

REPORT OF SENATE SELECT COMMITTEE ON SUPERANNUATION AND STANDARDS OF LIVING IN RETIREMENT: ANALYSIS AND REVIEW

Jocelyn Horne
jhorne@efs.mq.edu.au

Abstract

This paper examines and assesses the Report of the Senate Select Committee on Superannuation and Standards of Living in Retirement of an inquiry into “the adequacy of the tax arrangements for superannuation and related policy to address the retirement income and aged and health care needs of Australians”. Two criteria are used in the assessment. First, do the proposed measures address effectively the key issues of concern? Second, do the measures find strong support from economic principles, in particular those relating to tax reform? The main conclusion reached is that the recommendations, including the central proposal for removal of multi-stage taxation on superannuation will address only partially the problem of a projected adequacy gap and other weaknesses of Australia’s retirement income system. While the proposed measures generally meet the first three tax criteria, a major shortcoming is the absence of estimates of their short and long-run fiscal impact.

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Introduction

The Report of the Senate Select Committee on Superannuation and Standards of Living in Retirement is the outcome of a long-awaited and timely investigation of Australia's retirement income system, in particular relating to tax arrangements in terms of meeting policy objectives. The Report is comprehensive in scope: 16 main recommendations cover the adequacy gap, equity and tax concessions, health and income support as well as simplification of superannuation. The inquiry is underpinned by 152 submissions from industry groups, government bodies, academics and observers.

This paper discusses and assesses critically the main recommendations based upon two sets of criteria. First, do the proposed measures address effectively the key issues of concern? Second, do the measures find strong support from economic principles, in particular those relating to tax reform?

The background to the inquiry lies in major changes to Australia's retirement income system that have taken place in the past few decades, especially the introduction of mandatory superannuation under the Superannuation Guarantee Act in 1992 and a scaling-down of tax concessions to superannuation. The overall policy objective of the system is stated in the Treasury submission ... "to enable Australians to achieve a higher standard of living in retirement than would be possible from the publicly funded age pension alone" (Report, p.10). The ratio of age pension benefits to male gross average weekly earnings is presently maintained at 25 percent and thereby sets a minimum floor to income replacement. However, the government has not announced a target ratio or other measure that would set a ceiling for retirement income adequacy.

Neither the main body of submissions nor the Report call for a major restructuring of Australia's retirement income system. The structure of Australia's system follows that of other industrial countries and is made up of three pillars that are differentiated by financing source and membership restrictions, the latter based upon income and employment criteria. The first pillar is made up of the aged pension and related benefits which are restricted to individuals who satisfy asset and income means tests. This pillar is intended to provide a minimum level of

safety net support financed from Commonwealth government revenue. A second tier comes from employment-linked compulsory superannuation introduced under the Superannuation Guarantee Act in 1992. This tier is financed from employer and employee contributions while the third pillar includes retirement income of individuals financed from voluntary retirement savings. Savings from the second and third tiers receive tax concessions provided specified work criteria are met.

What is at issue is not the pros and cons of the introduction of mandatory superannuation nor providing a safety net for the most vulnerable nor allowing some form of tax concessions to encourage superannuation and retirement saving. Instead, the impetus for the inquiry comes from concerns by stakeholders (community, industry and government) about the complexity of present tax rules and administrative arrangements for superannuation and whether the existing regulatory policy framework that covers the SG, tax concessions and superannuation funds will meet adequacy objectives. As discussed below, these objectives are not clear-cut, whether interpreted in terms of individuals' expectations and retirement needs or an unspecified policy target. These concerns have been heightened by the increased level of uncertainty and risk of highly volatile equity markets and confidence crises triggered by recent collapses in Australia's insurance sector.

The core recommendations focus on measures to address an adequacy gap defined as the gap between projected replacement income under unchanged policies and a target ratio. The focus is on the role of tax policy as stated in the terms-of-reference, namely to investigate "the adequacy of the tax arrangements for superannuation and related policy to address the retirement income and aged and health care needs of Australians" (Report, p. v).

Policy concern with determining the appropriate level of retirement savings may be questioned on theoretical grounds. The notion of a retirement income adequacy gap does not sit well with neoclassical economic theory based upon assumptions about forward-looking individuals whose savings decisions optimize lifetime income. Nor does it accord with portfolio theory based upon the assumption of constant relative risk that sets the retirement consumption floor to zero (see Bateman and others, 2003). The literature on tax policy also suggests an uncertain and weak impact of taxes on savings incentives. Nevertheless, a case may be argued for the existence of an adequacy gap and role for government intervention in the presence of market failure such as savings myopia. While tax policy is arguably a weak savings instrument, one advantage is that it lies directly within government control.

