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TAX AND SUPER — UNFINISHED BUSINESS

The Henry Review acknowledges the adverse-selection and supply-side problems stunting the Australian market for longevity insurance. We propose a resolution that would give workers a choice between either or both of two kinds of super account, one taxed under the current arrangements (or those proposed in the Henry Review) and the other only in retirement and at the marginal rate of the retiree. The new accounts would be reserved for the purchase of lifetime annuities.[1]

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The *Review of Australia's Future Tax System* (known as the Henry Review) reported to the Government in December 2009 (AFTS 2010a, 2010b, 2010c) and proposed taxing employer and employee contributions progressively while halving the 15 per cent tax on investment earnings.[2] The Government's main response thus far involves lifting the headline compulsory contribution rate from 9 to 12 per cent of wages, by 2020.[3] This would eventually go a long way towards rectifying the continuing inadequacy of most superannuation balances at retirement.[4]

Neither the Henry Review nor the Government comes up with a solution to the adverse-selection problems that stunt the Australian market for longevity insurance.[5] In this paper we propose a solution involving workers having a choice between either or both of two kinds of super account, one of which would be reserved for the purchase of lifetime annuities.

In the next two sections we briefly outline the evolution of the tax and transfer arrangements for superannuation and retirement benefits. We then discuss the recommendations of the Henry Review as it applies to superannuation and summarise the minimal response by government. Overall, the Henry Review proposals, if implemented, would improve the equity and reduce the complexity of the superannuation system as well as improving the supply side of Australia's life annuity market. We conclude with a proposal for superannuation taxation, based on the US experience, which allows choice of front or back-end taxation of retirement saving and provides a mechanism to revive the demand side of Australia's life annuity market.

Evolution of superannuation taxes

As at end 2009, Australian superannuation was taxed under a comprehensive income tax regime (TTE). Superannuation contributions were subject to tax (T) at different rates depending the source or quantum of the contributions, superannuation fund earnings were subject to tax (T) at different rates by type of income, and superannuation benefits (and fund earnings in specified circumstances) were free of tax (E) for persons aged 60 and above.

Earlier arrangements involved an expenditure tax regime prior to 1988 (EET, where contributions and superannuation fund earnings were exempt from tax and benefits taxed) and a hybrid regime between 1988 and 2007 (TTT, where contributions, fund earnings and benefits were all taxed, albeit at concessional rates). The TTE regime has applied since July 2007.[6]

The taxation of superannuation has long been criticised on the grounds of its complexity and inequity. These criticisms were highlighted in the many submissions to the *Review*

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of Australia's Future Tax System (AFTS) and were emphasised in preliminary recommendations of the Henry Review panel (AFTS 2009b).

The lack of alignment of superannuation taxes with the personal income tax system had resulted in the flat rate superannuation tax rates becoming more regressive, as they had failed to benefit from the substantial falls in personal income tax rates over the previous two decades. As well, the reduced visibility of superannuation taxes as compared with personal income taxes has jeopardised the political insulation offered by private retirement income provision.[7]

The failed market for life annuities[8]

Mandatory retirement saving has not been accompanied by mandatory retirement benefit purchase requirements, and the tax-transfer treatment of retirement benefits has, through changes over several decades, become neutral across alternative benefit types.

Throughout the 1980s and early 1990s, tax-transfer reforms were introduced to encourage lifetime annuities. Measures included tax exemption for income on the underlying assets; offering a 15 per cent tax rebate which, when compared with the 15 per cent tax then imposed on lump sums, gave a 30 per cent advantage to life annuity purchases;[9] and a doubling of the retirement accumulation eligible for tax concessions (known as the reasonable benefit limit) as compared with lump sums. Life annuities were later afforded concessional treatment under the age pension income and assets tests.

