Institute of Actuaries of Australia

Tax-free superannuation benefits: a future revenue problem?

A paper by the Institute's Superannuation Tax Reform Task Force

Summary

Questions have been raised by Institute members and others as to the financial consequences of the Government's proposal to remove taxes on benefits paid to those over age 60.

Based on work by our Task Force, the cost of this change may be less significant than many might anticipate. The revenue from these taxes is currently less than $500m or 0.05% of GDP, and is estimated to grow to 0.33% of GDP in 2040. By contrast, contributions tax revenues are currently about $5bn or 0.5% of GDP.

This paper:

- explores the reasons why revenue from benefits tax is relatively small;
- discusses some of the problems of taxing benefits instead of contributions; and
- discusses the issue of whether benefits tax is a solution to the ageing population's revenue needs.

Please note that, on the subject of equity or fairness, the paper identifies some issues but does not attempt to follow them through in any way. The essential purpose of the paper is to explain the results of the Task Force's analysis of the long term financial consequences of the proposed removal of benefits taxes.

Our primary observations are that –

- Few retirees pay benefits taxes under the existing system;
- Tax revenue on benefits is small and would have remained small under the existing system;
- To tax benefits instead of contributions would reduce revenue indefinitely; and
- Superannuation taxes were unlikely ever to support the ageing population.

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Background

This paper has been prepared for Institute members and other parties who are interested in the revenue consequences of the proposals recently announced in the Budget (a package which effectively removed taxes on benefits paid to those over age 60). We have done so because the apparent generosity of the package has raised questions in some quarters, including among Task Force members, as to whether the proposal may compromise future revenue generation, especially in an ageing population.

As a matter of principle, the Institute has long advocated taxing superannuation benefits instead of contributions (i.e. to move taxes to the "back end"). However, in practice, the taxation of benefits has become so complex that the principle has been compromised. On this basis, the Institute has welcomed the major simplifications that emerge from the removal of the taxes on benefits.

Our Task Force, which was established last year, has been considering various alternative proposals for reform of the tax system. While the Task Force's preferred position was to tax benefits, the results of modelling work produced some surprising results which challenge the notion of taxing benefits.

1. Few Retirees Pay Benefits Taxes Under The Current System

Only a minority of retirees currently pay any tax on benefits. There are four main reasons for this.

Firstly, the average size of benefits at retirement is small. While statistics on sizes of benefits are scarce, we estimate that the current average balance at retirement is around $165,000[1] (with the median balance being $115,000). Under a mature SG system, we estimate the average balance would increase to around $320,000[2] in today's dollars. Our modelling suggests that today fewer than 10% of people would have a total balance of more then $320,000.

Secondly, the existence of the "tax free threshold", which applies to the first $135,590 on ETP's (post 1983 component), and of undeducted contributions which are not taxed, limits the quantum of taxable benefits.

Thirdly, many individuals retiring today have significant pre-1983 components of their benefits, only 5% of which are taxed.

Fourthly, the tax on income streams is further reduced by the Senior Australians' Tax Offset. An ETP of around $400,000 may never generate any income tax revenue for the Government if the recipient has followed a recontribution strategy and rolled the money over into an income stream.

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[1] Based on AMP/NATSEM results in 2003 adjusted for further contributions and subsequent investment returns.

[2] Results based on investment returns of 7% pa (after tax), deflated to today's dollars using Average Weekly Earnings growth of 4% pa

These factors illustrate why current tax revenue from benefits is relatively small.

2. Tax Revenue On Benefits Is Small and Would Have Remained Small Under The Current System

The table below illustrates that taxes on benefits are currently quite a small proportion of all superannuation taxes:

Tax Measure	**Revenue in 2006/07 (approx) Amount**	**Proportion of GDP**
Contributions Tax	$5.0bn	0.50%
Tax on Investment Return	$2.0bn	0.20%
Benefits Tax	$0.5bn	0.05%
Total Tax	$7.5bn	0.75%

Figures estimated from 2006/07 Budget figures. Approximations are required to adjust for the tax paid on contributions by life companies and to apportion contributions tax and investment tax. These figures do not include surcharge revenue.