The inclusion of aged and health care needs in the terms-of-reference also deserves comment. Its inclusion may be justified by the close linkages between the

social welfare, health and income retirement systems, especially from a fiscal policy perspective. Reforms in each area, including the introduction of mandatory superannuation have been driven in part by a projected rise in government expenditures on health and the age pension due to population aging. However, health reform raises complex issues that are independent of retirement incomes policy. In the event, relatively little attention is paid to health care in the submissions and Report. In contrast, the issue of integration of social welfare and income retirement systems receives dominant attention. The latter issue has potentially significant implications for income adequacy and fiscal sustainability because the majority of low and middle-income Australian workers are expected to qualify for at least partial income support from the age pension even under full implementation of the SG.

Restated, the reform issues confronting the Senate inquiry do not involve a radical restructuring of the retirement income system. Rather, the focus is centred upon its effective workings and linkages between its components. Broadly interpreted, the policy issue is whether greater or less government intervention in superannuation is desirable, whether through taxation or other policies such as raising the SG or regulating retail fund fees. And at what cost or benefit to stakeholders?

The specific issues addressed in the Report uncover a mix of expected and unexpected concerns. The expected key issue is a projected adequacy gap and designing appropriate tax measures to reduce or eliminate it. The specific tax issue centres upon the perceived adverse impact on savings incentives resulting from Australia's three stage tax system that levies taxes at each stage of transactions (contributions, fund income, benefits). The inquiry also highlights several unexpected issues in terms of their potential significance for the future working of the system and adequacy impact. These issues involve the desirability of loosening or eliminating the employment-superannuation nexus and the efficiency and performance of superannuation funds.

The remainder of the paper discusses the Report and the above issues in more detail. Section II discusses the economic principles of tax reform and specific reform issues facing the inquiry. The structure follows that of the Report and is divided into four main areas of reform; the adequacy gap, equity of tax arrangements for superannuation, integration of the social welfare and retirement income systems and simplicity of superannuation. Section III provides an overall assessment of the recommendations and concluding comments.

II. Principles of tax reform and reform issues

This section discusses first the main principles behind tax reform and their relevance for the inquiry. The discussion also examines the specific issues identified in the inquiry and the effectiveness with which the proposed measures address them and their economic rationale.

Tax reform principles

A well recognised set of economic principles underpin tax reform relating primarily to efficiency, equity, administrative complexity and revenue impact. Even when the economic basis for tax reform appears soundly based, the overall set of recommendations involve balancing policy tradeoffs between conflicting effects on the above criteria. Such effects may be difficult to identify and quantify for reasons discussed below.

One limitation of this approach deserves emphasis at the outset and concerns the high weight attached to equity by policymakers in the superannuation debate as reflected in the structure and focus of the Report. The problem is not the high weight but that neoclassical economic theory based upon Pareto optimality has little to say in guiding equity issues beyond the compensation principle. The principle is that the gainers compensate the losers so the latter group are no worse off after the reform. This principle is difficult to implement because of the need to identify and quantify the impact of reforms on gainers and losers. Nevertheless, the principle does indicate the general direction of analysing the equity impact of reform measures, namely identifying the different types of equity concerns (vertical, horizontal and intergenerational) and respective gainers and losers in each area pre and post-reform.

Efficiency

Efficiency of resource allocation is a well established principle in guiding tax reform. In the case of savings, efficiency has a dual dimension, static and dynamic; the first involves a within-period choice between work and leisure while the second entails intertemporal choice between present and future consumption..

The above issue is central to the debate because of the violation of static and dynamic efficiency that results from the three stage taxation of superannuation. The presumption in the literature and reflected in the submissions and the Report recommendation for its replacement by taxation of end-benefits is that a single tax levied at the benefits stage is unambiguously superior on efficiency criteria. The reason is that it approximates a progressive expenditure tax on savings and thereby eliminates the savings distortions created by income taxes. An expenditure tax

avoids this form of inefficiency. But in common with income taxes, an expenditure tax also creates static inefficiency by distorting the work/leisure choice. The superiority of one system over the other will depend upon the relative magnitudes of tax elasticities with empirical work offering little guidelines (see King, 1980).