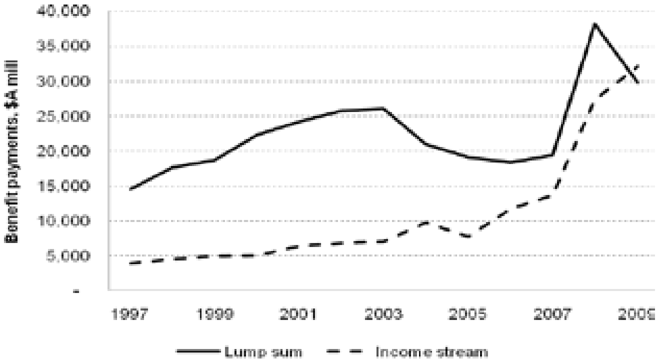
However, almost as soon as they were introduced, these tax-transfer incentives were progressively extended to non-longevity insured products, including phased withdrawals (allocated pensions) from 1994, life expectancy term annuities from 1998, term allocated pensions in 2004 and transition to retirement pensions in 2005. The Simpler Super reforms of 2006–07 resulted in the removal of all tax-transfer preference by benefit type (Australian Treasury 2006).

This withdrawal of tax-transfer preference for life annuities, coupled with adverse selection resulting from the small and voluntary nature of the life annuity market in Australia, has resulted in almost no demand for life annuities. Supply-side constraints, such as a lack of products to hedge the long-term liabilities and uncertainty surrounding mortality risk, has led to a reluctance of providers to promote life annuities as a retirement benefit option (Purcal 2006).

As a result, few Australian retirees are covered for longevity risk by virtue of their private retirement saving. Figures 1 (lump sum v retirement income streams) and 2 (alternative income stream products) summarise trends in the take-up of retirement income products.

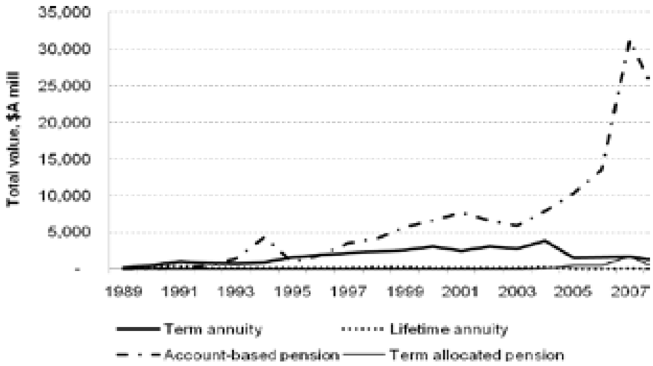
A number of trends are evident. One is the switch in preference from lump sums to retirement income streams, with a sharp increase in the demand for phased withdrawal-type products (allocated pensions, account-based pensions and transition to retirement pensions). A second is the growth in, and then decline of, the market for term annuities, and finally, the disappearance of the market for life annuities.

FIGURE 1: *Value of retirement benefits – lump sum and income stream, 1997–2009*



Source: APRA (2007, 2010).

FIGURE 2: *Value of private retirement income streams, 1989–2009*



Note: Account-based pensions include transition to retirement pensions. Account-based pensions were previously known as allocated pensions.

Source: Plan for Life Research (2010).

As Figure 2 illustrates, the market for phased withdrawal alternatives expanded rapidly from the mid-2000s. Two factors were responsible. One was the introduction of the 'Transition to retirement' legislation of 2005 which allows, and provided tax benefits to, individuals over 55 years to simultaneously contribute to a superannuation fund, continue to work, and draw down benefits taken as an income stream. The second was the Simpler Super reforms of 2006–07 (Australian Treasury 2006) which abolished taxes on all retirement benefits taken after age 60, and exempted tax on the underlying assets of retirement income streams that satisfied minimum age-based drawdown requirements. As a result, there were incentives to keep retirement assets in the superannuation system. This translated into a rapid increase in the demand for account-based pensions.

TABLE 1: *Patterns of annuity purchase in Australia: 2001–10*

	Term certain annuities (without RCV)		Term certain annuities (with RCV)		Lifetime annuities	
Year	**No.**	**Average value ($A)**	**No.**	**Average value ($A)**	**No.**	**Average value ($A)**
2001	11,072	71,677	19,725	82,798	1,927	86,227
2002	15,004	73,065	20,326	93,296	1,750	88,349
2003	18,606	72,893	12,530	107,925	1,477	135,674
2004	37,296	73,951	9,159	116,731	2,801	99,886
2005	7,233	75,746	7,664	114,307	293	93,072
2006	6,566	80,810	7,187	131,588	341	88,446
2007	7,355	107,353	6,010	145,749	403	92,184
2008	999	110,951	5,496	182,997	61	195,082
2009	685	110,657	3,517	185,036	29	203,793
2010*	283	115,194	893	205,622	19	68,421

**Note: Data for 2010 covers the year to the end of March only.*

Source: Plan for Life Research (2010), Immediate Annuity Report, March 2010.

