SECURING RETIREMENT INCOMES

TAX, SUPER AND THE AGE PENSION: ASSESSING THE VALUE OF TOTAL GOVERNMENT SUPPORT

FEBRUARY 2012

CONSULTING. OUTSOURCING. INVESTMENTS.

CONTENTS

EXECUTIVE SUMMARY

- The level of total government support provided for retirement income is remarkably level across most individuals, irrespective of an individual's lifetime income
- This support comprises both superannuation tax concession and the means-tested age pension, reflecting Australia's three pillar system of retirement income
- The value of the tax concessions increase with income but this is offset by a reduction in future age pension payments
- Ongoing increases in life expectancy will increase the level of future age pension payments which will primarily be provided to low and middle income Australians
- The planned low income superannuation contribution will improve the equity of the current arrangements

The commonly held myth that total Government support for retirement income significantly increases as an individual's income increases is false and needs to be better understood to protect the sustainability of Australia's retirement income system.

This report, which is an update from our initial study, *The Fairness of Government Support for Retirement Income*, published in February 2010, shows that the level of total government support provided for retirement income, through the age pension and superannuation tax concessions, is almost constant across all individuals, notwithstanding different lifetime incomes. It highlights the importance of superannuation tax concessions at a time when debate on both tax reform and superannuation are particularly timely and significant in Australia.

Last year the House of Representatives agreed to increase the Superannuation Guarantee to 12% as part of the Mineral Resource Rent Tax legislative package. With the Senate planning to consider this legislation in the near future, it is now critical that we understand the financial framework of our overall retirement income system. That is, we must ensure that we provide all Australians with a more adequate and secure retirement income in the future whilst also acknowledging the increasing funding pressure of an ageing population on future Governments and taxpayers.

As people live longer, the cost of supporting our ageing population has the real potential to be a significant drag on our economy. However a well-supported, adequate and efficient retirement income system will have a profound impact on the management of these costs.

In the context of this demographic change and the ongoing discussion around taxes, Mercer compares the cost of total government support of individuals across a variety of income levels, encompassing both the government funded age pension and superannuation tax concessions.

We will consider the cost of government support for eight individuals based on the proposed 12% Superannuation Guarantee contribution. We will also assess other changes on the horizon, such as the new personal income tax rates, the increasing burden on the government as people live longer, and what could be the impact of key proposals in the Henry Tax Review.

Perhaps the most telling finding in this study is the effect of increasing longevity. We model the costs based on a three year increase in life expectancy. Even based on this conservative increase, the age pension costs for individuals will rise, with the additional cost to government focussed on lower and middle income earners. This finding underlines the importance of incorporating the cost of both the age pension and superannuation tax concessions when assessing the true cost to government of supporting our retirement income system.

INTRODUCTION

THE TAXATION TREATMENT OF SUPERANNUATION IN AUSTRALIA HAS BEEN CONTROVERSIAL FOR MANY YEARS AND SUBJECT TO NUMEROUS CHANGES.

In particular, the fairness of the taxation concessions has been raised by several commentators and organisations. For example, several submissions to the Tax Forum in October 2011[1] raised the lack of progressivity (or regressivity) in respect of the taxation treatment of concessional contributions. In addition, the annual Taxation Expenditure Statement produced by the Commonwealth Treasury shows that superannuation represents the second highest tax expenditure, after the family home.[2]

The Henry Tax Review noted this lack of progressiveness[3] but acknowledged that superannuation should continue to be taxed more favourably than other saving as the effective rate of tax on the real value of saving increases the longer the asset is held (and superannuation, by its nature, is long term saving) and superannuation is a form of deferred income. That is, people should be taxed on superannuation at the rate that would apply if their income had been spread over their entire life rather than merely over their working life.[4] It also recommended a fundamental change to the taxation of both concessional contributions and investment income as part of a major reform of the taxation of the personal income taxation system.

However, before reviewing the possible effect of these recommendations, let's take a step back and consider taxation, superannuation and Australia's retirement income system.

Taxation is normally paid by an individual at the time when they receive a financial or other form of benefit. For example:

- Income tax is paid when income is received from exertion in the workplace
- GST is paid when a good or service is purchased
- Capital gains tax is paid when an investment profit is received

In each case, the individual receives a benefit today and the level of taxation is related to the benefit received.

Superannuation is very different. The individual receives no immediate benefit when a contribution is paid into their superannuation fund by their employer. Instead the benefit is normally received by the individual in many years' time, at or during their retirement. In some cases the benefit may not even be received by the individual. For example, if the individual dies before retirement the benefit is likely to be received by their partner, children or a third party. In some of these cases, for example where the children are not financially dependent, additional taxation is paid on the benefit received by the individual's children.

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1. These submissions to the Tax Forum included those from Anglicare Australia, Australian Council of Social Service, Australian Council of Trade Unions, Brotherhood of St Laurence and Uniting Care Wesley Adelaide.
2. Treasury, Tax Expenditure Statement 2011, January 2012, page 7.
3. Australia's future tax system, Report to the Treasurer, Part Two, December 2009, p 100 .
4. ibid, p 97.

Our progressive personal income taxation system determines the level of taxation paid according to the individual's income each year and therefore their capacity to pay income tax in that year. Again, superannuation is very different. The benefit will be received by the individual in many years' time. As the Henry Report noted, the individual's capacity to pay tax in respect of their retirement benefit should not be based on their income in a single year during their working career. Several examples highlight this disconnect, including sports players who may receive high income for a few short years and many women who return to the workforce after family responsibilities. A progressive tax on concessional contributions would penalise some women who have not had a full working career but have the potential to reach the same superannuation benefit as another person who has been able to work full time throughout their career.

Such an outcome would be neither fair nor good social policy.

So what is the solution to this inconsistency between our progressive income tax system which is based on annual income and superannuation which aims to spread an individual's earned income from their working years over their total lifetime?

