BLAKE DAWSON WALDRON

L A W Y E R S

Partner
George Raitt
Telephone (03) 9679 3372

Our reference
GDR

19 March 1999

The Secretary
Review of Business Taxation
Department of the Treasury
Parkes Place
CANBERRA ACT 2600

Dear Dr Preston

Tax Reform & Superannuation: has tax reform lost its way?
Submission on Discussion Paper No. 2

I wish to make the following submission personally – the views expressed do not necessarily reflect the views of my firm.

The superannuation industry and all persons saving for retirement are vitally interested in the impact of tax reform on incentives for national saving.

In my submission the taxation of savings at the point of income / saving and at the point of dissaving / expenditure has a major business impact on the superannuation industry which ought to be carefully and deliberately addressed as part of the process of Business Tax Reform.

I enclose a paper I have prepared on the subject of taxation reform of superannuation, and how I believe GST should impact on the current regime of taxing superannuation savings. In contrast to some other proponents of reform of the taxation of superannuation,[1] I recognise that the practical revenue-raising needs of Government must be addressed. I believe my reform proposal meets the objectives of increasing efficiency, equity and simplicity of administration.

To date, the discussion does not deal directly with retirement income policy objectives, even though the tax reform proposals being considered by the Business Tax Review will have a major impact on savings and the superannuation industry.

Tax concessions for superannuation were significantly reduced during the 1980s and by 1993 it was apparent Australia faced, and still faces, a shortfall in national savings.

According to various experts, superannuation savings in the range 15% to 18% of annual earnings are required to provide retirement income in the range 60% to 70% of pre-retirement income. It follows that compulsory superannuation guarantee support of 9%,

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[1] See Dr. V. W. Fitzgerald, paper to Conference of Major Superannuation Funds, 16 March 1999, "Refocusing and Reinvigorating Retirement Policy", pp. 25-28.

when it reaches that level on 1 July 2002, is going to fall well short of replacing the old age pension.

Many people believe that tax reform ought to improve incentives for retirement saving in order to encourage self-provision and boost national savings. I endorse that view.

Imposition of GST on dissaving / expenditure will increase economic distortion of savings decisions if corresponding changes are not made to the income tax system.

There is abundant material to suggest that Australia's taxation system is staggeringly complex and costly to administer. There is no doubt that the taxation of superannuation is a prime example of this – the superannuation contribution surcharge tax springs readily to mind.

The surcharge is also probably constitutionally invalid, but the test cases in the pipeline will probably not emerge until the new millennium. There is a major opportunity at the present time for tax reform to address this issue.

There is a sense of deja vu about current proposals for tax reform, as the following extracts from the Treasurer's 1985 Tax Reform Statement shows:

> *"It has long been a complaint of taxpayers that dividend income is effectively taxed twice--once as company profits and once as personal income. A further problem has been that the company tax rate is less than the maximum personal marginal tax rate. This has provided an advantage to some higher income earners who can avoid the higher marginal tax rate by establishing companies for tax sheltering. While the existing tax system provides a positive incentive for some people to channel income through companies, it effectively discourages most investors from buying shares altogether. For decades the pattern of investment by Australians has been distorted away from productive enterprise owing to the double taxation of dividends. The Government believes the raising of equity for our continuing national development should be encouraged. Accordingly the Government has decided to proceed with a system of full imputation on company income distributed to resident individual shareholders."* [2]

> "*Today we are addressing a crisis in our national taxation system... The top marginal rate... has been paid by barely a few of those whose incomes should place them in that bracket... In their place middle income Australians have been forced to take up the load... It would be stupid not to recognise the lesson of recent history; taxpayers just will not pay ridiculously high marginal tax rates. The system invites abuse if it attempts to impose such a burden... today's measures will... make possible the vital innovation of aligning the top personal income tax rate with the company tax rate...*" [3]

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[2] House of Representatives Weekly Hansard, No. 13, 1985 at pp. 1352-3. See also the Explanatory Memorandum, pp. 3-4, to Act No. 58 of 1987, which inserted Part IIIAA into the Income Tax Assessment Act 1936 from 1 July 1987.

[3] House of Representatives Weekly Hansard, No. 13, 1985 at pp. 1345.

The figures show that Australians are still paying about 30% of gross domestic product in taxes of various kinds. I submit that if the tax base is too small, and tax avoidance is still a problem, it may mean that the Government wants to raise more revenue than the community wants to pay. This issue does not seem to be on the tax reform agenda, but in my submission it ought to be.

Of particular concern to the superannuation industry are the following proposals in the Discussion Paper:

- life insurers should be taxed on superannuation business at the company tax rate instead of the 15% concessional rate (para 34.60).

- PSTs should be taxed at the company tax rate and pass on imputation credits under a redesigned imputation system (para 36.5).

- superannuation funds should not be permitted to transfer tax liability on contributions to PSTs (para 37.8).

- superannuation funds should not be exempt from tax on profit on current pension business (para 37.6).

In my submission the pursuit of entity taxation – for the purpose of clawing back, upon distribution to shareholders, tax concessions received by companies – is a return to double taxation of company profits.

If the top personal marginal rate is not aligned with the corporate rate we will no doubt see pressure from officials within a short space of time to reintroduce undistributed profits tax!

As many people will recall, it was the double taxation of company profits and the company tax rate being less than the maximum personal marginal tax rate that in the 1960s and 1970s created the incentive for tax arbitrage and avoidance that the 1985 Statement on Reform of the Australian Tax System sought to address.

Not only is the entity taxation regime inconsistent with reform imperatives acknowledged 15 years ago, it is out of step with developments overseas, such as the limited liability companies, or LLC, in the United States. This is a company that is treated for tax purposes as if it were a partnership, with profits flowing through to shareholders.

In my submission, the current tax reform proposals have a major adverse impact on the superannuation industry – a significant business sector in Australia – which ought to be carefully and directly considered.

Yours sincerely

G D Raitt

BLAKE DAWSON WALDRON

L A W Y E R S

THE TAXATION OF SUPERANNUATION - SUGGESTIONS FOR REFORM

by George Raitt, Partner, Blake Dawson Waldron

Abstract:

A tax system serves two main goals: to raise revenues to pay for government services fairly as between people in the same economic position (horizontal equity); and, to redistribute income from the rich to the poor through progressive taxation (vertical equity). Economists acknowledge that income tax militates against saving by distorting economic choices between present and future consumption.

The author considers often stated objectives of retirement incomes policy: compulsory self provision for target groups; encouragement for self provision; and, maintaining the age pension as an adequate public safety net funded out of general revenue. It seems reasonably clear that compulsory superannuation will not relieve the burden on the age pension, and so does not achieve the objective of intergenerational equity.

The author reviews the current system for the taxation of superannuation and models based on taxing saving at the point of withdrawal of benefits, and concludes that they militate against saving and fail the objectives of horizontal and vertical equity.