The small market for life annuities, which had emerged in the 1980s, reached its peak after the introduction of the age pension means test incentives in 1990. Life annuities then held a small niche in the retirement product marketplace until 2004, when their exemption under the assets test was cut to 50 per cent. However, after the removal of benefits taxation to retirees over the age of 60 in 2007, all incentives towards life annuities ceased, other than for those retiring before 60. Between 2007 and 2008, the market declined by 90 per cent in value, and by two-thirds in the number of sales. A similar pattern is seen for term annuities. The disappearance of Australia's life annuity market is illustrated in Table 1. Of 32,722 immediate annuity policies sold in 2001, 1,927 were life annuities. By 2009 only 29 life annuity policies were sold out of a total of 4,202 immediate annuity policies.

The Henry Review on superannuation taxes

In its preliminary report on strategic issues, the Henry Review panel made, *inter alia*, two important observations: first, that the access and take-up of superannuation tax concessions was uneven, with low-income earners receiving little or no personal income tax benefit compared to substantial tax concessions for high-income earners; and second, that there were insufficient products to insure against a person outliving their assets (AFTS 2009a, 2000b). In response, the panel recommended:

> maintaining tax assistance to superannuation but improving the fairness of concessions for contributions, including broadening access to superannuation tax concessions and limiting access to generous salary-sacrifice; and

> improving the ability of people to use their superannuation to manage longevity risk.

In its final report, the Henry Review proposed taxing employer and employee contributions progressively while halving the 15 per cent tax on investment earnings.[10] The review envisages a rate scale for taxing contributions set at an offset to the marginal rate faced by the worker on her personal income. The rate of the offset for a worker on the 'standard' marginal tax rate would be set at a level that resulted in her effective tax rate on contributions remaining at 15 per cent. The review floats 20 per cent as a possible value for the offset.

The review proposes that the compulsory contribution rate be raised from the current effective rate of (1 - 0.15) x 9 = 7.65 per cent to the current headline rate of 9 per cent. This would be achieved by abolishing the tax on superannuation contributions in the fund. Instead, employer contributions would be taxed at the personal income tax rate less the offset.

There would be a new uniform tax of 7.5 per cent on the investment income and capital gains of superannuation assets before retirement. The tax would also fall on 'assets supporting income streams', notwithstanding a term of reference stipulating the continuation of tax-free retirement benefits to those aged at least 60.[11] The resulting regime would be more progressive overall than the present one but less progressive than the personal income tax, owing to the 7.5 per cent flat tax on fund earnings before and after retirement.

Overall, the Henry Review proposes a Ttt regime for the taxation of superannuation, resulting in an improvement in the equity of the superannuation arrangements.

The Review notes the unpopularity of lifetime annuities in Australia and the supply-side constraints facing providers. It reports persuasive evidence that adverse selection is a major problem here. Other problems reported include unduly restrictive rules for providers of life annuities, ongoing increases in longevity, and an incomplete market for long-term securities in Australia. The review floats the possibility of government-provided lifetime annuities (Evans and Sherris 2010).

The Government's response

The Australian Government has issued a document (Australian Treasury 2010) providing an interim response to the Henry Review. It proposes a phased lift in the headline compulsory contribution rate from 9 per cent to 12 per cent of wages and salaries (not recommended by the Henry Review). In line with the review, the Superannuation Guarantee age limit would be raised from 70 to 75. From July 1 2012, a new superannuation contribution of up to $500 (non-indexed) is proposed to be made by the Government on behalf of workers with incomes up to $37,000, in accordance with the concerns of the review over the comparative lack of tax concessions available to the low paid. The idea is to return, in effect, the tax on Superannuation Guarantee contributions made to funds used by the lowly paid. Changes to employer contribution limits, linked to super account balance size, are also mooted.

