2015-16

PRE-BUDGET SUBMISSION

February 2016

<u>Disclaimer and Information</u>

This submission uses results from the "Pension Sustainability Computer Model" based upon certain assumptions. The contents of this paper and the results from the Pension Sustainability Model should not be construed as the provision of financial advice as we disclaim all liability in this respect. The views expressed in this paper, including the assumptions and computations used in the Pension Sustainability Model, are the personal views of the authors and should not be relied upon by any party.

The SMSF Owners' Alliance Limited is a not-for-profit public company established to represent the interests of trustees and owners of Self-Managed Superannuation Funds (SMSFs). Whilst there are other organisations with similar interests and objectives, SMSF Owner's distinction is that membership is strictly limited to the trustees and owners of SMSFs.

Prepared by:
Duncan Fairweather, Executive Director and
Malcolm Clyde, Research Director
SMSF Owner's Alliance Limited
admin@smsfoa.org.au

Summary

The SMSF Owners' Alliance (SMSF Owners) is encouraged by reports that the Treasurer wishes to reduce expenditure to 25% of GDP. Since our first pre-Budget submission three years ago we have consistently pointed out that the facts clearly demonstrate that the Australian Government's 'spending problem' is bigger than its 'revenue' problem.

We also applaud the Government's stated position that the main purpose of tax reform is not to raise more revenue but to adjust how taxes are imposed so as to minimise the tax drag on economic growth and savings.

The Treasurer has also reiterated his understanding of the damage retrospective taxation can cause self-funded retirees and that the direct or indirect imposition of taxes can adversely impact the earnings they have to live on. In this regard, we understand the appeal of increasing or extending GST in order to improve bracket creep but it should be acknowledged that if this happens, self-funded retirees will be about the only group that will pay more GST but have no compensation.

As we write this, it is unclear as to whether or not the Government will continue to follow the current Tax White Paper process in its consideration of tax reform issues. Accordingly, we cover issues in this Pre-Budget Submission that should perhaps be more appropriate in a response to a Green Paper. However, we have endeavoured to keep this submission as short as possible. We have not included much of the analysis that supports our conclusions. In the event that the Government wishes to further understand how we have reached certain conclusions, we would be happy to provide more detailed explanations as necessary on request.

Throughout this submission we refer to the existing superannuation tax structure as the 'Current System' and compare it to the 'International Standard' – the EET system applied in many comparable countries and which used to apply in Australia until the late 1980s when new taxes where introduced on superannuation contributions and accumulating earnings. We also refer to the Proposal in our submissions to the White Paper Task Force which entails taxing individuals on contributions with a flat tax benefit and removing the tax on superannuation earnings. This Proposal would result in a fairer and more efficient retirement savings system that would deliver better outcomes for savers at a lower cost to the Federal Budget.

As we finalise this submission, we read that Industry Super Australia has published tables purporting to show large numbers of Australians would be worse off under a similar system to this that the Government appears to be considering. It is therefore worthwhile pointing out why this is not the case under our Proposal:

1. The introduction of progressive taxation of contributions should only be done concurrently with improvements in the current bracket creep situation;
2. We propose dropping super earnings taxation which, as Dr Henry pointed out, would make the system more efficient and so lower the contributions necessary to achieve the same ends;
3. Lower superannuation guarantee and contribution rates should mean the savings in contributions can be paid directly to the taxpayer.

We canvassed these issues in our earlier submissions to the Task White Paper Task Force.
150603_SMSFOwnersAlliance_submissionTaxWhitePaperTaskForce.pdf and
150724_SMSF_Owners_Alliance_supplementary_submission_to_Tax_White_Paper_Taskforce
We welcome debate of these issues but they should be supported by thorough analysis.

The main subjects of this submission are:

1. **Budget balance is mainly a spending issue.**

While there are some signs of expenditure controls taking effect, the highest level of Government revenue ever is still not meeting the expenditure blow-out.

