Is superannuation really taxed concessionally?

The state of the nation's superannuation savings creates debate on many levels, not least the fact that the government taxes this pool of money three times. **DAVID KNOX** provides some compelling evidence showing that government taxes are a disincentive to national savings.

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In recent years, there has been considerable public debate about the taxation of superannuation in Australia. The discussion has many facets, including the controversial surcharge, the three points of superannuation taxation and the suggestion that the taxation support for superannuation is biased towards high-income earners.

However, one key question that remains unresolved is the extent to which the taxation treatment makes superannuation an attractive proposition for the average Australian, when compared to other forms of personal investments. The government claims that this concessional treatment is designed to encourage Australians to set aside income during their working lives to help fund their retirement. But does this incentive really exist?

The comparison

This article will compare the benefits arising from employer contributions to superannuation with personal investments from after-tax income. This comparison represents the same cost for the employer in each case (superannuation contributions or salary) and may be considered to be comparing salary-sacrifice into superannuation with other investments.

Two alternative investments will be considered. The first option represents a fixed interest investment where the interest income is fully taxed while the second option represents a balanced investment fund with the same investment allocation as the superannuation fund, comprising Australian and overseas equities and fixed-interest securities.

The initial results

Superannuation is often promoted as an attractive investment as the tax rate on employer contributions is only 15%, compared to marginal tax rates ranging from 17% to 47%, plus the Medicare levy. Furthermore, the subsequent investment income from superannuation is also taxed at 15%. On the surface, such comparisons suggest that superannuation has real tax advantages.

Table 1, which excludes any taxation on the final superannuation benefit, shows the relative advantage of superannuation for a range of investment periods. For the comparisons, it is assumed that the superannuation contributions or investments are made each year and that these payments increase by 5% pa. Furthermore, it is assumed that each benefit is received as a lump-sum payment at the end of the period.

The superannuation benefits are significantly greater than the benefits that arise from the other two investment options, particularly for those with marginal tax rates of 30% or higher. In all cases, the advantage increases over time due to the compounding effects.

However, it is also noted that at the lowest marginal income tax rate, the advantage of superannuation over a balanced fund is marginal. This result is not surprising as the contributions tax is only slightly below the lowest marginal tax rate.

It is important to note that all investments (superannuation, fixed interest and the balanced fund) are assumed to earn 7% pa before tax. This assumption means that the differences in the final outcomes are driven by taxation only. For the purposes of this exercise, fees are ignored.

Table 1 also shows that the advantage over the balanced fund is less than the fixed interest option due to the effect of imputation credits and lower capital gains tax rates, received by both the superannuation fund and the balanced fund.

Table 1 deliberately ignores the 15% tax that is payable on lump sum superannuation benefits in respect of post-83 service, when the total benefit exceeds $117,576 in 2003-04.

While all superannuation fund members will receive this tax-free benefit on the first portion of their lump sum benefit, it is also appropriate to compare the advantage of superannuation after allowing for the 15% tax plus Medicare levy on lump sum benefits above this threshold. Table 2 shows these results. Of course, in practice, a portion of an individual's lump sum superannuation benefit will be subject to no benefits tax (Table 1), with the balance subject to this tax (Table 2).

As expected, the advantage of superannuation decreases under this scenario. In fact, for low-income earners, superannuation is now a disadvantaged form of savings. On the other hand, many low-income earners will not reach this benefit threshold so that Table 1 remains most appropriate for them.

The results in Tables 1 and 2 are consistent with recent results produced by George Rothman from the Retirement and Income Modelling Unit in the Department of Treasury.

A significant difference

A major difference between superannuation and alternative forms of investment, which is often forgotten in comparisons, is that superannuation must be preserved to at least age 55 (increasing to age 60 in the future). That is, superannuation fund members do not have immediate access to their funds. This lack of access should be factored into any realistic comparison from the individual's perspective.

The value of accessing investments (or the cost of the lack of access for superannuation) will vary between individuals and there is no single approach that can be used to calculate this difference definitively.

However, we may consider that the inability to access (or use) our superannuation throughout the period of investment could be offset if the final superannuation benefit were increased by 0.5% or 1% for each year of preservation.

This would mean that we would require the superannuation benefit to be 10.5% (at 0.5% pa) or 22.0% (at1% pa) higher after 20 years to have equivalent value to an investment that was accessible throughout the period of the investment.