Many countries have adopted an EET[5] system to their taxation of funded pensions or superannuation, namely:

- Exempting contributions from taxation (sometimes up to annual limit)
- Exempting investment income received by the pension or superannuation fund
- Taxing the lump sum or pension benefit when received by the retiree

Such an approach is consistent with the earlier comment that taxation is normally paid when a benefit is received by an individual. Of course, the actual levels of taxation can be debated but the advantage of the EET system is that it considers the financial position of the individual in retirement and not their position, years or decades earlier.

The Australian system is very different. Our system has evolved into a ttt or a ttE system, where t represents taxation at a concessional rate as distinct from T which represents a full rate of taxation. The current Australian system can be described, in broad terms, as:

- Concessional taxation on concessional contributions (including employer contributions) at 15 percent
- Concessional taxation on investment income within the fund at 15 percent
- Tax exemption for benefits received after age 60 with a concessional tax treatment of benefits received between the preservation age (currently age 55) and age 60

It is apparent that this current taxation treatment of superannuation is, in effect, a flat tax system as the same tax treatment is applied to all individuals, irrespective of their income in any year or the size of their superannuation benefit. This does appear unfair and the Government is to be applauded for planning to reduce the tax on concessional contributions for low income earners.

5. These three letters stand for the tax treatment of contributions, fund investment income and benefits respectively. The letter E indicates that no tax is paid (ie. it is exempt) whereas T indicates that tax is paid at full rates relevant at that time.

The real problem is that with the ttE system, there is no opportunity to tax the superannuation benefit when it is received. But is that really the complete picture?

It is well known that the Australian retirement income system has three pillars[6]:

- The means-tested age pension, incorporating both assets and income tests
- Compulsory superannuation with an employer contribution rate of 9 percent, with the current proposal to increase it to 12 percent
- Voluntary superannuation for the self-employed and employees, subject to contribution caps that limit the level of taxation concessions

It is a well respected three pillar system (as indicated by its second placing in the 2011 Melbourne Mercer Global Pension Index) and it is therefore critical that the system is considered as a whole. Simply put, increases in superannuation provision will affect future age pension costs. If the age pension were universal and there were no means tests, different arguments would apply, but that is not the case.

One of the effects of the compulsory superannuation system will be to reduce the cost to Government of the age pension in future years. This is a very laudable purpose in the context of the ageing population and will help our future financial position when compared with most other developed countries. In effect, the means tests act as a tax on individuals who have significant assets or income in retirement, by reducing the transfer from the government that would otherwise occur. For many retirees, these assets or income have arisen from superannuation.

The purpose of this paper is to review the level of total government support received by individuals in respect of the overall retirement income system and to place the debate over superannuation taxation concessions in this much broader and holistic context.

6. The Henry Tax Review into the tax system found that "the three pillar architecture of the current system is well-suited for a balanced and flexible response to the challenges it faces and should be retained." (Australia's future tax system, Report to the Treasurer, Part Two, p 96)

A REVIEW OF THE CURRENT POSITION

MERCER'S PREVIOUS STUDY, THE FAIRNESS OF GOVERNMENT SUPPORT FOR RETIREMENT INCOME[7] STRESSED THAT THE LEVEL AND DISTRIBUTION OF TAX CONCESSIONS SHOULD NOT BE CONSIDERED IN ISOLATION. RATHER WE NEED TO CONSIDER THE TOTAL SUPPORT THAT THE GOVERNMENT PROVIDES TOWARDS THE PROVISION OF RETIREMENT INCOME.

In the previous paper we considered both individuals and couples and found that the total government support for retirement income, taking into account both superannuation tax concession and the age pension, is remarkably similar across a range of lifetime income levels.

We will concentrate on individuals here as this permits us to limit the number of comparisons and concentrate on the key findings. However, as shown in the previous Mercer paper, the findings shown in this research also apply to couples.

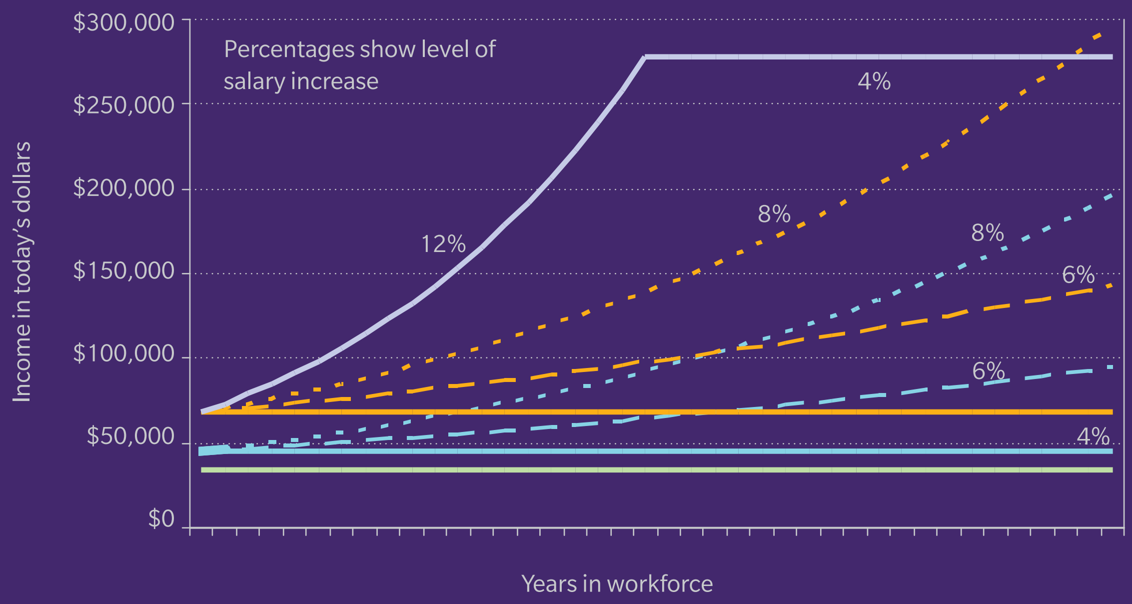
The current Superannuation Guarantee (SG) rate is 9% of ordinary time earnings. However as part of the legislation associated with the Mineral Resource Rent Tax (which has now passed the House of Representatives), the Government plans to increase the SG to 12% and to introduce a low income superannuation contribution which, in effect, removes the tax on concessional contributions for low income earners. These new developments represent the base position for this research.

