As an independent association reliant on volunteer effort this submission is less comprehensive and perhaps less focussed on the requirements of the Commission than we could produce if we had more time and resources. However we hope it makes a useful contribution to the Commission's thinking and we would be pleased to engage in consultation with the Commission with a focus on self-managed funds as indicated in the Issues Paper.

3. Objective of Superannuation

The Commission notes in its Issues Paper that: *"The sheer size of the superannuation system, combined with its compulsory and broad nature, makes the efficiency of the system paramount. Even small changes in the efficiency of the system can have significant impacts on the wealth and wellbeing of Australians. Competition is often the impetus to promote efficiency and members' best interests — an important means to a wellbeing end."*

We agree.

The Commission further notes that:

"*What is efficient ultimately depends on what you are trying to achieve, that is the objectives of the superannuation system. The Australian Government has announced that the objective of superannuation is 'to provide income in retirement to substitute or supplement the Age Pension' and has introduced a bill into the Parliament to enshrine this in legislation (Australian Government 2016).*"

We agree that assessing the efficiency of the system depends on the purpose of the system.

We understand the Commission must work within its terms of reference and must accept stated Government policy and legislation on superannuation. However, the Commission's review of competition and efficiency in superannuation does provide an opportunity to reiterate our strongly-held view that the proposed 'substitute or supplement' objective for superannuation falls well short of ideal.

SISFA and other representative groups, including the major funds, have expressed disappointment at the inadequacy of the 'substitute or supplement' definition.

As we stated in our submission to Treasury on the draft Superannuation (Objective) Bill 2016:

The primary objective for superannuation set in the Bill – to provide income in retirement to substitute or supplement the age pension – is inadequate.

It lacks vision and ambition.

It subordinates superannuation to supporting the age pension which remains the central pillar of the retirement incomes system.

It is a missed opportunity to instead position superannuation as the central pillar by providing the means for more Australians to take responsibility for the own financial security in retirement rather than to rely on the taxpayer-funded age pension.

As Australians live longer and spend longer in retirement it is imperative to boost their savings via superannuation so they do not become a burden on the next generation.

Unless the focus of retirement income policy is shifted to superannuation rather than the age pension, the gloomy prediction of the 2015 Intergenerational Report – that by 2055 two thirds of Australians will still be reliant on the age pension – is likely to be realised.

The role of the age pension should be a social safety net for Australians who are unable to save sufficiently to fund their own retirement.

Australians who have the potential to be self-sufficient should be required, enabled and encouraged to do so via mandatory and voluntary contributions that are taxed concessionally, recognising that they are a forced savings measure that defers consumption at the expense of other priorities and savings are locked away until retirement.

Defining superannuation as merely to "substitute or supplement" the age pension sets no benchmark for the performance of superannuation. It is meaningless to set an objective for superannuation that does not include even a very general performance goal.

In our submission to the review of the objective, we proposed the following definition:

The primary objective of the superannuation system is to give every working Australian the opportunity and encouragement to save enough so that they can fund an income in retirement that allows them to maintain to a reasonable degree their living standard after retirement.

We suggested that an appropriate benchmark for retirement income is the Reasonable Replacement Rate generally accepted to be two-thirds of pre-retirement, after-tax income.

This would provide a target for the achievement of an effective retirement income system that rests on the main pillar of superannuation. – SMSF Owners' Alliance submission to Treasury - 16 September 2016.

In framing the 'substitute or supplement' objective of superannuation legislation, the Government took the easy option of adopting the definition proposed by the Financial System Inquiry in the chapter of its report dealing with superannuation. This chapter was, in our view, a weak link in the FSI report and quite misleading in its references to the cost of superannuation tax concessions and the distribution of them. In particular, the FSI report noted that the top 20% of income earners received 60% of superannuation tax concessions, without acknowledging that the top 20% of income earners pay over 60% of income tax. It is unremarkable that a tax concession will provide a greater dollar benefit to those who pay the most tax.

With hindsight, the FSI's comments on superannuation set the scene for the attack on self-managed funds in the 2016 budget resulting in new contribution limits and new taxes in the most significant changes to superannuation in the past 25 years, all of them adverse for SMSFs and without benefitting the superannuation system overall.

4. Setting a performance benchmark

Even within such a timid objective as 'substitute and supplement', the Government has failed to set any general performance benchmark for superannuation. That there is no performance target for a $2 trillion segment of the economy created by government through mandatory retirement savings and hugely significant for economic and social policy is astonishing.

It must be very difficult for the Commission to assess the efficiency of superannuation when no overall system performance benchmark has been set.

The Australia's Future Tax System review led by Dr Key Henry supported the concept of a 'reasonable replacement rate', a concept widely accepted in comparable economies.

This sets a general benchmark for retirement incomes of about two-thirds of pre-retirement, post-tax income. Broad as it is, the 'reasonable replacement rate' at least sets a bar against which the efficiency of the system in achieving that standard of retirement income can be judged.

Another important question relates to the efficiency of the tax incentives provided to superannuation fund members to encourage them to save for their future retirement.

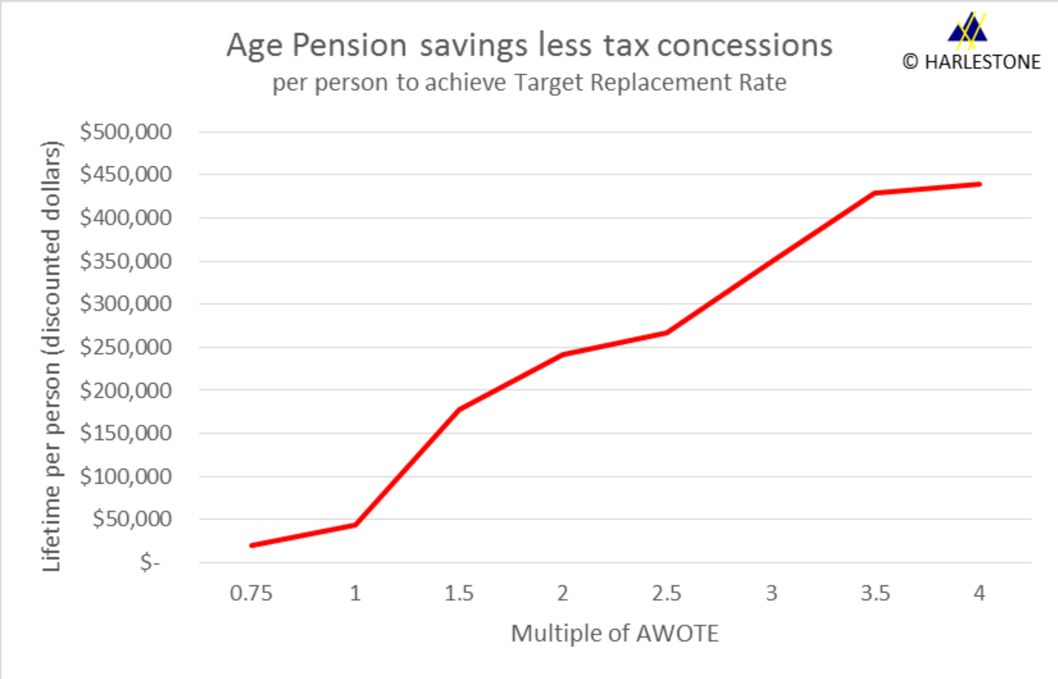
Here reference is often made to Treasury's annual Tax Expenditures Statement that attempts to measure the cost to the budget of superannuation and other tax concessions. The TES numbers are arguable and will vary according to the methodology used to calculate them. They are often misquoted and misused to justify restrictions on superannuation that are primarily aimed at SMSFs. Even Treasury has warned against relying on the TES as a justification for policy change.

The most fundamental shortcoming of the TES as a tool to inform policy decisions is that it only takes account of current costs to the budget. It takes no account of future reduced expenditure on the age pension as the consequence of savings made with the benefit of tax concessions.

We question how the economic efficiency and social utility of a tax concession can be assessed if it takes into account only one part of the equation and does not include the future benefit to the budget of reduced age pension payments.

We have carried out considerable analysis on this issue in the past (see SMSF Owners' Alliance Submission to the Tax White Paper Task Force 31 May 2015 "White Paper submission" –

attached) and the following graph illustrates how tax concessions are outweighed by Age Pension savings such that the net benefit to the Government increases with income.



Graph 10 page 21 of SMSFOA White Paper submission

Another data shortcoming is that the ATO statistics on SMSF assets do not reveal the value of non-concessional contributions on which income tax has been paid. Publication of this figure by the ATO would assist a more informed and balanced policy debate.

5. Assessing efficiency in superannuation

There are principally three "inputs" into the superannuation system – contributions; tax incentives and net investment returns – and one output – net pension payments.

Efficiency of tax incentives

Different tax incentive structures can provide different results for the same quantum of incentive. A comparison of the efficiency of alternative tax incentive structures can be made by valuing the level of incentive necessary to achieve a particular result in terms of pension payment – everything else being equal.

Two main factors within the control of government can impact this efficiency.

- The timing of tax incentives vs timing of contributions and pension withdrawals; and
- The complexity and certainty of the tax system.

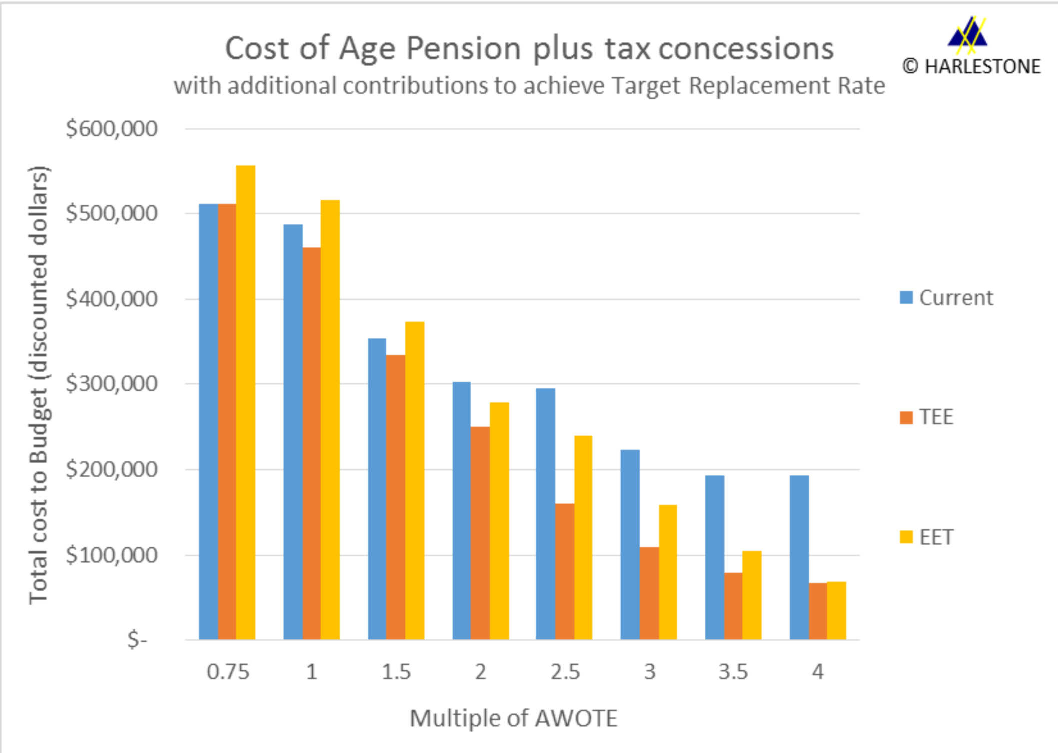
If the value of incentives and resultant pension payments is measured in present value terms, the discount rate used by the government in valuing the cost to it of an incentive structure would be lower than the discount rate applicable to a superannuation beneficiary in valuing the benefit of such tax incentives. Therefore, the earlier tax incentives are applied to the system the greater the net apparent advantage to the beneficiary.

This is one reason why our superannuation system as it operated from early in the 20th century until 1988 ranked better on this measure than our current system. Under this earlier system both contributions and superannuation earnings were tax free – i.e. benefitted from tax incentives – and the pension withdrawals were fully taxable (referred to as Exempt-Exempt-Taxed or EET system). In 1988, the Government started to defer tax incentives by bringing forward taxes on superannuation by introducing a tax on contributions. This delay in tax incentives in the lifetime of a superannuant increases the present value of the cost of tax incentives to the Government at a greater rate than the increase in value of incentives to the beneficiary and thus reduces the net value of the incentive. Under the current system, the Government must provide a greater incentive to achieve the same result.

The second factor influencing the efficiency of the tax incentive structure is its complexity. This is more difficult to measure and is a point that is infrequently discussed but we believe should not be ignored. Increased complexity of the tax incentive structure can lead to increased costs and thus reduce investment returns; this aspect is addressed in the next section. The other impact is less measurable but it is undoubtedly true that the less beneficiaries understand about how the superannuation system works and the less certain they are that a particular set of tax incentives or other government regulations will not change, the greater the incentive required to achieve the same result (effectively this uncertainty increases a beneficiary's discount rate in valuing tax incentives).

We have modelled the impact of taxation on alternative superannuation taxation structures and would be happy to share the details of this with the Commission. It is set out in the White Paper submission referred to above. In it we compared the then current system with the pre-1988 EET system and an alternative TEE system.

The following graph illustrates the total cost to Government of Age Pensions plus tax concessions for the three systems over a range of incomes.



Graph 3 page 28 of SMSFOA White Paper submission.

This appears to illustrate not only declining cost to Government with income but a dramatically fairer and more efficient system under either EET or the alternative TEE than the current system. It is more tax efficient because the cost to Government is less to achieve the same outcome.

The TEE system is one initially based upon a proposal by Dr Henry and described and recommended by us in our White Paper submission for serious consideration.

Investment return efficiency

The other main input that can be influenced by trustees and, to some extent, governments is the net investment returns achieved by superannuation savings.

One important issue to remember in considering investment returns is that the superannuation system is a very long-term investment vehicle. In assessing efficiency one should review factors that maximise gross investment returns and reduce cost imposts over decades. At present the market place in which superannuation funds operate is not conducive to such long-term thinking. For example, with regard to gross investment returns:

- One of the key providers marketing their services to trustees are share brokers who tend to have a very short term focus;
- Their remuneration system of being paid brokerage also incentivises them to promote share turnover – selling when share-market looks gloomy and buying when the market is optimistic. Not only does this behaviour lead to more exaggerated market falls and rises, it leads to precisely the wrong behaviour for a long-term trustee;
- Managed funds, including superannuation funds, report performance quarterly – or even over a shorter period – and therefore tend to focus on short-term rather than long-term performance;
- The most widely reported index is the ASX All Ordinaries index. However, this is not a useful index for measuring and indexing performance over the long-term for superannuation funds. A more relevant index could be the ASX Accumulation Index with includes both increases in share prices and dividend returns. To be of greater use as an indicator of performance, this index should be reported grossed up for imputation on dividends. An imputation credit is part of the dividend return to all Australian shareholders – it is just not paid by the company in cash but given to the shareholder as a credit note to be subsequently redeemed from the ATO.

The ASX Accumulation Index is not readily found and anything the Productivity Commission can to do encourage the wider publication and acceptance of such an accumulation index that includes imputation would be helpful.

In the above environment, it is perhaps not surprising that much commentary and advice given even with the best of intentions, can mislead superannuation fund trustees with regard to the investment structure and nature of the best long-term investments.

Many advisers suggest a level of cash or interest-bearing securities that should be held in a superannuation fund at a higher level than may be in the long-term best interests of the fund members. There may be several reasons for this.

In managed superannuation funds, a level of cash is required to prudently manage their uncertainty regarding withdrawals by members – either pension withdrawals above the minimum, or members wishing to change funds. In SMSFs by comparison, the trustee is obviously much more certain regarding the expected withdrawal activity of the fund's members.

However, the issue of cash level goes beyond that. Many commentators suggest that a high level of cash should be held in order to increase the certainty of returns to beneficiaries. However, whilst higher returns from the share market and other similar investments do tend to reflect higher risk, some advisers appear to confuse volatility with risk. In the share market (bearing in mind the environment described in the dot-points above) a more volatile share is perceived as more risky and indeed is so for someone with a short term horizon because of the risk of loss when a share is sold. Various share valuation models, such as Black and Sholes, use the volatility of a share in assessing its value. However, over the long-term – say, over 5 to 10 year horizons and certainly over the decades' long term of a superannuation fund – the share market has provided consistently higher returns than cash. Without a doubt a share portfolio with adequate diversification would provide a substantially higher superannuation pension than a fund held in cash. The lower the cash level, the better the long-term return in this regard. A high cash portfolio would provide a more certain return but it would certainly also be lower than a diversified share portfolio.

[Obviously a level of cash is prudent so that an SMSF can pay pensions without being forced to sell shares in a share-market downturn. However, let us consider someone, say, on a 5% withdrawal pension, whose fund is earning 5% gross in dividends. So he expects his withdrawals to be funded by dividends in most years, but what about a share market crash? In the 2007/8 share market crash share prices fell more than dividend payments. For a diversified portfolio dividends fell about 25%. However, to be conservative, if one assumes dividends fall by 50% and take about 5 years to recover then the fund would need 5%x50%x5 = 12.5% of the fund in cash to conservatively meet any cash shortfall without having to sell any shares. Even so called 'growth' managed funds tend to hold higher levels of cash than 12.5% because they wish to smooth out returns. By such an approach they do not maximise their long-term returns but minimise the risk of a negative return in a quarter which may lead to fund withdrawals.]

At a macro level, the source of investment returns is business. Business generates profits for the economy and its shareholders and is the source of growth in the economy. We therefore believe that the long-term ASX All Ordinaries Accumulation Index (grossed up for imputation credits) is an appropriate benchmark in assessing performance and efficiency of superannuation funds.

No higher return should be expected from the superannuation sector. Given the size of the sector the average gross return cannot be above the All Ord Index as it is a "zero-sum game".

In our view the appropriate benchmark for assessing returns from the superannuation sector should be the ASX All Ordinaries Accumulation index grossed up for imputation credits and adjusted for CPI. As a measure of long-term returns, this index should be measured over, say, 5 or even 10-year rolling periods.

We do not believe there is value in having different benchmarks for different "asset-classes" and introduces an unnecessary complexity. The above index should be used for an overall benchmark without any so-called "risk adjustment" on the basis that volatility and credit risk with regard to individual investments can be ameliorated by appropriate diversification within a fund.

Investment costs

All costs on such investment returns reduce the long-term net return achieved by the fund. Such costs include:

- Fund administration;
- Tax returns lodgement;
- Audit compliance;
- ATO and ASIC fees;
- Brokerage;
- Advisory fees; and
- Management fees inherent in managed or manufactured products.

A number of these are unavoidable but some are the result of government action. We have previously reported that the fee imposed by the ATO on SMSFs can have a larger negative impact on the final pension payable than a market crash. We can illustrate this if it would be of interest to the Commission. This impact appears to have been ignored by governments. SMSFs are about the only tax-paying group on which the ATO imposes a fee for it to perform its legislated role and this fee has a substantial long-term impact on the efficiency of converting contributions and tax incentives into pensions.

Another aspect of above list that is often ignored is the level of fees – often quite hidden – in managed products. An increasing number of organisations are marketing “manufactured” investment products to SMSFs. However, all such products obviously include a fee for the promoter and, in our view, ANY such fee reduces the long-term returns achieved by the investor relative to a diversified portfolio of shares. A long-term investor is best served in most cases by minimising the number of organisations taking a fee between the profits of the company (dividend) and the final payment to the investor.

6. Access to unlisted market

We have proposed the use of a listed equity benchmark for performance of the superannuation sector as a proxy for the Australian economy. However, we do acknowledge that there is a substantial segment of the investment market – the unlisted market - in which the larger funds can operate but which are generally unavailable to most SMSFs and small APRA regulated funds.

Action to facilitate access to this market by a broader range of super funds would be of benefit to the investment environment and to super funds, given their long term focus. We do not have any clear answer as to how to achieve this but suggest that perhaps the ASX or other institution could be encouraged to facilitate a market in unlisted investments. Some parameters for such a market could be:

- That trades are only carried out infrequently – say annually or maybe quarterly;
- Only profitable businesses would be allowed to list;
- The pricing of trades would be the average of 2 independent valuations (if no more than 20% apart; otherwise a third is necessary and price is average of the two closest);
- Brokers need not be involved; trades can just happen on-line at the independent valuation when and if there are buyers and sellers;

- The independent valuers should not be appointed by the entity involved; maybe appointed by an organisation that then is reimbursed on a cost-recovery basis by fees charged to listed entities;
- There should be a minimum size of entity to list and a minimum trade size;
- Listed entities maybe commit to a minimum dividend as a percentage of profits.

