Fixing the Tax-Super Retirement Mess

Our current tax and benefit treatment of retirement incomes is a mess. It can be improved in a politically feasible way by a policy change combining the introduction of a universal (non-means tested) age pension together with restoration of taxation of super income in the pension phase, and some other tax changes.

Any policy change involves winners and losers, but a judicious choice of tax rates can mean that the only losers will be those with retirement superannuation balances currently generating tax free income in the region of $100,000 p.a and above. Squeals would be heard, but the number of squealers would be relatively small and unlikely to gain much sympathy. And the change could be near budget neutral.

Why is our current system a mess? Complexity and adverse incentives and distributional outcomes. Currently much of financial planning seems to be about structuring affairs to maximize age pension entitlements. The age pension means test and other eligibility requirements create bureaucratic nightmares and involve significant resource costs for their implementation. There are ongoing fights about the taper rate (at which other income reduces pension eligibility).

There are also ongoing debates about distributional features of the current system. Then-Treasurer Costello's introduction of a zero-tax regime for super fund earnings in the pension phase has proven misguided. The scale of the benefits to wealthy households is inequitable and has necessitated a range of complicated administrative measures to limit such benefits. Under our imputation tax system, government corporate tax revenue is cannibalized via dividends being paid to zero tax rate super funds.

What would be the effects of introducing a universal age pension (removing huge bureaucratic costs) and taxing pension-mode superannuation earnings? Ball-park figures can illustrate that this is a feasible change. For simplicity, the figures calculated below assume all retirees are treated as individuals rather than couples and initially that all non-age-pension-income is from super. The world is more complex obviously, but the calculations are designed to indicate that the proposed solution is worth considering and warranting more sophisticated modeling to incorporate those complexities.

The mechanics of the proposal involve either the shift into retirement (or reaching of retirement age), triggering (a) receipt of the full age pension and (b) the retiree's superannuation fund(s) being converted into retirement mode and earnings on the fund being included in personal income for tax purposes. Thus super fund earnings in retirement mode would go from being untaxed to being taxed as part of the individual's taxable income at the relevant rate. Retirees with additional super fund balances still in accumulation mode (being above the $1.6 million threshold) would then have earnings on those balances taxed at their personal tax rate rather than at the concessional rate. Whether automatic triggering occurs at retirement age or on announcement of retirement is a policy choice to be made after more detailed consideration of the proposal's implications. Also incorporated in the proposal in calculating budgetary effects is the removal of the Senior's Tax Offset, which would become largely irrelevant under the assumptions used here (but may need some modification when income from other than superannuation is considered).

Any calculations of the effects, based on current statistics, of the changes proposed are at best ball-park, since behavioural responses can be expected. And the benefits of those behavioural responses is part of

the rationale for the proposal. Less resources would be wasted in pre-retirement advice aimed at increasing pension eligibility, the pension application process would be markedly simplified, and assets and income tests would no longer be required. Maintenance of large balances in superannuation post retirement as tax-preferred estate planning (inconsistent with the rationale for super tax concessions) would no longer be as attractive. There would be no disincentive to save in the pre-retirement phase due to concerns about reduced pension-eligibility (although the post-retirement equality of tax treatment of super and non-super income would marginally reduce incentives for near-retirement allocation of voluntary savings into super versus other investments). How incentives to work beyond retirement age (or retire prior to pension eligibility age) would be affected would differ for different income groups and depend on details of the policy changes.

The ball-park figures used here are as follows. There are approximately 4 million people over pension eligibility age of which around 45 per cent (1.8 million) currently get the full pension of approximately $20,000, 35 per cent (1.4 million) a part pension, and 20 percent (0.8 million) no pension. The last group are ineligible since (ignoring the assets test) other income (initially assumed for both them and part pensioners to be all from super) is above approximately $50,000. The average part-pensioner is assumed to have $25,000 super income and receive $10,000 of pension. (The effect on the calculations of retirees having non-super income is considered later).