THE EIGHT INDIVIDUALS

In this study we will consider eight individuals with different lifetime income experiences ranging from low to high incomes. This enables us to compare the results for these different income levels. Figure 1 shows the projected incomes during their assumed 40 years of work, expressed in today's dollars.

7. A summary of the paper can also be found in Knox, David M. 2010, The Fairness and Future of Australia's Retirement income System, Australian Economic Review, vol 43, 3, 302-311.

Figure 1: The projected incomes during each individual's working career



GREEN LINE

Represents a part-time low income earner, earning about half the average wage throughout their career, namely $34,000 in today's dollars

BLUE LINE

An initial income of $45,000 (which represents about 75% of the median income for a full time worker) with a 4% pa increase resulting in a final annual income of $45,000 in today's dollars

DASH BLUE LINE

An initial income of $45,000 with a 6% pa increase resulting in a final annual income of $94,589 in today's dollars

DOT BLUE LINE

An initial income of $45,000 with a 8% pa increase resulting in a final annual income of $196,082 in today's dollars

SOLID ORANGE LINE

An initial income of $68,000 (which represents the average ordinary earnings for a full time worker in 2011) with a 4% pa increase resulting in a final annual income of $68,000 in today's dollars

DASH ORANGE LINE

An initial income of $68,000 with a 6% pa increase resulting in a final annual income of $142,935 in today's dollars

DOT ORANGE LINE

An initial income of $68,000 with a 8% pa increase resulting in a final annual income of $296,302 in today's dollars

PURPLE LINE

An initial income of $68,000 with very high salary increases of 12% pa for the first 20 years and 4% pa thereafter, with an annual income of $277,983 from year 21 to year 40, in today's dollars

This variety of assumed lifetime incomes means the results will cover the vast majority of Australian workers. We will therefore be able to consider the fairness of the level of total government support for retirement income across all income levels. It is acknowledged that these eight individuals do not represent the typical income hump observed in many studies of lifetime income. However the importance of this study is not to compare particular individuals; rather it is the relativities between different lifetime income levels that are more important.

THE APPROACH ADOPTED

Appendix 1 outlines the approach used to value the superannuation taxation concessions received by each individual over their working lifetime. It considers the concessions available in respect of both employer contributions and investment income. It is noted that this approach concentrates on SG employer contributions and thereby ignores member contributions which could receive the government co-contribution if the individual were a low income earner.

The government-funded age pension represents a fundamental component of Australia's retirement income system. Appendix 2 outlines the assumptions used to value the cost of the age pension payments for each individual.

Of course, any longer term financial model requires a set of economic assumptions and these are outlined in Appendix 3.

THE RESULTS

TABLE 1 AND FIGURE 2 SHOW THE RESULTS FOR THE EIGHT INDIVIDUALS DESCRIBED EARLIER ASSUMING A 12% SG CONTRIBUTION RATE. TABLE 1 ALSO SHOWS THE VALUE OF THE TOTAL SUPPORT EXPRESSED AS A PERCENTAGE OF THE VALUE OF THE FULL AGE PENSION AND THE EXPECTED AGE AT WHICH PART OR FULL AGE PENSION PAYMENTS WOULD COMMENCE.

THE RESULTS ALSO HIGHLIGHT THE FOLLOWING FACTS:

- As expected, higher income individuals receive a higher level of superannuation tax concessions but are also likely to receive a lower level of age pension payments
- Similarly, those individuals who receive higher salary increases during their career receive a higher level of superannuation tax concessions but a lower level of age pension payments
- The introduction of the low income superannuation contribution improves the level of government support received by low income earners
- Many income earners who receive a full time income for 40 years are not expected to receive a full age pension until some years after age 65, if at all. This result highlights the fact that the Australian superannuation system is still maturing and that the distribution of the current age pension payments is unlikely to reflect the long term situation
- The level of total government support received by all these individuals towards their retirement income is greater than the present value of a full age pension. This is an important result as it highlights the support provided by the government to workers given that superannuation requires them to preserve a percentage of their remuneration until retirement
- The lowest level of support is received by the full time earner who receives the average wage throughout their career
- The highest level of support is received by the somewhat extreme example of an individual who doubles their salary every six years during the first half of their career. Whilst this experience is relevant to a very small number of individuals, it does not represent the experience of most high income earners
- Finally, we have shown the level of total support expressed as a percentage of income tax paid during the individual's career. Not surprisingly, this percentage reduces as lifetime income rises

The most important result is that the level of total government support provided for retirement income is almost constant across individuals, notwithstanding their different lifetime incomes. These results contradict the commonly held myth that the government support for retirement income increases as incomes rise.