The author proposes the following reforms to achieve the policy objectives that have been noted:

(i) employer superannuation support would be fully taxable to the employee at marginal rates, for reasons of horizontal equity (consequently the contributions tax and contributions surcharge would be abolished);

(ii) contributions would not be tax deductible to the individuals, but would attract a rebate of tax, for reasons of vertical equity;

(iii) the exemption from the tax on superannuation fund earnings for assets supporting pensions being drawn would be abolished (the progressive rate structure automatically encourages pensions rather than lump sums through the impact on investment earnings);

(iv) superannuation savings withdrawn as lump sum benefits and pensions and annuities would be entirely tax exempt.

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Level 39
101 Collins Street
Melbourne VIC 3000

legal.info@bdw.com.au

Telephone (03) 9679 3000
Int + 61 3 9679 3000
Fax (03) 9679 3111
DX 187 Melbourne

GPO Box 4958 WW
Melbourne VIC 3001
Australia

1. BACKGROUND

1.1 The position before 1983

Employee and employer contributions were tax deductible.[4] Self employed persons received a very limited tax deduction for superannuation contributions. The Commissioner of Taxation permitted self-employed persons the fiction of being employed by an administration entity solely for the purpose of making superannuation contributions.[5]

Earnings of superannuation funds were exempt.[6]

Lump sum benefits from superannuation funds were subject to tax at the recipient's marginal rates on 5% of the lump sum, and pensions were subject to tax at the recipient's marginal rates, subject for deductions for the previously undeducted purchase price.[7]

1.2 The reforms of 1983

The conditions applying to the above tax concessions were minimal. Superannuation funds could lend back 70% of their assets to contributors, thus making tax deductions cash positive at the expense of the revenue. There were no conditions locking in superannuation savings until retirement from gainful employment or death or disability, thus enabling withdrawal of superannuation savings as a concessionally taxed lump sum upon changes of employment during a person's working life.

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4 This is an oversimplification. See Senate Select Committee on Superannuation "Super Taxing: an Information Paper on the Taxation of Superannuation and Related Matters", Canberra, February 1998, p. 6.

5 FCT v. Galland 85 ATC 4797; Ruling IT 2503.

6 Senate Select Committee, note 1 above, p. 6.

7 Senate Select Committee, note 1 above, p. 6-7.

The Government's initial response was to increase taxation on eligible termination payments (ETPs) to encourage locking in superannuation savings until retirement from gainful employment. The ETP measures were in summary:[8]

(i) the previous tax treatment of lump sums was grandfathered for service pre-1 July 1983;

(ii) lump sums in respect of service after that date would be taxable, but at concessional rates;

(iii) the maximum marginal rate would be 30%;

(iv) this would be reduced to 15% if the recipient was 55 or over;

(v) undeducted contributions by employees and the self-employed would be exempt from tax.

ETPs could be rolled over within the superannuation system to defer the taxing point.[9]

Many tax changes through the 1980s were the result of a process of reform which reacted to the tax avoidance industry of the 1970s and 1980s in Australia.[10] I believe this contributed to the loss of significant concessions that had been available to superannuation.

At the time the Government was relying solely on the taxation power. In 1987 the Government introduced the *Occupational Superannuation Standards Act* to tighten up the regulation of superannuation, including by requiring that benefits be preserved in the superannuation system until retirement from

8 Senate Select Committee, note 1 above, p. 7-8.

9 Senate Select Committee, note 1 above, p. 14.

10 For example: introduction of the Crimes (Taxation Offences) Act 1980 from 4 December 1980, to counter tax evasion schemes known as "bottom of the harbour" schemes; introduction of Part IVA of the Income Tax Assessment Act, from 27 May 1981, to counter artificial and contrived avoidance schemes; introduction of the Prescribed Payments System from 1 July 1983 to counter tax evasion by contractors in the building, transport, motor vehicle repair and cleaning and other industries; introduction of Capital Gains Tax to apply to assets acquired after 19 September 1985 to address many tax avoidance arrangements involving the conversion or dressing up of income as capital gains (Second Reading Speech, Senator Button, Senate Hansard, 4 June 1986 at p. 3392); introduction of Fringe Benefits Tax from 1 July 1986, to prevent avoidance of tax through remuneration being provided as fringe benefits rather than salary.

gainful employment on or after age 55, or prior death or disability. This legislation was, however, still based on the taxation power, and imposed conditions to be satisfied for superannuation funds to receive tax concessions.

It is now possible to regulate superannuation directly under the *Superannuation Industry Supervision* legislation.

1.3 The reforms of 1988

From 1 July 1988 the Government brought forward the taxing point created by the 1983 changes, with a number of measures, in summary:[11]

(i) a 15% tax was imposed on tax deductible contributions;

(ii) the rate of tax on ETPs was reduced from 30% to 15%;

(iii) the first step component of the ETP which had been concessionally taxed at 15% became zero rated;

(iv) the old ETP taxation regime continued to apply to post-June 1983 contributions which were not taxed;[12]

(v) a 15% rebate was phased in to apply to the post-June 1983 portion of a pension or annuity commencing after 1 July 1988 and after age 55 (to compensate for the contributions tax);

(vi) a 15% tax was imposed on earnings of superannuation funds, and for this purpose capital gains tax applied to all assets of complying superannuation entities as if they were acquired at 30 June 1988;[13]

(vii) income earned on assets set aside to provide pensions or annuities was exempted from the 15% tax on fund earnings.

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11 Senate Select Committee, note 1 above, p. 8.

12 See Table 2, Senate Select Committee, note 1 above, p. 18.

13 Division 10 of Part IX of the Income Tax Assessment Act.

1.4 The 1990s reforms

From 1 July 1990 the reasonable benefit limits (RBLs) were used to limit the amount of ETPs that would be concessionally taxed.[14] Prior to then, RBLs were used to limit deductible contributions. From 1 July 1994, subject to transitional provisions, the lump sum and pension RBLs have been set at fixed amounts to be indexed each year.[15] ETPs received in excess of RBLs, and pensions and annuities containing excessive components, derived from deductible contributions are taxable at full marginal rates.[16]

From 1 July 1994 the Government simplified the 15% rebate for pensions and annuities by modifications which apparently were revenue neutral, in summary:[17]

(a) the rebate was extended to the taxable amount of all pensions and annuities payable after age 55, based on the whole taxable amount;

(b) the exemption for the undeducted purchase price component was limited to undeducted contributed post-June 1983.

From 20 August 1996 a contributions surcharge of 15% applies to deductible contributions for persons having adjusted taxable incomes (including superannuation contributions) above \$88,910, phasing in from \$73,220.[18]

From 1 July 1997 a taxpayer will be entitled to an 18% rebate of up to \$540 for contributions of up to \$3,000 a year for a spouse who earns no more than \$13,800 a year.[19] This allows couples to double their reasonable benefit limit (RBL) and to shelter earnings on savings from personal marginal rates.[20]

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14 Senate Select Committee, note 1 above, p. 6.