Equity

Standard equity criteria distinguish between within and inter-generational equity. The first involves vertical (redistribution between different income groups) and horizontal equity (equal treatment of individuals in similar income groups). Inter-generational issues are also relevant in the superannuation debate because of equity issues that arise between workers and retirees. The latter concern is a major factor driving recent reforms such as the SG with the intention of shifting financing sources from general revenues borne primarily by workers to self-financing by retirees.

The majority of submissions and literature on tax arrangements for superannuation in Australia focus on within generation equity issues. In particular, contributors argue that tax arrangements violate both vertical and horizontal criteria; the first through tax support including salary sacrifice given to high-income earners even allowing for restrictions on benefits such as the surcharge and reasonable benefit limits. Horizontal equity may be violated through the differential tax treatment of contributions such as between self-employed and employed and between employed and unemployed. Attention has also been directed towards the inequitable treatment of women under the SG who tend to be characterized by interrupted work patterns, low incomes and high life expectancies compared to men.

The strength of some of the above arguments may be questioned, for example, the perceived inequitable treatment of women (see McDiarmid, 1994). Nevertheless, the central issue in regard to within generation equity is whether further modifications are needed to existing mechanism and, more generally the need for rationalization of these restrictions.

The issue of inter-generational equity has attracted correspondingly less attention in the debate. However, one emerging problem is brought to the attention of the Committee concerning the unintended equity and savings distortions impact of the differential tax treatment of income stream products. A retiree may receive a partial age pension and concessional tax pension income with a resulting post-tax retirement income well above that of average income earners.

Tax administration

The overwhelming perception of industry groups and community surveys is that tax arrangements for superannuation are too complex. One dimension of simplicity is clarity in terms of what is being taxed and what is not and an understanding of the benefits and costs to individuals. Survey evidence on superannuation (see ASFA, 1999) show that one of the main concerns of taxpayers is the complexity of tax rules. The same survey also indicates a concern with the notion of taxing superannuation which suggests a lack of understanding of the benefits to individuals from superannuation tax concessions for most income brackets. A further dimension of simplicity is the cost-effectiveness of the tax system as measured by compliance costs of regulations such as the surcharge and the ratio of the administration costs of taxing superannuation relative to revenue raised.

Revenue impact

Quantifying the revenue impact of tax reform of superannuation is critical for two reasons. First, as noted earlier, fiscal pressures on the age pension from an aging population is a major impetus behind recent reforms, including the SG and a scaling-down of tax concessions. The scenarios presented in the Report demonstrate that even with the SG, the majority of low and middle-income wage earners will rely in retirement on partial income support financed from government revenues. A second reason for quantifying the revenue impact is to obtain policy support for implementation of tax reforms in response to the inevitable question: “how much will this cost the budget?”

There has been considerable debate on the appropriate methodology for measuring the fiscal costs or benefits of tax concessions to superannuation (see Knox, 1992; Brown, 1993). The Treasury adopts a tax expenditure approach (TES) based upon a revenue foregone concept relative to a chosen benchmark. In the case of Australia, the benchmark adopted is an income tax system and revenue foregone is measured by the tax payable if the concession were removed. According to this methodology, tax concessions to superannuation are estimated to impose a net cost to the Commonwealth budget, averaging 3 percent of GDP over the past decade. Using this approach, a given reform such as removal of the contributions tax has an adverse revenue impact roughly equal to the annual revenue contribution from this tax to superannuation tax revenue.

The problem is that the above methodology is flawed because it ignores the intertemporal nature of superannuation. As a result, annual TES estimates may give a misleading picture of both the sign and size of the revenue impact of tax concessions to superannuation. Setting aside the fundamental issue of choice of

the benchmark system, such estimates may overstate the revenue costs of removing tax concessions because they exclude the potential strengthening of the revenue base from increased savings incentives. There may also be reduced pressure on budget expenditures from lower spending on age pensions on account of increased private savings. An alternative methodology uses the RIM model that allows for changes in savings behaviour and suggests a net policy benefit from tax concessions to superannuation, its size dependent on the assumed offset between superannuation and private savings (see Brown, 1993). Under the second methodology, removing the contributions tax strengthens long-term revenue although it may have a short-term adverse impact.

