Lorraines's Vision for a Better Super Future

Summary

In this submission I will cover some of the problems with the current system and suggest some amendments which would overcome all of these problems in a way which is cost effective for the government, fairer and more equitable for retirees and which leaves no current retiree worse off than they are now.

The problems covered here all relate to the draw down phase of super.

1. The huge tax benefits currently available to retirees with high super balances, but not to retirees with their assets outside of super.

2. The income leveling effect of the current system which is a disincentive to save and a huge incentive to draw down much of your super and either spend it or hide it in some way.

3. The current age pension means testing is dysfunctional. It causes stress to pensioners, housing inefficiency, discourages pensioners from remaining in the workforce and lowers productivity.

I am proposing a solution to these three problems that involves some quite simple changes to the rules for the government pension and the tax treatment of super but which vastly reduces the complexity and inequality of the system and totally eliminates all of these problems with no additional cost to the government.

Please note that all the figures and tables quoted in my submission refer to a single retiree pensioner. The values for a couple would be slightly different due to different amounts for the government pension and the Senior Australian's Tax Offset, however the effects of the problems covered here and the proposed solution would be similar for couples.

The Problems – Why we need things to change

1. Huge tax benefits for retirees with large amounts in super.

With the current system, eventually no-one over the age of sixty will be paying any tax at all. This is not sustainable in the long term as more people retire under the new rules.

Currently those with high balances supporting their income streams are receiving a tax benefit far in excess of the government pension. A single retiree earning around $85,000 within their super fund and a couple earning $110,000 combined both receive a tax benefit greater than the age pension. For incomes above this, the sky is the limit. A single retiree with earnings on their super of $200,000 receives a tax benefit of $66,547, well over three times the single pension amount.

For a system designed to reduce the number of retirees requiring the pension, giving those not receiving a pension a tax benefit worth more than the pension just doesn't make any sense. In fact it is total insanity. Do we really want a super system that is a tax haven for the wealthy? Although there is some restriction on the amount you can stow away into super, there is still scope for some retirees to build up huge balances and receive large amounts of tax free income when they retire.

The proposal in the recent Budget to charge a 15% tax on earnings over $100,000 on the assets supporting an income stream is nowhere near enough to counter this discrepancy.

There is also a large divide between retirees who have the same income within super and outside of it. One of the aims of a well structured tax system is that taxpayers with the same

incomes should pay the same amount of tax. This is not the case for retirees who hold their assets within super compared to those holding the same assets outside of super.

A retiree earning $200,000 on the assets supporting his or her income stream currently gets a tax benefit of $66,547 compared to a similar retiree with assets outside of super. In addition the retiree with the super income stream can earn an additional $20,542 outside of super and pay no tax on this, equivalent to a further tax break of $9,552. Under the proposed rules announced in the Budget this retiree would be required to pay $15,000 in tax on the earnings within the fund, but this still delivers them a tax break of $51,547 (plus the $9,552) compared to the retiree with the same earnings outside of the super system or a younger person on a salary of $200,000.

Table 1. Tax Benefit of Super Income Stream Earnings

Investment Income	Tax if not in super	Tax if in super	Cost to Govt
20,000	0	0	0
30,000	0	0	0
40,000	3,482	0	3,482
50,000	5,882	0	5,882
60,000	11,847	0	11,847
70,000	15,347	0	15,347
80,000	18,747	0	18,747
90,000	22,597	0	22,597
100,000	26,447	0	26,447
120,000	34,147	3,000	31,147
140,000	41,847	6,000	35,847
160,000	49,547	9,000	40,547
180,000	57,247	12,000	45,247
200,000	66,547	15,000	51,547
220,000	75,847	18,000	57,847
240,000	85,147	21,000	64,147
260,000	94,447	24,000	70,447
280,000	103,747	27,000	76,747
300,000	113,047	30,000	83,047

Note that the SATO is included in the tax calculation. The tax value for the super
Includes the proposed 15% tax on fund earnings above $100,000. The cost to govt is the
tax revenue foregone by the favourable tax treatment of the earnings supporting the income stream.