15 Senate Select Committee, note 1 above, p. 9.

16 Senate Select Committee, note 1 above, pp. 17 and 19-20.

17 Senate Select Committee, note 1 above, p. 9.

18 Senate Select Committee, note 1 above, p. 10.

19 Senate Select Committee, note 1 above, p. 9-10.

20 Senate Select Committee, note 1 above, p. 10.

From 1 July 1998 a savings rebate of 7.5% from 1 July 1998 and 15% from 1 July 1999 will apply to member undeducted contributions (excluding contributions made for a spouse) and income from savings and investments, up to an annual cap of $3,000.[21]

1.5 Purpose of this paper

The purpose of this paper is to:

(a) critically review the policy basis for the taxation of superannuation;

(b) identify any problems with the present tax regime that may hinder achievement of its policy objectives, with particular reference to overall efficiency and equity objectives and the impact on savings;

(c) recommend any reforms which may overcome any problems identified.

1.6 Scope of this paper

I don't believe it will be possible within the available space to deal comprehensively with all issues.

For example, I won't get into the area of compliance and administration costs. There is material to suggest that Australia's taxation system is staggeringly complex and costly to administer.[22] I don't think there is any doubt that the taxation of superannuation is a prime example of this.[23]

Nor will I get into the tax deductibility of contributions for employers. Maximum deductible contribution limits have been imposed on employers for policy reasons, apparently to limit abuse of the system by employees. I think employers should

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21 Senate Select Committee, note 1 above, p. 10-11.

22 See Melbourne Institute of Applied Economic and Social Research, "Tax Reform: Equity and Efficiency". August 1997, p. 27, Table 3.9; Chris Evans, "The Australian Capital Gains Tax: Rationale, Review and Reform", January 1998, p. 9; and Peter Griffin, "Is CGT the most inefficient tax?" Taxation in Australia, Vol. 4 No. 1, August 1995.

23 Professor David Knox, "A Future Tax Policy for Superannuation", Submission to the Tax Consultative Task Force, February 1998, p. 2; John Edstein, "Is the Surcharge the Future? The Future Tax Policy for Superannuation Funds", *Superannuation 1998*, Conference Papers, Law Council of Australia and the Leo Cussen Institute, 1998, p. 1.

have unlimited tax deductions for contributions, but in my view that is a side issue to the taxation of superannuation *savings* of individuals.[24]

I will not examine a number of tax provisions of a regulatory rather than taxing nature, such as maximum deductible contribution limits, reasonable benefits limits and the superannuation guarantee charge. Now that we have the *Superannuation Industry Supervision* legislation (SIS), I think regulatory issues should be addressed under SIS rather than through tax rules that attempt to influence behaviour, as opposed to raise tax. Clearly some tax differentiation is necessary to influence savings decisions, and these provisions are the focus of my paper.

A fascinating issue I don't believe I will have space to address fully, is whether it might be possible to introduce mild progressivity into the taxation of earnings of superannuation funds, such as by using the flat tax model mentioned below.

It is beyond the scope of this paper to calculate the revenue effects of the suggested reforms.

2. ISSUES

2.1 OBJECTIVES OF TAXATION

The two main objectives are to equitably raise revenue to pay for the activities of government and to redistribute income.[25] Australian income tax is progressive: the average tax rate rises with income. The average rate of tax indicates redistributional and equity effects, whereas marginal rates influence economic decisions and indicate the neutrality and efficiency effects of taxation.[26]

In the superannuation context there are additional policy objectives of raising private savings for retirement incomes and

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[24] Edstein, note 20 above, pp. 3-6 takes the view that deductibility of contributions for employers is a fundamental issue.

[25] Melbourne Institute, note 19 above, p. 3.

[26] ibid.

achieving intergenerational equity in the provision of publicly funded retirement incomes.[27]

I will now examine each of these objectives.

2.2 EFFICIENCY OBJECTIVE

(a) What does efficiency mean?

Efficiency refers to the concept in economics of the efficient allocation of resources through the operation of the unimpeded market mechanism.[28] It does not refer to administrative or compliance efficiency of a tax.[29]

(b) Is there such a thing as an efficient tax?

Any feasible tax system distorts the choice between work and leisure and the choice between present and future consumption (that is, saving), which interferes with the efficient allocation of resources in the economy.[30] I don't think there is any doubt that income tax reduces the rate at which future consumption can be substituted for present consumption.[31]

Musgrave concludes that all that can be said is that a poll tax is superior to both a consumption tax and an income tax, and that progressivity increases the distortion.[32] He concludes that the distorting effects of income tax on saving can be avoided by a tax on consumption.[33] This needs to be borne in mind if Australia moves to a mix of income tax and consumption tax, which could give rise to effective double taxation of saving.

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[27] Vince Fitzgerald, "Superannuation and Saving: Where To?", *ASFA National Superannuation Conference*, Conference Papers, Association of Superannuation Funds of Australia, 1993, p. 3.

[28] John G. Head, "Capital Gains Taxation - An Economist's Perspective", (1984) at p. 150; Richard A. Musgrave, "The Theory of Public Finance" (1961) McGraw-Hill at p. 141.

[29] Evans, note 19 above, p. 7.

[30] Head, note 25 above, p. 150; Musgrave, note 25 above, pp. 157-159 notes that the only non-distorting taxes are the poll tax and land tax.

[31] Musgrave, note 25 above, pp. 150-154.

[32] Musgrave, note 25 above, p. 154.

[33] Musgrave, note 25 above, p. 159.

Rosen notes that linear, or flat taxes are less distorting because they adopt a constant marginal rate, while still being progressive; however, he acknowledges that economic models cannot produce a blueprint for the optimal tax system.[34]

The objective, therefore, is to design a tax that interferes as little as possible with the operation of the market mechanism, unless you intend to use taxation to achieve social or economic policy objectives.[35]

It seems that pursuit of equity objectives inevitably requires that there must be some loss of efficiency, through the distorting effects of a tax.[36]

2.3 RETIREMENT INCOME OBJECTIVE

(a) How do you overcome the distortion created by income tax?

As noted above, income tax reduces the rate at which present consumption can be substituted for future consumption, that is, militates against savings.[37]

Tax policy in Australia up until 1983 was apparently to remove the distortion by exempting from income tax amounts set aside as savings for retirement, and further, to encourage savings by exempting earnings on retirement savings. On the basis of the efficiency implications of income tax noted above, the pre-1983 taxation of superannuation appeared to have a sound policy basis.

Tax concessions were significantly reduced during the 1980s and by 1993 it was apparent Australia faced, and still faces, a shortfall in national savings.[38] One can only speculate on the

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34 Harvey S. Rosen, "Public Finance", 4th Edition, McGraw-Hill, Boston 1995, p. 341-3.

35 Head, note 25 above, p. 150; Musgrave, note 25 above, p. 141.

36 Musgrave, note 25 above, p. 159; Rosen, note 31 above, p. 344.

37 This conclusion is supported by Australian Retirement Income Streams Association (ARISA) "National Tax Reform: The Potential Impact on Retirement and Saving", March 1998, p. 7.

38 Fitzgerald, note 24 above, p. 1 - gross national saving of 16% of GDP was down from a three-decade average of 22.5%, but the impact of the superannuation guarantee was expected to result in annual savings of only 1.4% to 1.7% of GDP within 10 to 20 years (p. 6). ARISA, note 34 above, p. 30 states that gross national savings declined as a percentage of GDP over three

possible causative link between these facts,[39] nevertheless, Fitzgerald argued in 1993 that an uncapped 15% rebate was necessary to encourage the desirable level of superannuation savings.[40]

(b) What level of tax incentive is required to boost private savings?