Specific reform issues

The above general principles need to be considered within the context of the specific reform areas covered by the inquiry. In identifying the key issues of the inquiry, the discussion follows the structure of the Report. The Report focuses upon four areas of reform: (1) income adequacy under the present retirement income system; (2) equity and tax concessions; (3) integration of superannuation with the social security system and (4) complexity of administrative and tax arrangements for superannuation. The main recommendations in these areas are summarized in the Appendix.

1. Retirement income adequacy

a. Key adequacy issues

Adequacy of retirement income raises three key issues. First, what is an appropriate definition and operational measure of the concept of retirement income adequacy for policy purposes? Second, does an adequacy gap exist and what are the factors influencing the size of the gap? Third, what measures, especially tax might be implemented to close the gap and what are their relative benefits and costs using the above criteria?

(1) Definition and measurement of income adequacy

The question of designing appropriate benchmarks of adequacy is of policy concern. Neither the cited academic submission by Knox (Report, p.10) nor the industry submissions offer much insight into this issue beyond noting that the preferred definition and measure is the ratio of gross or net retirement income or expenditure to earnings and that the appropriate ratio lies within a broad range of 40-80 percent (as measured by gross income) depending on income group and individual situation.

Even if a pragmatic approach of using replacement income or expenditure is adopted, there remains an element of subjectivity in distinguishing between the needs and desires of individuals and a likely gap between the two concepts. This problem is well-known to financial planners who focus on needs in contrast to their clients whose behaviour is influenced by desires. In the Report, the problem of unrealistic expectations is not addressed directly. Instead, it is assumed that the adequacy gap is the difference between a projected replacement ratio (the outcome of savings behaviour) and a chosen benchmark (a target of 60-65 percent of gross pre-retirement average earnings (or 75-80 percent of late working life consumption)).

All recommendations for closing the adequacy gap are conditional on both the assumed benchmark and the set of specific assumptions that underpin the projections of adequacy of retirement income under unchanged policies. This qualification deserves much greater emphasis throughout the Report.

(ii) Adequacy gap

A second issue is whether an adequacy gap exists and the factors influencing its size. Projections from the RIM model indicate an adequacy gap of around 20-30 percent of replacement income. However, as revealed by the subsequent discussion, there is considerable disagreement about some of the key RIM assumptions, especially that concerning a full 40 years work pattern under the SG and the use of the CPI indexation measure. The complexity of the RIM model also limits its policy usefulness.

Overall, specific assumptions such as uninterrupted work patterns and over-optimistic estimates of fund earnings suggest that the RIM model tends to understate the size of the adequacy gap. The resulting bias reinforces the policy thrust of the Report and emphasis on measures to close the adequacy gap.

The treatment in the Report of the factors driving the adequacy gap is uneven. Considerable attention is devoted to two factors, choice of appropriate indexation measures and impact of fund fees. But almost no discussion is given to the issue of whether taxation exerts a significant impact on savings incentives. On the contrary, the Report assumes this is the case despite a considerable body of literature that highlights a high degree of uncertainty about the size of relevant savings coefficients.

(iii) Other adequacy issues

Two further issues receive attention in the Report; the impact on adequacy of high fees charged by superannuation funds and the situation facing baby-boomers. On

the first issue, much attention is given to the negative impact on retirement savings from high fees levied on retail funds and whether a cap on fees and charges is desirable. In regard to the second issue, the situation facing baby-boomers is recognised as a transitional one since this group is prevented from benefiting from full implementation of the SG as assumed in the modelling exercises. The policy issue is whether additional measures are warranted in addition to those recommended to close the adequacy gap.

b. Recommendations to address adequacy

The main recommendations to address the adequacy gap include the following: two recommendations dealing with the issue of identifying and measuring adequacy (para.2.19; para.2.75), non-tax measures to close the adequacy gap (para.3.4; para 6.46) and tax measures directed towards adequacy, equity and simplicity (see below).

The first recommendation is for a stated government target of retirement income adequacy but begs the question of what is an appropriate benchmark. It is unclear whether setting a single target or target range would be helpful since the key message that emerges from the discussion is that a single target or even range is undesirable because of differing needs of income groups and, within such groups, individual circumstances. This also means that existing policy instruments such as the SG for dealing with adequacy concerns are blunt-edged tools although the Report does not support a proposal for setting differential SG rates.