2. The income leveling effect of the current system discourages saving.

One of the aspects of the current system that should be addressed is the income leveling effect of the interaction of the govt pension and the non-pension income of retirees.

The system is currently a great leveler of retirement income, making it a bit pointless going to any great length to save more than a basic amount of money for your retirement either within super or outside of super. This effect actively encourages retirees to take money out of super and spend it as there is so little benefit in leaving it there.

I have produced here a table that calculates the income and govt pension for a range of asset balances and shows the net 'take home' pay of a retiree with each balance either within or outside of super. I have done this for a single retiree; the effect would be similar for a couple.

I have assumed that the assets earn 5% and I have used the current values for the deeming rates and the age pension. The tax is calculated at 2012-2013 rates and includes the effect of the Medicare Levy, the Low Income Rebate (LIR) and the Senior Australians Tax Offset (SATO).

Table 2. Interaction of Pension and retirement incomes

Total Assets	Income At 5%	Govt Pension	Income Tax	Total if in super	Total if not in super
0	0	19,500	0	19,500	19,500
100,000	5,000	19,500	0	24,500	24,500
200,000	10,000	18,358	0	28,358	28,358
300,000	15,000	15,083	0	30,083	30,083
400,000	20,000	11,183	0	31,183	31,183
500,000	25,000	7,283	1	32,283	32,282
600,000	30,000	3,383	458	33,383	32,925
700,000	35,000	0	1382	35,000	33,618
800,000	40,000	0	3482	40,000	36,518
900,000	45,000	0	5882	45,000	39,118
1,000,000	50,000	0	8282	50,000	41,718

Column 1 – Assets, these can be either all in super (zero tax on the earnings) or outside of super.
Column 2 – Income on the assets at 5%
Column 3 – Government Pension calculated using current income and assets tests as at May 2013
Column 4 – Tax owing on income plus pension if assets held outside of super (2013 rates)
Column 5 – Take Home amount if all the assets are held in super (no tax on earnings)
Column 6 – Take Home amount if all the assets are outside of super (tax payable on earnings)
Note that this table has been produced from available information about complex products and does not constitute financial advice. All care has been taken when compiling it, but the accuracy is not guaranteed.

What is really striking about this table is the very small increase in income for the retiree over the asset range of $200,000 to $700,000, mainly due to the asset test reduction in government pension income and the very high (12.5%) taper rate of the SATO.

The retiree with a super balance of $200,000 receives a total annual income of $28,358, while the retiree with a balance of $700,000 receives $35,000. The extra half a million dollars saved by the second retiree results in an increase in annual income of only $6,642. For retirees who hold their assets outside of super, so they pay tax on the earnings, the difference is only $5,260.

On an increase in investment income of $25,000, the retiree receives only $5,260, equivalent to an effective marginal tax rate of 79% and a return on the assets of 1%. The retiree can of course draw down the savings if they want to, but most people don't want to – they worry about their money running out before they do. To save $500,000 you need to forego $20,000 of your income for twenty five years and all you get at the end is an extra five or six thousand dollars in income for the next twenty five. Why would anyone bother?

And if you do find yourself with the extra money in super it only makes sense to take some or all of it as a lump sum, pay down any remaining debt, renovate the house, buy a new car and anything else you think you may possibly need for the next twenty five years, have a holiday, store cash or gold under the bed, open an offshore account, invest the funds in someone else's name…. After all the 1% effective return you are getting on the money in super is way below the inflation rate.

The most obvious way to alleviate this problem is to assess financial assets of a pensioner using only the income test, not the assets test, as this gives a much fairer outcome with the return on the extra $25,000 income being around 3% for the retiree holding their assets in super, and 2% for the retiree with their assets outside of super. This would be better, but is still not great. However the solution I am proposing below will result in much better outcomes for these retirees, while costing the same or less overall to the government.

3. The social inefficiency of the current system

The current age pension means testing is dysfunctional. It causes stress to pensioners, housing inefficiency and lowers productivity by discouraging seniors to stay in the workforce and by tying up Centrelink staff in the administration of the scheme and financial planners in the avoidance of it.