Fascinating question. No amount of reasoned analysis can tell us how much of a tax concession is required to achieve a given social policy objective. However, logic suggests that, if national savings is still below socially desirable levels, we have to take tax policy back in the direction we came from before 1983.

(c) Will compulsory superannuation boost private savings?

Economics tells us that compulsion generally cannot control market forces. Accordingly, if people don't want to save for retirement because short term consumption or other investments are more attractive for savings, then compulsory superannuation savings will simply result in other saving being reduced.[41]

Despite this, the superannuation guarantee legislation was introduced with effect from 1 July 1992 as a major plank in the Government's retirement incomes policy.

(d) Will compulsory superannuation savings relieve the burden on social security in future?

Fitzgerald was of the view that superannuation savings of 18% of earnings would be required to provide an incentive for people to rely on private superannuation alone. He calculated that this would give a pension equal to 70% of pre-retirement income, which would comfortably exceed the age pension

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decades, reaching a low of 15.5% in 1991-92, and although it has recovered to just under 18% in 1996-97 is still under the target of about 23% adopted in Fitzgerald's 1993 National Savings Report.

39 ARISA describes the 1988 measures and the 15% contributions surcharge as "less than positive", note 34 above, p. 10.

40 Fitzgerald, note 24 above, p. 10.

41 Fitzgerald, note 24 above, p. 10. ARISA note 34 above, pp. 23 and 48.

threshold income test of between 55% and 60% of average weekly earnings.[42]

ARISA believes that Australians should contribute 15% of earnings over their working life to get an indexed pension of about 60% of pre-retirement income.[43]

Accordingly, superannuation guarantee support of 9% when it reaches that level on 1 July 2002 is going to fall well short of replacing the old age pension. On Fitzgerald's figures that level of support might provide a benefit equal to half of the age pension when fully operative.[44] ASFA cites similar figures suggesting a replacement rate under 50%.[45]

(e) Where does this leave the "Three Pillars" of retirement incomes policy?

Edstein describes ASFA's "three pillars" for a coherent retirement incomes policy as:[46]

(i) the age pension as an adequate public safety net funded out of general revenue;

(ii) compulsory self provision for target groups;

(iii) encouragement for self provision.

In my opinion Fitzgerald was right in 1993 in calling for the objectives of retirement incomes policy and the superannuation guarantee system to be clarified, and for voluntary saving above compulsory levels to be encouraged by tax concessions.[47]

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42 Vince Fitzgerald, "National Saving: A Report to the Treasurer", Australian Government Publishing Service, June 1993, p. 56. The proposed 3% co-contribution that Fitzgerald speaks of as potentially taking superannuation guarantee support to 12% has subsequently been abandoned by the Government.

43 ARISA note 34 above, pp. 3 and 34.

44 Fitzgerald, note 39 above, p. 56.

45 "Blueprint for Retirement Income Policy", February 1998, p. 16.

46 Edstein, note 20 above, p. 2.

47 Fitzgerald, note 39 above, p. xv and xvi.

The superannuation guarantee system does not cover self-employed persons or persons who may be out of the work force for extended periods. There are also disincentives in the current taxation regime for self-provision by people who may be more able to save. I will discuss these issues below in relation to equity objectives.

ARISA considers that reducing the level retirement income provided by the safety net is the best way to boost private savings.[48]

(f) Should retirement savings be limited?

In my view, if the taxation of superannuation achieves equity objectives and savings are genuinely preserved for retirement there is no need for maximum deductible contribution limits or RBLs. A number of commentators have called for the removal of these limits.[49]

(g) Should benefits as income streams be encouraged in preference to lump sum benefits?

There is a certain bias in the current tax system towards this. Edstein notes that this seems directed towards preventing people having to rely on the safety net of the old age pension,[50] presumably because they may be tempted to spend a lump sum "living the life of Riley" (as John Stone once put it when arguing for the preservation age to be increased), and fall comfortably into the safety net. I find this a bit unlikely.

Edstein notes that retirees may need a lump sum to pay off commitments they may still have at retirement.[51]

In my opinion it should be enough to encourage income streams that income from savings would be sheltered from tax if savings are held in a superannuation fund compared to income being taxed at marginal rates if a lump sum benefit is withdrawn and invested by the individual. I query whether it

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48 ARISA note 34 above, pp. 27 and 35.

49 ARISA note 34 above, pp. 28 and 35; Edstein, note 20 above, pp. 21-22; Access Economics, cited in Senate Select Committee, note 1 above, p. 22.

50 Edstein, note 20 above, p. 15.

51 Edstein, note 20 above, p. 15.

is necessary to completely exempt earnings on assets supporting pensions being drawn by an individual.[52]

ARISA proposes that direct regulation of benefits should provide for a gradual move from lump sums to income streams.[53]

2.4 EQUITY OBJECTIVE

(a) How do you tell if people are in equal positions?

Like motherhood, no-one would argue against the principle that people in equal positions should be treated equally. This is the principle of horizontal equity.[54]

There are differences of opinion among economists as to whether consumption or income should be the index of equality.[55] However, there seems to be agreement among economists that, if income is selected, the concept of income should cover total accretions to wealth, meaning income in the ordinary sense and any kind of windfall.[56]

(b) Should employer contributions to retirement plans be treated as income?

Rosen summarises the economic concept of income by saying that what economists are trying to measure is the increase in *potential* consumption.[57] Rosen is quite clear that this means that employer contributions to retirement plans should be included in income under this concept.[58]

Rosen also notes an interesting argument I will come back to below, that if the advantages of wealth are open to everyone,

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52 Senate Select Committee, note 1 above, p. 13.

53 ARISA note 34 above, pp. 28 and 34-35.

54 Head, note 25 above, p. 149; Musgrave, note 25 above, p. 160.

55 See Musgrave, note 25 above, pp. 161-164.

56 Head, note 25 above, p. 148; Musgrave, note 25 above, p. 165.

57 Rosen, note 31 above, p. 361.

58 ibid.

then those advantages may reduce tax progressiveness, but they have no effect whatsoever on horizontal equity.[59]

Edstein undertakes a lawyerly analysis of the tax rules concerning derivation of income and concludes that employer contributions are not income under our tax laws.[60] He is quite right, and could also note that employer contributions are not subject to fringe benefits tax. However, in my opinion, the historical state of the law does not give us much guidance on policy issues relevant to law reform. The legal analysis does not address the relevant economic concepts or horizontal equity issues between employees and the self-employed.[61]

I therefore adopt the following principles as a central elements of my suggested approach to reforming the taxation of superannuation:

(a) amounts contributed to superannuation by a person or by someone else on the person's behalf, whether under salary sacrifice arrangements[62] or otherwise, represent savings of the person for future consumption.

(b) such amounts represent income of the person which should for reasons of horizontal equity be included in the tax base (recognising that we must address the distorting effects an income tax has on saving).