The second recommendation calls for greater coordination of stakeholders in modeling retirement income and signals a well-founded concern about the lack of interaction between the RIM modelers and industry “stakeholders”. This recommendation is timely. However, given the concern expressed with recouping RIM modeling costs, it would also be desirable to set an appropriate fee structure that encourages further participation of academics in this area. A critical stakeholder, namely the general community is also ignored. This issue could be addressed by opening up the debate through a designated website that encourages community input and greater transparency of RIM and other modeling exercises.

The main non-tax measures recommended to close the adequacy gap involve a broadening of the SG coverage through greater flexibility of work-related rules, including extension to self-employed individuals, removing threshold earnings criteria and work tests for voluntary contributions for those under 75 and extension of qualifying superannuation income stream products. Even when combined, the total impact of these measures on closing the adequacy gap is likely to be small but there are other benefits such as improving equity and simplifying tax administration. The measures also increase the range of tax preferences with a

resulting short and long-run revenue effect. Their potential fiscal impact is not examined.

In regard to the issue of regulation of fund fees and charges, the Committee resists the temptation to recommend direct capping and instead proposes greater disclosure. This recommendation is appropriate because the underlying issue is not fund fees per se but the competitiveness of super funds and the effectiveness of their management structure. Further research in this area would be desirable. No direct recommendation is made to improve the lot of baby boomers with reference made to the introduction of the tax offset (SATO) for this purpose although its quantitative effect on income adequacy may be questioned.

2. Equity and tax concessions

a. Key issues

A fundamental issue for tax reform of superannuation is the appropriate benchmark for measuring the initial level of tax concessions to superannuation. Specific issues concern the adverse impact on equity and other tax criteria of the three stage tax system and other perceived weaknesses of present measures to address equity concerns, including the surcharge and restrictions on annual and whole-of-life benefits from tax concessions.

(i) Choice of benchmark

The choice of benchmark, whether income or expenditure-based has different implications for measuring the degree of tax concessions. The problem is further compounded by the fact that quantitative measures exist using the income approach but not the expenditure approach, at least for Australia. Based upon the income approach, taxation of superannuation is estimated to be concessionary, providing a tax subsidy per dollar that ranges from a few cents for low income groups (those with a marginal tax rate of 17-18 percent) to 30 percent for middle to upper middle income groups. At an aggregate level, the tax expenditure statement shows the annual foregone revenue to be equivalent to Commonwealth spending on health or almost 6 percent of age pension outlays. In contrast, an expenditure-based approach suggests superannuation yields a negative tax subsidy because of tax layering at the three transactions stages.

Resolution of the above issue is fundamental since it is difficult if not impossible to make a case for reform or estimate its impact unless there is consensus on the initial starting point, both qualitatively and quantitatively. Having acknowledged this point, it is also realistic to accept that this issue is unlikely to be resolved, at least in the foreseeable future. Hence, the assumption that underpins the Report,

submissions and government policy that superannuation is a tax preferred instrument is a realistic one bowing to pragmatic concerns.

(ii) Specific tax issues

A specific tax issue concerns the effectiveness of the main tax instruments for superannuation and case for reform based upon equity and other tax criteria. These instruments include primarily the three stage tax system together with specific equity instruments of annual age-based contribution limits, RBLs and the superannuation surcharge.

The Report provides a comprehensive survey (pp. 80-87) of the main economic issues raised by the three stage tax system. The efficiency argument is represented in the ASFA submission (p. 80) that a shift from the post-1988 system to an expenditure-based tax system is more efficient than one that taxes savings. The equity argument is put forward by ASFA (p. 83) that a shift to benefits would help promote equity between individuals because it closer approximates individual circumstances. ABA (p. 80) makes the simplicity case that the new system would avoid the present complexity involved in administration and understanding the three stage tax system. The revenue implications of the proposed removal of the contributions tax are discussed by Fitzgerald (p. 84) and ABA (p. 85). Both submissions concur that the long-term or present-value revenue effect is likely to be positive although there may be an initial negative impact. However, while Fitzgerald avoids giving an estimate of fiscal costs, ABA estimates the net annual revenue loss to be only about one quarter of present tax expenditure estimates although the basis for this estimate is unclear.