The most obvious problem is pensioners retaining homes which are inappropriate for their needs as the family home is exempt from the government pension assets test. This ties up larger houses and larger inner city blocks of land. If we could eliminate this problem, our housing could be allocated much more efficiently, with pensioners choosing to live in smaller units which are more appropriate for them and the larger houses being occupied by families with children who would benefit from having a garden. Inner city blocks with old houses on them could be subdivided or redeveloped to increase housing density in areas already well serviced by public transport and infrastructure. This would alleviate housing shortages. It would eliminate a major cause of stress for pensioners, who cling to houses they know are unsuitable for fear of losing income. It would also result in a lower rate of accidents as many of our seniors live in older houses with steps, outdoor toilets, insufficient heating and cooling, and outdated kitchens and bathrooms.

Another related problem is that the current asset test encourages pensioners, particularly those whose income is calculated under the assets rather than the income test, to hide cash around their houses. This cash could be invested, earning interest for the pensioner and profit for the bank, thus benefiting the whole economy.

The high taper rate for the pension, combined with the current high marginal tax rates for pensioners caused in part by the 12.5% taper in the SATO, is a disincentive for those over the pension age to continue in the workforce. The mature age worker tax offset was a great step forward here, but sadly this has now been discontinued. The reduction in the pension taper rate to 25% for earned income has also helped, but it has not solved the problem. Pensioners are still subject to an effective marginal tax rate of 58% on earned income (rather than the 83% they pay on investment income), where their total income exceeds $32,279. This rate is even higher (66.5% and 91.5%) at the phase in stage of the Medicare Levy. If this problem could be addressed, then more age pension recipients would remain in the workforce, at least part time, and this would increase productivity.

Financial planners are tied up with devising complex schemes to maximise pensions for retirees and Centrelink staff are employed to calculate entitlements and oversee the rules. There is scope here for a vast increase in productivity of these people if the system is changed in the way I will set out in my proposed changes.

The Solution - Lorraine’s Proposed Changes to Pension and Super

1. The accumulation phase

The changes I am proposing mainly relate to the draw down phase of Super. I would envisage that the accumulation phase would work more or less as it does now, but with some caps in place as suggested in the ASFA discussion paper. Any high income earner wanting more than a reasonable retirement income is welcome to save as much as they like outside of the super system to fund the extra. Most of the discussion on super seems to ignore the fact that people can and do save some of their money outside the super system.

I find it a bit strange that we concentrate so much on the tax benefit of contributions to super by high income earners when they are so much less than the huge tax breaks at the draw down phase. A salary earner on $200,000 can contribute up to $25,000 into super, including their Superannuation Guarantee (SG) amount. This gives them a maximum benefit of $7,875. However at that stage they are paying $66,574 in income tax. A retiree with a super income stream where the earnings of the fund are $200,000 currently has a tax break of $66,574. This is the issue we need to be addressing as a priority.

There is scope to reduce the tax benefit of the contribution of all income earners to a maximum of 15%, as this would still give people an incentive to save in super and would increase the equity across all earners, particularly with the excellent proposal to refund the contributions tax of lower paid workers who currently get no tax benefit at all.

One of the main benefits of super is the low tax rate on the earnings within the fund. Many people are happy to contribute after tax income, with no tax concession at all, into their super to gain the benefit of the lower tax rate on the earnings. Minor changes to the tax concessions will not drive people away from contributing to super.

2. The Transition Phase

The transition phase would also work as suggested in the ASFA discussion paper with those above preservation age but under age pension age unable to access a lump sum, but able to draw down up to 10% of their balance each year which is taxed at normal rates with a 15% rebate attached. The suggested exceptions for disability would of course apply.

Under my proposed amendments to the system the assets would not need to be transferred to pension mode to accommodate this, the super would stay in accumulation mode, tax would be paid on the earnings at the usual 15% and the fund could still accept contributions, both SG and employee, under the usual rules. The 10% maximum would be calculated on the opening balance of the fund at the start of the financial year.

This would give retirees who are above preservation age but below age pension age the opportunity to retire early. There is, again, nothing stopping these people from saving money outside of super to fund an early retirement.