(c) if we wish to use tax policy to encourage saving for retirement, we should do this after deliberating upon the implications for efficiency and redistributive objectives, to which I shall turn in a moment.

Edstein notes that the Campbell Committee favoured this approach, but that he and other commentators currently prefer the approach of taxing superannuation savings when benefits

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[59] Rosen, note 31 above, p. 346.

[60] Edstein, note 20 above, p. 6-8, citing Constable v. FCT (1952) 5 AITR 371.

[61] Edstein does acknowledge this, note 20 above, pp. 13-14.

[62] Edstein, note 20 above, p. 8 says that properly constructed salary sacrifice arrangements avoid being treated as income of the employee. In my view the "form over substance" approach to tax law ought to be a thing of the past.

are withdrawn.[63] I believe the advantages of the income approach are that we can focus tax policy on consumer behaviour at the *point of saving*, which is what policy is attempting to influence.[64]

2.5 REDISTRIBUTIVE OBJECTIVE

(a) Is redistribution a national objective?

Economists agree that the "proper" state of income distribution (vertical equity) is a socio-political issue.[65]

The Federal Treasurer in his 1985 Statement on the Reform of the Australian Taxation System re-affirmed a community commitment to progressivity.[66] The Melbourne Institute of Applied Economic and Social Research asserts that there is still community support for progressivity.[67]

Progressivity clearly creates inefficiencies that adversely affect income generation, saving and accumulation of capital.[68]

(b) Has redistribution worked in Australia?

Perhaps the irony of the following passage was lost on the Treasurer in 1985:[69]

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63 Edstein, note 20 above, pp. 19-20.

64 ARISA acknowledge the need to provide strong incentives at the point of saving (note 34 above, p. 24) but nevertheless favour taxing superannuation only once, at the point of withdrawal of benefits (note 34 above, p. 44).

65 Head, note 25 above, p. 149; Musgrave, note 25 above, pp. 19-20.

66 Ministerial Statement by the Treasurer, Paul Keating, House of Representatives Hansard, 19 September 1985 at p. 1345.

67 Melbourne Institute, note 19 above, p. 30.

68 See for example "Public Finance", R. W. Houghton (Ed.) (Penguin, London, 1970) at p. 29 (an excerpt from H. C. Simons "Personal Income Taxation", 1938 - "it is hardly questionable that increasing progressivity is inimical to saving and accumulation") and p. 158 (an extract from the 1966 Canadian Royal Commission on Taxation - "In our opinion, it is essential that the marginal rates of tax by kept low enough that the incentive to produce goods an perform services and invest funds is not destroyed").

69 Keating, note 63 above, p. 1345 (the context of this excerpt was the introduction of capital gains tax).

> "It would be stupid not to recognise the lesson of recent history; taxpayers just will not pay ridiculously high marginal tax rates. The system invites abuse if it attempts to impose such a burden... Lower marginal rates will enhance our economic performance by better rewarding initiative....It is this action along with the abolition of tax shelters and the introduction of stronger penalties which will act to end the rorts and abuse of the system .... today's measures will restore the system's effective progression..."

The Melbourne Institute suggests that there is still tax avoidance caused by a desire of people to avoid the progressive tax system.[70] This says to me that the redistributive agenda of our tax system still does not have the community support it needs in order to have integrity.

In my opinion, the tax treatment of superannuation savings ought not discriminate against self-employed[71] or wealthy individuals on the basis that they could be expected to self-provide anyway and that tax concessions, being worth more to them, are just a rort. This approach discourages poor people accumulating savings and wealth just as much as it facilitates redistribution of wealth from the rich to the poor. In my view this deters the market operating to produce a more equal distribution of wealth.

(c) Should progressivity be transparent?

In my view progressivity should be transparent, being evident from published tax rates.[72] Because rich people have a higher propensity to save than poor people,[73] taxation policy that discourages saving by rich people is in my view adding to progressivity in an undesirable way.

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70 Melbourne Institute, note 19 above, pp. 13-14, 17-20

71 Contributions by employers are not taxable to the employee, but contributions tax applies. The same age-based deduction limits apply for self-employed persons but, because only the first $3,000 and 75% of the excess is tax deductible, it costs them more to generate the same deductible contribution (to which contributions tax will apply).

72 For example, capital gains tax adds to progressivity in a way that lacks the transparency of published tax rates, because ownership of capital is more highly concentrated in the higher income brackets. See: Evans, note 19 above, p. 6; Head, note 25 above, p. 150.

73 Knox, note 20 above, p. 9.

(c) Should redistribution be abandoned as an objective in the taxation of superannuation?

Surprisingly, Edstein thinks it should, describing vertical equity as a distraction.[74]

I would not go that far. In my opinion, vertical equity can and should be addressed, recognising that politically it must be addressed, but that if carried too far the damaging effects on economic decisions will impact on our whole society.

2.6 INTERGENERATIONAL EQUITY OBJECTIVE

(a) Is the population ageing?

The age distribution of the Australian population is clearly changing towards an "older" population, which means that the proportion of aged people dependent on the working population is rising.[75]

(b) What are the effects of the ageing population?

If retirement incomes policy is administered through unfunded age pensions, future generations will bear an unfair burden of supporting earlier generations in retirement.[76]

(c) What are the policy implications of the ageing population?

In terms of the "Three Pillars" statement of retirement incomes policy objectives, the implication of intergenerational equity is clearly that reliance on the age pension needs to be diminished.

It is a matter for judgment whether the estimated impact of the superannuation guarantee charge in reducing reliance on the old age pension by about 50%, when its full impact on savings has occurred around the year 2020, is enough.[77] A number of commentators do not believe it is enough.[78]

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74 Edstein, note 20 above, p. 4.

75 Fitzgerald, note 24 above, p. 4-5.

76 Fitzgerald, note 24 above, p. 4-5.

77 Fitzgerald, note 39 above, p. 56.

78 ARISA note 34 above, p. 33; ASFA note 42 above, p. 16.

2.7 THE TAXATION OF INCOME AND SAVING

(a) Should saving be treated as being made out of income after tax?

I believe that in substance contributions to superannuation funds by or on behalf of a person represent savings set aside out of income, and tax policy should reflect this.

As noted above, I believe contributions to superannuation funds by or on behalf of a person should be included in the person's income for reasons of horizontal equity.

This would also mean that employees who do not themselves contribute, employees who contribute for themselves, non-working spouses who benefit from contributions made for them, and self-employed persons could all potentially be treated in an economically neutral way.

As noted above, the current tax system does not do this.

(b) Would this impose an unfair burden where superannuation is a fringe benefit?

I don't believe so, for the following reasons, but I do believe that we need to carefully consider the effective tax rates on this income because it is not cash income of the taxpayer.

As noted above, superannuation contributions paid by an employer are not regarded as a taxable benefit,[79] nor are they subject to fringe benefits tax.[80]

Fringe benefits tax was intended to cause employees to "cash out" of benefits and take salary instead. This has not happened in all cases because of tax arbitrage opportunities.