Even though we suggest that it is inappropriate for super funds to invest at an early stage of a project before an entity is profitable, the existence of this market should also dramatically improve the ability of such entities to raise venture capital or project finance given improved opportunities for such investor to exit.

7. **Access to other capital markets**

While SMSFs can now more easily access Commonwealth Government bonds as they are listed on the ASX, access to corporate bond markets is generally not open to SMSFs. These markets are generally wholesale in nature and corporate bond issues are usually snapped up by large institutional investors, many located offshore. State governments also prefer to market their bonds to institutional investors.

While this may be economically efficient, it does tend to shut SMSF investors out of these markets.

Government and corporate bond issuers could be encouraged to offer bite-sized investment opportunities to SMSFs and other small scale investors, similar to the way in which equity raisings are shared between retail and wholesale investors.

We believe that more can be done to tailor infrastructure bonds issued by governments and the private sector to SMSF investors. This would give SMSFs an opportunity to 'invest in Australia' at both the national and regional level. We can envisage that SMSF owners would be interested in investing in projects that will improve their local economies.

Another option that may be worth exploring is for the Future Fund to attract investment from SMSFs and managed funds. The Future Fund was intended to be funded by Commonwealth Government surpluses and government asset sales but has not received any contributions from these sources for the past decade.

Allowing the Future Fund to tap into the pool of retirement savings may be a good way to grow the Fund so it can serve its intended purpose in covering public service pension obligations while giving SMSFs an opportunity to investment with a fund that has demonstrated it is capable of meeting its targeted returns on funds.

8. **What can be done?**

What can be done to improve the efficiency of the superannuation system?

Apart from improvements in the taxation structure to make it more efficient and fair – which remains a key issue for us in the long term interest of building a more effective and sustainable retirement savings system for Australia – issues that could be addressed by Productivity Commission include:

- Improving benchmarking by encouraging the ASX to report and make freely available an All Ordinaries Accumulation Index which includes imputation;

- Ensuring the Government must always include an "efficiency impact statement" regarding any change that impacts superannuation covering both direct cost and indirect behavioural impacts;
- Encouraging the establishment of low management fee indexed funds. There is almost an argument for a government run fund because there is little incentive (profit) for the private sector to provide such products;
- Ensuring all investment products include a clear statement of all the fees and costs that reduce returns from those achievable from a portfolio of shares, in a form that allows comparison between products.

The 'efficiency impact statement' referred to above needs to be much more rigorous than the 'statements of compatibility' mentioned in the Explanatory Memorandum to the Superannuation (Objective) Bill 2016 which only require Ministers to justify changes to superannuation by reference to the system objectives which we believe are too broad to be meaningful anyway.

9. SMSFs are different

With regard to the Commission's intended approach to investment performance benchmarking, we note that comparisons based on average returns may be an appropriate measure of performance for large managed funds, but averages are a less reliable indicator of the performance of self-managed funds.

Each one of the half a million SMSFs is, in a sense, unique because of the differing investment strategies adopted by the trustees, taking into account their knowledge of and access to markets and their appetite for risk which may change as they move through the accumulation and pension cycles.

Also, fund members will have differing perspectives on what they regard as an adequate retirement income.

So while average performances by SMSFs may be of general interest and of some use in comparing sector performances within the superannuation system, they may mask quite wide variations in individual fund performance based on investment strategies and the circumstances and expectations of their members.

So we caution against a 'one size fits all' approach with regard to measuring and comparing the performance of self-managed funds.

We are also strongly opposed to any attempt to influence or direct SMSF trustees towards particular asset mixes. We believe trustees, with appropriate advice should they choose to seek it, are best placed to judge what is in the best interests of their members who are essentially the same people.

What matters fundamentally is whether self-managed funds are enabling their members to build sufficient retirement savings to be financially independent in retirement. In this regard. SMSFs are the most successful type of fund in terms of asset values at retirement sufficient to generate an adequate retirement income.

In general, SMSF trustees are more conservative than the managers of large funds with a weighting towards cash and Australian shares whereas the large funds invest more of their members' assets offshore. SMSF trustees are generally averse to taking on exchange risk and sovereign risk.

Ironically, they are exposed to sovereign risk at home in Australia from governments changing the rules by imposing new limitations on contributions, and introducing new taxes with retrospective effect on superannuation fund earnings and assets. These changes are made primarily for revenue reasons rather than to make the superannuation system work better so more Australians can achieve financial independence in retirement.

Confidence that the rules won't be changed to adversely and retrospectively affect investment outcomes is an important element of an efficient retirement savings system.

Contact:
Malcolm Clyde
Director, SISFA & Member, SISFA Policy Committee
mclyde@smsfoa.org.au

SMSF Owners' Alliance

Limited ABN 96 161 052 464

Not-for-profit public company

Submission to the

TAX WHITE PAPER TASK FORCE

31 May 2015

Contents

The SMSF Owners' Alliance Limited is a not-for-profit public company established to represent the interests of trustees and owners of Self-Managed Superannuation Funds (SMSFs). Whilst there are other organisations with similar interests and objectives, SMSF Owners' distinction is that membership is strictly limited to the trustees and owners of SMSFs.

Prepared by:
Duncan Fairweather, Executive Director and
Malcolm Clyde, Research Director
SMSF Owner's Alliance Limited
admin@smsfoa.org.au

Graphs

Definitions:

AWOTE	Average Weekly Ordinary Time Earnings
FSI	2015 "Financial System Inquiry" report for Government
Henry Report	2009 Report entitled "Australia's Future Tax System" prepared for Government by a committee chaired by Dr Ken Henry AC
OECD	Organisation for Economic Cooperation and Development
PSM	Pension Sustainability Model developed for SMSF Owners by Harlestone
Replacement Rate	A measure of pension adequacy by relating it to pre-retirement incomes (Described further in Appendices C and G)
SG	Superannuation Guarantee level
SMSF Owners	SMSF Owners' Alliance Limited, a not-for-profit company limited by guarantee
SMSF	Self-managed Superannuation Funds
TES	Tax Expenditure Statement published annually by Treasury
TEE;EET;TTE	Alternative systems of taxing superannuation, referring to the three taxing points; contributions/earnings/withdrawals. Described further in Section 1

1. Summary

The SMSF Owners' Alliance Limited (SMSF Owners) agrees with and applauds the Government for initiating a national conversation on our tax system with a view to developing a system that delivers taxes which are lower, simpler and fairer.

Despite a number of similar reviews and studies over the years, there remain some misconceptions regarding certain aspects of our system which we hope will be dispelled by a thorough and transparent review process delivering a Tax White Paper leading to a considered restructuring of the tax system for the long-term benefit of Australia and Australians.

We note in particular that you invite interested parties to submit new ideas for discussion and consideration.

In this context, given the charter of SMSF Owners, our submission is limited to comments and ideas regarding our superannuation/super system. In particular, we note that the current system is not yet mature and we believe that it will ultimately work better than some commentators and detractors suggest. This submission endeavours to dispel some of the misleading 'myths' regarding the current superannuation system.

The original system design ranked well internationally but the introduction of taxes on earnings in the 1980's impacted its long-term effectiveness. Recent frequent rumours of tax changes also risk increasing uncertainty, causing lack of confidence in this system and detracting from its longer-term success. After the Government has implemented improvements to the superannuation system, following this White Paper process, we urge it to install measures to minimise any subsequent "fiddling" by future Governments to fix short-term Budget problems.

The main issues our analysis raises with the current superannuation system are:

1. It is not yet mature and so the full benefits have not yet materialised;
2. The contribution cap limits are too low for long-term accumulation of adequate super;
3. The contribution caps are too inflexible and disadvantage workers with broken work patterns;
4. It is too complex and there does not appear to be adequate competition amongst fund managers and investment product providers, resulting in lower investment returns than expected; and
5. The structure does not appear to easily allow most 'middle income' Australians to accumulate enough in superannuation.

There is therefore room for improvement and we have used our Pension Sustainability Model (PSM), developed by Harlestone Pty Ltd, to assess some alternative tax structures and compare expected long-term results under such systems with our current system. The current system taxes contributions and earnings during accumulation phase but not earnings nor withdrawals during pension phase. This could be called a Tax;Tax;Exempt or "TTE" system. It is generally accepted that, using similar nomenclature, an "EET" system (which we had before the then Government introduced superannuation taxes in the '80s) is a more effective system. However, it may be very difficult and complex for any Government to now revert to that system.

We therefore also consider a "TEE" system based upon the introduction of progressive taxation of contributions proposed by Dr Henry in his "Australia's Future Tax System" Report (Henry Report) but modified to improve super's effectiveness and be more aligned with the "EET" system by removing super earnings taxation as proposed by Professor Freebairn of Melbourne University.

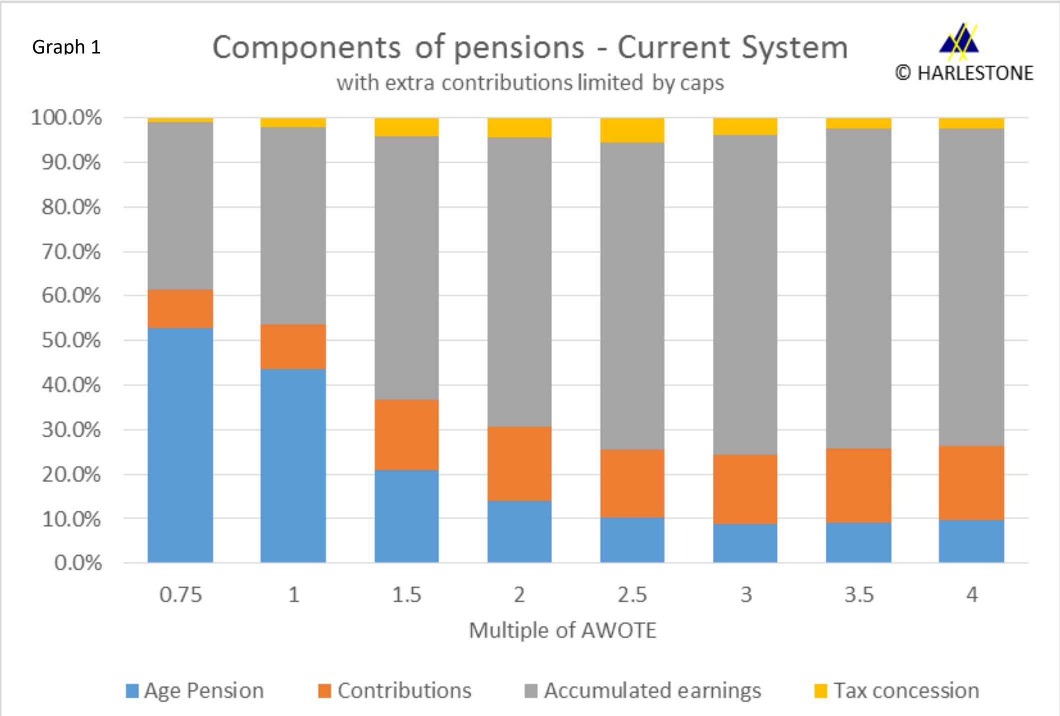
Under this "TEE" system, contributions are included in an individual's taxable income and thus taxed at progressive income tax rates, with a flat % tax rebate. Superannuation earnings during both accumulation and pension phases have been returned to their original tax exempt status which is consistent with the Henry Report but which was not in the end recommended therein. To offset this loss of superannuation taxation earnings so that this alternative could be Budget neutral, we have proposed to use a lower (15%) rebate on contributions than that proposed in the Henry Report (20%). Pension withdrawals remain tax exempt as per the current system.

We must stress the importance of stability and certainty in relation to a long-term investment structure. Whatever changes may look good in the long term, they should be implemented carefully over an extended period with adequate notice to Australians and adequate protection of the savings of those Australians who have constrained their lifestyle to save for retirement in good faith and in accordance with the laws and regulations at that time.

We must also remember that by far the largest component of peoples' super funds is their savings and earnings thereon with less than 10% of super comprising tax concessions. This significant difference between the sources of funding for a super pension and for the Age Pension is a fact frequently overlooked by commentators.

This submission includes some alternatives to the current tax concession regime. However, we believe that a focus by the Government on measures to simplify superannuation and to strengthen competition and choice amongst fund managers and investment product providers would contribute significantly to the effectiveness of super. To the extent such measures reduce costs and therefore improve investment returns, the impact on super is dramatic and the chances of the system providing adequate super for more Australians is improved at no extra cost to the Budget.

This can be illustrated by looking at the sources of funding of retirement pensions across a range of incomes (expressed as multiples of Average Weekly Ordinary Time Earnings-AWOTE).



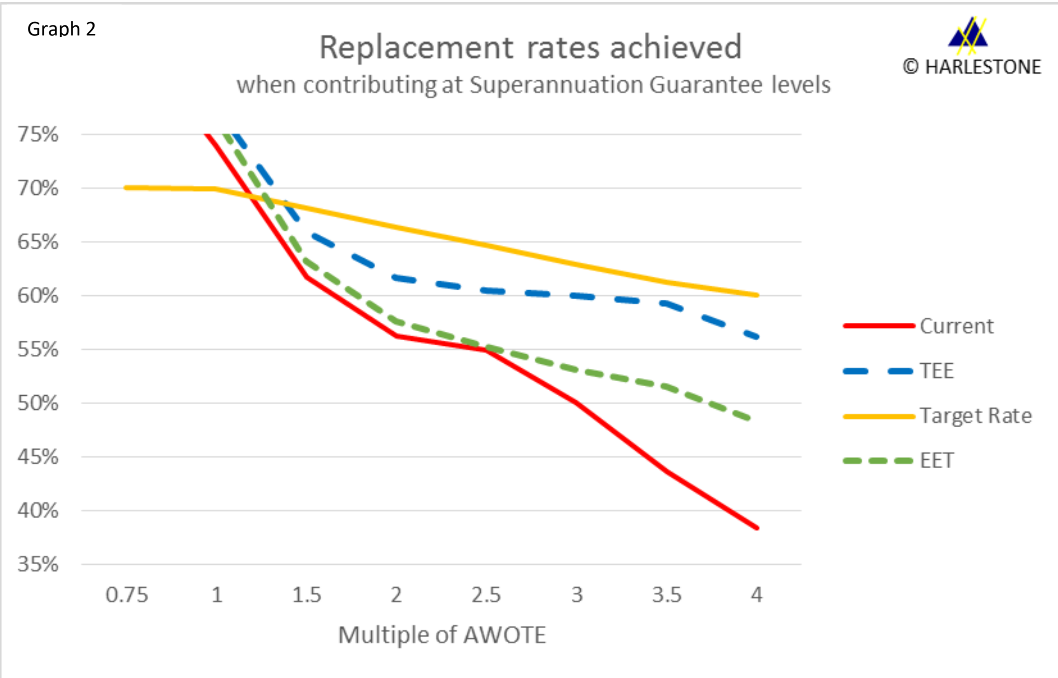
The important lessons from Graph 1 is are how small the tax concessions are (much less than 10% and far smaller than the cost of Age Pensions) and how large and significant the accumulated earnings are. This graph is discussed in more detail in Section 2.2.

We also believe, as a principle, that a review of the impact of the superannuation tax system for the long-term benefit of Australia should not include short-term changes designed to rectify perceived anomalies arising from past taxation rules. To do so risks having a long-term design that is sub-optimal. In particular, much has been made by the media recently of a small number of high superannuation balances. It is not possible to accumulate such balances under the current rules and so we do not address such issues in the main part of this submission which focusses on improvements to the system for the long-term benefit of Australians. Such balances were accumulated legitimately under earlier rules (in particular when system was an EET system) and action with regard to such balances, if any, must not prejudice the optimal design of our superannuation system for the long term.

In relation to ideas for an alternative, we present and encourage debate of a TEE system which:

1. Should lead to more Australians achieving adequate superannuation balances;
2. Would be 'fairer' – and perceived to be fairer – across income brackets;
3. Would be simpler and less costly, leading to better net superannuation investment returns;
4. Could be introduced relatively efficiently;
5. Should require less 'grandfathering' than other alternatives; and yet
6. Be tax revenue neutral or possibly positive.

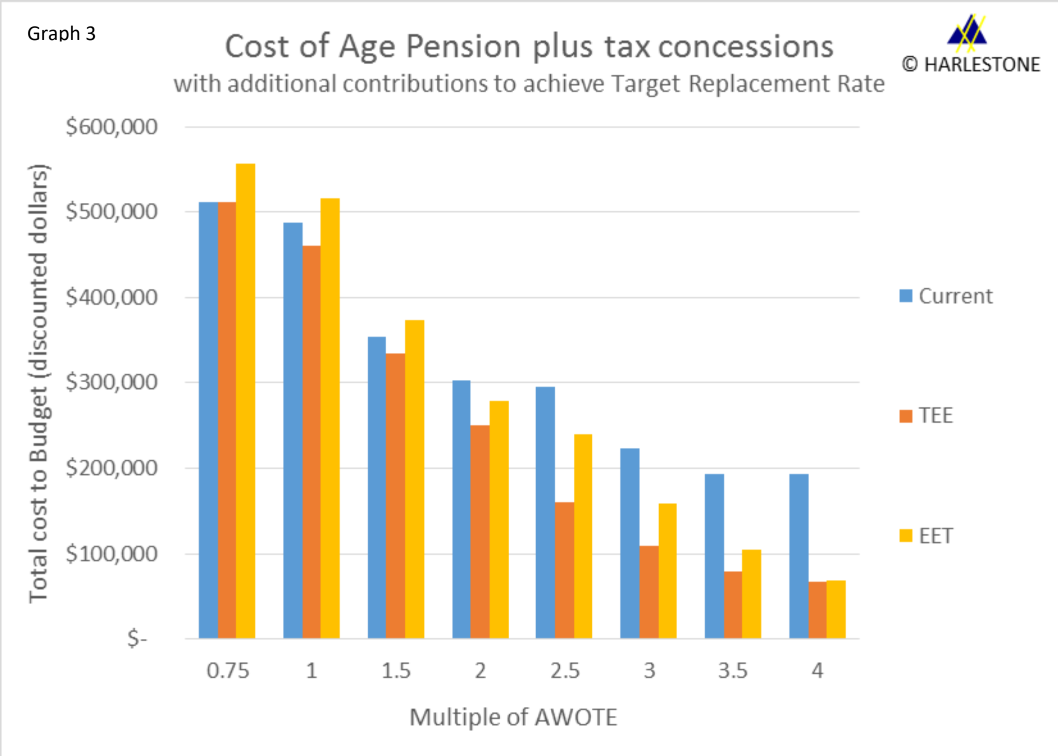
This system is more effective than the current one at the same cost to the Government. As discussed in this submission, we have measured the effectiveness of alternative systems in providing a reasonable pension for most Australians across the income range. The Replacement Rate concept (described further in Appendix C) is the measure we have used for a "reasonable pension" and have determined a "target" Replacement Rate across income groups. The following graph 2 presents a comparison of the extent to which alternative systems meet the target Replacement Rate. These are based on our PSM assumptions including the 12% Superannuation Guarantee (SG) level planned under the current system and an 'equivalent' 10% level for the alternatives. Why this is equivalent is described further in section 4.1 and Appendix G.



The current system falls well short of target for all but the lowest income groups even assuming a 12% SG level. The alternatives (described in Section 4) are noticeably better even though we have used a 10% SG rate. Those on or below AWOTE achieve a higher pension at the contribution rate assumed due to their eligibility for the Age Pension (or part thereof).

Further analysis presented in Section 5 suggests that an SG level of 9% or under could be adequate if the system was moved to the alternative TEE presented.

This alternative also provides a very 'progressive' benefit to Government illustrated by the following graph 3. This shows the lifetime cost per person to the Government of Age Pension payments plus tax concessions for individuals across income groups for the two alternatives compared with the current system. Not only do the costs fall with income in all cases but they are lowest at all income levels for the alternative TEE system discussed further in Sections 4 and 5.



We do not accept that a review of superannuation necessarily implies an increase in taxes on super. A thorough review should consider improvements that can be tax neutral to the Government.

We strongly support the Government's view that the tax system should be simplified. In particular, the complexity of superannuation rules and regulations, many added over time and not necessarily now relevant, reduces the chances of people engaging with super, increases the cost of administration and thus reduces net returns. In Section 5 below, we illustrate the dramatic impact on the effectiveness of the alternative TEE superannuation system that simplifying superannuation may have through improved returns.