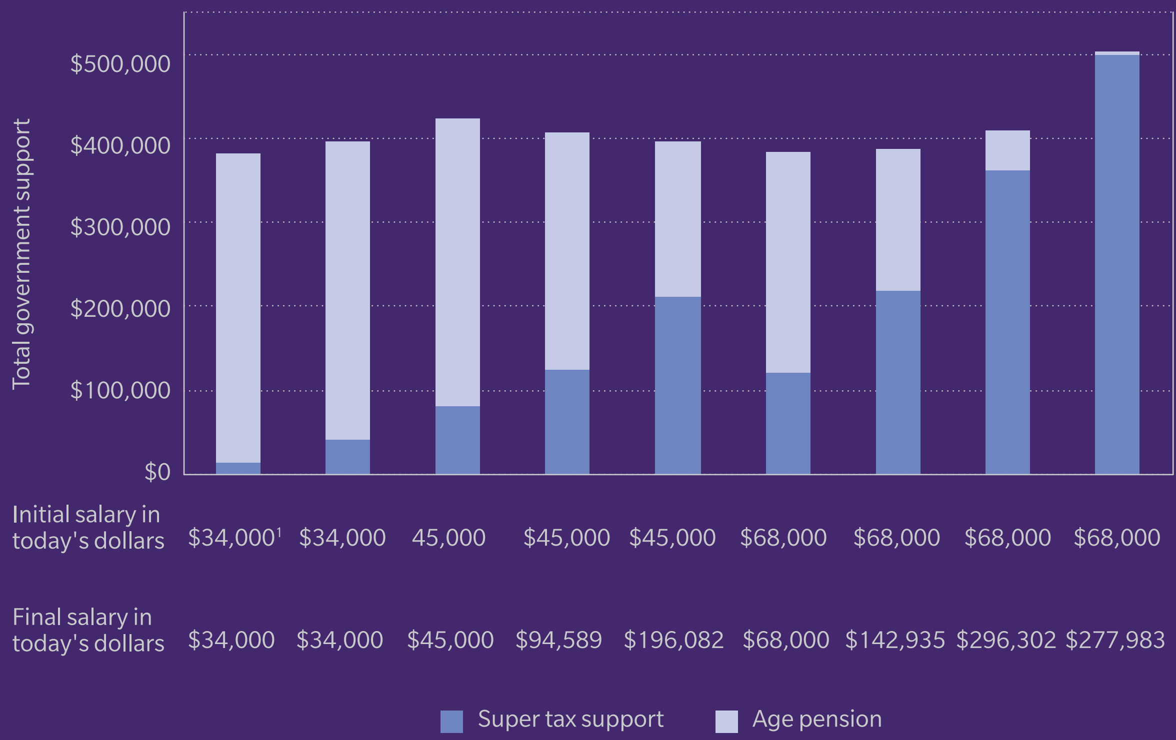
For example, the Henry Tax Review noted that "The structure of the existing tax concessions is inequitable because high-income earners benefit much more from the superannuation tax concessions than low-income earners."[8] These results confirm this finding. However superannuation forms only part of the Australian retirement income system and it is important to consider the level of total Government support across the whole retirement system and not just part of it. Indeed, as Dr Ken Henry himself noted at the Tax Forum in October 2011, "the fairness of a tax and transfer system should be assessed in respect of the incidence of the system as a whole."[9] As Dr Henry commented, it makes no sense that every tax has to be fair and equitable. Indeed such an overall approach makes no sense and would lead to inefficiency.

8. Australia's future tax system, Report to the Treasurer, Part Two, p 100.
9. www.futuretax.gov.au/content/Content.aspx?doc=TaxForum/transcripts/ken_henry.htm

Table 1: The total level of government support with the SG at 12% for different income levels

INITIAL INCOME	**$34,000[1]**	**$34,000**	**$45,000**	**$45,000**	**$45,000**	**$68,000**	**$68,000**	**$68,000**	**$68,000**
SALARY GROWTH RATE (% PA)	**4%**	**4%**	**4%**	**6%**	**8%**	**4%**	**6%**	**8%**	**12%/4%**
PRESENT VALUE OF SUPER TAX CONCESSIONS	$15,017	$40,790	$80,606	$124,295	$211,234	$121,804	$218,258	$361,483	$498,634
PRESENT VALUE OF FUTURE AGE PENSION PAYMENTS	$367,173	$356,025	$342,425	$283,249	$184,314	$262,340	$168,229	$47,667	$3,705
LEVEL OF TOTAL GOVERNMENT SUPPORT IN TODAY'S DOLLARS	$382,190	$396,815	$423,031	$407,544	$395,549	$384,144	$386,487	$409,150	$502,339
LEVEL OF TOTAL SUPPORT EXPRESSED AS A PERCENTAGE OF THE FULL AGE PENSION	103.3%	107.3%	114.4%	110.2%	106.9%	103.8%	104.5%	110.6%	135.8%
AGE AT WHICH PART PENSION COMMENCES	65	65	65	65	65	65	65	73	81
AGE AT WHICH FULL PENSION COMMENCES	70	76	79	NEVER PAID	NEVER PAID	NEVER PAID	NEVER PAID	NEVER PAID	NEVER PAID
PRESENT VALUE OF INCOME TAX PAID DURING CAREER	$184,800	$184,800	$305,400	$585,351	$1,126,059	$595,200	$1,073,733	$1,977,162	$2,996,376
LEVEL OF TOTAL SUPPORT EXPRESSED AS A PERCENTAGE OF INCOME TAX PAID	206.9%	214.7%	138.5%	69.6%	35.1%	64.5%	36.0%	20.7%	16.8%

Figure 2: The level of total government support for a single male with an SG rate of 12%



1. The first column excludes the effect of the low income superannuation contribution whereas the next column shows the effect of its introduction.

THE IMPACT OF OTHER POSSIBLE CHANGES

THIS SECTION WILL CONSIDER THE IMPACT OF THE FOLLOWING THREE CHANGES ON THE ABOVE RESULTS:

- The revised income tax scales from 1 July 2012
- Continued increases in life expectancy
- The introduction of further superannuation tax reform based on the recommendations included in the Henry Tax Review

REVISED INCOME TAX SCALES

The Government has announced some structural improvements to the personal tax system through the introduction of a higher tax free threshold which will apply from 2012–13.

The combined effect of the higher threshold and the fact that taxpayers above $80,000 will not receive a tax cut means a slight increase in the marginal tax rates for incomes below $80,000. For example, the low marginal tax rate which will now apply from $18,200 (instead of $6,000) will increase from 15% to 19%. Similarly the tax rate that applies from $37,000 to $80,000 will increase from 30% to 33%.

The effect of these higher marginal tax rates means that the value of the superannuation tax concessions for low-middle income earners will rise as the difference between the 15% tax on superannuation contributions and these individuals' marginal tax rate increases.

Table 2 shows the effect for the eight individuals described earlier.

Every individual receives increased government support although it should also be noted that there is no change in the benefits received by the individuals or the future age pension cost. The change is purely driven by the difference in tax rates.

As would be expected, the greatest increase in total support is received by those individuals who spend a higher proportion of their career with incomes below $80,000 (in today's dollars).