The Government's document "A Plan to Simplify and Streamline Superannuation" states the fiscal impact of the Plan to be $1.6bn in 2006/07. Of this $1.6bn, only $500m relates to removal of benefits tax. The remainder relates to other elements of the package including the changes to age pension means tests and the impact of other changes including anticipated greater levels of salary sacrifice (reducing PAYG revenue).

It should be noted that, under the government's proposals, there will continue to be a small amount of tax revenue from people receiving benefits under the age of 60 and those receiving death and disablement benefits.

Our modelling suggests that revenue under the current system from benefits taxes is not only small today but is likely to increase very slowly in the future.

Year Ended 30 June	**Contributions Tax Propn of GDP**	**Investment Tax Propn of GDP**	**Benefits Tax Propn of GDP**	**Ratio of Benefits Tax to Contributions and Investment Tax**
2007	0.50%	0.20%	0.05%	7%
2025	0.51%	0.45%	0.19%	20%
2040	0.49%	0.59%	0.33%	31%

We can see from the table that in 2025 the revenue from benefits tax under the current system would be around 0.19% of GDP, and by 2040 would be 0.33% of GDP.

The table illustrates that benefits taxes are destined to remain much smaller than contribution and investment taxes well into the future. Currently they are just 7 % of contributions and investment taxes and it will take nearly 35 years for them to reach 30% of contributions and investment taxes.

3. To Tax Benefits Instead Of Contributions Would Actually Reduce Revenue Indefinitely

While the Institute has advocated in the past (and indeed continues to prefer) taxing benefits instead of contributions, we note that to do so would actually reduce tax revenue now and the reduction would never be recouped in the future.

As an exercise, we have considered the hypothetical situation of introducing tomorrow a different system whereby contributions are no longer taxed and benefits are taxed at marginal rates, with no transitional arrangements to acknowledge taxes already paid. We assume all benefits would be taken as income benefits in this case.

Although the average benefits for future new retirees would increase, our modelling shows that the average current level of income in retirement is likely to give rise to a tax rate of less than 6% (even before the 15% rebate). In a mature SG system, this might increase to 11%.

Hence the Government would be trading a tax of 15% on contributions for a tax on benefits of between 6% and 11%. If the contributions tax is considered a proxy for future benefits tax, then it can be argued that the contributions tax is set at a level that, in most cases, is too high to allow it to be replaced by increased benefits taxes.

***It's too late for the "magic pudding" to be undone by taxing benefits*.**

Introduction of the contributions tax in 1988 brought forward superannuation tax revenue and can be seen as the then Government's "magic pudding" for raising revenue in a manner that was at worst painless and at best unnoticed.

In practice, the above hypothetical system of taxation of benefits would, for equity reasons, need to be modified to give some credit for contributions taxes already paid (otherwise double taxation would occur).

To give a tax credit on benefits commensurate with the value of tax already paid (and not just an arbitrary rebate) would lead initially to Government revenue being negative (as the value of the 15% contributions tax is higher than most retirees' marginal tax rates). Furthermore, any credit given for "accrued tax rights", such as the pre-1983 component and the low tax threshold for existing members, would further erode the tax revenue received in the future.

Consequently, under a system where taxes on benefits replace fairly the taxes on contributions, full revenue would not be realised until today's 18 year old new entrant

into the workforce retired in 40 (or perhaps 50) years' time (i.e. when there is no-one left who has paid contributions tax or who enjoyed the "accrued tax rights"). The upshot of this delay is that the growth in revenue from moving taxes from contributions to benefits would not be available for a very long time.

In other words, the "magic pudding" of 1988 (the contributions tax), which effectively brought forward superannuation tax revenue, cannot now be undone without compromising future superannuation tax revenue.