To stimulate constructive debate, we include as Appendix A a list of some aspects of the superannuation system which we believe could be reconsidered in the context of a focussed review of the system. Some of these ideas could be implemented immediately and easily, with or without an overall change to the superannuation tax system, without cost to the Budget and to the benefit of all Australians.

In relation to a general review of Australia's tax system, we also provide our comments on why we believe that self-managed superannuation funds have been so successful and to dispel some of the stories spread by commentators and interest groups that have a political view or that may feel threatened by or envious of the success of SMSFs.

Finally, we provide in Appendix B our views on the recommendation from the Financial System Inquiry that the imputation system should be reconsidered. Although such a system is not part of superannuation taxation, it is such a fundamental part of Australia's investment environment that we must provide our views on behalf of our members who invest a third of their assets into Australian stocks, more than other types of superannuation funds.

We would be happy to share further detail regarding our Pension Sustainability Model with the Tax White Paper Task Force and to enter into a dialogue regarding the assumptions we have used and some sensitivity analysis.

In summary, if changes are made to superannuation, make sure they lead to a simpler and more efficient superannuation system designed to ensure more Australians are able to and are encouraged to save for their comfortable retirement.

2. Main Issues Regarding the Current Superannuation System

If one cuts through some of the commentary and opinions regarding our superannuation system, there appear to be three underlying questions:

1. What are we trying to achieve? What are the objectives of superannuation?
2. Are the tax incentives for superannuation justified or too large (or too small) in the context of our tax and welfare system to meet that objective? and,
3. Are such tax incentives fairly applied across income groups?

2.1. Objectives of superannuation

We note that the Financial System Inquiry supported the '3-pillar' structure of our superannuation system. Both the Henry Report and Jeremy Cooper's "Super System Review" also suggested that such a system should meet the following retirement objectives as proposed by the World Bank:

- Through a combination of compulsion and incentives allow most taxpayers to retire on a privately-funded pension at a reasonable Replacement Rate; and
- Provide a Government-funded pension only as a 'back-stop' for a minority of taxpayers who for whatever reason have been unable to achieve this objective.

The rationale for encouraging retirement savings with tax incentives was well expressed in the Henry Report:

> *"The essential reason for treating lifetime, long term savings more favourably is that income taxation creates a bias against savings, particularly long-term savings. Taxes on savings income, including the taxation of inflationary gains, can discriminate against taxpayers who choose to defer consumption and save. The longer the person saves and reinvests, the greater the implicit tax on future consumption….These individuals pay a higher lifetime tax bill than people with similar earnings who choose to save less."*

The Financial System Inquiry's Report made some constructive comments about superannuation including that:

- *"it is an important source of funding for capital formation",* but that
- *"its policy settings lack stability, which adds to costs and reduces long-term confidence and trust in the system"* and that
- stability would be assisted if the Government committed to "*a legislated and formal statement of the guiding principles for a retirement income system."*

We agree that it would be helpful for the objectives of superannuation to be formalised but that the primary objective proposed in the Financial System Inquiry's Final Report – *"To provide income in retirement to substitute or supplement the Age Pension"* – is too limited. A statement of purpose needs to indicate an appropriate benchmark for a reasonable 'income in retirement'. We support the concept of a target Replacement Rate which the Henry Report and other international bodies accept as a benchmark. This indicates in general terms a relationship between pre and post retirement incomes.

A more complete description and explanation as to how we use Replacement Rate in our simulation model are set out in Appendix C.

The need to set a reasonable benchmark for the level of income in retirement is particularly important given recent commentary suggesting that the objective of superannuation is ONLY to provide enough money in retirement so people are not on the Age Pension. Whilst the Age Pension is of assistance as a safety net, we believe that most people would not believe that it provides an acceptable standard of living for those who have worked and contributed to super all their lives. Such a system would not meet the World Bank's view of an acceptable system for a developed country. In particular, Australians who have established SMSFs are driven by the goal of financial independence in retirement and do not see themselves becoming reliant on the Age Pension.

Apart from the obvious purpose of superannuation to provide a pension in retirement, a clear set of guiding principles along the lines of those espoused by the World Bank would therefore be helpful in locking in some system stability and minimising the risk of subsequent Governments rewriting objectives and trying to 'unwind' the benefits of peoples' long-term savings.

Our views of issues that could be considered when formulating clearer guiding principles are as follows:

a. an acknowledgement that:
   - *"the potential risks and vulnerabilities arising from a high current account deficit can be mitigated by ensuring a strong national savings effort"* (Henry Report Pt 1 p9) and that
   - *"income taxation creates a bias against savings and discriminates against taxpayers who choose to defer consumption and save*" (Henry Report Pt 1 p32) so that the superannuation system should incorporate tax incentives to offset this bias and to compensate for the restrictions on use of funds in super;

b. the objective of the retirement system is "*that in retirement people should enjoy a certain standard of living comparable to the one they had during their working lives* (OECD)". This can be benchmarked by using an appropriate Replacement Rate;

c. the Government's retirement system comprises 3-pillars:
   i. compulsory savings;
   ii. voluntary savings encouraged by tax incentives;
   iii. the Age Pension for those Australians unable to fund their own retirement;

   There seems to be little disagreement that this system is appropriate. The Henry Report stated that:

   > *"The ageing of the population, longer life expectancies and more people interacting with the system pose challenges for the retirement income system. A key finding of the Review Panel's strategic report on the retirement system, released in May 2009, was that the current three-pillar retirement income system is well placed to deal with these challenges."*

d. the cost to the Federal Budget of providing an Age Pension is substantially higher than the cost of tax revenue foregone through superannuation tax incentives and the system should therefore allow and encourage most Australians to save adequate super to fund a suitable pension, with the Age Pensions retained as a 'safety net' (say for no more than 30% of retirees);

e. the mechanism to limit access to super tax incentives should not limit or tax investment success as this is economically inefficient and distorts investment activity; and

f. that the largest influence on an individual's fund size is the long-term after-tax return generated, so the superannuation investment environment should be competitive and the system should be as simple as possible to reduce costs and encourage more engagement by individuals with their superannuation. We illustrate, in section 5, the impact improved returns can have on an alternative/simpler system.

These points may be a bit long-winded but there is a risk in setting simplistic objectives that don't mean much unless spelled out clearly.

2.2. Justification for tax incentives

That there are tax concessions with regard to superannuation is not in doubt. However, some reported suggestions that superannuation tax concessions may not be of benefit ignores the importance of national savings for the ongoing health of the Australian economy.

In his context, Dr Ken Henry's comments in his 2009 Report on 'Australia's Future Tax System' should be noted. He clearly stated that "*income taxation creates a bias against savings"* and *"discriminates against taxpayers who choose to defer consumption and save"* with the result that "*individuals* (savers) *pay a higher lifetime tax bill than people with similar earnings who choose to save less".* In particular he reported that the bias against long-term savings was evident *"for lifetime savings such as superannuation"* and that ***"superannuation should receive preferential income tax treatment compared to other savings".***

Further relevant comments from the "Australia's Future Tax System' Report are included in Appendix D.

Any review of superannuation tax concessions should recognise the difference between any concession or deferral of taxation on **contributions** into super and any tax concession on the **earnings** in super.

Most people don't realise that there is no tax concession on super earnings if it were calculated on an expenditure basis as done by many reputable organisations overseas. Too many commentators and organisations that should know better have been quoting the superannuation 'tax concessions' reported annually in Treasury's Tax Expenditure Estimate (TES) without appearing to understand them. Treasury's Tax Expenditure estimates are prepared using an "income tax benchmark" which we understand they are required to do in accordance with procedures set down when this process was established by the Charter of Budget Honesty. However, this does not appear to reflect reality and does not recognise the bias against savings inherent in our (earned) income taxation system reported on in the Henry Report.

We had expected that some media and other organisation who should know better would not continue to use the reported 'aggregate' $32bn superannuation tax concession figure (or extrapolate it as has been done recently) given reports from a Treasury official recently that could not have been clearer.

Rob Heferen, Executive Director of Treasury's Revenue Group, told a recent SMSF conference that the annual TES is not a document with a policy message. *"When it is reported in the press...there seems to be an inference that simply because there is a large measured tax expenditure, the Government should do something about it. That is not the case. There is no policy message in the Tax Expenditure Statement."*

He went on: *"We are asked to do an audit, so we do. But be wary on the revenue gain estimates.* ***Don't use them, they are too unreliable.*** *On the revenue foregone (estimates), done according to international best practice,* ***that is not a measure of what is saved.*** *Anyone who says this is not reading the fine print - it's not even in fine print, it's in bold print. Every year when we put it out, we get criticism so I wanted to make it clear."* (emphasis added).

With this clarification Treasury has made it possible to have a more objective and rational discussion about the purpose, effectiveness and benefits of superannuation and how Australia's retirement savings system can be improved, without undue focus on a large but artificial number.

Like Rob Heferen, the Henry Report also questioned the validity of over-reliance on the reported tax expenditures due, in part, to differences of opinion as to what benchmark should be used. The reported figures depend upon the benchmark used. The Henry Report raised questions about the benchmark used in the Tax Expenditure Statement, by reporting that *"most countries' retirement income systems use an expenditure tax benchmark."* The TES in contrast uses the "income tax benchmark".

To give Treasury due credit, and to illustrate the problematic nature of this exercise, in the 2013 TES they also reported on superannuation tax expenditures using the "expenditure tax benchmark". This resulted in the tax expenditure with regard to the concessional taxation of super earnings swinging from the $16.1 billion it usually reports to <u>minus</u> $5.8 billion (i.e. a tax <u>penalty</u> rather than a tax <u>concession</u>). This methodology recognised that the $5.8 billion received in super taxes on earnings would not have been received if there had been no savings – in or out of super. Unfortunately, Treasury did not repeat the exercise for 2014. Despite the problems with the TES, Rob Heferen explains that they are obliged to report some of these figures in order to comply with a recommendation in 2007-08 by the National Audit Office and the Charter of Budget Honesty Act.

Treasury have also been consistent in warning that the two superannuation components - tax concessions on contributions and tax concessions on fund earnings - are not additive. (i.e. the $32 billion number is definitely wrong) Treasury also notes that *"Readers (of the TES) should exercise care when comparing tax expenditure estimates with direct expenditure estimates."*

The overall point is not that one method is right and another wrong, but that the whole process is inexact and will produce different numbers according to the benchmarks used. As we have consistently stated, it should not be used as an estimate of the tax saved by individuals, and a corresponding cost to the budget, as a result of the super system. In contrast, the Pension Sustainability Model which we use calculates **actual** tax payments with or without super, compares them and then reports them in today's dollars. This provides a much better estimate of the level of tax concessions and we do this calculation across a range of eight income levels (multiples of AWOTE).

The other flaw in the TES is what it doesn't report. It was recently reported that, although some level of progressive taxation is generally accepted for an individual's earned income, Australia has one of the most progressive income tax systems in the developed world. However, this 'tax expenditure' is not reported.

We understand that 20% of Australians pay about 65% of income taxes. This is about $100 billion or 6 times per person what the other 80% pay per person. If one calculates the tax concession received by those Australians vs the average tax paid per person, the 'concession' received by 80% of Australians is worth over $70 billion per year.

For example, including superannuation tax concession reported by Treasury in 2013 on an expenditure tax basis, a 'fairer' comparison of the large concessions could possibly be:

- Superannuation $11billion
- GST exemptions $23billion
- Tax exemptions on own home $46billion
- Income tax 'concession' $70billion

We are not suggesting that there should be no progressivity in the income tax system. Rather that, if it were benchmarked and transparent, it might help put some of the other 'tax concession' figures into perspective.

Whilst some tax exemptions are granted for social reasons, some are justified for economic reasons and superannuation is one of those as it offsets the bias elsewhere in the tax system against savings.

All developed countries recognise the necessity to offset the natural taxation bias against savings and in that context one could argue that it is not a ‘concession’. As a side benefit, it also reduces the cost to the Government of the Age Pension.

Of the 23.5 million Australian resident population, 3.5 million are aged 65 and above. If all these were on the Age Pension of $22,000, the annual cost to the Government would be $77 billion.

This compares with an actual current cost of $45 billion.

The ‘cost’ of super tax concessions in a year when calculated on an “expenditure tax” basis is about $11bn which is about a third of the extra $32bn it would cost the Government if everyone were on the Age Pension. i.e. every $1 of tax concession saves Government $3 in Age Pension as well as providing a better standard of living in retirement.

It should also be recognised that these figures are based upon an immature super system. The Superannuation Guarantee was introduced in 1991 and so has only been operating for 24 years (and at lower SG rates than planned for the future) compared with a normal working life of 30-35 years. Whilst super balances for many are inadequate, even with the current system we believe this should improve over time with consequential reductions in the average Age Pension cost per retiree.

The following explains further why the actual tax ‘concession’ for super is less than the high figure misquoted. If, as most commentators and reports suggest, an individual is assumed to spend funds that are not contributed into super, then:

a. A tax concession on contributions is the difference between the tax that would have been paid if such contribution had been classified as salary and the tax paid on it as a contribution;

b. Any earnings on such super contributions would not have occurred if there were no super and so any tax on earnings is tax revenue the Government would not otherwise have received (**and reduces the tax concession on contributions referred to above)**;

c. If the super balance is all paid out as a pension, such pension is equal to the sum of the contributions **plus** any after tax earnings on such contributions; and also

d. If it assumed that there is 10% GST on marginal expenditure then an individual would have paid GST on after-tax spending if there were no super; however on the assumption that all the super balance is paid out as a pension and spent, he/she will in future **pay GST** on the super balance, which comprises not just the super contributions but the large accumulated earnings. So apart from the super earnings tax, the individual also pays GST on such accumulated earnings when spent.

We recognise that GST payments do not directly impact the Federal Budget. However, their impact on the effectiveness and efficiency of superannuation is not insignificant and we believe should be included in any comprehensive review of alternative superannuation tax systems. A simple illustration of how the super taxes and GST on earnings accumulated in super **reduce** the tax concession on contributions is included in Appendix E.

What also does not appear to be well understood is the small amount tax concessions contribute to an Australians super savings. Most of a person’s pension savings are contributions made instead of spending during their working life plus a huge amount of accumulated earnings thereon. Contrary to some who appear to believe it makes sense to reduce superannuation tax concessions and use such moneys (if any) saved to increase Age Pensions, it actually makes more budgetary sense for governments to provide encouragement for Australians to save for their retirement and retain the Age Pension as just a safety net.

Not only is an Age Pension paid out of tax revenue received from subsequent generations, but 100% of it is provided from such revenue. In contrast, a fully-funded private pension is substantially funded by that individual's savings (superannuation contributions) during his or her working life. Whilst a 'tax concession' is a vital incentive to make such savings by overcoming the taxation bias against savings and to compensate savers for having their super funds 'locked' away, its component of such funding is only small (less than 10% for the cases we've modelled). These tax concessions are also substantially contributed during that individual's working life rather than out of tax revenue exacted by the Government from subsequent generations. In contrast, the Age Pension is a relatively expensive form of Government support, is an unfunded obligation paid for by generations subsequent to the retirees and should be limited to providing a genuine safety net as originally intended.

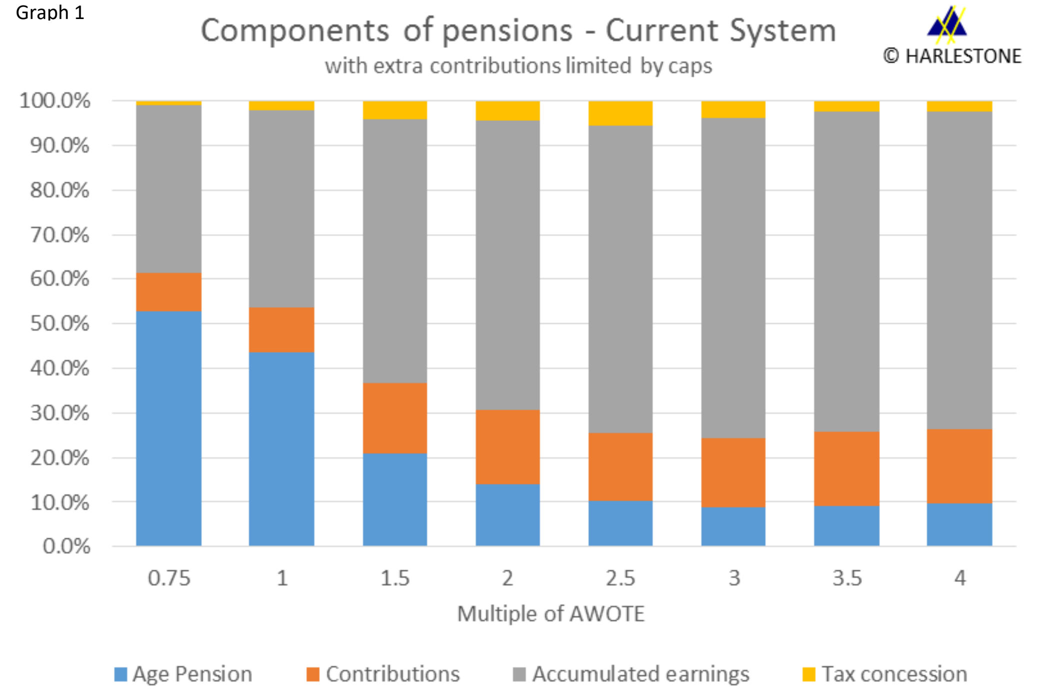
Superannuation tax concessions are a much better way to build an effective retirement income system as they comprise less than 10% of a super-funded pension, the far larger balance comprising an individual's own savings and accrued income.

The following graph illustrates these points, showing (for a single male under mature superannuation assumptions) how retirement pensions are funded. Our modelling shows the relative contributions to retirement pensions of the following:

- Age Pension payments(full or part);
- Super contributions assuming made at adequate level to achieve target Replacement rate;
- Accumulated earnings on super during a working life and retirement; and
- The value of tax concessions.

For Australians on a range of incomes – expressed as multiples of Average Weekly Ordinary time Earnings (AWOTE).

Graph 1



The important lessons from Graph 1 is are how small the tax concessions are (much less than 10% and far smaller than the cost of Age Pensions) and how large and significant the accumulated earnings are.

The benefit of a good superannuation system is that more people can retire on pensions that bear a closer relationship to their income during working life and at the same time result in Federal Budget savings. Even though the current system is not perfect, the savings in Age Pension costs vastly outweigh tax concessions to provide a net benefit to Government across all income levels. These savings actually increase with income, contrary to some myths about super as illustrated in section 3.4 below.

It therefore makes fiscal sense and is more equitable as between generations for the Government to provide adequate incentives for most Australians to save enough during their working life to retire on a fully-funded private pension. Encouragement to make such savings should not just be a matter of tax incentives. Providing a more certain framework for such savings and other steps to encourage a culture of saving would greatly assist the effectiveness of any tax incentives provided.

2.3. Fairness of super tax incentives

Dr Henry is correct in his “Australia’s Future Tax System” Report in explaining that contributions into super would have been taxed at progressive rates if there were no super but that, because there is no ‘progression’ in the current super tax system, the ‘flat’ super taxes reduce the level of progressive taxation that is otherwise in the system. Essentially the Henry Report recognised any tax ‘concession’ on contributions should ideally be a deferral of income tax on earnings that would otherwise be paid.

However, the media commentary on the ‘unfairness’ of the current tax concession system to those on low incomes has been exaggerated and generally ignores the fact that our income tax system, **even after such ‘flat’ super taxes,** is still one of the most progressive in the world.

To introduce progressivity into the superannuation system on top of an already very progressive tax system would be clearly unfair and economic madness, reducing the incentive for Australians to work hard and better.

The Financial System’s Inquiry Report suggested that the existing system of tax concessions favoured high income earners who would in any event be *“likely to have saved sufficiently for their retirement, even in the absence of compulsory superannuation or tax concessions.”* However, there is no evidence presented to support this observation and it does not appear to take into account our highly progressive income tax system. Such a claim requires more considered analysis which we attempt in this submission.