Table 2: The effects of the new marginal tax rates on the level of total government support

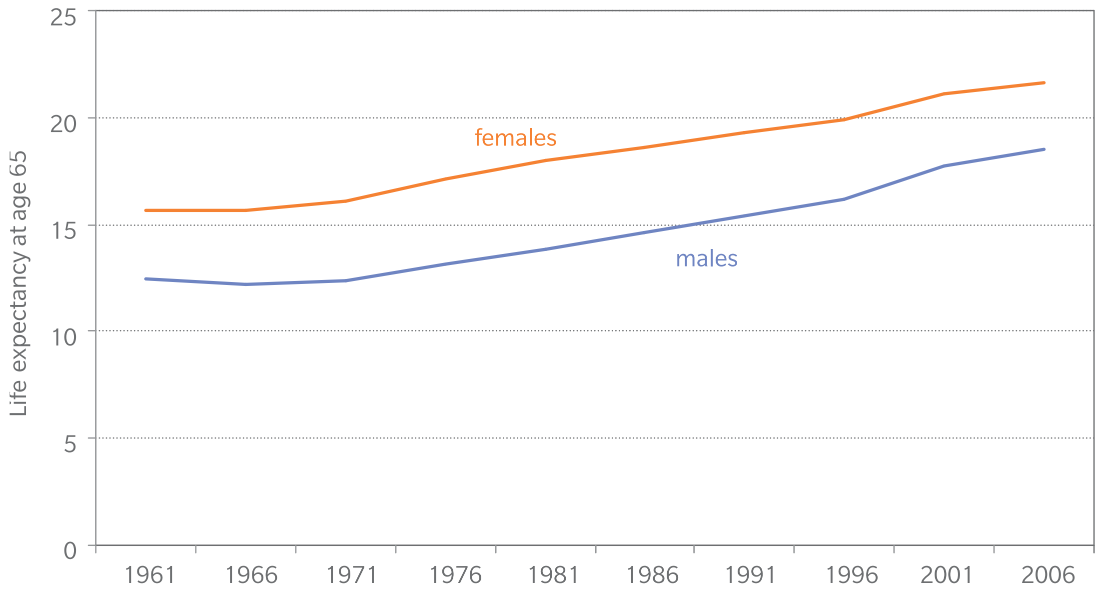
INITIAL INCOME	$34,000	$45,000	$45,000	$45,000	$68,000	$68,000	$68,000	$68,000
SALARY GROWTH RATE (% PA)	4%	4%	6%	8%	4%	6%	8%	12%/4%
LEVEL OF TOTAL SUPPORT USING TODAY'S TAX RATES[1]	$396,815	$423,031	$407,544	$395,549	$384,144	$386,487	$409,150	$502,339
LEVEL OF TOTAL SUPPORT USING 2012-13 TAX RATES	$410,103	$433,153	$416,188	$399,080	$399,439	$388,680	$410,293	$503,004
INCREASE IN DOLLARS	$13,288	$10,122	$8,644	$3,531	$15,295	$2,192	$1,144	$665
PERCENTAGE INCREASE	3.3%	2.4%	2.1%	0.9%	4.0%	0.6%	0.3%	0.1%

1 These are the same figures as shown in Table 1 but are repeated here for comparison purposes

CONTINUED INCREASES IN LIFE EXPECTANCY

The life expectancy of Australians continues to increase and this fact is particularly relevant for older Australians. Figure 3 shows the increase in life expectancies for 65 year old Australians from 1961 to 2006 based on Australian Life Tables. During the last 25 years, the life expectancy for a 65 year old has increased by 4.7 years for males and 3.6 years for females. With ongoing medical advances, it is expected that these increases in life expectancies will continue. For example, it is now expected that half the baby girls born in Australia in 2012 will live beyond age 95.

Figure 3: Life expectancies for 65 year olds



Source: Australian Life Tables 2005-07

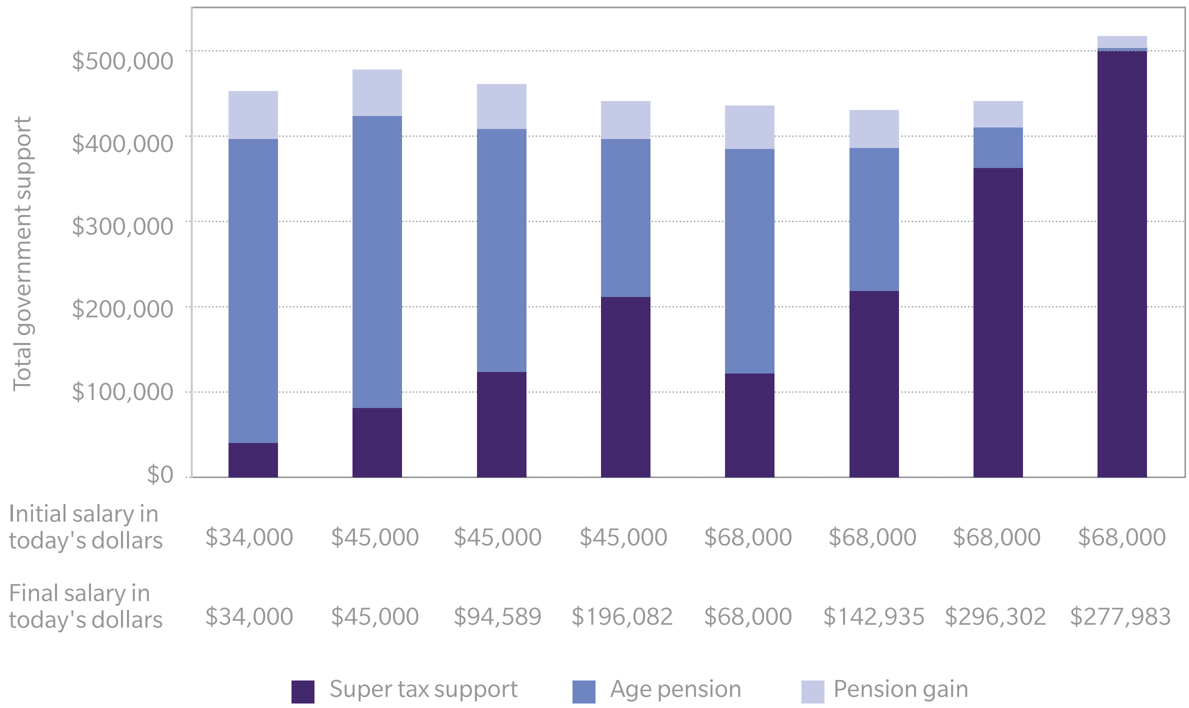
This increasing life expectancy will have an impact on the cost of Government support for retirement income, particularly age pension payments for a longer period.