A number of tax instruments including annual age-based contribution limits, RBLs and the income surcharge are designed to address equity issues. Hence, the issue is whether they achieve their desired effects and their accompanying costs. The surcharge on high-income earners has attracted dominant attention because of its unintended adverse equity impact for defined benefits funds and the burden placed on funds of administering the levy and resulting spreading of compliance and administrative costs to all fund members.

b. Recommendations to address equity and tax concessions

The central recommendation is the gradual replacement of the superannuation contributions tax by a tax on end-benefits (para. 8.33). Other main recommendations call for the removal of maximum deductible contribution limits accompanied by the retention of the RBL but with limits to indexation and the gradual removal of the surcharge. It is also recommended that administration of the surcharge be shifted from superannuation funds to the ATO and a surcharge

cap be implemented for members of private sector defined benefit funds (para. 9.29).

Overall, the combined economic case for the central proposal for replacing front-end taxes by a back-end or benefits tax is qualitatively strong. However, it lacks quantitative support, especially in terms of the likely impact on efficiency and savings incentives and revenue. The proposed rationalisation of existing tax instruments to address equity concerns will help simplify the system but its impact on administrative costs is unclear.

3. Integration of social welfare and superannuation

a. Key issues

Integration issues relating to social welfare and superannuation are of a fundamental and specific nature. A fundamental issue is whether there is a problem of fiscal sustainability of the projected retirement income system under unchanged policies. A second set of issues concern leakages between the age pension and superannuation.

(i) Fiscal sustainability

Data presented on p.139 of the Report show that Commonwealth government expenditure on social welfare is projected to rise from 6.85 percent of GDP in 2001-2 to 7.38 percent in 2041-2. This projection takes into account an almost doubling of the age pension ratio from 2.93 to 4.59 percent of GDP even under full operation of the SG. Such an outcome reflects population aging and continued reliance on the pension for low and middle-income earners. According to the discussion (p.139), a single male earning 1.5 times the average weekly wage who retires at 65 after 40 years of work would still draw 82 percent of the age pension.

A disappointing feature of the Report is that it fails to explore further the issue of fiscal sustainability of Australia's retirement income system which is closely linked to the projection of increased expenditures on social welfare and health associated with an aging population. Instead, the dominant share of attention is devoted to specific integration issues as discussed below.

(ii) Leakages and savings distortions

The main leakages social welfare and superannuation lie in the distortions to savings behaviour that result from tax and social security rules, in particular in the areas of the age pension and means testing, double-dipping and differentiated tax treatment of income stream products.

Present setting of the asset test for the age pension (\$140,000-\$280,000) falls within the range projected for individuals on average earnings under full SG operation. An incentive exists to dissipate savings since individuals who have saved end up with assets that equal in present value terms the discounted income of the age pension (currently around \$200,000). Despite tax incentives to shift preferences towards income stream products, some scope for superannuation dissipation after early retirement and subsequent access to the age pension (double-dipping) remains. The differentiated tax and social security treatment of allocated pensions and complying annuities also create distortions to savings incentives.

b. Recommendations to address integration

The key recommendations to address integration issues are para. 12.104 which proposes standardisation of rules for income streams, para.12.67 for exploring options to encourage older workers to remain in the work force past superannuation preservation age and para. 12.115 which proposes consideration of reverse home mortgages.

Recommendation 12.115 is the most innovative as it involves consideration of the option of using housing equity to finance retirement expenditures, including health and aged care. However, the main message of the discussion is that while the concept of reverse mortgages and its implications for income adequacy are worth examining, the mechanisms for achieving it in Australia are not yet fully developed and need further research.

4. Simplicity of superannuation system

a. Key issues

There is broad agreement in the community and the superannuation industry that the superannuation system and related tax arrangements are unduly complex, thereby creating uncertainty and potential disincentives to save for retirement. Specific concerns lie in the complexity of transition arrangements for grandfathering and rigidities introduced by various work-related rules on voluntary contributions.

The Report fully concurs with the perception of complexity and provides a detailed analysis of the four main areas of concern; the legislative and regulation framework, grandfathering, work tests and education. However, what is missing from the discussion is any attempt to provide empirical support for the claim that administrative complexity increases compliance costs and reduces voluntary contributions. A further weakness is the absence of data on the cost-effectiveness

of tax administration of superannuation in terms of the ratio of costs to revenue raised and a comparison of this ratio with other taxes.