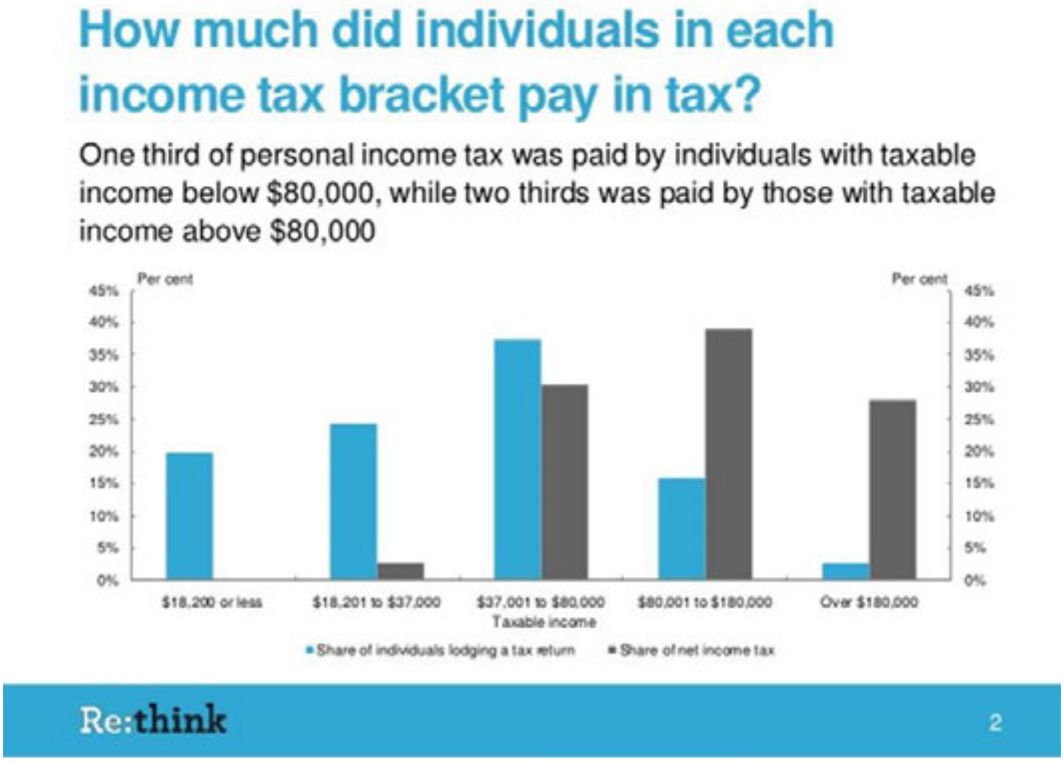
The fundamental purpose of the superannuation system is, or should be, to enable as many Australians as possible to be financially independent in retirement and enjoy a standard of living based on the widely accepted concept of a Replacement Rate (see Appendix C). Those who achieve this goal will also not be a burden on the Age Pension budget.

Even if there was a flat income tax rate, Australians on higher incomes would contribute more in income tax dollars to support those on lower incomes. The combination of our very progressive rate income tax system and our welfare structure exaggerates this to a dramatic extent. The retirement system should not be another mechanism for redistribution of wealth in addition to existing transfer mechanisms, notably income tax and social welfare payments.

The reality is that although the dollar benefit of the tax concession on higher income earners is higher than the dollar benefit to others, this is because they are paying more tax! Even after the tax concession, those on higher incomes are still paying a higher rate of tax and therefore substantially higher actual tax dollars than those on lower incomes. It is no different to saying that the benefit of a tax deduction to someone on a higher marginal tax rate is worth more than the same deduction for someone on a lower marginal tax rate.

As the Better Tax website illustrates, with figures from the *ATO Taxation Statistics 2012-13,* the top 20% of taxpayers pay around 65% of tax collected.

Graph 4



One of the issues with our tax and welfare system is that about half of Australians do not pay any tax net of welfare. They are net recipients of welfare funded by the other half of Australians.

The Financial System's Inquiry Report showed that the top two deciles of income earners receive about 57% of total superannuation tax concessions. It failed to present a more balanced picture, showing that the top two deciles of income earners pay around 65% of income tax revenue. That is, they more than pay their way as their level of super tax concession is actually lower than the proportion of the total income tax which they pay, as we have pointed out in previous reports and elsewhere in this submission.

The ATO statistics clearly show that top 20% of income earners get a share of superannuation tax concessions that is proportionally <u>less</u> than the share of income tax they pay.

It seems entirely logical and fair that the people who pay the largest share of income tax also, as a consequence, get the largest dollar share of superannuation tax concessions even if a lower percentage and it is misleading to suggest this is inequitable.

An illustration of our point is included in Appendix F which is reproduced from one of our earlier Research Papers.

Policy discussion on the 'fairness' of superannuation tax incentives would be assisted by a thorough analysis of all taxes paid and benefits received by individuals across income groups rather than by just focussing on the value of a particular concession, such as for superannuation contributions and earnings.

3. Analysis of Current/Retirement System

We have commissioned further work using the Pension Sustainability Model (PSM) developed for us by Harlestone. For the purposes of assessing the long-term suitability and sustainability of the current super system, we have used PSM to project results for the system for Australians on a range on incomes on the assumption it is "mature".

This simulates the impact of superannuation on our retirement system, taking into account welfare entitlements, tax payments (including GST) of single Australians on a range on incomes through their lifetime and retirement. Whilst we have used this model in the past to illustrate various aspects of super for Australians at different stages in their working life and who have therefore been in the current super system for differing periods, we assume for the purpose of this analysis that all Australians have the benefit of the current superannuation system when in a mature state for all their working and retirement lives.

A summary of the assumptions used by the model for this submission is set out in Appendix G. The figures and graphs in this section are sourced from this model. In the next section we then use the results of the model to compare alternative superannuation retirement systems.

3.1. Meeting Objectives

The Intergenerational Report projected that in another 40 years' time 67% of retirees will still be on some pension. OECD's 2013 report also said that Australia had one of the highest levels of poverty amongst the over 65s (35% below poverty line). These and other World Bank statistics suggest that the current superannuation/retirement system in not working as well as it should.

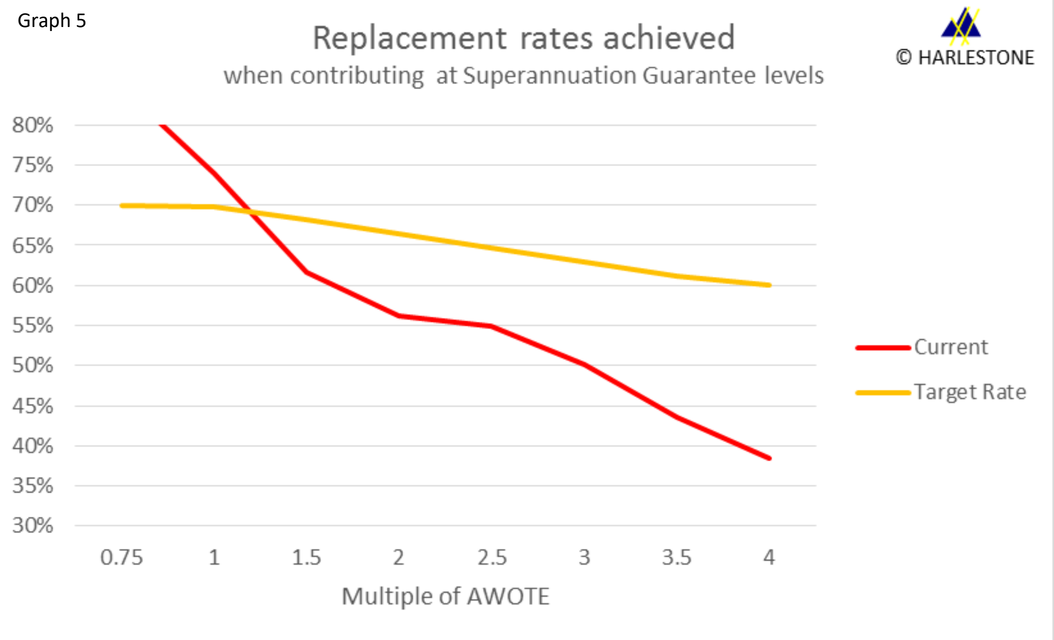
The biggest impact on super savings is the rate of return achieved after tax, as illustrated in Graph 1 above. One of the strongest features of the Financial System's Inquiry, and one which we support, was a focus on improving competitiveness of providers of products and services into this sector. One of the advantages of the alternative system we analyse in the Sections 4 & 5 below is the greater likelihood of higher returns and we include in Section 5 a sensitivity analysis illustrating the significance of investment returns on super pensions achieved.

3.2. Adequacy of Current System

PSM projects superannuation balances under realistic investment assumptions. It then takes into account entitlements (if any) to the Age Pension or part thereof and calculates how much needs to be drawn from super to provide a total pension for the whole retirement period. This aggregate (Age Pension plus super) pension is then compared with an assumption regarding 'target' Replacement Rate pension for each income category.

Graph 5 shows what pension Replacement Rates are achieved under the current system if individuals contribute at the (long-term bipartisan) superannuation guarantee level of 12% and compares this with 'Target' Replacement Rates (see Appendices G and C).

Graph 5



The results are shown for Australians on a range on incomes shown as multiples of AWOTE.

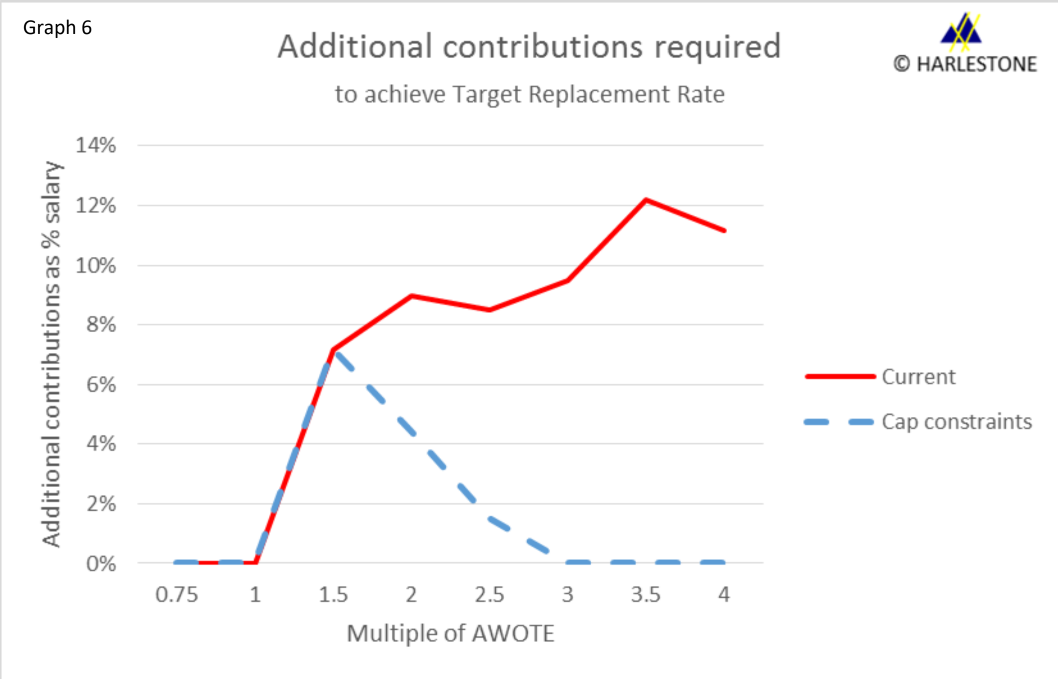
This graph illustrates that lifetime contributions at a 12% Superannuation Guarantee (SG) level will not result in adequate super for most people. Effectively only those on average weekly earnings or under will have adequate pensions because of their access to the Age Pension system.

To the extent that superannuation at the SG level falls short of a "target" replacement rate, we calculate the additional contributions necessary during the last 15 years of working life to reach that target. For this graph, additional contributions are specified as a percentage of salary for each of the last 15 years of a person's working life on the assumption that, prior to this period, other priorities for income (mortgage, children) negate any possibility for extra contributions above the compulsory SG level.

The results are shown in the following Graph 6 on the assumption that there is no constraint on contributions (solid line). These graphs show the results under current tax system with a sharper 'taper' of Age Pension eligibility as proposed in the recent Budget.

For many Australians, they would have to contribute around an extra 10% of salary to save enough in super.

However, we also show in the same Graph 6 the impact of the current contribution caps. For Australians on above average earnings, the cap limits their ability to contribute adequately to super to achieve reasonable savings and indeed those on three times average earnings, no additional contributions can be made because the cap is already reached by their SG contribution (dotted line).



Those on or below average weekly earnings do not require any further contributions to super above the 12% superannuation guarantee level.

3.3. Constraints on access to tax incentives

We believe that there should be limits on the availability of tax concessions so that the system's objectives can be achieved at the lowest cost to the Government budget.

The largest tax concession on super (and arguably the only one that should be applied) is at the contribution stage and this is where any limit should apply. Taxing or limiting super earnings/pensions or balances is taxing or limiting people's **success** in handling their investments in super. Such an approach is economically inefficient and would distort investment decisions and therefore lead to a less effective super system. The whole approach to superannuation should be to encourage sound long-term investment, as it is investment returns that have one of the largest impacts on the effectiveness of super, as we show in Section 5.

We have already explained this in the context of a response to the recent announcement by the Opposition of their proposed policy to add a tax to earnings above $75,000 per account in pension phase. This is a new tax because, contrary to the Opposition's and some media claims, there has never been any tax on earnings supporting a pension income stream. A copy of our recent response to this proposal is attached as Appendix H.

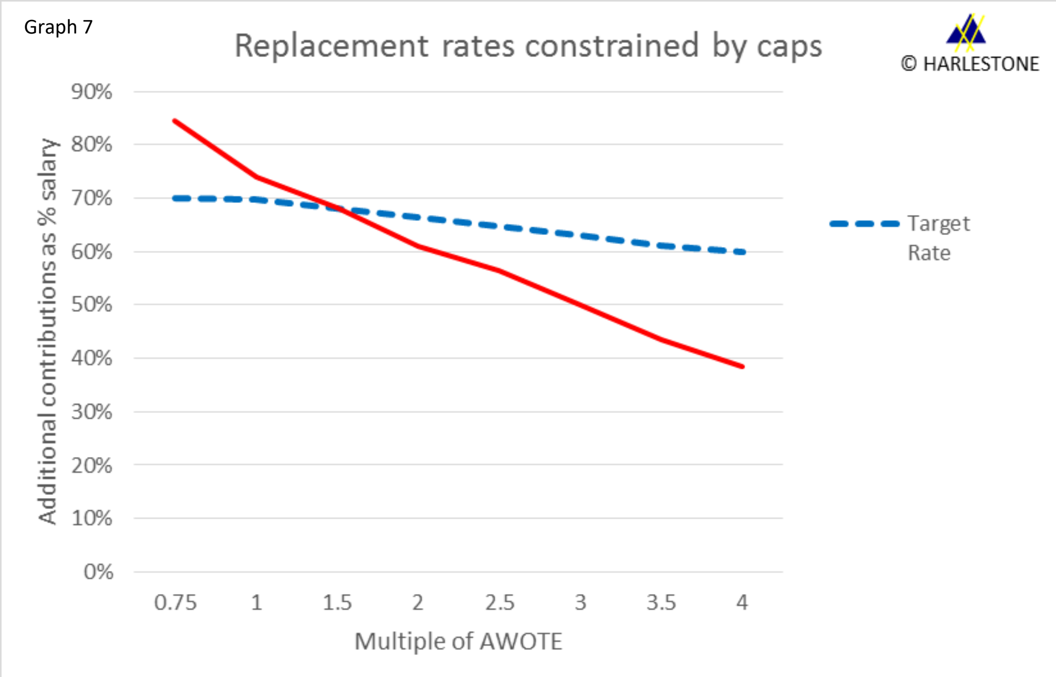
We therefore agree with putting caps on contributions as in the current system. However, there should be a system of rolling caps to assist those with broken or volatile earnings patterns and the caps should be adequate to allow Australians to achieve their appropriate 'target' replacement rate.

The existing system of annual dollar limits on contributions discriminates against women, the self-employed, whose incomes may be variable from year to year, and others who may have broken or volatile work patterns during their working life.

We have previously proposed that the Government allows a system of 'rolling' contribution caps, similar to the contribution limits that apply to non-concessional contributions. This would be fairer and assist women, the self-employed and others with disrupted work patterns.

An alternative is a lifetime AWE indexed contributions cap which may be even more equitable but perhaps ruled out due to unreasonable administrative complexity.

With respect to whether the current constraints are fair – in the long term - the previous Graph 6 illustrated that Australians on above average earnings cannot make adequate contributions to reach a reasonable pension. The following Graph 7 shows the maximum Replacement Rates that can be achieved under the current cap regime compared with 'target' Replacement Rates



This shows that for those on over 1.5 times AWOTE, the current caps are not allowing them to accumulate adequate super savings.

We have estimated that the level of annual cap that would allow this to happen for Australians on three times average weekly earnings or below is $80,000 in today's dollars. They should then be able to save enough in super if they wish and with adequate incentive and encouragement. We have previously suggested that reverting to a general cap of $50,000 with a higher, $100,000 cap for those over 50 may be appropriate. Our model now shows that an even higher general cap is necessary largely because we have made more conservative assumptions of long-term rates of return (7% p.a.) after costs vs the 8% p.a. we used previously and because we are now assuming greater longevity.

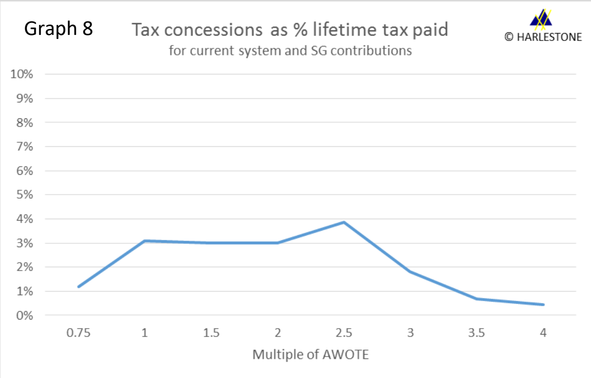
This analysis focusses on the long-term results expected from our superannuation system, In practice, no Australians have yet had the benefit of a 12% SG level and many have not had any compulsory superannuation system for much of their working lives. They are being unreasonably constrained by the level of caps on contributions and in the meantime a higher contribution cap for, say, over 50's is necessary to achieve reasonable results. This will lead to better retirement incomes and also lower Age Pension costs.

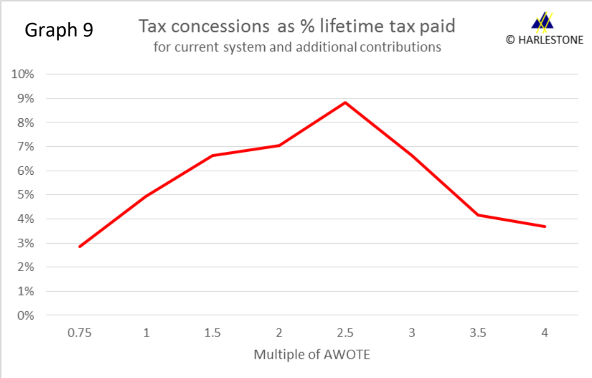
3.4. 'Fairness' of Current System

Contrary to the TES method of calculating tax concessions, we take a 'whole of life' approach. In parallel to the modelling of individuals on a range of income and super contributions, we project the taxes paid, Age Pension entitlements and pensions received for each individual in the model if there were no superannuation system.

The actual taxes paid and benefits received under each scenario are then discounted to adjust for different timing and compared to estimate tax concessions and Age Pension savings.

Whilst those on higher incomes, and therefore paying more tax, receive a higher dollar benefit from concessions, the 'unfairness' of this has been exaggerated by the media. We have endeavoured to provide a more rational view of the 'fairness' of the current super/pension system by projecting tax concessions as a % of lifetime income tax paid (in today's dollars).