3. The Draw Down Phase

This is where the changes I propose occur. The basic change I am suggesting is to tax all income of those over age pension age in the normal way, including the earnings of their income stream assets, but with everyone entitled to a special pensioner tax rebate of $15,000 that can be taken as a fortnightly payment, replacing the age pension, or as a refundable rebate at tax time, but obviously not as both.

Current age pensioners and current self-funded retirees
All people who are currently retired or above age pension age will have the option of staying on the current rules for as long as they want to – most people will be better off on the new system and will want to change. All new pensioners would use the new system as they reach age pension age.

While most retirees will be slightly better off, the proposed new system will not be a significant cost to the government as overall the changes are likely to be revenue neutral. The increased tax on higher retirement incomes will cover the cost of eliminating the unfair income leveling effect on middle incomes, discussed previously.

The new system can easily be extended to retirees who are on annuities and defined benefit pensions as their income would be taxable as it is now, with allowance made for an undeducted purchase price or a tax free amount. These people would be taxed on their income and they would receive the same $15,000 either as a tax rebate or as a pension.

Pension Mode
At age pension age (currently 65 but shortly to raise to 67) all new retirees will automatically go into pension mode. At this point they will have the option of leaving their super in a fund or taking part or all of it as a tax free lump sum that they then invest themselves or with the help of a financial planner.

Uniform Tax treatment of all earnings and proposed tax rebate
All investment earnings whether in super or outside of super and any salary or business income will be added together and taxed at usual rates, with a special pensioner refundable tax rebate of $15,000. This will be indexed to AWOTE. The SATO will be eliminated.

The rebate can be taken as a tax free pension and paid fortnightly or used to reduce the tax paid by the retiree with any unused rebate being refunded to them. All pensioners will receive this base amount and it will replace the current government pension payment. This amount is less than the current single pension, but similar to the couple pension rate. The single pension is dealt with further in a later section.

Amounts drawn down from the super fund will be treated in exactly the same way as for people accessing their capital outside of super – no tax whatsoever will apply. The tax only applies to the earnings on the assets held in the fund in the same way that someone with assets outside of super pays tax on their investment income but not if they draw on their capital.

Continuing contributions and effects on super funds
Contributions can still be made to the super fund with the usual tax concessions – a separate pension account will not be required. The fund manager will pay tax at the normal 15% on the earnings of the fund as for the accumulation phase, however at the end of the year a statement will be sent to the retiree detailing the fund earnings and the tax paid by the fund.

The earnings amount will be declared by the taxpayer on their return with any other income they have (excluding the tax free pension amount) and the tax paid by the super fund will become a tax rebate in a similar way to the current treatment of franking credits.

This will simplify the administration of super funds; currently they are required to segregate the assets and earnings for all individuals but not pay tax on the earnings of those in pension mode. With the new system they will pay the tax at the usual 15% on all fund earnings and will send a statement to the pensioner detailing the amount earned for the year and the tax paid. The pensioner will then include this amount on their tax return and receive a refundable rebate for the tax paid.

Single pensioners
For single pensioners with very low additional income (up to $20,000), a pension supplement will be paid to take the total payment up to the current single pension rate of around $19,500. This would phase out at 30% for every dollar earned above $5,000, phasing out completely at an income of $20,000. (Minor adjustments may be required to this formula to match current pension levels and maintain the *status quo*. In my calculation I have used actual income rather than deemed income, hence the lower pension rate in the table for the retiree with $10,000 in income).

All government pension income would be totally tax free, leaving these single low income pensioners with a maximum taxable income of $20,000 which is below the current tax free threshold (after allowing for the low income rebate). Thus the current high effective marginal tax rates are totally eliminated. The pension supplement phases out before income tax kicks in.

It is unlikely that anyone would go to drastic lengths to manipulate their income and assets to gain the extra pension supplement as the amount is quite low and only applies to single pensioners.

For everyone else, including pensioner couples who currently receive around $15,000 each, the pension income test would be eliminated. The assets test would be entirely eliminated for all pensioners. Everyone over pension age would receive the basic tax free pension rate of $15,000 either as a fortnightly payment or a tax rebate.