2. **Objectives of superannuation**

We agree that the main purpose of superannuation is to fund retirement. There is general acknowledgement that retiring on 60-70% of pre-retirement after-tax income is a desirable objective for a developed retirement system However, we are concerned that Treasury modelling of super pensions equal to 70% of **median** income suggests that they may be pushing to **reduce** contribution caps.

A fair system should have caps set high enough to allow **most** Australians to retire on self-funded pensions equal to 60-70% of **their** pre-retirement income.

On another matter, many people are anxious to ensure that their savings last throughout their retirement and are also sufficient to meet any unforeseen costs. Any plans by Government to address excessive tax-free transfers to non-dependants should not adversely impact retirees during their retirement.

3. **Improving superannuation equity**

An equal tax benefit on contributions is fair if tax threshold rates are lowered to reduce bracket creep. Our Proposal is fairer and costs the Government less in Age Pension and tax concessions than the current system – to achieve the same outcome.

4. **Ignore the Tax Expenditures Statement – and focus on tax efficiency**

Forget narrowly focussed theoretical benchmarks that economists can't agree on. Let us compare the effectiveness of any proposed changes to superannuation with the International Standard (EET) system.

5. **Drop taxes on superannuation earnings**

Dropping taxes on superannuation earnings would, with correct adjustment to taxation of contributions, increase Government tax revenue from superannuation.

6. **Imputation**

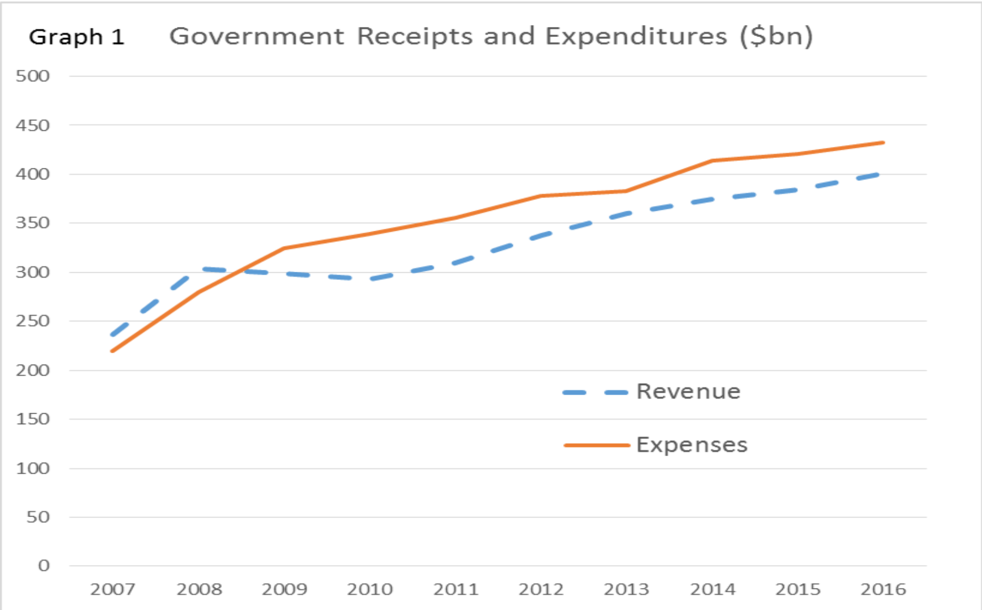
Superannuation funds are treated no differently to other Australian investors in relation to imputation. Removing or reducing imputation will lead to higher gearing levels in companies, distort capital structures and be devastating for Australian equity values.

1. Budget balance is mainly a spending issue.

The Budget Papers frequently refer to Government revenue and expenses as a percentage of GDP. Whilst this measure can be a useful long-term benchmark, over-reliance on it in relation to short-term budget assessment can lead to poor policy decisions.