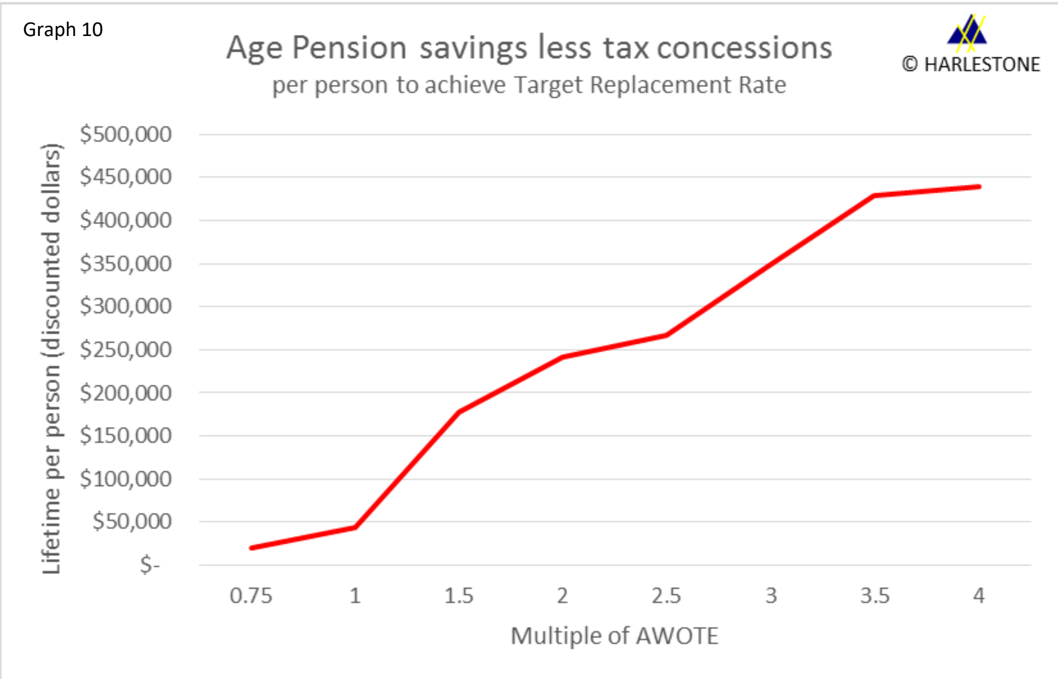




Graph 8 shows tax concessions compared to lifetime tax paid **falling** with higher income levels. This shows results on the assumption that contributions are made at the SG level. Graph 9 shows the tax concessions applicable if additional contributions are made in order to achieve the 'target' Replacement Rate and there was no cap on contributions.

It shows a strange pattern due to the interrelationship between income tax rates, superannuation tax surcharge and Age Pension eligibility. Those on lower incomes have less need to make additional contributions because of their access to the Age Pension and their retirement is more substantially funded (up to 100%) by Government rather than their own savings supplemented by tax concessions.

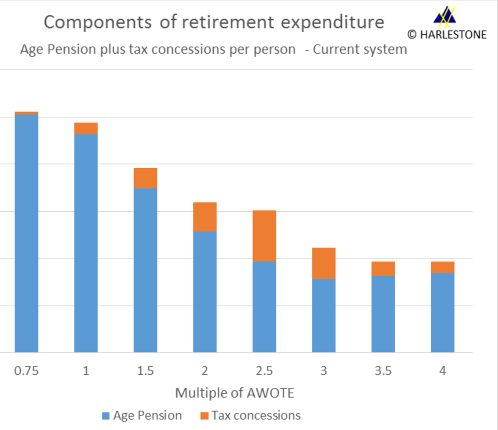
Tax concessions to achieve a more comfortable pension than the Age Pensions are more than offset by savings in age pension to provide a net benefit to the Government. Graph 10 below shows the net lifetime benefit per person (savings in Age Pension plus extra GST less tax concessions) to the Government of the super system for each income level. The projected savings have been discounted to take into account different timing of cash flows



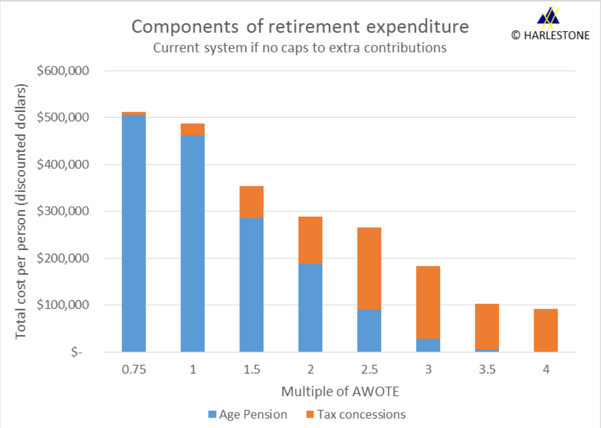
Graph 10 shows that the net **benefit** to the Government of the super system **increases** with income.

An alternative way to consider this is to look at the total cost to Government of funding pensions for different income groups. The following Graph 11 shows the total Government cost per person for Australians on a range of multiples of AWOTE and contributing at the SG level. This cost comprises the Age Pension (or part thereof) and the cost of tax concessions, less extra GST paid when superannuation savings are spent. This cost **falls** with rising income.

Graph 11



Graph 12



That the cost to Government in Graph 11 does not appear to continue to fall at high (over 3 times average weekly) earnings is because even at just the Superannuation Guarantee levels, contributions for such persons are constrained by the caps but they are subject to a higher contributions tax. The modelling thus shows that for some of their retirement, a higher part of their retirement pension comprises the part Age Pension than would be the case if the contribution cap were more realistic or the superannuation surcharge did not apply.

Graph 12 shows a more accurate result from the current system without the distortion of contribution caps. It shows the same results if there were no caps and Australians make additional contributions as necessary to achieve the 'target' Replacement Rate. Net of extra GST it shows negligible cost to the Government of the system for high income earners.

4. Alternative systems

The objective in considering alternative systems is to address the following issues highlighted with the current system:

- Difficulty many Australians will have to reach a their ‘target’ Replacement Rate;
- Impact of taxation of superannuation earnings;
- No progressivity with respect to contributions; and
- Unnecessary complexity which increases costs and reduces returns.

We are not considering changes to the system to raise more taxes. We have endeavoured to consider alternatives that are broadly tax neutral.

The Henry Report emphasised how the *“compounding effect of interest* (income) *has a significant influence on how much superannuation a person can accumulate”* and that “*the taxation of earnings reduces this compounding effect.”* A reduction in the tax rates on superannuation fund earnings from 15% would improve the effectiveness of superannuation.

We agree with this statement and our analysis supports it. This is one of the reasons why most researchers into superannuation systems report that the most effective application of tax incentives for retirement savings is to exempt contributions and investment returns on savings and to just tax these when they are spent (i.e. tax the pension). This is a tax deferral system generally known as an Exempt; Exempt; Tax or EET system.

This was the system we had in Australia until governments started to tax contributions and earnings in the ‘80s. We have argued that Australia should seriously consider how we could revert to such a system but have been told by Treasury that properly grandfathering savings that have already been taxed would make the implementation of such a system unreasonably complex. Since we are a strong supporter of simplifying superannuation, we would not support the idea of running two systems in parallel if an alternative could be found.

We have therefore considered the proposal in the Henry Report. It addressed the ‘flat’ taxation of superannuation and the perception that it benefitted those on higher income more than those on lower income by suggesting that superannuation contributions be included in an individual’s taxable income (and therefore taxing them at marginal income tax rates) with a percentage rebate.

We do not believe it fair to introduce more progressivity into our income tax system given that ours is one of the most progressive in the world at present, and so we have modelled this idea on the basis that it could be introduced in parallel with a **reduction** in the progressive nature of our income tax system.

The Henry Report also emphasised the benefit of reducing the taxation of earnings and suggested the 15% tax on earnings be reduced to 7.5%.

However, there appear to be two issues with this. Firstly, Henry suggested introducing a new tax on all earnings in pension phase from the zero it has always been to 7.5% and secondly, whilst he argues correctly that superannuation would become more effective if the tax on earnings pre-retirement were reduced, he does not explain why he did not therefore reduce it to zero and improve the effectiveness of super further. One can only assume that he was not just considering superannuation effectiveness but perhaps ‘political’ and budgetary issues.

We believe that a proper and transparent review of tax should **first** consider what is best for super in the long-term. I.e. which system provides most benefit to most Australians at least cost to Government. It should not firstly consider ‘political’ issues if this results in a compromised system and it should address budget issues separately.

We note that an esteemed economist, Professor Freebairn, also proposes that, concurrent with the introduction of the progressive taxation of contributions, earnings on super savings both during working life and retirement should be tax exempt.

We believe that the budget impact of this can be adjusted by reducing the 20% rebate that the Henry Report suggested should apply to the taxation of contributions to 15%.

We have therefore modelled this modified "Henry" system and called it the TEE system. i.e. Tax on contributions; Exempt earnings; Exempt withdrawals/pension. Appendix I provides further detail on how we have structured and modified the proposal in the Henry Report.

We have set the rebate figure at 15% so that the budgetary benefit of this TEE system about the same as the budgetary benefit of our current superannuation system.

How to transition to any alternative system is, we believe, a secondary though important issue. We have considered this issue and are happy to discuss it with the Tax White Paper unit. In particular, we will be continuing to argue that any changes should recognise that current participants have made long term plans under existing rules and should not be disadvantaged by any changes to the taxation of super.

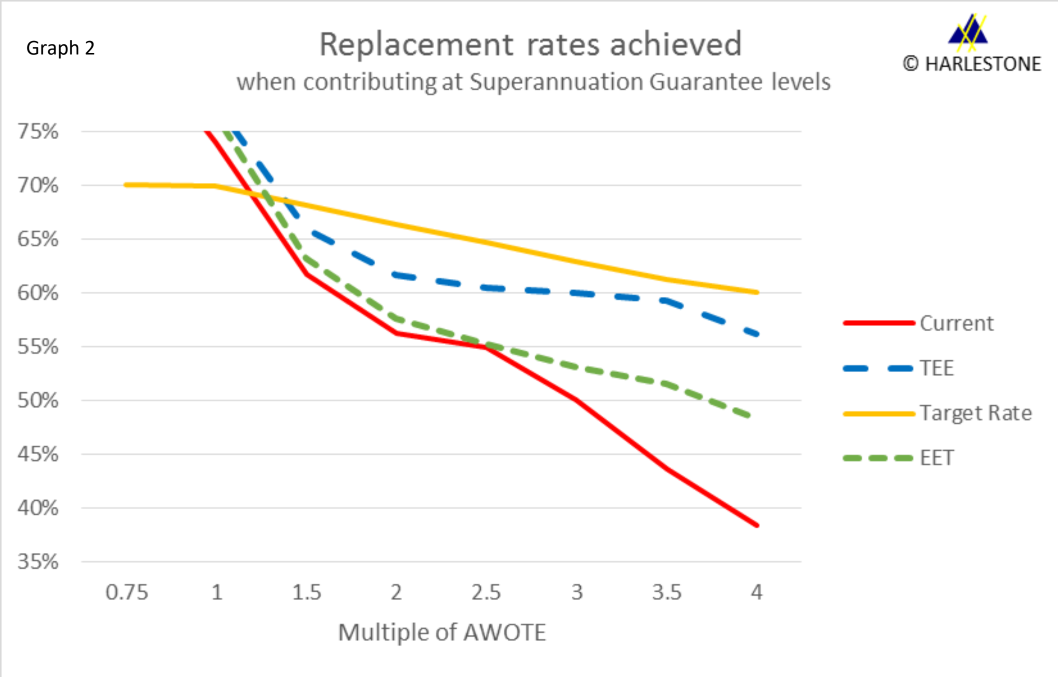
This submission presents a comparison of the current system (TTE) with a modified version of the system proposed in the Henry Report (TEE) and the internationally preferred EET system.

4.1. Adequacy Comparison

Graph 2 (presented earlier and again below) shows what pension Replacement Rates are achieved under the three systems if individuals contribute at a superannuation guarantee level equivalent to 12% and compares these with 'Target' Replacement Rates (see Appendices G and C).

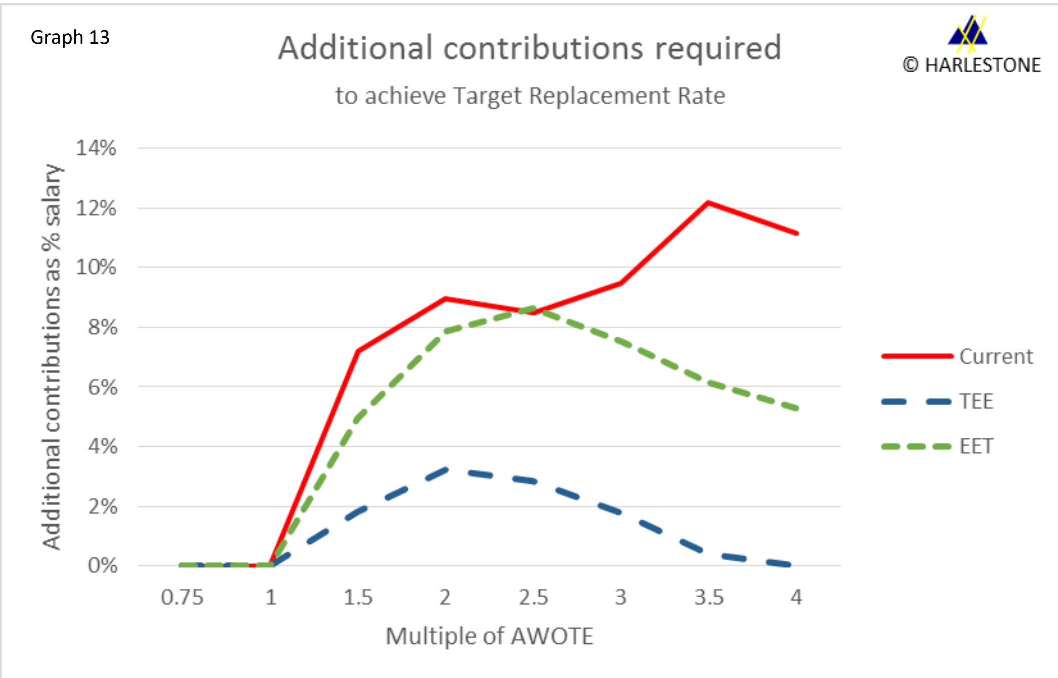
It is very important, in comparing systems, that we are not comparing 'apples' with 'oranges'. For example, we suspect that the charts included in the Henry Report showed its proposal as resulting in much higher replacement rates because it retained the same contribution percentage under the proposal, even though it was not then taxed within super. This obviously results in higher super balances. In order to properly illustrate the compounding effect of earnings and beneficial impact of exempting earnings from tax we have structured the models so that, for each individual in the range of incomes, the dollars contributed each year net of tax paid by the super fund remain the same.

A Superannuation Guarantee level of 10% under systems with zero contribution taxation within the fund is equivalent to the 12% level that will be reached under the current system. We explain further in Appendix G how these assumptions are used in comparing the systems. Alternatively, we understand that Professor Freebairn has proposed an SG rate varying with income but for this comparison of effectiveness we have held the SG rates at equivalent levels.



Graph 2 also shows that both the alternative TEE and EET systems provide a better Replacement Rate than the current system when contributions are made at 10% vs a 12% Superannuation Guarantee level under the current system. The dip in Replacement Rate for high incomes under the TEE system is due to the contribution cap (which we have assumed remains as per current system) limiting even 10% SG contributions.

To the extent that these fall short of the target "reasonable" replacement rate, we calculate the additional contributions necessary during the last 15 years of working life to reach that target. This is shown in the following Graph 13 on the assumption that there is no constraint on contributions. In all cases, these graphs show the results assuming a sharper 'taper' of Age Pension eligibility as proposed in the recent Budget.



The TEE system requires the least additional contribution as a % of salary. Indeed for higher incomes the target Replacement Rate is reached at the Superannuation Guarantee levels. Consideration could be given to reducing the SG level under the TEE system below the 10% assumed.

4.2. Constraints

As discussed in section 3.3 above, constraints on the access to superannuation tax concessions are best applied to contributions. Constraining, penalising or taxing earnings or accumulated earnings penalises investment success and is economically inefficient.

We have already calculated in section 3.2 the cap that should apply under the current system to allow Australians on the range of incomes to achieve target Replacement Rates. We have undertaken a similar calculation for the TEE and EET systems and show the results below:

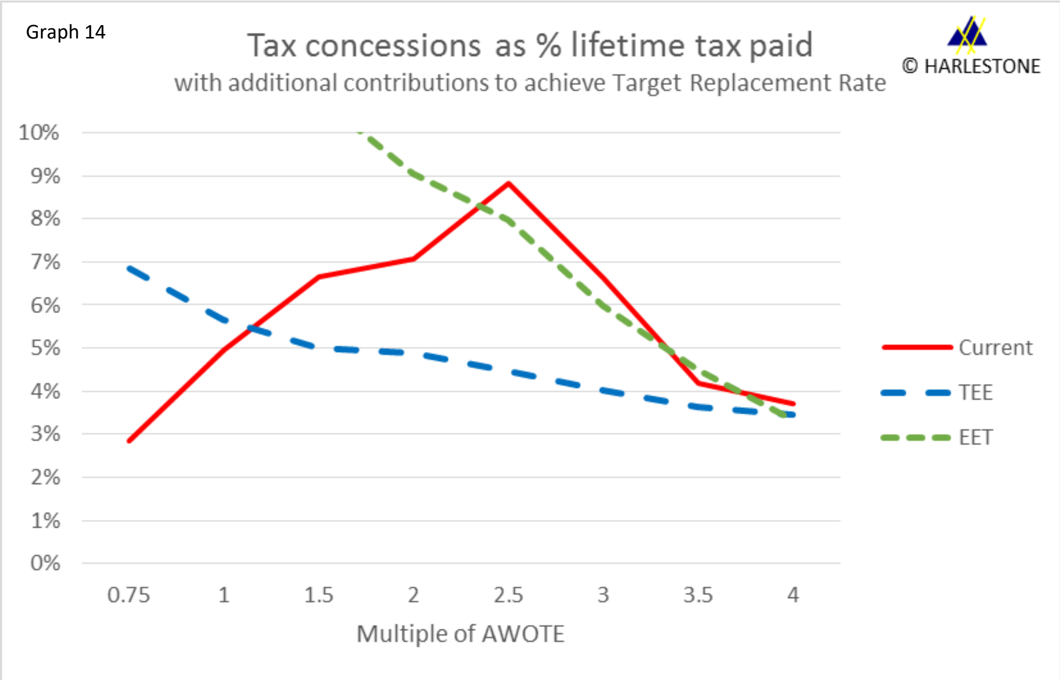
System	Contribution cap in today's dollars
TTE (Current)	$80,000
EET	$57,000
TEE	$35,000

One of the side benefits of a more efficient system is that the Government can keep apparently tighter caps on contributions without jeopardising the ability of most Australians to save enough in super for their retirement. In this regard, the TEE system fares better than both the EET and the current system

4.3. Fairness Comparison

We show below the same graphs from Section 3.3 above but comparing the current TTE system with the EET and TEE systems.

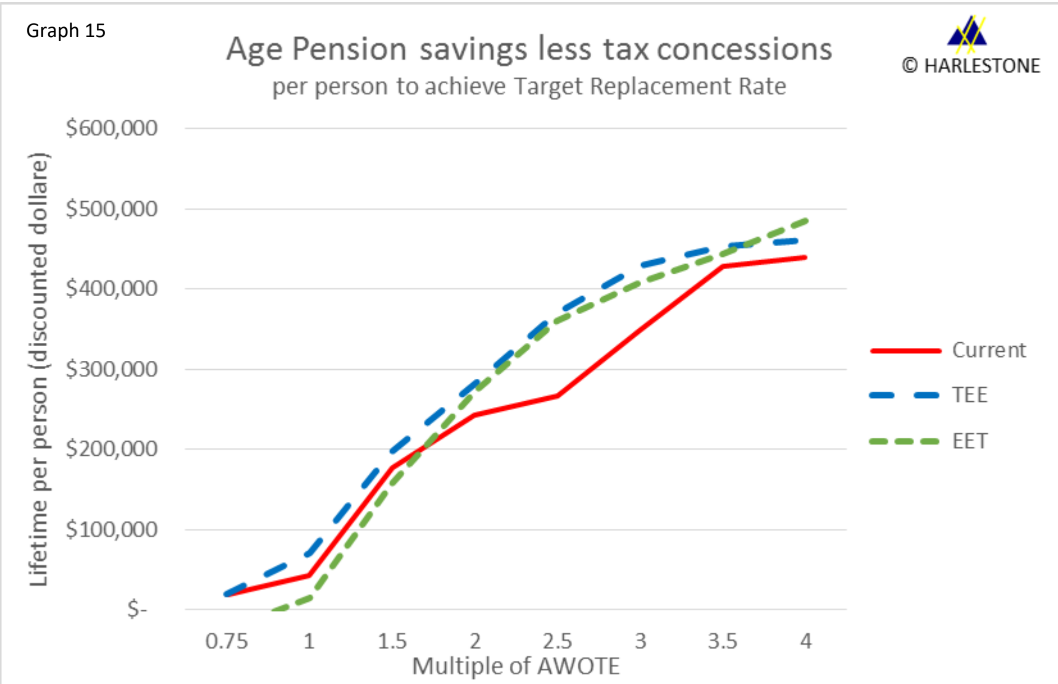
Graph 14 shows how tax concessions as a percentage of lifetime tax paid vary with income on the assumption that each person contributes enough into super to retire on at their 'target' Replacement Rate pension.