In terms of specific issues raised, the complexity of transitional arrangements for grandfathering of entitlements pre and post 1983 tax reforms and that of various work-related restrictions on voluntary contributions deserve particular attention. To some degree, the employment-superannuation linkage has already been eroded by recent changes that allow spouse contributions and superannuation splitting under family law. The policy tradeoffs involve balancing possible short-term revenue losses from extending tax concessions to voluntary contributions that are not based on work rules against increased adequacy and equity.

b. Recommendations to address complexity

Two general recommendations are made for simplifying the superannuation system: the first recommends more resources be directed to government agencies involved in retirement policy implementation (para. 13.52) and the second calls for better education to help understand the superannuation system (para. 13.55). Elsewhere, the Report supports the removal of the work test for voluntary contributions for individuals under 75 (para. 3.41) but does not recommend the removal of grandfathering arrangements.

When combined with other tax recommendations, these measures will help reduce the complexity of the present system. The recommendations for greater government resources might be better framed as urging a more efficient use of existing education resources that are targeted to life-cycle income and savings issues facing different age cohorts. These initiatives would also help address the problem of savings myopia and the building of unrealistic expectations about future retirement income that underpins adequacy concerns.

III. Overall assessment and concluding comments

The two sets of criteria are adopted in the preceding analysis to assess the Senate Report and its recommendations. First, whether they address effectively the key issues of reform of Australia's retirement income system and second, whether the proposed measures are supported by economic principles.

The inquiry reveals expected and unexpected key issues. The expected critical issue is the projected gap in adequacy of retirement income facing the majority of Australians under the present system with full implementation of the SG and tax concessions. Unexpected key issues involve the scope and desirability of loosening the employment-superannuation nexus and the case for further regulation of the superannuation funds sector.

In regard to proposed measures to address the adequacy gap, reform of three stage taxes on superannuation dominates the agenda. The specific problem is that the imposition of taxes at three stages of transactions (contributions, fund income, benefits) exercise an adverse impact on dynamic efficiency, create vertical inequity and increase administrative complexity. The Report's central recommendation for a shift to a benefits-tax would move the tax system closer to the ideal expenditure tax benchmark and follows the majority of industry-dominated submissions.

While this recommendation meets the above assessment criteria, two qualifications may be made. First, the efficiency case for an expenditure tax on saving is ambiguous once allowance is made static inefficiency created by the failure to tax leisure. Nevertheless, there may be other economic grounds such as equity and administrative simplicity to justify this reform. The second qualification concerns the fiscal impact of strengthening tax concessions to superannuation. A major weakness of the Report is that this recommendation is not accompanied by a quantified assessment of its short and long-run fiscal impact

The Report also makes a number of proposals to address key weaknesses in equity and administration of the superannuation system as well as its integration with social welfare. In regard to equity concerns, the proposed measures are directed towards rationalizing tax rules on restricting benefits. Such measures will help address vertical and horizontal inequity and simplify the system. However, while the emphasis of the Report on tax equity issues is well founded, the discussion fails to identify clearly the gainers and losers both pre and post reform. Nor is there any discussion or attempt to quantify the policy-tradeoffs between the different tax criteria, including revenue impact.

Proposed measures to tighten integration of the age pension with superannuation help address the key concerns of leakages created by double-dipping and mean-testing of the age pension. However, the critical issue of fiscal sustainability is not addressed.

The inquiry also brings several unexpected issues to the forefront of future reform of Australia's retirement income system. Two issues are of particular interest; the employment-superannuation nexus and the regulation of superannuation funds. Both factors have the potential to exercise a significant impact on retirement income adequacy.

The employment linkage with superannuation reflects its historical roots and union involvement in the SG initiative. However, market forces such as changing work patterns and other factors such as recent changes in family law have progressively eroded this linkage. The issue is whether further deregulation is desirable in order

to make the system more flexible to changing needs such as removing work-related rules on voluntary contributions to superannuation.

The Report's recommendation for a review of the employment-superannuation nexus errs on the side of caution. This caution is well justified since it opens up a much broader debate on the structure of Australia's retirement income system, including proposals for a universal pension than that originally envisaged in the terms-of-reference. The fiscal impact of widening the spread of tax concessions is also unclear.

A second emerging issue concerns the structure, behaviour and performance of the superannuation industry and its regulation. This issue lies behind the policy debate on fund fees and proposals for a fee cap on retail funds. High volatility of equity markets and a worsening global economy have sharpened this concern in recent years.

The Committee's decision not to follow the U.K in recommending a cap on retail fund fees is well justified because the arguments for fee regulation are more complex than those suggested by its advocates. In particular, studies need to be done of the structure, behaviour and efficiency of the Australian superannuation industry, especially compared to other industrial countries.