Other age pension benefits
The current system of rent support and health care cards would continue more or less unchanged, with the health care card available to all pensioners with a taxable income below $80,000 as at present.

Benefits of the new system
This system is really only a small change to the current system but vastly simplifies it and eliminates all of the three problems that I outlined above.

All taxpayers are treated the same regardless of whether their income is from salary or investment income and regardless of whether it is within super or not. This also eliminates the situation of high income retirees with large super balances being given huge tax breaks. The maximum tax benefit received would be the $15,000 rebate and this would be the same for everyone.

The income leveling effect, where those with super balances between $200,000 and $700,000 get very little benefit from their extra saving, is also eliminated as they are not losing pension with increasing assets.

The current discouragement for retirees to downsize their homes is completely eliminated with this new proposed system. Any difference in the selling price of their home and the cost price of the new home can be invested with no loss of pension and with tax at normal rates on the earnings. The extra could affect the pension supplement paid to single pensioners; however with a taper rate on earnings of only 30% they would clearly be better off overall.

This aspect alone would have huge social advantages. Housing could be allocated more efficiently with more large homes available for families with children, giving them a better environment and gardens to play in safely. Old houses on large blocks in inner city suburbs would become available for redevelopment. Pensioners would generally be happier living in smaller more suitable premises, with less stress about maintenance, and with proximity to other retirees in adjacent homes or units. They are also less likely to have accidents living in homes designed for seniors with no steps, modern heating, indoor toilets, and better designed bathrooms and kitchens.

The incentive for pensioners to hide away cash is also eliminated. This money could be banked with the interest available to the pensioner with no loss of benefit.

Many pensioners stress about their income and pension entitlements, and worry about loss of income. The complexity of the pension income and asset testing and its interaction with the tax system is a source of confusion for most pensioners. This new proposed system would totally eliminate this. The new system is simple and easily understood.

Pensioners would no longer have any disincentive to remain in the work force either full or part time. Tax on earnings would be payable only at the normal marginal rate for these people. The high effective tax rates for pensioners earning just above the threshold amount of $32,279 is also totally eliminated as these people get the standard $15,000 pension with no reduction, pay tax at usual rates on their other income and the SATO is consigned to history.

Financial planners could spend their time more productively than in devising schemes to maximise pension income. They could be employed in investing the assets to give the best possible outcome for the pensioner with regard to risk and return. They would also look after the tax returns for the pensioners and could offer a complete wrap service, looking after all aspects of investment and tax and paying a fixed income amount to the retiree sourced from their assets and earnings.

Centrelink staff would no longer have to field calls from pensioners for minor changes in asset and income levels – only those on the single pensioner supplement would need to report these details. Pensioners claiming their entitlement as a tax rebate would need no interaction with Centrlink at all. This would lead to higher productivity as these Centrelink staff members could do more useful work.

Cost to the government
Table 3 gives the cost and or the benefit to the government over each asset range with income calculated at 5% of assets. As all income difference to the retiree stems from alterations to tax and pension, the ultimate cost or benefit to the govt is the same as the change in income for the retiree. This is calculated for a retiree with all their income producing assets held in super.

The pensioners who gain the most are those who previously were penalised the most by the interaction of the current pension system with the tax system, ie those with an asset balance between $200,000 and $700,000 whose net income was increased only slightly with the extra amount of super. However this would be offset somewhat by the tax collected from those with super earnings of $70,000 or more. I have produced this table up to an income of $100,000. For higher incomes the benefit to the government is increasingly higher. For an income of $200,000, the tax payable is $51,547.

Sadly I was unable to find any information on the distribution of the balances of current income stream assets. With this I would have known how many retirees were in each class and I could have calculated the approximate cost the proposed system. However the extra tax raised from those with very high incomes in their super could well totally cover any revenue shortfall from making the system fairer to the disadvantaged middle group. As time goes by more and more retirees will have saved significant balances post the 2007 rule changes and will be falling into the higher income groups whose tax will fund the adjustments for the middle income group.

Under this system the effective tax free threshold for pensioners would automatically be raised very slightly from $32,279 to $35,542. This is because the $15,000 pension or rebate is entirely tax free, as well as other income below $20,542. However the small amount of tax currently collected from pensioners in this range would be negligible.