However, neither the Government's response to the Henry tax review nor to the Harmer pension review (see Harmer 2009, Australian Treasury 2009) advocated a reintroduction of the tax-transfer incentives for lifetime annuity purchase. The overall Government response is disappointing. The Government did not address the inequities in the super taxes nor has it made concrete recommendations to revive the dormant market for life annuities.

Lessons from North America[12]

The United States has evolved a system for taxing superannuation which is settled, reasonably straightforward, and generally perceived as fair. It appears to avoid inordinate tax expenditures. It ensures sizeable revenue streams to government both in the near term and in two to three decades' time. It promotes labour force participation by the elderly, facilitates the needs of fast trackers, and eases members of badly performed plans into a low tax bracket in retirement. It promotes voluntary contributions. In 2009 Canada emulated key features of the US system.

We do not say that Australia should copy all aspects of the US system. Notably, the United States has thus far failed to enact compulsory pre-funded super of the Superannuation Guarantee variety, with the result that about half of the US workforce is not covered by pre-funded super. But a tweak of the US model (including its optionality characteristic) could resolve the adverse selection problem bedevilling our market for life annuities.

US 401(k) plans are EET defined contribution vehicles for retirement saving by employees. The plans involve employer sponsorship; employers can contribute at up to half the rate of employees. Distributions received after age 59½ are generally taxed at the investor's marginal rate, and can take the form of periodic equal-sized drawdowns apportioned in line with average life expectancy. Tax-deferred individual retirement saving

The overall government response is disappointing. The Government did not address the inequities in the super taxes nor has it made concrete recommendations to revive the dormant market for life annuities.

takes place through Individual Retirement Accounts (IRAs), which do not require employer sponsorship, and are generally used as supplements to 401(k)s. Contributions to traditional IRAs come from after-tax income, but are generally deductible from federal income tax. Hence the tax efficiency of IRAs is the same as that of 401(k)s. These back-end-taxed vehicles quickly became a staple source of tax deductions for wage-earners in the upper half of the income distribution, rather as negative gearing has become common for Australian wage-earners in the top two tax brackets for personal incomes. In 1998 the United States introduced the Roth IRA alongside the standard IRA. These vehicles are taxed under a pre-paid expenditure tax regime (TEE); contributions come out of your after-tax income but are tax free thereafter. Only if your marginal tax rate in retirement is the same as your rate at the time you contribute will the tax efficiency of the two kinds of IRA be the same. Yet members of pension plans do not rely exclusively on standard IRAs. One reason is that a minority anticipates that their marginal tax rate in retirement will exceed their rate at the time of contribution into a pension fund. Another is that there are annual limits on what can be contributed to tax-favoured savings plans. Because contributions to Roth plans are taxed before they are counted towards the global limit, Roth plans give high-income earners an opportunity to squeeze more into tax-favoured savings plans. Roth 401(k)s were introduced in 2006. Like standard IRAs they are employment related. Like Roth IRAs, tax is paid at the point of contribution rather than in retirement. Currently around 31 per cent of American households have traditional IRAs and around 15 per cent have Roth IRAs (Internal Revenue Service 2010; Investment Company Institute 2010).

We propose an Australian version of this differential approach (i.e. back-end and front-end taxed arrangements operating simultaneously) that would be introduced by initially restrictive contribution limits, to moderate short-term tax expenditures. Over time, we envisage more generous limits with the result that back-end-taxed accounts would eventually become Australia's primary vehicle for superannuation, as in the United States. At retirement, and in contrast to the United States, these accounts would be reserved for life annuities, which could be either offered by insurance companies (at preset prices) or tightly regulated tontines. These life annuities could be either fixed or variable. We suggest that variable annuities allocate no more than 50 per cent of their portfolio to growth assets. This cap would mitigate the moral hazard problem for taxpayers of unlucky investors with risky allocations who end up falling back on the age pension.[13]

We envisage that Australia's existing TTE (or the Ttt proposed in the Henry Review) super accounts would eventually come to play an analogous secondary role in the Australian system. Contribution limits would gradually be tightened so as to limit tax expenditures while progressively working towards a system in which the new EET accounts would hold most super assets. Investors in these new accounts would be rewarded with a middle E rather than a middle T (or t) to compensate them for loss of the age pension along with the liquidity advantages of retirement benefits in the form of lump sums, as they would be required to purchase lifetime annuities.