4. Superannuation Taxes Were Unlikely Ever To Support The Ageing Population

Tax revenue on superannuation should be considered in the overall context of Government revenues and expenses. Superannuation is a relatively small part of overall revenue. The following table provides some context:

Item	**06/07 Budget**	**06/07 % of GDP**	**Projected 2041/42 % of GDP[3]**
Total C'wealth Government revenue	$232.0bn	23.0%	22.4%
Total C'wealth Government expenditure	$220.0bn	21.8%	27.4%
The social security age pension	$22.5bn	2.2%	4.6%
Health expenditure (federal only)	$39.8bn	3.9%	8.1%
Superannuation benefits tax revenue	**$0.5bn**	**0.05%**	**0.33%**
Overall Superannuation tax revenue	$7.5bn	0.75%	1.41%

This table shows that superannuation benefits taxes represent a very small part of all tax revenue (both now and 35 years hence) and overall superannuation tax revenue, while material, is and will remain a modest part of all tax revenue (now less than 1% of GDP and still less than 1.5% in 35 years' time).

It is clear from various measures introduced by the Government that increasing participation rates for older employees is the Government's primary focus for both financing additional revenue and reducing the demands of an ageing population (identified in the Intergenerational Report).

It is notable also that, when the contributions tax was introduced in 1988, the GST did not exist. Now, with or without taxes on superannuation benefits, GST revenue will be generated from the spending of the retired population (and will increase as the population ages). Hence it is possible to argue that some taxes still apply on superannuation benefits (to the extent they are spent on items that attract GST).

[3] Figures obtained from the Governments Intergeneration Report 2002-03 except for the superannuation results which are produced from Institute modelling

If growth in tax revenue is to be relied upon to fund the forecast increase in Government expenditure, then superannuation benefits taxes were only ever a small part of the answer.

Other Issues

The current benefits taxes are not effective tax policy

Economic textbooks suggest a well designed tax should be efficient (from a resource allocation perspective), equitable and administratively simple.

While the current benefits tax attempts to preserve equity, it is neither efficient nor administratively simple.

To place the benefits tax in perspective, the superannuation surcharge raised $1.0bn in 2005/06. It is possible to argue that the current benefits taxes are more costly to administer than the surcharge. Viewed from the perspective of revenue per page of legislation, the Government does not receive a very good return on its investment in the current benefits tax arrangements.

From an efficiency perspective, the current benefits tax distorts behaviour by encouraging complicated recontribution strategies and by encouraging substantial resources to be allocated to tax planning, with limited resources being allocated to more important issues such as budgeting for retirement.

Equity

Under the current system, most contributions paid by employers effectively attract tax relief at marginal rates for employees. This means that the government subsidises the 46.5% marginal rate taxpayer to the tune of 31.5% of each contribution (46.5% – 15% contributions tax). However, the 31.5% marginal rate taxpayer receives only a 16.5% subsidy after allowing for the contributions tax, those on 16.5% only a 1.5% subsidy and those with no income tax still pay 15% contributions tax. This feature of the current system is arguably inequitable in itself.

This equity question is a difficult one, especially as there are many different views as to what constitutes fair or equitable arrangements. Fairness is often in the eye of the beholder.

We note that elimination of taxes on benefits (largely paid by those on higher incomes) will make the system less equitable. It will also represent a windfall gain for some individuals, in particular those who have excess benefits under the current system (through exceeding their RBL's). Hence the transition to the new system will create some winners. It appears to create no losers.

Although much of the current complexity, especially in relation to benefits taxes, is aimed at increasing equity or fairness in the system, it often fails to do so. The complexity can itself lead to inequitable outcomes (e.g. those who cannot afford to pay for advice may pay too much tax or otherwise fail to benefit properly from the concessions offered).

The equity issue is fundamentally a question of whether the simplifications in the new system, which are radical and very substantial, create any unreasonable or unfair outcomes, either in the transition to the new arrangements or in the inherent fairness of the new arrangements themselves. Further exploration of equity issues is, however, beyond the scope of this paper.

Contacts:

Steve Schubert
Convenor
Institute of Actuaries of Australia
Superannuation and Employee Benefits Practice Committee
Ph: 0409 078 250
Email: sschubert@russell.com

Darren Wickham
Member of the
Institute of Actuaries of Australia
Superannuation Tax Reform Task Force
Ph: 02 8864 6782
Email: darren.wickham@mercer.com

The Institute of Actuaries of Australia
ABN 69 000 423 656

Level 7 Challis House 4 Martin Place
Sydney NSW Australia 2000
Telephone 02 9233 3466 Facsimile 02 9233 3446
Email: actuaries@actuaries.asn.au Web site: www.actuaries.asn.au

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