As well as these cash costs and savings, the cost benefits should also take into account the increase in tax revenue and productivity from pensioners remaining in the workforce, the increase in income and profit to banks from money invested that was formerly hidden, the better social outcomes from seniors living in more appropriate housing and the savings on Centrelink administration costs, with many pensioners needing no contact with Centrelink at all.

Table 3 Costs and Benefits of Lorraine's proposed new system

current system							proposed new system					
Total Assets	Income at 5%	Govt Pension	Tax Owing	Tax if in super	Take Home	Cost to Govt	Rebate/ Pension	Tax Owing	Take Home	Cost to Govt	Diff take home	Diff to Govt
0	0	19500	0	0	19500	19500	19500	0	19500	19500	0	0
100000	5000	19500	0	0	24500	19500	19500	0	24500	19500	0	0
200000	10000	18358	0	0	28358	18358	18000	0	28000	18000	-358*	-358*
300000	15000	15083	0	0	30083	15083	16500	0	31500	16500	1417	1417
400000	20000	11183	0	0	31183	11183	15000	0	35000	15000	3817	3817
500000	25000	7283	1	0	32283	7285	15000	1222	38333	13333	6050	6050
600000	30000	3383	458	0	33383	3842	15000	2247	42308	12308	8925	8925
700000	35000	0	1382	0	35000	1382	15000	3272	46283	11283	11283	11283
800000	40000	0	3482	0	40000	3482	15000	4747	49853	9853	9853	9853
900000	45000	0	5882	0	45000	5882	15000	6522	53153	8153	8153	8153
1000000	50000	0	8282	0	50000	8282	15000	8297	56453	6453	6453	6453
1100000	55000	0	10072	0	55000	10072	15000	10072	59753	4753	4753	4753
1200000	60000	0	11847	0	60000	11847	15000	11847	63053	3053	3053	3053
1300000	65000	0	13622	0	65000	13622	15000	13622	66353	1353	1353	1353
1400000	70000	0	15347	0	70000	15347	15000	15347	69653	-347	-347	-347
1500000	75000	0	17047	0	75000	17047	15000	17047	72953	-2047	-2047	-2047
1600000	80000	0	18747	0	80000	18747	15000	18747	76253	-3747	-3747	-3747
1700000	85000	0	20672	0	85000	20672	15000	20672	79328	-5672	-5672	-5672
1800000	90000	0	22597	0	90000	22597	15000	22597	82403	-7597	-7597	-7597
1900000	95000	0	24522	0	95000	24522	15000	24522	85478	-9522	-9522	-9522
2000000	100000	0	26447	0	100000	26447	15000	26447	88553	-11447	-11447	-11447

Column 1 – assets in super
Column 2 – income at 5% of assets
Column 3 – Government Pension
Column 4 – Tax Owing if the income was not in super
Column 5 – Tax Owing if the income is in super
Column 6 – Take home amount for assets in super
Column 7 – Cost to govt – pension plus lost tax

Column 8 – Proposed new system – pension or rebate
Column 9 – Tax owing in new system
Column 10 – Take Home amount new system
Column 11 – Cost to govt new system
Column 12 – difference in take home amount for new scheme
Column 13 – difference in cost to govt of new scheme - +ve cost, -ve benefit
* Note that the slight reduction in income for this group may require an adjustment to the pension supplement

Conclusion

In this submission I have covered some of the problems with the current system; the very high benefit of super income streams to high income earners; the discouraging income leveling effects of the interaction between super incomes and the age pension for middle income earners; and the dysfunctional effect of the current pension means testing on social efficiency and productivity in Australia. These are real problems with the current system that need to be addressed.

I have put forward a suggestion for amendments to the current system which would overcome all of these problems in a way which is cost effective for the government, more fair and equitable for retirees and which leaves no retiree worse off than they are now. It would also be simple to implement for all new retirees and most current retirees and pensioners would be happy to change over to it. Those who weren't happy to change would be allowed to stay under the current system.

Thank you for taking the time to read my submission.

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