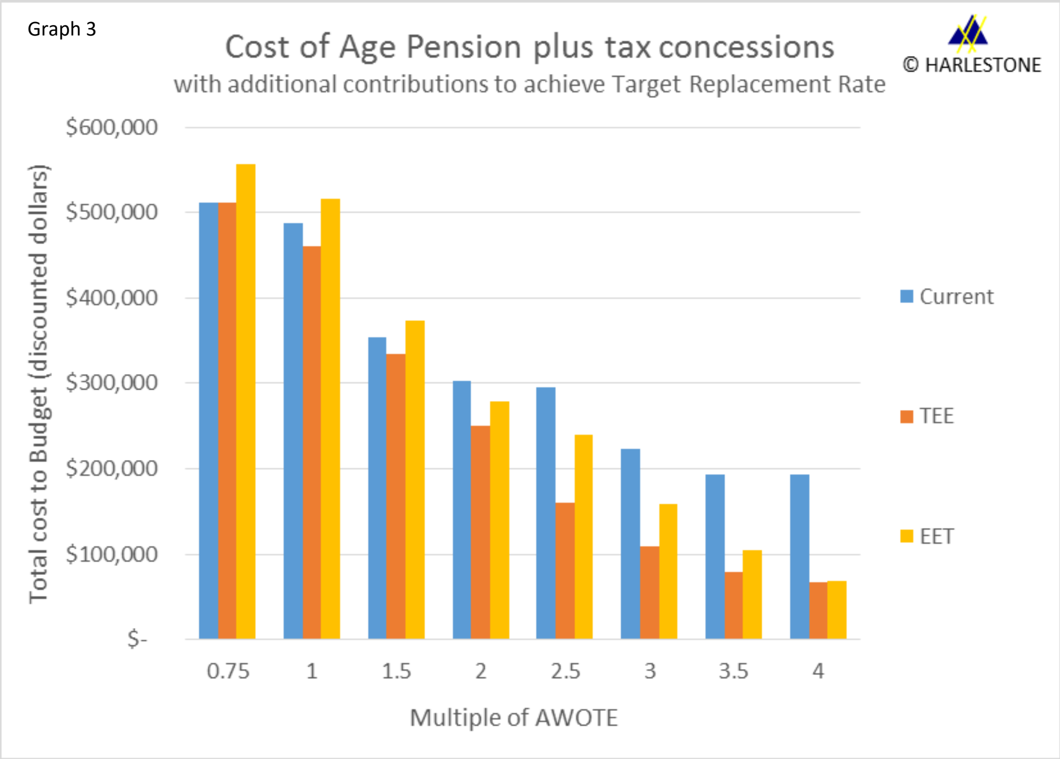
.

All three system have a declining % tax concession with income. The EET system tax concession for low income workers is dramatically raised. This may be because contributions are fully tax exempt and, on withdrawals from super, such persons also have the benefit of the tax-free threshold.

Graph 15 compares the net benefit to the Government of savings in Age Pension less tax concessions granted across income groups for our three cases. In all three systems the budget savings increase with income and are similar overall. i.e. neutral Budget impact of alternatives



In the context of 'fairness', Graph 3 (also presented earlier) shows the cost to the Government budget of each system when contributions are made in order to achieve the relevant target Replacement Rate, such cost comprising the cost of Age Pension plus the cost of any tax concessions and takes into account extra GST paid.



This shows that the cost to Government of the retirement system (Age Pension plus tax concessions) falls with income and that for the TEE system it is the **lowest** cost for all income groups.

In the modelling for the above comparison, we have not made any assumptions regarding changes to our progressive income tax system which we believe are necessary to justify introducing progressivity into the superannuation system.

We believe that Australia should strive to reduce our ultra-progressive income tax system to match international standards and then introduce progressivity into the superannuation system. To do the latter without the former would be unfair on those Australians who are already bearing an unreasonably high share of the taxation burden. To do the former without super changes would further exacerbate the perception than superannuation is benefitting higher income earners. To do nothing will not improve the super system's ability to provide adequate super balances for middle Australia.

5. Conclusions regarding an Alternative System

Whilst the EET system has been shown in the previous section for comparison, we do not propose its implementation because of the complexity in now 'winding' back the current system.

The main conclusions regarding our analysis of the TEE system can be summarised below:

1. Without taxation by the fund of contributions, the percentage contribution into the fund to provide the same net balance is lower. An SG level of 10% is equivalent to the 12% for which there is bi-partisan support under the current system. This level could possibly be lower still – see analysis of the impact of improved earnings on super below.
2. Progressivity of taxation is introduced, though we believe it would be unfair to implement this without concurrently reducing our otherwise very progressive income tax system.
3. Of more significance is the impact of returning the taxation of superannuation earnings to its original exempt form for earnings in **both** accumulation and pension phases.

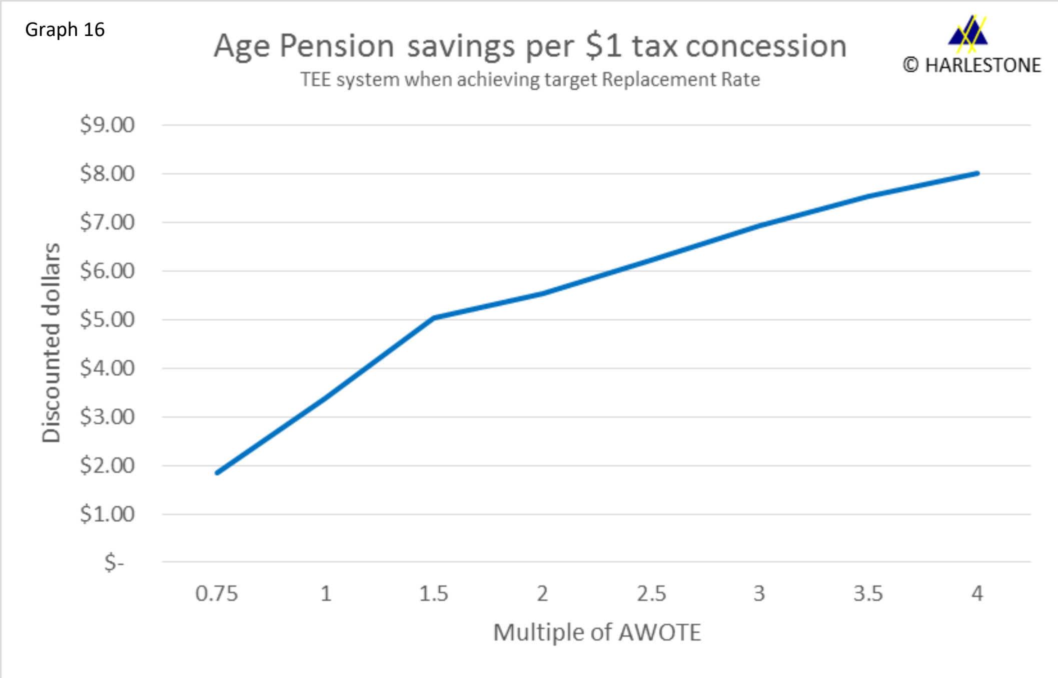
   Our computer simulation exercise starkly illustrates the point made in the Henry Report that the *"compounding effect of interest* (income) *has a significant influence on how much superannuation a person can accumulate"* and that "*the taxation of earnings reduces this compounding effect."* A reduction in the tax rates on super fund earnings would improve the effectiveness of superannuation.

   As a result of the impact of compounding, Australians on all income levels achieve super savings levels with just SG contributions much closer to that required to provide a reasonable pension and a SG level lower than today's level could possibly be justified.
4. This achievement plus the greater earnings efficiency of this system means that the level of additional contributions necessary to reach the target Replacement Rate is much lower than under current system.
5. The maximum contribution cap can therefore be considerably lower.
6. Tax concessions fall with rising incomes as a percentage of lifetime tax paid.
7. The cost to the Government of Age Pensions and super tax concessions is lower for all income levels under the TEE system than the current system and falls more sharply with income.

All this can be done while holding the cost to the Budget to about the same as the current system.

Introducing progressive taxation on superannuation contributions whilst retaining the existing income tax scale skews the benefits of superannuation towards lower income groups. The following Graph 16 illustrates this by showing the dramatic increase in Age Pension savings per dollar of tax concession under the TEE alternative (discounted dollars).

It is clear that 'spending' a $1 on tax incentives in order to encourage Australians to save for their own retirement is better for the Government than spending it on the Age Pension where the taxpayer bears 100% of the cost.



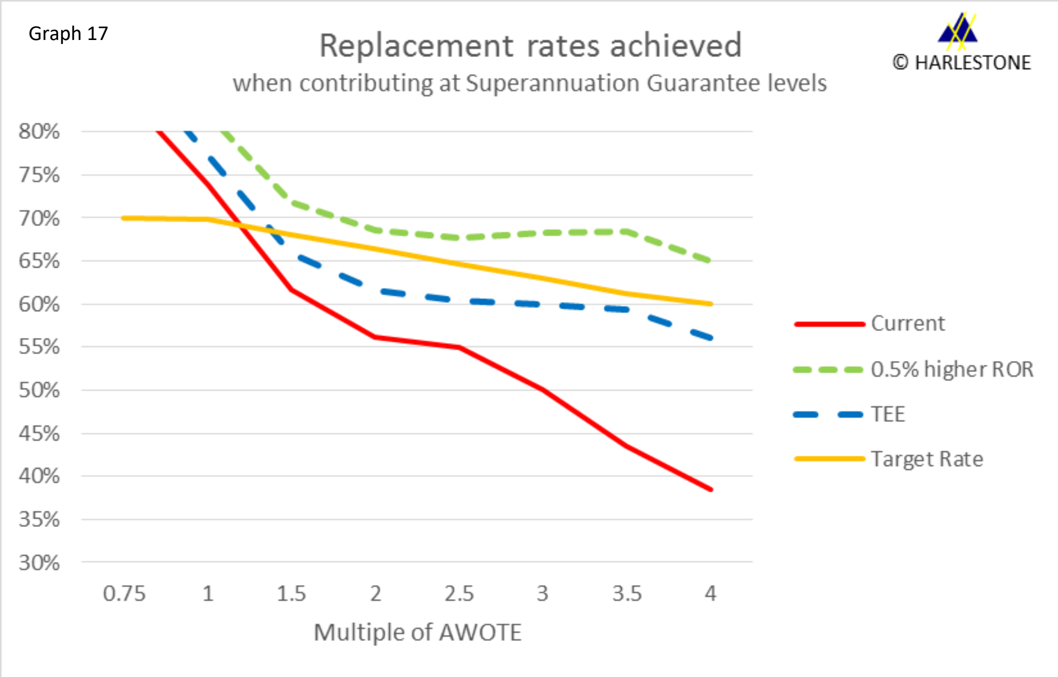
What is not always clear is how this benefit varies with income. Graph 16 above illustrates that the savings in Age Pension per $1 of tax concession under the TEE alternative, rises from about $3 for someone on average weekly earnings to $8 for someone on four times average weekly earnings.

With no taxation imposed on the fund, the complexity of the system would be dramatically reduced. Not only should this improve Australians' engagement with their super but it would lower administration costs.

We set out in Appendix A some other ideas on improving parts of the current superannuation system which could be considered in some cases with or without changing to a different taxation structure.

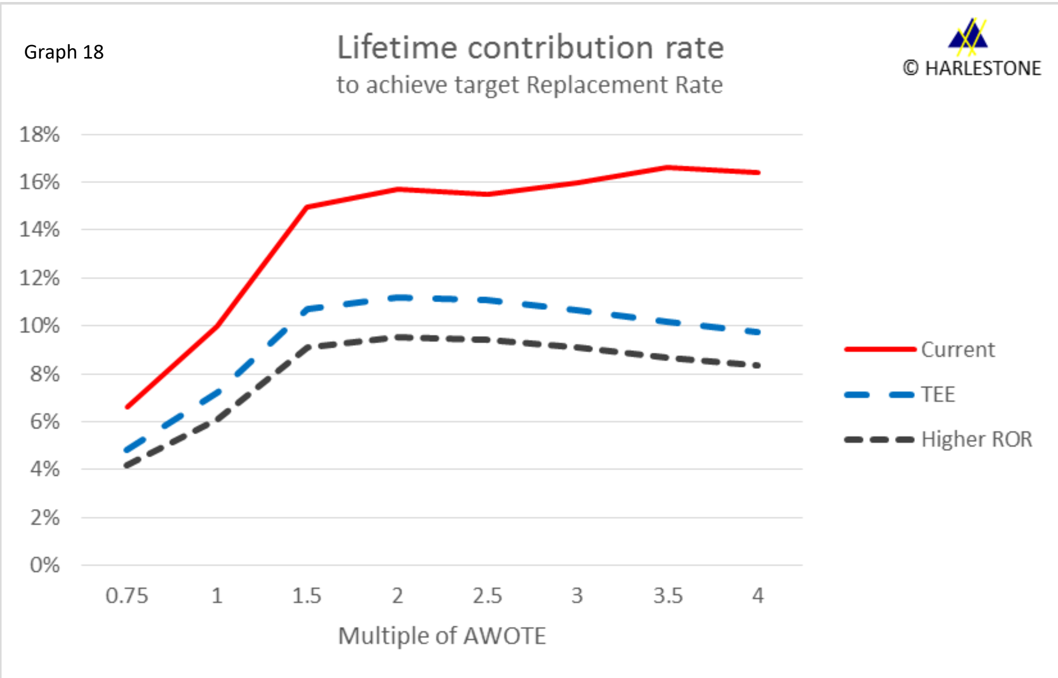
The timing of any changes, their inter-relationships and transitioning arrangements would also need to be considered and we would be happy to enter into further discussion regarding these points.

An increase in returns has a dramatic impact. If one assumes that returns from super improve by, say, just 0.5%p.a. as a result of improving its simplicity, then the pension rates achieved by contributing at the assumed equivalent SG levels (12% for TTE and 10% for TEE) increase noticeably. Graph 17 illustrates this by comparing them with the TEE system and current (TTE) system without such return improvement.



You will note that the target Replacement Rates are exceeded under these assumptions when contributing at a 10% rate. An alternative way of illustrating the benefit of compounding earnings without taxation is therefore to look at the lifetime contribution rate that is **necessary** for an Australian at each income level to save enough to retire on at his/her applicable Replacement Rate.

The following graph 18 shows this for the current system, and the alternative TEE and TEE systems if higher returns are achieved as a result of substantial simplification of the superannuation system.



It may be that Superannuation Guarantee levels of less than today's level and perhaps as low as 8% are adequate if this system works effectively.

We have heard a criticism of the TEE system regarding its adverse impact on Australian's take-home pay during a transition period. In response to any criticism that a TEE system can have an adverse impact on take-home pay, we have considered this and set out in Appendix K an analysis of this impact.

The reality is that the impact on take-home pay is small and, if the TEE system is introduced as part of a reduction in the progressive income tax system, is almost eliminated.

In particular, it may not be appropriate to compare take-home pay under the equivalent SG contribution rates. Since the TEE system is more effective the comparison should be done using **the contribution rate necessary** to achieve the relevant "target" Replacement Rate.

We have done this in Appendix K and the results suggest that there is no reduction in take-home pay even without assuming any improvement in the progressive income tax scale. One should note however that this comparison assumes equal total 'cost to employer/economy' across the alternative systems, which may not occur in practice in the short term. An alternative approach suggested by Professor Freebairn is to vary the SG rate across income levels.

6. Dispelling the 'myths' about SMSFs

Super is an unfair tax break

Members of self-managed funds are subject to exactly the same tax rules as members of managed funds.

Critics point out that the top 20% of income earners get the lion's share of super tax concessions but they don't always acknowledge that the top 20% also pay the lion's share of income tax. The FSI Report neglected to mention this very relevant fact. We discuss tax equity further in Section 4.3.

A progressive income tax system is used to re-distribute wealth in a fair and equitable manner. It does not follow that retirement incomes should also be taxed progressively. What people manage to save for their retirement, having paid tax throughout their working lives, is their money and should not be 're-distributed' to others who have not saved as much. Of course, higher income earners have the capacity to save more, but they also pay much more in tax along the way.

Super tax concessions cost too much

The annual Tax Expenditures Statement which estimates the amount of revenue foregone by various tax incentives is used by some commentators to claim that superannuation tax concessions are costing the budget too much and should be reduced. A cost of $32 billion (based on the 2012 TES) is often quoted to illustrate the supposed cost to the budget. As explained earlier in this submission, such claims are derived by wrongly adding the estimated value of the concessions on contributions and fund earnings. It is then claimed this is the measure of tax that could be raised if the super tax concessions were reduced or removed.

It is not.

If the tax concession on contributions was reduced, less money would flow into super, fund earnings would be lower and the revenue collected from earnings would be less. Further, because superannuation savings would be lower, there would be a greater call on the Age Pension funded off the budget.

We believe that Treasury understand this issue. In our view, Treasury should therefore now clearly warn in the TES that the two elements of superannuation tax concessions cannot be added together to estimate the cost to the budget. It should also be best practice for a report such as the TES to identify budget savings that result from a tax concession. Treasury's TES does not do this. It does not refer to the higher cost of the Age Pension that would result from any action taken to reduce or eliminate the effectiveness of the superannuation system.

Tax incentives to save for retirement are sensible policy because in the long run it's cheaper than paying out the Age Pension. If super tax incentives are reduced, less will be saved, fewer people will be financially independent and more will have to rely on a full or part taxpayer-funded pension.

The cost of running an SMSF

It's claimed SMSFs are too costly to run. It's true that a relatively low account balance in a self-managed fund will cost more to administer than one held in a managed fund. But above around $100,000, costs are comparable or much lower. Two thirds of self-managed funds have an operating expense ratio to assets of less than 1% and 40% have an expense ratio of less than 0.25%.

It is not just a question of cost. The main reason people set up self-managed funds is to take control of their savings and more are doing so relatively early in their working lives. They make a commitment to save and as they build their assets, the relative cost of running their fund comes down. They are being helped by the emergence of a range of low-cost, online fund management service providers.

The real cost issue in superannuation is the level of fees charged by the large industry and retail funds which are estimated to have consumed a quarter of these funds' returns in the past decade, a cost borne by their members.

SMSF investment fuels house prices

Another common criticism of SMSFs is that they drive up residential property prices through highly leveraged investment. But no hard evidence is presented to back up this claim. Very low interest rates and an inadequate supply of new housing are more likely fuelling house and apartment prices. SMSFs actually put quite a small proportion of their assets – consistently around 3.5% according to the ATO's SMSF Statistics – into residential property as we point out in Section 4.5.

SMSF are too cautious investors

It's said, usually by investment advisers, that SMSFs are too conservative in their asset allocation. In particular, they are missing out on better share market performance overseas. It is true that SMSF trustees appear to be more conservative, evidenced by the large percentage of their portfolios (30%) invested in cash at a time of low interest rates; an equally large percentage (30%) invested in Australian shares and a very low proportion (0.39%) invested in international shares at a time when they are outperforming Australian share prices. Yet SMSF investors are still managing to deliver satisfactory returns. The latest ATO annual statistical report stated:

"In 2012–13, estimated return on assets for SMSFs was positive (10.5%), the highest over the five-year period, and in positive terms for the fourth consecutive year. The trend in estimated returns is consistent with that for APRA funds of more than four members." Self-managed funds – a statistical overview 2012-13, Australian Taxation Office.

ATO fund performance statistics show that over 5 years, with some ups and downs, SMSFs generally do as well as the large APRA-regulated funds.

SMSFs invest too much in blue chip shares and distort capital allocation by companies

SMSFs invest around 30% of their assets in listed shares and favour companies that deliver franked dividends. So do other investors including the large industry and retail funds. SMSF trustees have a legal responsibility to manage their fund in the best interests of its beneficiaries. It makes sense for them to favour listed companies that deliver solid and dependable dividends on which a tax credit is available.

It's the responsibility of company directors to decide how profits are to be distributed and striking a balance between returns to shareholders and the capital needs of the company.

While SMSFs are significant share investors, they hold a relatively minor share of the value listed on the ASX – 13% in 2013 according to ASX.

To conclude this section, it's important that Government policy decisions are based on reality and hard facts, are well-targeted and proportionate to the identified issue.

In considering submissions to the Tax White Paper, Treasury and the Government should reflect on the singular success of self-managed funds in achieving the objectives of the superannuation system, appreciate the motivation of people who set them up and recognise the social and economic benefits they deliver.

Appendix A

Details of the superannuation system that could be simplified

Note that some of the suggested changes listed below can be implemented without any change to the underlying taxation system; other changes are dependent upon changing the system to a TEE structure.