However, the impact of adding superannuation to the income tax base may result in some "cashing out" of this benefit. At least employees on the top marginal rates ought to be able to partially cash out to facilitate paying their tax.

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[79] *Constable v. FCT* (1952) 5 AITR 371.

[80] The definition of "fringe benefit" in Section 136(1) of the *Fringe Benefits Tax Assessment Act* 1986 excludes contributions paid to complying superannuation funds.

If the net effect of adding superannuation to the income tax base is to shift the burden of administering the contributions tax from superannuation funds to the normal income tax collection system there should be no adverse cash flow effects, and some simplification of the overall tax collection system.

(c) Is the current system really progressive?

For the following reasons I don't believe it is.

Exempting superannuation from income (which is effectively the case for employees receiving employer superannuation support) or allowing a deduction for self-made superannuation contribution (partly the case for certain self-employed persons) removes progressivity from the system. The value of the tax concession is greater for the person on a higher income and, as noted above, wealthy persons have a greater propensity to save, which further increases the value of the concession to them.

In light of this, there are a number of features of the system intended to limit superannuation savings by imposing adverse tax consequences on "high" savings individuals:

(a) maximum deductible contributions limits (the "age based" deduction limits) that apply for employees and self-employed alike.[81]

(b) reasonable benefits limits that apply for the purpose of taxing withdrawals from superannuation.[82]

(c) the superannuation contributions surcharge is a proportional tax on contributions for people above the specified thresholds.[83]

In my opinion these measures do not restore progressivity, but merely limit the perceived "damage" to vertical equity caused by the regressive nature of current tax concessions for superannuation saving. Even the surcharge, a proportional tax which was introduced for the purpose of preventing

[81] See Sections 82AAC(2) and 82AAT(2) of the *Income Tax Assessment Act*.

[82] See Division 14 of Part III of the *Income Tax Assessment Act*.

[83] See the *Superannuation Contributions Tax (Assessment and Collection) Act* 1997 and related Acts forming part of the surcharge package.

wealthy people rorting the system, cannot be regarded as restoring true progressivity.[84]

The Senate Select Committee on Superannuation note a "perceived inequity" in proposals to abandon RBLs.[85] However, with respect, I consider that by transparently addressing progressivity it should be possible to eliminate or simplify the complications caused by the above measures.

(d) If you tax income do you still need to tax saving?

No, if superannuation is brought into the income tax base, it would clearly be double taxation to tax contributions or withdrawals from the superannuation system.

There is potentially a massive saving in administration and compliance costs by exempting benefits on withdrawal from the superannuation system.

(e) Can superannuation be taxed at a concessional rate without reducing progressivity?

Yes, a rebate could be introduced for superannuation saving that would reduce the effective tax rate on amounts included in the income tax base at the point of saving, without reducing progressivity.

(f) Could a revenue neutral package be developed at pre-tax reform rates?

Yes, superannuation contributions paid by an employer or third person would be included in the income tax base to be taxed at current marginal rates. Self-employed persons already contribute out of after-tax income, so this would ensure horizontal equity for all income earners.

The progressive rate structure is the community's transparent commitment to redistributive or vertical equity.

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84 ARISA note 34 above, pp. 10-11; Edstein, note 20 above, p. 12. ASFA, note 42 above, p. 9 observes that taxing contributions and earnings proportionally is not compatible with equity goals, but curiously at p. 25 expresses the view that taxing contributions at marginal rates is a poor way of achieving equity because of year to year variations in *saving*. In my view this misses the point that you are taxing *income*.

85 Senate Select Committee, note 1 above, p. 24.

The contributions tax and surcharge (and taxation on lump sums and pensions and applicable rebates as I will mention below) would be repealed as part of the package.

There would be a rebate to ensure that all taxpayers get relief from full tax rates on income which is channelled into superannuation savings. This would reflect the community's desire to encourage savings for retirement.

I would not limit the rebate, for example by setting a maximum tax benefit on similar lines to the current aged based maximum deductible contribution limits. The rebate clearly ought not to exceed the tax payable.[86]

To ensure revenue neutrality it may be necessary to juggle the amount of the rebate and the rate of tax on earnings of superannuation savings.

(g) How should a reduction of tax rates under tax reform impact on the suggested savings rebate?

As a number of commentators have noted, a reduction in income tax rates as part of tax reform (for example if a consumption tax is introduced into the tax mix) would make superannuation savings less attractive, and this needs to be addressed.[87]

However, under the proposals above, the impact of a reduction in income tax rates as part of tax reform would make superannuation savings *more* attractive, which may lead to a desirable increase in the ability of the taxation system to deliver policy objectives of promoting retirement savings.

2.9 THE TAXATION OF EARNINGS ON SUPERANNUATION SAVINGS

(a) Should earnings on savings be part of the tax base?

Musgrave notes the arguments that this involves the double taxation of savings, but concludes that earnings on savings

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[86] See section 2.9(e) below for a discussion of possible abuse of superannuation as a tax shelter.

[87] Knox, note 20 above, pp. 1-2; ARISA note 34 above, pp. 2, 4, 17 and 22.

should be part of the tax base for reasons of horizontal equity.[88] I agree.

Edstein notes that there is no logic that dictates exemption of earnings on superannuation savings.[89] This is correct: any concession could only be justified on policy grounds as necessary to encourage private superannuation savings.

Proponents of taxing wholly at the point of withdrawal of benefits acknowledge that this is practically unsustainable given the need of governments to raise revenue at the point of saving and while saving is accumulated.[90]

(b) Is it feasible to tax earnings on savings at progressive rates?

I don't believe full progression would be possible, because the relevant tax base would be the income of the fund member. Progressive rates encourage income splitting. To enforce progressivity, it would be necessary to aggregate with the fund member's income all the earnings on benefits in each superannuation fund of which he or she is a member.

The administrative nightmare created by the method of collecting the superannuation surcharge would be exacerbated.

However, I think there are interesting possibilities to introduce mild progressivity into the taxation of earnings of superannuation funds, such as by using the flat tax model.

This would involve a tax free threshold for member accounts or accrued benefits and a constant marginal rate. Progressivity would have to be mild enough to make it not worthwhile for individuals to split benefits between funds to avoid progressive taxes on earnings. Defined benefit funds create significant problems for the contributions tax, and similar problems would have to be overcome for a progressive tax on fund earnings. However, I think it could be done.

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88 Musgrave, note 25 above, pp. 161-162.

89 Edstein, note 20 above, p. 22.

90 ARISA note 34 above, p. 34; Knox, note 20 above, p. 4; Edstein, note 20 above, pp. 15-16.

(c) Should there be any change in pre-tax reform rates?

I don't believe that any increase should be necessary in order to develop a revenue neutral package. There may be good reasons, however, to consider trading off a lower savings rebate against reductions in the current 15% income tax rate on the earnings of superannuation funds.

(d) Should a reduction of tax rates under tax reform impact on the rate of taxation of fund earnings?

Yes, I believe it is necessary to retain or increase the relative attractiveness of superannuation as an investment.

It is my judgment that superannuation savings, being of such a long term nature, needs substantial tax concessions to make it an attractive investment compared with other forms of savings,[91] such as the family home and negatively geared property investments.