In other words, an individual would place equal value (or utility) on the

TABLE 1 THE SUPERANNUATION ADVANTAGE WITH NO TAXATION ON BENEFITS

	Advantage over fixed interest				Advantage over balanced fund			
Marginal tax rate	17%	30%	47%	47%+S[1]	17%	30%	47%	47%+S[1]
Period of contributions								
5	6.5%	29.5%	77.2%	45.9%	4.7%	27.2%	73.7%	43.1%
10	8.7%	35.1%	90.1%	56.6%	5.2%	30.4%	82.9%	50.6%
20	13.4%	47.3%	119.0%	80.3%	6.1%	37.2%	102.9%	67.1%
30	18.6%	60.9%	152.3%	107.8%	7.1%	44.6%	125.5%	85.7%

1 In these cases, the surcharge is payable, thereby reducing the advantage of superannuation.

TABLE 2 THE SUPERANNUATION ADVANTAGE ALLOWING FOR TAXATION ON BENEFITS

	Advantage over fixed interest				Advantage over balanced fund			
Marginal tax rate	17%	30%	47%	47%+S	17%	30%	47%	47%+S
Period of contributions								
5	–11.1%	8.1%	47.9%	21.8%	–12.5%	6.2%	45.1%	19.5%
10	–9.2%	12.8%	58.7%	30.7%	–12.2%	8.9%	52.7%	25.8%
20	–5.3%	23.0%	82.8%	50.6%	–11.4%	14.5%	69.4%	39.5%
30	–1.0%	34.3%	110.7%	73.5%	–10.6%	20.7%	88.3%	55.0%

TABLE 3 THE SUPERANNUATION ADVANTAGE ALLOWING FOR ALL TAXES AND 0.5% PA FOR THE LACK OF ACCESSIBILITY OF SUPERANNUATION[1]

	Advantage over fixed interest				Advantage over balanced fund			
Marginal tax rate	17%	30%	47%	47%+S	17%	30%	47%	47%+S
Period of contributions								
5	–13.3%	5.4%	44.3%	18.8%	–14.7%	3.6%	41.5%	16.5%
10	–13.7%	7.3%	51.0%	24.4%	–16.4%	3.6%	45.3%	19.6%
20	–14.3%	11.3%	65.5%	36.3%	–19.8%	3.7%	53.3%	26.3%
30	–14.8%	15.7%	81.4%	49.4%	–23.0%	3.9%	62.1%	33.5%

1 As an example of the calculation, the 8.1% advantage that superannuation has over fixed interest over five years for the 30% marginal rate taxpayer is reduced by $(1.005)^5$ in Table 3. Hence an 8.1% advantage becomes a 5.4% advantage as $1.081/(1.055)^5 = 1.054$.

TABLE 4 **THE SUPERANNUATION ADVANTAGE ALLOWING FOR ALL TAXES AND 1% PA FOR THE LACK OF ACCESSIBILITY OF SUPERANNUATION**

	Advantage over fixed interest				Advantage over balanced fund			
Marginal tax rate	17%	30%	47%	47%+S	17%	30%	47%	47%+S
Period of contributions								
5	–15.4%	2.8%	40.7%	15.9%	–16.8%	1.0%	38.0%	13.7%
10	–17.8%	2.1%	43.7%	18.3%	–20.5%	–1.4%	38.2%	13.8%
20	–22.4%	0.8%	49.9%	23.4%	–27.4%	–6.1%	38.8%	14.3%
30	–26.6%	–0.3%	56.3%	28.7%	–33.6%	–10.4%	39.7%	15.0%

two investments, with the higher superannuation benefit required to offset the lack of access, as well as the risks associated with a possible change of superannuation rules during the preservation period.

In Tables 3 and 4, the figures from Table 2 have been adjusted to reflect this cost of preservation by discounting the value of the final superannuation benefit by 0.5% or 1% per year. Tables 3 and 4 also allow for the tax on benefits above the threshold.

The impact of this change for the average Australian worker with a marginal tax rate of 30% is profound. While superannuation retains a 16% advantage over a fixed interest investment over 30 years using the 0.5% pa discount, this advantage almost disappears when the balanced fund is compared.

Furthermore, if the 1% pa discount is used (and this is not an excessive discount rate for the value of access), superannuation is now disadvantaged when compared to both alternatives.

These tables also show that superannuation is not attractive for those subject to the lowest marginal tax rate but remains attractive for higher income earners.

CONCLUSION

Superannuation is often promoted as being an attractive form of long-term saving due to its concessional tax treatment. However, these comparisons are often misleading due to the omission of the lump sump tax payable when a benefit exceeds the lump sum threshold and/or any allowance for the "loss of value" represented by the preservation requirements of superannuation.

This research has shown that when allowing for the benefits tax and making some reasonable allowance for preservation, superannuation does not represent an attractive form of long-term savings for Australians subject to low or average tax rates.