	Detail/issues	Comment	SMSFOA position
1	Contribution Caps	We agree that contribution caps are best way of limiting access to superannuation	Caps are set too low to allow adequate accumulation of superannuation savings.
2	Rolling contribution caps	Disadvantages those with broken work patterns	Introduce rolling 3 or 5-year caps as per non-concessional contributions; if not fully utilised, can be carried forward from year to year and period to period. A lifetime cap could be a possibility but may be more difficult to define and administer.
3	Non-concessional contributions	Introduced as a transitional measure in recognition that a developing super system had not been around long enough to accumulate enough funds to meet the objective of financial sufficiency in retirement. Also perhaps contributes to perceived bias towards wealthy; also allows people to withdraw and recontribute in spouse's name to adjust fund balance to secure Age Pension	If the system is improved so that most Australians can contribute adequate concessional contributions, non-concessional contributions may be unnecessary when the system is mature and are an additional complication.
4	Transition to retirement	Allows people to withdraw whilst contributing the same amount thus gaining a tax concession without increasing savings	Remove transition to retirement when system is mature. Contribution tax concession only available on net contribution into the fund
5	Number of SMSF members	Currently limited to 4	Arbitrary limit; efficiency and intergenerational transfer of expertise could be improved if the limit is defined as, say, direct descendants of the initial fund sponsor and their spouses. Why not?
6	Limiting directors to members	All directors of corporate trustee have to be members except for a single person fund which can also have a non-member director	To improve effectiveness of SMSFs and intergenerational transfer of expertise, why not allow non-member directors provided they are not in the majority? Maybe it should also not be compulsory for a 'family' SMSF member to be a director provided they have that unilateral right.
7	Align pre & post retirement earnings tax rate	Causes difficulty in designing products; adds to administrative complexity in auditing or segregating assets if some members are retired and others not. If the same would be easier to have different generations in same fund thus adding to efficiency and intergenerational transfer of expertise	Henry Report suggested this and said lower earnings tax rate has huge compounding impact, but unclear why it then suggested 7.5% rather than zero. Others said zero earnings tax. We believe zero earnings tax pre and post retirement would considerably simplify administration of funds and the tax system.

8	Gearing		Keep the issue in perspective - if necessary limit gearing to 50% of fund assets.
9	Minimum withdrawal schedule		OK in principle but should be adjusted as life expectancies increase; maybe possible to link withdrawal % to market rates so not forced to eat into capital when interest rates are low.
10	Unlimited withdrawals (lump sums)	Can lead to people with low balances taking it all out, spending it and then going on Age Pension	Tax or limit withdrawals that would take the fund balance below the assets test for access to the part Age Pension.
11	Preservation age	Increasing to 60	Should increase as Age Pension eligibility increases - say 5 years under Age Pension access age.
12	Mandatory contribution level	Increasing to 12%	Under alternative TEE system SG level can fall to 10% or even lower with same effect as present system.
13	Mandatory pension	At present there is no necessity to commence a pension (and some people don't despite tax incentive) and so super money may not ever get paid out as a pension.	Perhaps there is an age by which a super fund must start paying out a pension. Perhaps Age Pension eligibility age plus 10 years?
14	ATO levy on SMSFs		Still not justified - ATO has not delivered claimed benefits. Levy has bigger impact on members' super than a GFC!
15	Offshore residence		Allow non-resident members of SMSFs provided there is still a resident director (see 6 above). Perhaps just remove the "active member" test.
16	Age limits to non-mandated contributions	Non-mandated contributions can only be accepted if between 65 and 75 if meet 'gainful employment test' and zero non-mandated contributions if 70 or over	Drop test; allow any contributions up to the cap and any age (up to the mandatory pension age suggested in 13 above?)
17	Requirement for electronic service address	All large super funds and certain SMSFs must have these after 1/7/15	Question the need for SMSFs to be part of system that is designed for major funds but is causing administrative hassles for SMSF members.
18	Personal contributions test	Only deductible if engaged in work and less than 10% of total assessed income attributable to such activities	Drop. Tax incentive to save is a tax incentive to save and should not be related to how much of earnings is from 'work'
19	Can't make personal contributions if over 75		Remove this ageist restriction. Though perhaps cease ability to make contributions after the mandatory pension age - if introduced - as suggested in 13 above
20	Spouse co-contributions		Drop. Adds complexity. Meant to allow contributions by a spouse for a partner who is not working. Disadvantages people not in such a relationship. Better to have rolling caps to handle this. (see 2)
21	Government co-contribution		Better to amend system to better provide for savings of low income earners and remove this complexity

Appendix B

Dividend Imputation

Dividend imputation was introduced, correctly in our view, to eliminate double taxation of corporate profits and remove the distortion that this would otherwise cause in the markets.

It is incorrect to suggest the bond market is disadvantaged because interest payments (coupons) on bonds do not carry tax credits. It ignores the fact that interest payments on bonds are deductible to the issuing corporations, whereas dividends are not, so that the tax impact on cost of capital is neutral with imputation and would be distorted without it.

It is true that imputation encourages investment by Australian taxpayers in domestic equities rather than investment in corporations based in other tax regimes that do not provide a full credit available to Australian taxpayers. However, this is a distortion caused by imperfections in our various tax-treaty arrangements and because we are not allowing a tax credit for tax paid in such countries rather than due to our imputation system.

It is also incorrect to suggest that the availability of imputation credits to superannuation funds may erode a valuable source of Government revenue over time. If the source of revenue referred to is corporation tax receipts then this suggests a misunderstanding of how the imputation system works in aggregate.

With respect to Australian taxpayers, if it is assumed that all taxed income is distributed over time to shareholders or unit holders, then the only relevant income tax rate is the individual one. From this viewpoint, raising or lowering the corporate tax rate does not change the tax raised by the Government because of imputation. Lowering the corporate tax rate benefits <u>foreign</u> shareholders of Australian companies and thus may attract more investment into this country. The Federal Government's tax receipts from corporations tax is irrelevant.

We would agree that the existence of imputation may bias rational investment towards domestic equities and that may be why SMSF's largest investment category is Australian equities. We would also argue that a high holding of domestic equities – earning over the long term a positive real rate of return and essentially an investment in the Australian economy – provides SMSF beneficiaries with a natural hedge against their retirement expenditure which in most cases would be substantially in Australia and subject to Australian inflation and cost pressures.

We do not agree that the refunding of imputation credits to superannuation funds is a benefit. It is merely refunding tax that has been paid by corporations so that the only relevant tax rate is that of the investor in a corporation's shares. Removing this credit would distort and damage the equity market in that corporation's earnings (dividends) would be paid out of corporate after-tax earnings but interest and coupons payments would be deductible to a corporation with no consequential taxation in a pension superannuation fund. However, we would not agree that a bias towards equities is the sole or even the most important impediment to the development of a retail bond market in Australia as suggested in the FSI report.

On balance, imputation can be considered to be contributing to the development of a strong domestic funding base for our industry and its removal would cause considerably more distortion by re-introducing double taxation and the bias in favour of debt funding.

Appendix C

Replacement Rates

The Replacement Rate is a widely accepted term meaning the pension as a proportion of a person's pre-retirement income or, as the Henry Report put it, the Replacement Rate *"compares a person's spending power before and after retirement."* It is generally accepted internationally that in an equitable and advanced society taxpayers should expect to retire on a pension that bears a reasonable relationship to their income before retirement.

Although some organisations use pre-tax income during working life, given the distorting impact of income taxes (especially when considering different retirement systems), we believe it is more appropriate to link pensions to after-tax income (consumption) during a person's working life.

For each person, their income after tax and after contributions at SG level is assumed to be consumption during working life for the purposes of calculating replacement rates. The average of such income, discounted by CPI to mid-2016 dollars, over the last 10 years of working life is used for the calculation of Replacement Rates. ('Base Pre-retirement Consumption')

The Target Replacement Rate in first year of retirement for those on AWOTE and below is assumed to be 70% of Base-Pre-retirement Consumption (in 2015-16 dollars) whilst for those on four times AWOTE it is assumed to be 60% and pro-rata for incomes in between.

"Replacement Rate achieved" shows the retiree's total pension (super plus Age Pension less tax if any) in first year of retirement and discounted by CPI to mid-2016 as a percentage of Base Pre-retirement Consumption.

Appendix D

Henry's comments on tax bias against savings

Following is a longer excerpt from the report on Australia's Future Tax System chaired by Dr Ken Henry, quoted in part in Section 2:

"*Australia's personal income tax system should continue to represent a hybrid personal income tax, with the main forms of lifetime savings for most Australians – superannuation and owner-occupied housing – taxed at a lower rate or exempt from income tax, but with other savings taxed more consistently to achieve a more productive and better allocation of savings.*

Savings invested in owner-occupied housing or superannuation would either be tax-exempt or close to exempt in practice, both being important determinants of peoples' living standards in retirement. This treatment would be consistent with a progressive expenditure tax benchmark, which exempts the returns to savings. Comprehensive income taxation, under which all savings income is taxed the same as labour income, is not an appropriate policy goal or benchmark.

The essential reason for treating lifetime, long term savings more favourably is that income taxation creates a bias against savings, particularly long-term savings. Taxes on savings income, including the taxation of inflationary gains, can discriminate against taxpayers who choose to defer consumption and save. The longer the person saves and reinvests, the greater the implicit tax on future consumption. These individuals pay a higher lifetime tax bill than people with similar earnings who choose to save less."

Appendix E

Simple calculation of how tax on earnings reduces tax concessions

Earlier in this submission we referred to the limitations of Treasury's TES calculations and the misunderstanding and misrepresentation of them by some commentators to support their argument that superannuation tax incentives are too generous and unfair.

The following table provides a simple illustration as to how the superannuation taxes and GST on super earnings **reduce** the cost of tax concessions on contributions. This assumes a single $100 contribution in super for 30 years.

Table x

No. years before retirement	30			
Investment returns p.a.	7.0%			
Effective earnings tax rate	11.0%*			
Marginal income tax rate	34.5%			
Marginal GST rate	10.0%	5%**		
		With super		Concession
	No super	Current $	P.V. $	
Contribution/income	$100.0	$100.0	$100.0	
Tax on contribution/income	$34.5	$15.0	$15.0	$19.5
Earnings over 30 years	$0.0	$489.9		
Tax on earnings	$0.0	$53.9	$33.7	($33.7)
Super balance	$0.0	$521.0	$248.4	
TOTAL TAX PAID	$34.5	$68.9	$48.7	($14.2)
Impact on GST	$6.6	$26.0	$12.4	($5.8)
Total tax paid/concession	$41.1	$94.9	$61.1	($20.0)

*Some earnings are taxed at 15%, whilst capital gains taxed at 10% when realised. We have used an 11% resultant effective tax rate when using the investment assumptions set out in Appendix G

** Whilst it may be reasonable to use a marginal GST rate of 10% on extra expenditure during working life if there were no super contributions, we have conservatively taken a lower figure for the GST rate when the accumulated savings are spent.

Yes, the negative numbers under the heading Concession means that not only is there no tax concession on earnings, the extra tax revenue from super savings in this example is actually greater than the tax concession on the contribution so there **is no concession** overall, even after taking into account the timing of tax payments.

In this example, we have shown earnings and taxes paid on $100 contributed into super, accumulating earnings over 30 years and then paid out. If there were no super, an individual would pay $34.5 in income tax on the $100 "contribution". With super he/she pays $15 contributions tax and then over 30 years pays $53.9 in extra tax on super earnings. His/her total tax paid of $68.9 is about double the "no super" case. However, these super earnings tax payments are in the future. If these payments are discounted to today's dollars the value of his/her tax payments falls to $48.7, but still clearly above the tax payments by someone without super. **So there is no concession.**

If GST is taken into account the gap widens because, in the end, the super earnings are paid out and spent so the Government gets GST on the super earnings. In this example, the $100 super contribution grows to $521 over 30 years. Although these super payouts are on top of any Age Pension the individual may receive, we have assumed a lower effective GST rate of 5% applies giving $26 of GST on this is worth $12.4 in today's dollars, about double the $6.6 in GST the Government would have received from someone spending the $100 after income tax, if it were not contributed into super.

Clearly the longer the $100 is in super the larger the tax receipts from super for the Government. On the above assumptions, if the $100 was invested in super for less than 20 years then the present value of super/GST tax payments would be less than the income/GST payments if there was no super and therefore the super contributor would have a net tax concession.

Over the life of a contributor…say 30 years of $100 p.a. contributions (escalating at 4%p.a.), the super/GST tax payments of $2,300 on these assumptions is about the same as the income/GST payments if there was no super – i.e. no concession. However, if the timing of payments is taken into account these figures fall to $1,334 and $1,532 respectively indicating that in today's dollars, there is an overall **tax concession** of $198.

If one were to calculate the tax concessions using Treasury's 'income tax' method for the above example, the tax concession would be $2,079, over ten times the $198 we've calculated above. Although this is a very simplistic analysis, it may be illustrative of the order of the magnitude of error that has now crept into media commentary on tax concessions.

Appendix F

<u>Illustration of 'fairness'?</u>

Bob is 30 years old and his earnings will average the national average weekly earnings. When he retires at 67 he will have paid a total of $1.9m in taxes over his working lifetime after taking into account the $76,000 in superannuation tax concessions he has received whilst contributing into super at the SG level. Although he will have nearly $2m in superannuation on retirement, he will immediately become eligible for part-Age Pension and receive $3.3m in pension welfare during his retirement (almost as much as if he had no super). Note that not only is his welfare greater than his tax concession, it is also greater than his lifetime tax payments.

Bob can be compared to Tom, a 30 year-old whose lifetime income averages three times average earnings. When he retires at 67 he will have paid a total of $8.7million in taxes over his working life after taking into account tax concessions of about $134,000. His super balance of $5million, almost all of which comprises his own savings and earnings thereon will be able to fully support him in his retirement and saves the Government about $2.2million in Age Pension payments.

His tax concession is substantially less than the welfare payments and tax concessions paid to Bob who makes no net payment for Government services.

So yes…Tom's tax concession is larger (nearly twice Bob's) but it is substantially less than Bob receives in part-pension payments. Significantly, Tom makes a total contribution to the Federal Government budget of over $8m which not only pays for Government services but helps pay the shortfall in Bob's Age Pension not covered by his own tax payments.

Without that tax revenue from the higher paid, the Federal Government would not be able to function and maintain welfare payments to those who genuinely need support.

So what is "fair and equitable"? Whatever it is, it has to be viewed from a "whole of life/whole of cost/benefit" basis per person, not just one measure of "superannuation tax concession."

Appendix G

Summary of Assumptions used in Pension Sustainability Model (PSM*)

*as developed by Harlestone Pty Ltd

1. Timing and ages

Superannuation contributions commence on 1 July 2016 at age 30.

Retirement on a superannuation pension and/or Age Pension on 1 July 2052 at age 67.

Currently 86% of Australian males are expected to live to 67 and their life expectancy (i.e. 50% of them) is then 17.6 years with 75% of them living to 90-91.(ABS Life Tables) PSM model provides some "longevity insurance" by assuming super should fund a pension through to age 90.

CPI assumed to be 2.5% p.a. for the purposes of calculating Replacement Rates.

We recognize that we are using the PSM to model a mature system but using current retirement and life expectancy figures. We implicitly assume that as the current or alternative systems mature key assumptions the relationship between such assumptions as retirement/Age Pension age and life expectancy will be adjusted.

2. Earnings

Results calculated for multiples of Average Full Time Weekly Ordinary Time Earnings (AWOTE). [$76,512.80 in mid-2014/15]. Note the lowest income is set at 0.75 of AWOTE rather than 0.5 because pensions for the latter are very dependent on the Age Pension and so distort the graph.

Today's AWOTE is assumed to grow by 4%p.a. as per assumptions used by the Henry Report.

However, it is also assumed each individual's earnings will also grow with age by an additional 1% p.a. above AWOTE growth such that their average lifetime earnings (discounted by AWOTE growth) are equal to the specified multiple of AWOTE for that person.

A person on, say, AWOTE begins life below AWOTE such that his/her average (real after adjusting for AWOTE growth) lifetime earnings are equal to AWOTE. [I.e. income at age 30 is reduced by 17% to $66,151; income at age 49 is approximately equal to AWOTE and income at age 66, 19% above AWOTE]

3. Contributions

Assumed gross Superannuation Guarantee rate of 12% is added to current AWOTE income in "Currrent" case. [i.e. gross cost to employer assumed to increase as SG level increases from today's level]

No non-concessional contributions are assumed for these cases.

4. Minimum withdrawals

Assume current minimum withdrawal rates apply but are moved back 2 years as retirement age moves back two years.

5. Contribution caps

The 'standard' contributions cap is $25,000p.a. indexed to AWOTE from 2011 but only increased in $5,000 increments and hence $30,000 in 2016 increasing to $35,000 in 2020; for taxpayers over 50, the cap on contributions is the greater of the indexed 'standard' cap and $35,000p.a. (which is not assumed to be indexed and so for the longer term model becomes irrelevant as the 'standard' cap applies)

If contributions attempted to be made at SG level or because taxpayers is trying to make additional voluntary contributions, are constrained by the caps, the excess is assumed to be spent (after income tax) rather than saved.

6. **Taxation**

   Income tax, and Medicare levy and surcharge thresholds are indexed from 2015 by growth in AWOTE; (although it appears that Government is assuming bracket creep continuing for a few more years, we have assumed that in the long term today's rates and thresholds will apply – after adjustment by AWOTE growth.)

   Superannuation surcharge threshold is not presently indexed but we have assumed this is unsustainable in long-term and to have indexed it to AWOTE after it 'falls' to 3 times AWOTE.

   Capital gains discounts are as per current legislation.

   Assumed 2% levy on top marginal tax rate announced last year is not relevant for simulation of the long term impact of super.

7. **Investment returns**

   Assumed superannuation investment portfolio holds target level of cash equal to 25% and turns over 10% of share portfolio every year (for portfolio balancing purposes, even though no share sales are strictly necessary in accumulation phase). It is assumed all share sales purchases occur on 30 June each year [capital gains tax is calculated on assumption the cost base of shares sold is the average of the portfolio cost base].

   For calculation of interest, it is assumed contributions are made evenly through the year and deposited in (interest-bearing) cash pending share purchases. Similarly assumed that funds for next year's pension are held in an interest bearing cash account at beginning of year and pension paid out of such account evenly through the year.

   As the super fund balance declines, shares are sold and the level of cash increased so that there is enough liquidity to fund the following year's pension. All shares are sold in the penultimate year of retirement.

   Long-term gross returns are assumed to be 8%p.a., comprising 3% capital growth and 5% income (including dividends gross of imputation credits); costs/fees equal to 1% p.a. are deducted from interest/dividend income to give a net annual return of 7% p.a.

   Interest rate is assumed to be 1% above gross dividend rate. [resultant calculation gives interest rate of 4.75% and gross dividend rate of 3.75% - both net of fees]

8. **Age Pension**

   Age Pension is as for a single homeowner pensioner [$22,211.80 in mid-2014/5] and then indexed to AWOTE.

   Deeming threshold for Age Pension income test is $48,000, escalating by AWOTE from 2016. Deeming rate 2% below threshold and 3.5% above

   The current Age Pension eligibility thresholds are assumed to be indexed by growth in AWOTE from 2014-15 [Income test threshold $4,160p.a. with "taper" rate reduction of $0.50 for every $1 over threshold; Lower asset test of $220,000] though "taper" rate for the assets test is doubled so that the reduction in fortnightly pension is reduced by $3 for every $1,000 in assets (previously $1.50), consistent with the Government's 2015-16 Budget.

9. **Pension calculation**

   The model calculates a pension (sum of Age Pension and superannuation-funded pension) by amortising the final super balance such that the super balance becomes zero on death (assumed

90 in this model) and that in each year the total of the super pension and (part) Age Pension less any tax paid (together assumed to be consumption during retirement) increases to maintain relativities with growth in AWOTE. To minimise the distorting impact of those with high initial super balance becoming eligible for a part Age Pension as their super balances decline, we have assumed that for the purposes of this model the assets test applied during the last 5 years of retirement uses the super balance applicable at the beginning of the 5th last year of retirement.

If the minimum withdrawal amount as per legislation is above this "pension", the excess is assumed to be invested outside super to be subsequently first used to meet "pension" requirements.

10. **Replacement Rate**

For each person, their income after tax and after contributions at SG level is assumed to be consumption during working life for the purposes of calculating replacement rates. The average of such income, discounted by CPI to mid-2016 $, over the last 10 years of working life is used for the calculation of Replacement Rates. ('Base Pre-retirement Consumption').