Further, if tax rates are reduced in conjunction with the introduction of a consumption tax, the rate of the consumption tax must be added to the tax rates on superannuation savings and income to work out the effective tax burden.

(e) Is there an unacceptable risk of superannuation being used as a tax shelter?

Under the present tax system, taxpayers may use superannuation funds as tax shelters because undeducted contributions are not subject to contributions tax or surcharge and earnings are sheltered from tax at the taxpayer's marginal rates. This undermine progressivity. However, in my opinion it is equally open to rich and poor who wish to forego access to the savings until retirement.

So long as the superannuation laws prevent withdrawal of savings before genuine retirement,[92] I don't believe this is open for abuse.

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91 Knox, note 20 above, pp. 3 and 6.

92 See Part 6 and Schedule 1 (Conditions of Release) of the *Superannuation Industry Supervision Regulations.*

As noted in section 2.3(g), I believe this tax shelter effect is desirable to encourage people to take pensions rather than lump sums.

2.10 THE TAXATION OF WITHDRAWALS FROM SAVINGS

(a) Should taxes on withdrawal of superannuation savings be repealed?

As noted above, if superannuation savings are made out of after-tax income there is no justification for taxing superannuation savings when withdrawn from the superannuation system, as that would involve double taxation.

Accordingly, in my view all withdrawals from superannuation savings should be tax free. I believe the current superannuation laws ensure that withdrawal is permitted only in cases of genuine retirement from the workforce or death or disability.[93]

Interestingly, Edstein proposes to tax benefits on withdrawal, with the consequence that some form of imputation credit system should be established to prevent the double taxation of earnings that would result on withdrawal.[94]

(b) Can we avoid grandparenting?

The problem is that at the time of any reform of the taxation of superannuation, there will be accrued benefits which are potentially liable to tax on withdrawal. These appear principally to be:[95]

(a) pre-July 1983 lump sum benefits, of which 5% is taxable at marginal rates;

(b) post-June 1983 taxed component of lump sum benefits, of which the first $90,474 is tax free and the excess taxed at 15%;[96]

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93 ibid.

94 Edstein, note 20 above, p. 17.

95 Senate Select Committee, note 1 above, pp. 18 and 20.

96 I disregard the position for under age 55 as those taxable components can be rolled over.

(c) excessive component of lump sum benefits, previously untaxed, which is taxable at marginal rates;

(d) untaxed component of employer contributions to benefits out of which a pension or annuity will be paid,[97] which is taxable at marginal rates and rebatable at 15%.

I believe it would be desirable to avoid grandparenting[98] the current system of taxing these benefits at withdrawal. Grandparenting would involve continuing the entire pre-reform complex regime for taxing lump sums, pensions and annuities.

It would be desirable to have an estimate of the likely tax liability, and bearing in mind the future dates at which the taxing point would occur, the *present value* of that tax liability. The options for dealing with this are:

A. Make transitional arrangements to continue collecting tax in respect of benefits accrued at the reform date in accordance with the previous tax law when the benefits are paid.

B. Forgive the liability by exempting withdrawals from the superannuation system absolutely, and compensate by either or both:

(i) introducing progressive taxes on earnings;

(ii) collect a once off tax as a percentage of the benefits accrued at the reform date that would have been subject to future tax.

I believe that option B ought to be preferred in principle.

(c) Can we trade off future taxes?

Professor Knox has suggested an increase in the tax rate on earnings from 15% to 20% to trade off abolition of the

[97] This is the amount left after eliminating undeducted purchase price component, taxed contributions and taxed earnings.

[98] The politically correct term for what used to be known as grandfathering, that is, preserving the old tax regime for benefits accrued before the date the law is changed. The treatment of ETPs in respect of pre-July 1983 service is an example.

surcharge.[99] Maybe an increase in earnings tax with mild progressivity would generate the necessary revenue.

For example, a flat tax with a constant 17% marginal rate and tax free threshold of $1,000 earnings per member (or $10,000 of accrued benefits per member in a defined benefit fund) might be a useful basis for further consideration.[100]

(d) Can the exemption of accrued benefits be bought?

It would be necessary to calculate the future tax liability being foregone. However, as an indication, I suggest considering something like a once off tax not exceeding 15% on the specific components of accrued benefits identified under paragraph 2.10(b) in order to buy their future tax exempt status on withdrawal from the superannuation system.

2.11 SOME REFORM PROPOSALS

(a) Vince Fitzgerald

The National Savings Report did not contain a comprehensive proposal for reform of the taxation of superannuation. However, Fitzgerald made some passing observations as to the "ideal approach" which may be of interest:[101]

(i) savings, including superannuation savings, should be exempt from tax at the point of saving;

(ii) there should be no tax on earnings in the savings vehicle;

(iii) withdrawals from saving should be fully taxed at marginal rates.

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[99] Knox, note 20 above, p. 5.

[100] As an indication, for a member with an account balance of $50,000 and earnings of $5,000 the trustee would pay an average rate of tax of 13.6%; for an account balance of $100,000 and earnings of $10,000 the trustee would pay an average rate of tax of 15.3%; and for an account balance of $500,000 and earnings of $50,000 the trustee would pay an average rate of tax of 16.6%. It would be desirable that the impact of progression not be so great as to justify the administrative costs of splitting the benefit between two or more funds.

[101] Fitzgerald, note 24 above, p. 10.

As a *reasonable approximation* to the above, Fitzgerald recommended in a footnote there should be a 15% rebate on contributions and a 15% tax on earnings.

Fitzgerald made a telling point that superannuation savings must be made competitive with other forms of household investment, such as owner-occupied and investment property, which enjoy preferential tax and social security treatment.[102]

(b) Professor David Knox

Professor Knox sets out to devise a revenue neutral reform proposal which, by definition, rules out replacing taxes on contributions with later taxes on benefits.[103]

In summary, his proposal is:[104]

(i) abolish the surcharge and reduce the contributions tax to something around 10%-13%, to encourage people to receive deductible superannuation contributions.

(ii) increase the tax on superannuation fund earnings from 15% to 20% while maintaining access to imputation credits,[105] to pay for the abolition of the surcharge and the reduction in contributions tax.

(iii) phase in over a 15 year period an increase of tax on post-1983 lump sum benefits exceeding $250,000 from 15% to 30%, to restore equity upon abolition of the surcharge.

(iv) maintain the current 15% rebate on pensions and annuities to encourage retirement income streams compared to lump sums.

(v) improve the effectiveness of the current savings rebate to encourage long term savings.

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102 Fitzgerald, note 24 above, p. 10.

103 Knox, note 20 above, p. 4.

104 Knox, note 20 above, p. 5.

105 He estimates that the effective rate of tax collections after allowing for imputation credits is about 7.5% currently and 12.5% under his proposal: ibid, p. 10.