To estimate the effect of this increase, we have increased the life expectancy of the eight individuals in this study by three years; a conservative figure given that it is less than the experience for both men and women over the last 25 years.

Figure 4 shows the additional cost of the extra age pension payments for each of the individuals described earlier.

These results highlight that increasing life expectancy will increase the age pension costs for all individuals but, not surprisingly, the additional cost to government will be particularly focussed on low and middle income earners. This hypothetical, but likely, outcome improves the equity across all lifetime income levels and again confirms that the level of total government support for retirement incomes is remarkably consistent across a very wide range of lifetime incomes.

Figure 4: The level of total government support for a single male with an SG rate of 12% allowing for increased life expectancy



THE HENRY TAX REVIEW PROPOSALS

The Henry Tax Review made some fundamental recommendations to change the taxation of superannuation. These include the following:

> **Recommendation 18:** The tax on superannuation contributions in the fund should be abolished. Employer superannuation contributions should be treated as income in the hands of the individual, taxed at marginal personal tax rates and receive a flat-rate refundable tax offset.
>
> a. An offset should be provided for all superannuation contributions up to an annual cap of $25,000 (indexed). The offset should be set so that the majority of taxpayers do not pay more than 15% tax on their contributions. The cap should be doubled for people aged 50 or over.
>
> … The remaining parts of Recommendation 18 do not affect the results of this research.
>
> **Recommendation 19:** The rate of tax on superannuation fund earnings should be halved to 7.5%. Superannuation funds should retain their access to imputation credits. The 7.5% tax should also apply to capital gains (without a discount) and the earnings from assets supporting superannuation income streams.

A critical component of these recommendations is to remove the tax on contributions paid by superannuation funds but to add employer contributions to the taxable income of individuals. Such a fundamental change, without other major changes to the income tax system, would immediately increase the income tax paid by most Australian workers. It is also unclear how employer contributions to defined benefit funds or unfunded Government schemes would be treated in the hands of individuals.

For the purposes of this study, we will assume the contributions tax will continue to be paid by superannuation funds but be calculated according to the individual's marginal tax rate. This approach should deliver similar equity outcomes to those sought by the Henry Review.

The Review's Report did not specify the calculation of the offset. However it did note that the majority of taxpayers should not pay more than 15% tax on their contributions. As the marginal tax rate for the average income earner is currently 31.5% (including the Medicare levy), it will be assumed that the offset will be set at 16.5% of employer contributions, thereby reducing the tax on contributions to 15% for the average income earner. It is also noted that under this arrangement a low income earner would pay no tax on employer contributions as the offset would be the same as their marginal tax rate. This effect is similar to the Government's low income superannuation contribution, discussed earlier.

Naturally the taxation of employer contributions at marginal tax rates reduces the value of the taxation concessions for higher income earners but it also increases the level of future age pension payments to these individuals due to their reduced superannuation.

The second part of Recommendation 18(a) doubles the contribution cap for those aged 50 and over. This would provide a benefit to higher income earners compared to the current arrangements.

Recommendation 19 would reduce the rate of taxation on fund investment earnings during the pre-retirement period but increase the taxation on investment earnings after retirement. The lower investment tax rate before retirement would assist all individuals to accrue their superannuation benefit at a faster rate but the introduction of tax on investment income after retirement would have the reverse effect. It is also likely to encourage many retired Australians to abandon their account-based pension accounts as the rate of tax outside superannuation may be lower. Furthermore, the introduction of taxation on the investment earnings of an account-based pension will reduce its value and therefore increase the level of age pension payments for many retired Australians.

Table 3 compares the results under the Henry proposals with the currently planned arrangements which were shown in Table 1.[10] Figure 5 shows the effects of the Henry proposals on the eight individuals discussed earlier.

The net effect is to provide a very small increase in the level of total support for low income earners whilst reducing the level of support provided to middle income earners. As expected, higher income earners would also be affected adversely although the highest income earners would continue to receive the highest level of total support.

It should also be noted that the Henry proposals would represent a substantial change and add significant complexity, if implemented within the current arrangements. It is likely that it would add significant administration costs, which have not been allowed for in this study.