The Target Replacement Rate in the first year of retirement for those on AWOTE and below is assumed to be 70% of Base-Pre-retirement Consumption (in 2015-16 dollars) whilst for those on four times AWOTE it is assumed to be 60% and pro-rata for incomes in between.

"Replacement Rate achieved" shows the retiree's total pension (super plus Age Pension less tax if any) in first year of retirement and discounted by CPI to mid-2016 as a percentage of Base Pre-retirement Consumption.

11. **Additional contributions – 'Target' Replacement Rates**

Additional contributions can be specified as a percentage of salary for the last 15 year of a person's working life on assumption that prior to this period other priorities for income (mortgage, children) negate any possibility for extra contributions above compulsory SG.

The model calculates what additional % of contribution is necessary for each person to achieve super savings to provide an after tax pension (including any part Age Pension) equal to the assumed "Target Replacement Rate" times Base Pre-retirement consumption. It calculates the % necessary if there were no caps on contributions and then shows the impact of contribution caps.

So as not to distort figures, the Base Pre-retirement consumption used for Replacement Rate calculation is the level calculated as if only SG contributions were made (i.e. the fact that someone makes additional contributions during some of their working life does NOT reduce the reasonable pension the model calculates such person should expect.)

Similarly, if a person's contributions are constrained (even at SG level) by caps, their "consumption" for the purposes of calculating Base Pre-retirement consumption and Replacement Rates is assumed to be the after tax income that person would have enjoyed if he/she had been able to contribute at the full SG level.

If the Target Replacement Rate is already reached with contributions at just SG level than "additional contributions" are zero. Similarly, if contributions are constrained by caps then additional contributions are zero and the Target Replacement Rate is not achieved.

12. **Tax concessions**

Tax concessions are calculated by comparing actual income and superannuation taxes paid under the projection with the income taxes that would have been paid by the same worker if there were no superannuation and he/she spent the funds (after tax) that would have been contributed into super.

For comparison purposes, the projected taxes are discounted to mid-2016 by the assumed p.a. growth in AWOTE.

13. **Impact on GST paid**

During working life, the scenario with no superannuation and assuming each taxpayer spends the funds (after tax) that would have been contributed into super, results in more GST paid.

Conversely, during retirement, someone with super savings would have a higher income/consumption than someone just on the Age Pension resulting in higher GST payments for the "super" case vs the "No Super" case. Since these superannuation pensions include earnings accumulated on the net super contributions, this essentially means that there ends up being GST on the accumulated superannuation earnings.

The marginal GST rate should not be used during retirement period because of exemptions from GST. The model assumes that any expenditure during retirement up to 50% of AWOTE in that year is free of GST and that the retiree pays 10% GST on expenditure above that level.

The model calculates the difference in GST payments between the superannuation and "No-Super" cases to give additional GST payments as a result of super.

14. **Net budget savings**

In calculating "Net Budget Savings" each projection is compared with a projection of same total cost to employer (i.e. income plus super contributions) fully paid out as taxed salary as if there were no super. For these projections, it has been assumed none of after-tax earnings are saved and each individual in the "No Super" case draws the Age Pension in retirement.

Any savings in Age Pension cost in each year as a result of superannuation is reduced by any reduction in income and super tax paid in that year and also reduced (increased) by any reduction (increase) in GST paid under the super system. The result is discounted by AWOTE to mid-2016 dollars.

15. **Model variations**

For the TEE alternative, contributions are included in an individual's assessable income and taxed at progressive income tax scale but with a 15% personal tax refund. No contribution tax or rebate in the super fund.

For the EET case, there is no taxation of contributions but withdrawals from super are included in an individual's taxable income.

Zero earnings tax and zero tax on pensions, as proposed by Professor Freebairn (see separate commentary on this), is assumed for both the TEE alternative and the EET alternative.

It is assumed that the aggregate of salary and super contribution (i.e. cost to employer) is the same for current TTE, EET and TEE projections.

Also assumed that the SG rate is varied for EET and TEE such that the $ contribution at SG rate is the same as the net dollar contribution under current system (net of current 15% contributions tax). This results in the long-term SG rate assumptions for EET and TEE being 10.02%

Appendix H

The proposal to add a tax onto superannuation earnings

On 22 April, the Opposition announced that in Government it would introduce a new 15% tax on the earnings of superannuation savings accounts in the retirement phase above $75,000. The Shadow Treasurer later told the National Press Club that the Opposition would seek a mandate for the tax at the next Federal election.

The proposal to tax superannuation account earnings was similar to a measure announced by the previous Government on 5 April 2013 when it said a superannuation account earnings tax of 15% would be applied above $100,000. Such earnings have never previously been taxed.

This proposal was not legislated before the 2013 election and the current Government decided not to proceed with the new tax.

Our understanding was that this decision was made on advice from Treasury and the Australian Taxation Office that a superannuation account earnings tax would be practically difficult and costly to administer.

The SMSF Owners' Alliance raised this and other issues at the time of both the 2013 and 2015 announcements.

Our media release of 24 April 2015 is reproduced below. The points it makes in response to the Opposition's policy are relevant to any proposal by Government to apply a new tax to the earnings on superannuation accounts.

SMSF Owners' Alliance
Limited ABN 96 161 052 464
Not-for-profit public company

10 Things Wrong with Labor's New Superannuation Earnings Tax

24 April 2015

1. Premature

It pre-empts the outcome of the Taxation White Paper. One of the recommendation of David Murray's Financial System Inquiry was that the Government should commit to a legislated and formal statement of the guiding principles and objectives of superannuation. These should be achieved, with bipartisan agreement, as part of the Tax White Paper process. When these are agreed, decisions on the structure of the superannuation system and appropriate taxation can be made. By announcing tax changes now and saying no further changes will be made for five years, Labor is sidelining a major policy review of the taxation system which should lead to a more effective superannuation system, just as it shelved most of the recommendations of the landmark report it commissioned from Ken Henry when last in Government – except the mining tax.

2. More tax
Labor say this 'policy' in intended to "improve fairness and sustainability" of the superannuation system. In reality it's just another way of raising money from taxpayers. The degree of 'unfairness' in the system has been widely exaggerated as has the size of the so-called tax concession. Even after taking into account the contributions into super, Australia has one of the most progressive tax systems in the world. Over half of Australians pay no tax net of welfare receipts and are supported by the other half. 20% of Australians pay 63% of all income taxes even after the current super system is taken into account.

The often quoted total tax concession figure of $32 billion has now been discredited and dismissed by informed commentators. In reality the total tax concessions are less than $10bn and therefore much less than concessions from other quarters. Even Treasury says the $32 billion number carries no policy message.

This is just another tax….and like the mining tax – not very well thought out!

3. More "fiddling"
This 'policy' is yet more knee-jerk "fiddling" with superannuation in the guise of taxing the rich but which raises more uncertainty with a consequential impact on people's – and particularly young people's – confidence in superannuation as a long term investment.

A tax which requires a $150 million payment to the ATO to make it work is clearly not simple or efficient. The cost is likely to be much higher as significant costs will be imposed on mainstream funds to identify members with multiple accounts, a cost that will be passed on to their members. SMSF members will be affected as well as many of them also have accounts with mainstream funds.

4. More people will pay
The number of people who will have to pay the earnings tax will be more than the number quoted by Labor and will include people with balances far lower than $1.5m.

The proposed earnings threshold of $75,000 is not to be indexed for inflation. This means that from year to year, more people will be drawn into this sneaky tax net as their superannuation earnings and their fund earnings grow.

Another factor is that the income of peoples' super fund accounts can vary dramatically from year to year depending on the performance of their fund. Labor assumes, simplistically, that the $75,000 earnings will be generated by an account of $1.5 million yielding a 5% return and this will affect 60,000 people. Fund earnings vary significantly from year to year depending on market conditions. In years when funds perform better (such as the 15% return achieved in 2012 as share markets rose after the GFC), more people will be caught. In such a good year for returns, balances of as low as $500,000 would be caught, drawing up to 420,000 people into the tax net.

Worse, the taxable income in someone's super fund may bear no relationship to the pension they are withdrawing from it. In particular, if this is structured like Labor's earlier failed attempt to tax super, then the sale of shares in a fund with balances as low as $100,000 could realise a capital gain that is caught by Labor's so-called tax on the rich.

5. More uncertainty
Labor has not explained how the earnings tax will work. For example: How will 'earnings' be defined? Will members of an SMSF – typically a couple – be able to average their accounts so each of them can stay under the threshold? Can capital gains be averaged over a period so they do not cause a spike in

earnings in one year which would trigger the tax? Will capital gains triggered by selling shares or a property to meet care costs towards the end of life or even just to make the mandatory minimum withdrawals each year be taxed? In years in which fund earnings are below par, can one carry forward such ‘deficit’ to be offset against the years it is above? For SMSFs with more than one member, both in pension phase, can the tax be applied to one member if the other member (or even the whole fund) is below the threshold?

6. Doesn’t improve super

This extra tax does nothing to improve superannuation for the many Australians who don’t have enough. Indeed, due to the extra complexity and cost, this idea would probably lower returns and reduce the chances for all Australians to save enough in their super.

Instead of worrying about curbing success, Labor should be focussed on making superannuation better for all Australians so more people have the opportunity to save for a comfortable and financially independent retirement. The Intergenerational Report predicted that by 2050 the majority of Australians (67%) will still be dependent on the age pension. This is the real policy challenge for both the Government and the Opposition.

If one wants to spread the tax concessions more widely, there are ways to do this that will help more Australians achieve a healthy superannuation balance on retirement. Labor’s ‘tax on the rich’, supported by a campaign by left-wing think tanks, is clearly using the politics of envy to cut down ‘tall poppies’ rather than trying to help more Australians become taller poppies. We, and other organisations, have been acting in good faith in looking at ways to achieve a better superannuation system. In keeping with its commitment to achieve a bipartisan approach to defining the objectives of superannuation, Labor should await the outcome of the Tax White Paper before locking in tax changes.

7. Penalises success

Economists agree that systems that penalise success – such as higher earnings that may arise from successful investment policies – are economically inefficient. They distort investment behaviour and will therefore lead to lower than optimal long-term returns from super. Over the course of a working life, the returns from super savings is the most important factor in helping all Australians amass enough in savings for an independent retirement, as recognised by David Murray in his Financial System Inquiry.

There are other, more effective, ways of improving the effectiveness of super for all Australians.

8. Unfair to the elderly

Labor’s policy does not appear to recognise that superannuation must last for a lifetime and that in the end pensions paid from superannuation savings are not funded just by the earnings. Their pensions are paid from capital as well as regular earnings.

As self-funded retirees get older, many will have to sell investments in order to fund their own pension and to meet minimum withdrawal requirements. Assets, such as shares or property, will usually have been held for long periods and give rise to a capital gain when sold. Even Australians with just $100,000 in super would have to sell these assets towards the end of their life to pay out a modest pension from capital and could easily be caught by what Labor calls a new “tax on the rich” but one that will hit older Australians.

9. Unsustainable

Every time the benefits of saving into superannuation are limited, such as through new taxes or lowering rigid contribution caps, the potential of the system to deliver better outcomes is curbed.

Over time the superannuation system as we know it will fail to fulfil its purpose and the number of people needing to draw on the Age Pension in retirement will increase at a huge cost to the Budget.

10. Retrospective

Making tax retrospective is unfair and bad policy in principle. The earnings tax will have retrospective effect because it will reduce the value of super savings which were made legitimately on the basis that no earnings tax would apply to super savings in the retirement phase. This has applied for nearly a decade since 2006, including during the six years of the Rudd-Gillard Labor governments.

It also appears not to differentiate between earnings from contributions that have borne a tax concession and contributions which have been made using after tax dollars.

In that time, many people made important lifetime decisions about how much to save and when to retire in the expectation that income drawn from their super fund in retirement would be tax free.

Contact:

Duncan Fairweather
Executive Director
SMSF Owners' Alliance

Appendix I

The Freebairn and Henry approaches

Dr Henry argued in his Henry Report that:

> *"the complexity of the tax arrangements imposes an unnecessary cost on individuals in gaining access to concessions. Complexity also adds to the administration costs of superannuation funds, which affect retirement incomes.*
>
> *The Review recommends removing the taxation of superannuation contributions within a superannuation fund and replacing it with a system that is more equitable, simple and provides higher retirement incomes.*
>
> *Superannuation contributions should be taxed at a progressive but concessional rate. This would be achieved by treating employer superannuation contributions as income in the hands of the employee, taxed at marginal personal income tax rates. A flat-rate refundable tax offset, payable to the individual, would apply to these contributions to ensure that investing in superannuation retains its preferential tax treatment over other types of saving.*
>
> *Taxing contributions within the superannuation fund would no longer apply."*
> and
> *"The recommendation would integrate employer superannuation contributions into the personal income tax system. This, along with the flat-rate tax offset, would increase the equity of the superannuation system by increasing the progressivity of the taxation of superannuation contributions."*

Such a system would increase progressivity – if the Government believes such objective is desirable, perhaps in conjunction with a general **reduction** in progressivity of the income tax system to bring it more in line with the OECD norm.

The Henry Report suggested that a 20% tax offset would be appropriate. With respect to taxation of super earnings it went on to say that:

> "*Because superannuation is a lifetime savings vehicle, the compounding effect of interest has a significant influence on how much superannuation a person can accumulate. The taxation of earnings reduces this compounding effect. It is therefore appropriate that earnings are taxed at a low rate. For the sake of simplicity this should be at a low flat rate within the fund without reference to the marginal tax rate of fund members"*

It then proposed a 7.5% tax rate on earnings in both pre and post retirement periods but presented no argument as to why this should not be zero – consistent with its view of the impact on accumulation.

As an alternative, Professor Freebairn a distinguished economics professor at Melbourne University, has proposed that the super fund be tax free in both pre and post retirement periods. Combined with Henry's idea of taxing contributions in the hands of the individual, this has a strong appeal in resulting in the super fund not being liable for tax at any time. This in theory – and in practice – would substantially simplify fund administration and costs and increase returns.

Our preliminary modelling indicates that Freebairn's modification to the Henry Report proposal produces better results and hence is the focus of this paper. However, because we have dropped the super earnings taxation we **reduce** the tax offset rate to 15%.

As shown in the paper, this still results in neutral impact on the Federal Budget compared with the current system, but a better result for Australian retirees.

Appendix K

Impact of TEE system on take-home pay

We have assumed constant "cost to employer/economy" when comparing the current TTE, TEE and EET systems.

We have assumed both the 'cost to employer/economy' stays the same and set the Superannuation Guarantee level such that the net contributions into super remain the same amount after any tax in the super fund. E.g. someone on $100,000 now pays $12,000 into super at 12% so total cost to employer is $112,000 and net receipts into super after current 15% contribution's tax is $10,200.

So we assume the total 'package' of super and salary remains at $112,000 when considering the EET and TEE systems.

However, the (net) contribution into super to be strictly comparable to the current system should be $10,200 because there is zero tax on the contribution within the fund.

This gives same person a salary of $112,000 less $10,200 equals $101,800. The Superannuation Guarantee level equivalent to the 12% under current system is therefore $10,200/101,800 equals 10.02%.

A comparison of the take-home pay for a range of incomes under the current system and the alternative TEE can be illustrated below:

Current system (TTE)					
Total cost	$ 56,000	$ 112,000	$ 168,000	$ 224,000	$ 336,000
Super @ 12%	$ 6,000	$ 12,000	$ 18,000	$ 24,000	$ 36,000
Income	$ 50,000	$ 100,000	$ 150,000	$ 200,000	$ 300,000
Income tax	$ 7,797	$ 24,947	$ 43,447	$ 63,547	$ 108,547
Take-home pay	$ 42,203	$ 75,053	$ 106,553	$ 136,453	$ 191,453
Net super contribution	$ 5,100	$ 10,200	$ 15,300	$ 20,400	$ 30,600
Alternative system (TEE)					
Total cost	$ 56,000	$ 112,000	$ 168,000	$ 224,000	$ 336,000
Super @ 10.02%	$ 5,100	$ 10,200	$ 15,300	$ 20,400	$ 30,600
Income	$ 50,900	$ 101,800	$ 152,700	$ 203,600	$ 305,400
Income tax	$ 8,982	$ 27,857	$ 47,812	$ 71,287	$ 120,157
Take-home pay	$ 41,918	$ 73,943	$ 104,888	$ 132,313	$ 185,243
% drop in take-home pay	1%	1%	2%	3%	3%
Net super contribution	$ 5,100	$ 10,200	$ 15,300	$ 20,400	$ 30,600

This shows how we have held the NET superannuation contribution constant at all income levels. I also shows the income tax paid under the TEE system on both the Income and the Super contribution less a 15% rebate on the super contribution.

The drop in net take-home pay is small, ranging from 1% up to 3%.

This analysis has assumed no change in the progressivity of the current income tax system. If for example all the income tax thresholds (except the first one) were increased by 15% then there would be no reduction in net take-home pay except for those at the top of the income range we've chosen.

Alternative system (TEE) "flatter" income tax system					
Total cost	$ 56,000	$ 112,000	$ 168,000	$ 224,000	$ 336,000
Super @ 10.02%	$ 5,100	$ 10,200	$ 15,300	$ 20,400	$ 30,600
Income	$ 50,900	$ 101,800	$ 152,700	$ 203,600	$ 305,400
Income tax	$ 8,233	$ 26,568	$ 46,523	$ 67,838	$ 116,708
Take-home pay	$ 42,667	$ 75,232	$ 106,177	$ 135,762	$ 188,692
% drop in take-home pay	-1%	0%	0%	1%	1%
Net super contribution	$ 5,100	$ 10,200	$ 15,300	$ 20,400	$ 30,600

This should illustrate that with some sensible adjustment to income tax thresholds this system could be introduced with minimal impact on most Australian's take-home pay and but a large positive impact on their superannuation balances.

However, even this perhaps overestimates the impact on take-home pay as it does not take into account the improved effectiveness of the alternative TEE system in providing adequate super pensions for more Australians. A better comparison is to look at the impact on take-home pay on the assumption that the individual has contributed enough to retire on his/her target Replacement Rate.

For this purpose we should vary the contribution level to that necessary to achieve the target Replacement Rate, as illustrated in graph 17 in section 5. The corresponding tables would be as follows:

Current system (TTE)					
Contribution rate	6.5%	15.0%	15.7%	15.5%	16.3%
Total cost	$ 53,250	$ 115,000	$ 173,550	$ 231,000	$ 348,900
Super contribution	$ 3,250	$ 15,000	$ 23,550	$ 31,000	$ 48,900
Income	$ 50,000	$ 100,000	$ 150,000	$ 200,000	$ 300,000
Income tax	$ 7,797	$ 24,947	$ 43,447	$ 63,547	$ 108,547
Take-home pay	$ 42,203	$ 75,053	$ 106,553	$ 136,453	$ 191,453
Net super contribution	$ 2,763	$ 12,750	$ 20,018	$ 26,350	$ 41,565
Alternative system (TEE)					
Contribution rate	4.0%	9.3%	9.5%	9.3%	8.3%
Total cost	$ 53,250	$ 115,000	$ 173,550	$ 231,000	$ 348,900
Supr contribution	$ 2,048	$ 9,785	$ 15,057	$ 19,655	$ 26,739
Income	$ 51,202	$ 105,215	$ 158,493	$ 211,345	$ 322,161
Income tax	$ 8,546	$ 29,029	$ 49,902	$ 74,549	$ 126,541
Take-home pay	$ 42,656	$ 76,186	$ 108,591	$ 136,796	$ 195,620
% drop in take-home pay	-1%	-2%	-2%	0%	-2%
Net super contribution	$ 2,048	$ 9,785	$ 15,057	$ 19,655	$ 26,739

If the income tax thresholds were adjusted as suggested above the take-home pay and difference to that under the current system would be:

Alternative system (TEE) "flatter" income tax system					
Contribution rate	4.0%	9.3%	9.5%	9.3%	8.3%
Total cost	$ 53,250	$ 115,000	$ 173,550	$ 231,000	$ 348,900
Super @ 10.02%	$ 2,048	$ 9,785	$ 15,057	$ 19,655	$ 26,739
Income	$ 51,202	$ 105,215	$ 158,493	$ 211,345	$ 322,161
Income tax	$ 7,797	$ 27,740	$ 48,613	$ 71,099	$ 123,092
Take-home pay	$ 43,405	$ 77,475	$ 109,880	$ 140,245	$ 199,069
% drop in take-home pay	-3%	-3%	-3%	-3%	-4%

This analysis suggests this issue in not insurmountable.