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Conclusion

The Henry Review proposes to replace the pre-existing 15 per cent tax on employer contributions with a three-step scale. It flags zero, 15 and 30 per cent as one possible set of rates. It proposes replacing the 15 per cent tax on fund earnings by one of 7.5 per cent. This flat rate would also apply to 'assets supporting income streams'.

The Government responded with what is, in effect, a two-step scale with rates on contributions set at zero and 15 per cent. Thus far it leaves undisturbed the pre-existing 15 per cent tax on earnings and the zero tax on fund benefits. The Government also announced a plan to raise the compulsory contribution rate from 9 to 12 per cent by 2020.

Combined with other recommendations, both the Henry Review and the Government response address equity concerns over superannuation taxes while neglecting efficiency concerns. In the case of the Henry Review, this neglect is at odds with its close attention to efficiency concerns in the design of taxes on personal and business incomes. Both sets of proposals hark back to the superannuation surcharge regime that was introduced in 1996 and abolished in 2005.[14]

We propose a hybrid of front-end and back-end taxes on superannuation, based on the successful hybrid regime for IRAs and 401(k)s in the United States. Our suggested Australian version addresses efficiency concerns as well as equity ones. Longevity risk, premature retirement, inadequate voluntary contributions, deficient risk sharing[15] and moral hazard[16] would be addressed. Our proposal also makes provision for people who would prefer simply to stick with their pre-existing tax arrangements. ■

Notes

1. We would like to thank the Australian Research Council for financial support. Kevin Davis made constructive comments on an earlier draft of this article.
2. Capital gains are currently taxed at 10 per cent rather than 15 per cent. Interest income is effectively taxed at more than 15 per cent whenever inflation is positive, as recognised by the Henry Review (AFTS 2010a, 2010b, 2010c) and Sorenson and Johnson (2009).
3. The Government also came up with what is in effect a two-step scale for taxes on employer contributions, setting rates at zero and 15 per cent (Australian Treasury 2010).
4. Strictly speaking, this is not a zero tax rate. It is framed as a 15 per cent contribution towards tax paid on concessional contributions up to a maximum of $500 per annum (non-indexed), and will therefore lose its impact over time.
5. Although the Final Report on Australia's Future Tax System (AFTS 2010a, 2010b, 2010c) does advocate policies to address the lack of longevity products through supply-side measures including: requiring that the government issue long term securities and through public provision of immediate and deferred annuity products (Evans and Sherris 2010).
6. Following the introduction of Simpler Superannuation announced in the 2006–07 Budget (Australian Treasury 2006).
7. See Bateman and Kingston (2007).
8. The material in this section is drawn from Bateman and Piggott, forthcoming in 2011.
9. However, the treatment of the principal repayment component of life annuities purchased with tax-preferred accumulations nullified this advantage (Bateman, Kingston and Piggott 1993).
10. Capital gains are currently taxed at 10 per cent rather than 15 per cent. Interest income is effectively taxed at more than 15 per cent whenever inflation is positive, as recognised by the Henry Review (AFTS 2010a, 2010b, 2010c) and Sorenson and Johnson (2009).
11. Strictly speaking, there are some taxes on super benefits paid to the over-60s, in particular, on shortfalls in age-dependent minimum annual drawdowns from allocated pensions, death benefits paid to non-dependents out of pre-tax contributions, and retirement benefits from untaxed funds. See Bateman and Kingston (2007).

12. This section's explanation of the US system draws on Kingston (2006).
13. As recently as 2008 we suffered this problem yet it has been disregarded by the Henry Review and the Government's response.
14. The initial version of the surcharge saw employer contributions taxed at rates between 15 per cent and 30 per cent.
15. This arises from the interaction between investment risk and the absence of progressive back-end taxes.
16. This arises from the interaction between comparatively high advice fees applicable to risky assets and the presence of a safety net in the form of the age pension.

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