Because he does not propose reductions in taxes on withdrawal of superannuation savings, there is no need to grandparent past benefits.[106]

Professor Knox estimates that his proposal would be slightly regressive due to his suggested higher rates on lump sum benefits, but that this could be ameliorated by persons electing to take pensions or annuities instead.[107]

Professor Knox notes that if tax reform results in a reduction in the rates of personal tax, superannuation will become less attractive - his suggestion of reduced contributions tax is designed to improve immediate attractiveness.[108]

(c) Access Economics

The proposal is in summary:[109]

(i) abolish the 15% contribution tax and the 15% surcharge on deductible contributions;

(ii) abolish the 15% earnings tax and allow a refund of tax for dividend imputation credits;

(iii) all superannuation contributions, voluntary or compulsory, should be deductible;

(iv) abolish RBLs and age-based contribution limits;

(v) lump sums and pensions and annuities to be fully taxable at marginal rates (the progressive rate structure automatically encourages pensions rather than lump sums);

(vi) the new regime to apply to contributions and earnings *after* the reform date.

The aim of the Access Economics proposal is to increase superannuation savings, but the Senate Superannuation

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106 Knox, note 20 above, p. 6.

107 Knox, note 20 above, pp. 10-11.

108 Knox, note 20 above, pp. 12.

109 Senate Select Committee, note 1 above, p. 22.

Committee has stated it is more concerned with providing retirement *incomes*.[110]

(d) John Edstein

The proposal is in summary:[111]

(i) all superannuation contributions, voluntary or compulsory, should be deductible (this requires extending deductions for self-employed and employer supported employees);

(ii) no tax on any contributions in the hands of superannuation funds;

(iii) tax fund earnings at 25% to 30% and provide the beneficiary an imputation credit on receipt of benefits for tax paid by the fund;

(iv) abolish RBLs and relax age-based contribution limits;

(v) lump sums and pensions and annuities to be fully taxable at marginal rates (subject to the proposed imputation credit noted above).

Edstein does not propose specific transition arrangements. He does not appear to favour grandparenting, but considers the possibility of a gradual change over 15 or 20 years, and alternatively a proposal to allow fund members a choice between new and old tax regimes.[112]

3. CONCLUSION & RECOMMENDATIONS

On the basis of my review of the current system for the taxation of superannuation, which has been put in place since 1983, I conclude that it:

(a) militates against saving in a way the previous taxation regime did not, and may be the cause of the decline in savings in the period 1983 to 1993 from previous 30 year levels;

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110 Senate Select Committee, note 1 above, p. 22.

111 Edstein, note 20 above, pp. 17-18.

112 Edstein, note 20 above, pp. 24-25.

(b) fails the objective of horizontal equity by discriminating between employees and self-employed;

(c) fails the objective of vertical equity by discriminating unfairly between employees and self-employed and high and low income earners *without achieving fair and effective progression*;

(d) fails the objective of intergenerational equity by substantially retaining reliance on the old age pension.

In my view reform of the taxation of superannuation ought not be revenue neutral, or undertaken in isolation from tax reform generally, but ought to enhance concessions to encourage voluntary saving by people within the superannuation guarantee regime and those employees outside the regime, the self-employed, and non-working or low income spouses.

In my view reform proposals which defer the taxing point from the point of saving to the point of withdrawal of savings from the superannuation system:

(e) militate against saving (despite the significant advantage at the point of saving in deferring tax), by taxing saving as income at full marginal rates at the point of withdrawal from the superannuation system (to which should be added the impact of any consumption tax which may be introduced in future);

(f) fail the objective of horizontal equity *at the point of saving* by excluding superannuation saving from the income tax base;

(g) fail the objective of vertical equity by sheltering income appropriated to superannuation saving from the progressive tax system *at the point of saving*, when individuals are working and generating income, and deferring exposure to progressive tax rates until individuals are receiving retirement incomes;

I believe that equity objectives underlie the 15% contributions surcharge (albeit in my opinion misguided) and far from equity considerations being a distraction,[113] I believe that these objectives must to be addressed by reform proposals to

[113] Edstein, note 20 above, p. 4; ASFA note 42 above, p. 9.

preserve the integrity of the system for the taxation of superannuation.

I believe that practical revenue-raising needs of Government should be recognised, which makes it unsustainable to defer taxation of superannuation savings until the point of withdrawal of benefits. We must therefore practically deal with the need to raise revenue at the point of saving and while saving is accumulated.

In summary, my recommended reforms to achieve the policy objectives noted above are:

(i) abolish the 15% surcharge and the 15% contributions tax;

(ii) employer superannuation support and salary sacrifice arrangements would be fully taxable to the employee as income at marginal rates, for reasons of horizontal equity between employees and self-employed;

(iii) superannuation contributions would not be tax deductible to employees or self-employed,[114] but would attract a rebate of tax, for reasons of vertical equity (an indicative figure could be in the range 27% to 30%);[115]

(iv) the superannuation savings rebate would apply to contributions for non-working or low income spouses (the contributions would not be taxed as income of the non-working or low income spouse);

(v) hold steady the tax on superannuation fund earnings at 15% while maintaining access to dividend imputation credits, but review this rate (it may be necessary to increase the rate to pay for the abolition of the surcharge

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114 Employer contributions should, of course, be fully deductible.

115 The effect of a 30% rebate would be: a person earning over $50,000 and on the top marginal rate of 47% would effectively pay 17% tax on contributions and a person receiving up to $38,000 and on the 34% marginal rate would effectively pay 4% tax. If as the result of a consumption tax being introduced, say at the rate of 20%, the top marginal rate of income tax is reduced to say 34%, I believe that the suggested rebate should be unaffected. This would mean a person on the top marginal rate would pay an effective contributions tax of 4% but on retirement would be paying 20% consumption tax on his or her savings.

and the tax on withdrawals, and possibly introduce an element of progression);[116]

(vi) abolish the exemption for earnings on assets supporting pensions being drawn by an individual (the progressive rate structure automatically encourages pensions rather than lump sums), but reconsider if tax reform results in reduced personal marginal rates;[117]

(vii) withdrawal of superannuation savings as lump sum benefits and pensions and annuities would be entirely tax exempt (if necessary to ensure revenue neutral transition, introduce a once off tax on the components of accrued benefits at the reform date that would have been taxable in future under the outgoing taxation regime);[118]

(vii) focus the current savings rebate on non-superannuation savings to encourage long term savings.

As I mentioned at the outset, it is beyond the scope of this paper to calculate the revenue impact of the proposal. The recommendations above therefore represent only the first stage in developing a workable proposal for reform.

WORD COUNT: 7,075

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116 See section 2.10(c) for my ideas on a possible progressive "flat tax" on superannuation fund earnings.

117 See section 2.3(f) regarding the objective of encouraging income streams rather than lump sums. Access Economics also takes this view: see Senate Select Committee, note 1 above, p. 22. At current marginal rates a person receiving income up to $38,000 and on the 34% marginal rate has an incentive to shelter income by retaining the investment in a superannuation fund at 15%. If the marginal rate for such a person is reduced to 20% the advantage may no longer automatically favour pensions to the necessary extent, so it may be desirable to tax earnings on assets supporting pensions being drawn by an individual at a concessional rate of say 10% instead of 15%.

118 See section 2.10(b) for detailed consideration of transition issues.

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