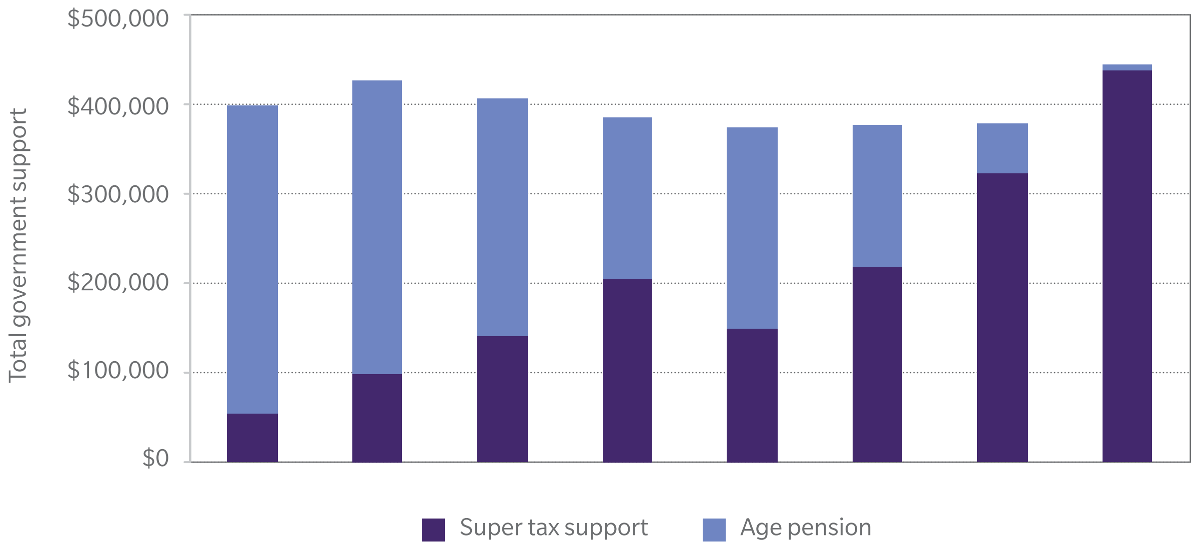
In summary, the Henry proposals would not generate a fundamental change to the overall outcomes in terms of the benefits provided or the level of total support received by individuals with different lifetime incomes. On the other hand, they would generate significant upheaval to the current arrangements and cause new equity issues concerning transition and individuals in different types of superannuation schemes.

10. For the purposes of this modelling we have assumed net tax rates (after allowing for imputation credits) of 1.3% in the pre-retirement years and 2.5% after retirement. Although the behaviour of retirees is uncertain if a tax on post-retirement investment income were to be introduced, we have continued to assume that 85% of the accumulated superannuation benefit would be rolled over into an account-based pension.

Table 3: The total level of government support with the SG at 12% for different income levels under the Henry Tax Review proposals

INITIAL INCOME	$34,000	$45,000	$45,000	$45,000	$68,000	$68,000	$68,000	$68,000
SALARY GROWTH RATE (% PA)	4%	4%	6%	8%	4%	6%	8%	12%/4%
LEVEL OF TOTAL SUPPORT, AS SHOWN IN TABLE 1	$396,815	$423,031	$407,544	$395,549	$384,144	$386,487	$409,150	$502,339
LEVEL OF TOTAL SUPPORT UNDER THE HENRY PROPOSALS	$399,110	$425,772	$406,385	$384,567	$373,984	$377,660	$378,899	$444,586
INCREASE IN DOLLARS	$2,295	$2,741	−$1,159	−$10,982	−$10,159	−$8,828	−$30,251	−$57,752
PERCENTAGE CHANGE	0.6%	0.6%	−0.3%	−2.8%	−2.6%	−2.3%	−7.4%	−11.5%

Figure 5: The level of total government support for a single male with an SG rate of 12% under the Henry proposals



CONCLUSION

THE VALUE OF SUPERANNUATION TAXATION CONCESSIONS HAS BEEN THE SUBJECT OF CONSIDERABLE DEBATE OVER MANY YEARS AND MORE RECENTLY, PROMPTED BY RELEVANT LEGISLATION BEFORE PARLIAMENT.

Within this discussion, it is misleading to ignore the impact of superannuation on the future costs of the age pension. That is, the debate about the taxation of superannuation cannot be carried on in isolation. It must recognise that increasing superannuation benefits (whether it be through higher contributions, greater investment income or taxation support) will affect the level of future age pension payments received by many individuals and couples. Such an effect cannot be ignored.

This research has confirmed that the total value of government support for most individuals with a full time working career of 40 years is approximately $400,000, based on a Superannuation Guarantee of 12% of earnings (see Figure 2). This amount is remarkably level across many patterns of lifetime earnings.

The plan to increase the SG to 12% has two important benefits. It increases the level of retirement benefits available from superannuation to future retirees whilst at the same time reducing the projected level of future age pension payments.

This research also considered the effects of the new income tax rates, increasing life expectancy and the Henry Tax Review proposals. Both the introduction of the new income tax rates and allowing for longer life spans, increase the level of total support received by low and middle income earners, relative to higher income earners.

The Henry proposals are more complex and could not be implemented without a major reform of the personal income tax and superannuation systems.

MERCER'S KEY OBSERVATIONS

- The level of total government support provided for retirement income is remarkably level across most individuals, irrespective of lifetime income, dispelling the myth that government support favours high income earners.
- Increasing life expectancy presents a real risk that reliance on the age pension will rise and points to the need to continue to encourage Australians to save more for retirement, to relieve pressure on government and to ensure a sustainable system over the longer term.
- Increasing the Superannuation Guarantee to 12% will bring two-fold benefits — both increasing the retirement savings pool and reducing the reliance on the aged pension in the future, with minimal long term cost increases to government.
- Appropriate policies and product development need to occur to create adequate post-retirement solutions for Australians so that most superannuation benefits produce a retirement income stream into the future.
- The proposals in the Henry Review will deliver little net gain, add complexity and risk eroding confidence in the system.

APPENDIX 1

VALUING THE TAXATION CONCESSIONS FOR SUPERANNUATION

Superannuation is taxed quite differently from normal income. It can be quite complex, but for most Australians all employer and salary sacrifice contributions are within the prescribed contribution caps and together with the superannuation fund's investment income, are taxed at 15% whilst benefits withdrawn after aged 60 are received tax free.

There are two main tax concessions for superannuation:

1. Employer contributions
2. Investment income

Our first calculation in valuing the tax concession is the amount of employer contributions multiplied by the difference between the individual's marginal tax rate and the 15% tax rate on concessional contributions.

Let us assume a level of employer contributions equal to 12% of earnings which represents the proposed long term Superannuation Guarantee level. Clearly, this concession is more valuable to higher income earners due to their higher marginal rates of tax, as shown in the following table.