If a universal pension were introduced, earnings of super funds in the pension mode were taxed at current individual tax rates, and the seniors tax offset (which means no tax is generally payable below income of $35,00) is removed, the following would result. First existing full pensioners would be generally unaffected. The average part-pensioner (currently receiving $10,000 pension and $25,000 tax free super income, ie $35,000 after tax) would now receive $20,000 pension giving a total income of $45,000 which would be subject to tax. At the current tax scales (after removing the Senior's Tax Offset scheme), tax would be around $6,000 giving increased after-tax income of $39,000 (a $4,000 increase).

For those just at the pension cut-off level (having $50,000 tax free super income), the combination of now receiving the full pension and having income taxed would result in them having an increase in after tax income from $50,000 to around $56,500 (a $6,500 increase). For a non-pensioner with $70,000 tax free super income, the net result would be virtually no change in after tax income since tax payments now required would be roughly the same as the age pension income now received). Those with higher super income would be worse off.

But could the government budget afford such a change? Yes – particularly with a few tweaks to the tax rates.

Extra pension payments would be in the order of $30 billion p.a. This reflects the 1.4 million part pensioners getting an extra $10,000 p.a. on average ($14 billion in total) and the 0.8 million non-pensioners getting $20,000 p.a. each ($16 billion in total).

But tax revenue could increase by around $21 billion assuming half of non-pensioners had around $700,000 in super in pension mode generating (at an earnings rate of around 7 per cent p.a.) an annual income of $50,000 p.a. (just missing out on a part pension) and the rest having an average of $1 million generating income of $70,000 p.a. Current non-pensioners would pay tax of around $13 billion, and part pensioners' contributions would be around $8 billion).

That is a shortfall of $9 billion - more if super income of those in retirement mode is less than assumed. One reason is that the changes (under the numbers used here) lead to current part pensioners, and those just above the part pension eligibility level, having higher after-tax incomes (approximately $5.9 billion and $2.6 billion in total respectively). Tax scale, and other, changes which kept after tax incomes for those groups unchanged could rectify the imbalance in the budget calculations.

What difference does it make if the income of part-pensioners and self-funded (non-pensioner) retirees is outside of super? Assume that it all is – since this will give the alternative polar extreme, with reality somewhere in between the two sets of calculations.

First, current full – pensioners are unaffected as before. Second, the effect on the average part pensioner is the same as before, Their taxable income of $35,000 ($10,000 pension and $25,000 other income) involved zero tax due to the Senior's Tax Offset. They now have pre-tax income of $45,000 (due to the additional $10,000 pension) and (in the absence of the Senior's Tax Offset) pay around $6,000 tax, leaving them around $4,000 better off.

Third, however, the current non-pensioners having taxable rather than currently non-taxable super income would be significantly better off (without other changes to the tax scales). The marginal (borderline) non-pensioner with pre-tax income of $50,000 would have had after-tax income of around $46,000. After the policy change, the after tax income increases to just over $56,000 with the $20,000 increase in pension income not being fully offset by the removal of the Seniors Tax Offset. For the non-pensioner with $70,000 pre tax income, the changes mean an increase in after tax income of around $10,500.

These greater benefits to current non-pensioners together with the part-pensioner benefits (around $15 billion in aggregate) of course make the budget implications more severe. The $30 billion additional pension payments are only offset by around $15 billion additional tax revenue. But again, this could be offset by appropriate changes to tax scales etc which make current part – and non-pensioners no worse off and raise the required sum to balance the budget implications.

Of course, nothing is this simple. Consequences and incentives for early retirement need consideration, as does more detailed analysis of the importance of non-super versus super income in retirement. There are bound to be particular groups within the part-pensioner category where the analysis here based on an "average" part-pensioner hides particular complications. Tax arbitrage involving imputation credits could foul the figures – suggesting at least a need to revisit and remove the rebates for unused tax credits. Under this proposal, that shouldn't be a deal-breaker for most retirees, but probably would meet opposition from those in accumulation mode (and other low tax rate investors).

But the proposal, if radical, appears feasible and has the potential to reduce much of the bureaucracy and costs associated with age pension administration and tax complexity and regulations regarding superannuation. Rather than fiddling at the edges, consideration of wholesale reform is warranted.

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3 February 2020