In sum, the inquiry, including the numerous submissions, open sessions and the Report make a valuable contribution to the ongoing policy debate on Australia's income retirement system. If implemented, the concrete set of measures will help strengthen the existing system while the discussion indicates the future direction of reform.

APPENDIX: Summary of recommendations

Adequacy

1. The Committee recommends that the Government announce a clear statement of objectives for Australia's retirement incomes system, including target
2. The Committee recommends that, having established the objectives or goals, the Treasury convene a panel of key stakeholders to identify, and where possible recommend, common modeling assumptions and techniques for protecting retirement incomes (para. 2.75).
3. The Committee recommends that the Government:
Extend the co-contribution concept by raising the threshold for people on average earnings, and improving the coverage to lower to middle income earners; Remove the work test for making voluntary contributions for those under age 75; Permit the contribution of any superannuation asset to superannuation income stream products, providing that, as far as possible, there are no adverse tax or age pension means test consequences (para. 3.41).
4. The Committee recommends :
Examining the option of extending to the self-employed a framework for making superannuation contributions, with tax treatment similar that which applies to employees making contributions; and examining the removal of the \$450 earnings threshold for SG contributions (para. 6.46).

Equity and tax concessions

5. The Committee recommends that, together with industry, the Government conduct a review of the appropriate benchmark or measuring the impact of superannuation tax concessions (para 7.31).
6. The majority of the Committee recommends that, in the long term, the superannuation contributions tax be gradually removed and replaced with a new approach to taxing end benefits (para 8.33).
7. The Committee recommends that, until such time as the taxation regime has moved to back-end taxes, which would ultimately enable Maximum Deductible limits (MDCs) to be removed (para. 8.66).
8. The majority of the Committee recommends that, as part of a policy to move towards a more equitable system of end-benefit taxation, the surcharge be gradually removed in the long term (given the revenue implications this may be achieved through a staged reduction) (para. 9.28).

9. The committee recommends that: a surcharge cap of the maximum rate of surcharge (currently 15 percent) be implemented for members of private sector defined benefits funds; and the burden of administering the surcharge be transferred from superannuation funds to the Australian Taxation Office (para. 929).
10. The Committee recommends that: the current Reasonable Limits (RBLs) be retained, but that the annual indexation Benefit applicable to RBL thresholds be limited (para.10.12); the lump sum tax free threshold be gradually reduced to the annual equivalent of average weekly ordinary time earnings (AWOTE) and maintained at that level; and lump sum taxes on amounts in excess of the thresholds be gradually adjusted in line with the tax applicable to income streams (para. 10.24).

Health and aged care

11. The Committee recommends that the Government consider proposals by which the superannuation system could be used to help meet health care costs in Australia, including dental health costs, which are expected to increase significantly in the next four decades (para. 11.62).

Income support

12. The Committee recommends that the Government : continue to strive for universal and adequate superannuation coverage with a focus on low and middle income earners (para. 12.31); review the current arrangements for access to the Commonwealth Health Card scheme to ensure that it focuses on those in greatest need (para. 12.47); examine options to encourage older workers to remain in the workforce beyond the superannuation preservation age, particularly on a part-time basis (para 12.67); monitor the uptake of complying annuities, to ensure that the restrictions imposed do not inhibit the attractiveness of complying annuities; consider the appropriateness of the current minimum draw-down limits for allocated annuities; develop a standard set of rules applying to income streams (para. 12.103); and examine options by which those who wish to could draw an income stream from their owner-occupied housing assets for retirement income purposes, including health and aged care expenses (para. 12.115)

Simplifying the superannuation system

13. The Committee recommends that more resources be allocated by Government agencies to assist people to prepare for retirement (para. 13. 52)
14. The Committee recommends that the Government consider the matters raised in this report to identify ways to make the superannuation system

less complex and more comprehensible to the Australian people (para. 13.55).

Other issues

15. The Committee recommends that, as means of increasing national savings and reducing the temptation for people to accumulate debt which is repaid with superannuation on retirement, the Government examine the introduction of a tax preferred medium to long-term savings vehicle which could be accessed prior to retirement for purposes such as: health; savings for a home deposit; and education (para. 14.13).
16. The Committee recommends that the Government consider indexing funded superannuation benefits to Male Total Average Weekly Earnings (MTAWE) or the Consumer Price Index (CPI), whichever is higher, in order that recipients share in the increases in living standards enjoyed by the wider community (para. 14.28).

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