TAXABLE INCOME	MARGINAL TAX RATE INCLUDING MEDICARE LEVY	TAX RATE ON CONCESSIONAL CONTRIBUTIONS	12% SG CONTRIBUTION	BENEFIT TO INDIVIDUAL
$25,000	16.5%	15.0%	$3,000	$54
$25,000[1]	16.5%	0.0%	$3,000	$495
$50,000	31.5%	15.0%	$6,000	$990
$75,000	31.5%	15.0%	$9,000	$1,485
$100,000	38.5%	15.0%	$12,000	$2,820
$200,000	46.5%	15.0%	$24,000	$7,560

1 This row assumes the introduction of the low income superannuation contribution.

The second tax concession relates to the investment income earned by the superannuation fund. The average tax rate paid by superannuation funds in respect of their investment income is in the order of 8% after allowing for imputation credits and concessions available in respect of capital gains. Hence, the starting point to value this concession is the difference between the individual's marginal tax rate and this 8% tax rate multiplied by the level of investment earnings received each year.

However, this approach is unrealistic as most individuals do not pay tax at their full marginal tax rate on their non-superannuation investment income. The reasons include the availability of imputation credits and capital gains tax concessions; the opportunity to invest through a lower income partner; the opportunity to invest in the tax exempt family home; and geared investment opportunities. Given these opportunities to reduce the tax on other investment income, we calculate the value of the investment tax concession as 50% of the difference between the individual's marginal tax rate and the super fund's investment tax rate, multiplied by the level of investment income earned each year, as shown in the table on the following page.

TAXABLE INCOME	LEVEL OF INVESTMENT INCOME	MARGINAL TAX RATE INCLUDING MEDICARE LEVY	ASSUMED TAX RATE ON INVESTMENT INCOME	BENEFIT TO INDIVIDUAL
$25,000	$5,000	16.5%	8.0%	$212.50
$50,000	$5,000	31.5%	8.0%	$587.50
$75,000	$5,000	31.5%	8.0%	$587.50
$100,000	$5,000	38.5%	8.0%	$762.50
$200,000	$5,000	46.5%	8.0%	$962.50

The concessions in respect of employer contributions and investment income are spread over the 40 years of an individual's working career. The total value of these concessions is then expressed in today's dollars through the use of a discount factor, which is discussed in Appendix 3.

It should be noted that no allowance is made for any tax concession in the post-retirement period. Although it is assumed that most of the superannuation benefit will be invested in an account-based pension for this period, the amount of income tax paid by most older Australians is very low due to a combination of factors including their low level of non-superannuation income, the Senior Australian Tax Offset, the presence of imputation credits and the concessions on capital gains.

Hence, the fact that the account-based pension pays no tax on its investment income almost replicates the situation that would occur if these investments were made outside the concessionally taxed superannuation environment. The more important issue for most retirees is the application of the means tests for the age pension.

The government co-contribution has been excluded from this model to keep it simple and improve understanding as this research concentrates on employer contributions only. Allowing for the co-contribution would increase the level of support received by some lower income individuals but has no effect on individuals with an income at or above $61,920 in 2011–12.

APPENDIX 2

THE AGE PENSION

The means-tested age pension represents the fundamental first pillar in Australia's retirement income system. It is subject to both an income test and an assets test with the most severe test applying to the calculation of the pension payable.

For the purposes of this research we will consider a single male[11] and assume that:

- 85% of the superannuation benefit will be rolled over into an account-based pension from age 65 — that is, 15% of the accumulated superannuation benefit will be spent immediately on retirement[12]
- The individual is age 65 when the superannuation benefit is received
- The individual is a home owner and will live for 19 years which is consistent with the life expectancy for 65 year old males shown in the latest Australian Life Tables[13] of 18.5. The corresponding female life expectancy is 21.6
- The age pension will be payable from age 65[14] subject to the means tests
- The existing income and assets tests will continue to apply in the future and the various thresholds will be indexed at 4% pa
- The individual will drawdown the minimum percentage required each year, commencing with 5% of the balance at age 65
- The retiree has no other assets or income, apart from the home, except for the higher income earners who have additional savings when the contribution cap is reached.

The value of the projected means tested age pension payments will then be expressed in today's dollars through the use of a discount factor.

11. The results for a single female will be the same except for the use of a different life expectancy number used in the income test.
12. This relatively low percentage is confirmed by the Henry Review which comments that the "evidence suggests that people make conservative decisions on how they use their assets in retirement." (Part Two, p 122).
13. Australian Government Actuary, Australian Life Tables 2005-07.
14. The Government is increasing the eligible pension age to 67 over time. However age 65 has been used in these calculations as the life expectancy figures that have been used make no allowance for any increase in life expectancy which is very likely to occur in future years.

APPENDIX 3

MODELLING ASSUMPTIONS

It should be stressed that the primary purpose of this research is to compare the relative level of government support at different lifetime income levels. It is not about projections of post-retirement income for individuals. Hence, although the assumptions are broad, they are sufficiently accurate to gauge the relative strengths of total government support for retirement income at different income levels.

The underlying assumptions used in the calculations are described below.

INVESTMENT EARNING RATE (AFTER FEES AND TAXES)

- Accumulation period (pre age 65)..7% pa
- Post retirement period..6.5% pa[15]
- Non-super savings for high income earners...5% pa

DISCOUNT RATE ....4% pa

This rate was chosen as it reflects the expected growth of average wages over the longer term, representing a combination of inflation and productivity increases.[16]

Age pension level for a single individual at December 2011 .... $19,469 pa

INCOME TAX SCALES

As applying for 2011–12 with the marginal tax thresholds indexed at 4% each year.

CONTRIBUTION CAP ON CONCESSIONAL CONTRIBUTIONS

A contribution cap of $25,000 for concessional contributions, indexed for two years from 2009–10, with the caps indexed at 4% each year in the future, but allowing for a one year indexation freeze, as announced by the Government in late 2011.

ADMINISTRATION FEES

No administration fees have been allowed as they are relatively minor and make no material difference to the comparative results between individuals.

15. Although the account-based pension pays no tax, a slightly lower rate of investment earnings has been assumed due to the higher level of conservatism adopted by many retirees

16. Discount rates of 2.5% (the midpoint of the Reserve Bank's inflation range) and 6% (the government's long term borrowing rate) are alternatives but it is considered that 4% represents a realistic rate and sits between the other two rates.

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