A more fundamental measure of Budget 'performance' such as benchmarking actual dollar expenses against historical performance (after adjusted for inflation and population) should also be considered and reported. Such a 'bottom up' cash approach is often taken by financial controllers of major corporations when analysing the causes of over-expenditure.

The dashed blue line in Graph 1 shows Government tax and other revenue and the solid red line shows Government expenditure, including the provision of such services as Social Security, Health and Education.

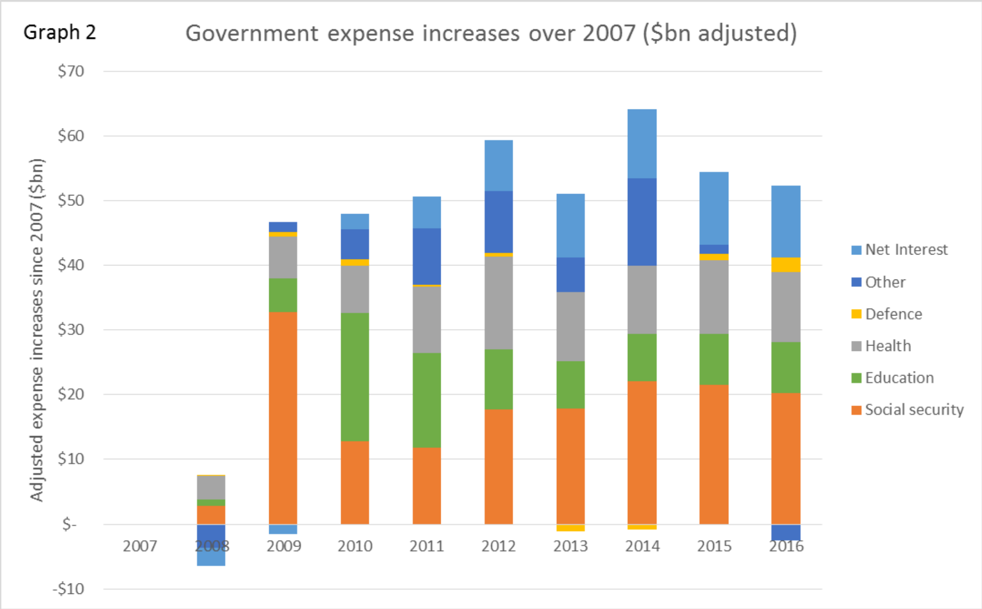


This graph illustrates the growth in both revenue and expenditure since 2007, a year in which at the time there were many complaints that the Government of the day was over-spending. The reality is that both revenue and expenditure have grown strongly since 2007 to record highs.

A key message from this graph is that what was supposed to be a temporary stimulus in response to the GFC was not wound back when the economy improved. Revenue has continued to rise to record levels but spending has also continued to rise; the gap between them remains significant and the deficit remains large.

An immediate criticism of the above graph could be that it does not consider inflation, nor the fact that Australia's population in growing and thus placing additional demands on Government. Another very effective measure of budget performance would therefore be to simply compare expenditures with 2007 after adjusting for inflation and also for increases in population.

Accordingly, in preparing the second graph (Graph 2) we have adjusted historical expenditures to be expressed in 2015-16 dollars and adjusted for increases in population. The increases in the resultant figures from 2007 are then graphed in $billions for Social Security, Health, Education, Defence and Other. We have also shown the Government's net interest expense separately.



This graph clearly illustrates how expenses blew out in 2009 and continued to grow. Although some reductions have been achieved in recent budgets, expenditures remain substantially above the level in 2007 - when the Government of the day was criticised for over-spending. This graph also shows the dramatic impact of the Government's growing interest bill.

Despite the complaints by various interest groups, the facts are that expenditure on Health, Education and Social Security are substantially higher now than in 2007 – even after adjusting for increases in inflation and population, though the graph also shows that there is starting to be some success in winding expenditures back to more reasonable levels.

There are some signs of expenditure controls taking effect but the highest Government revenue ever is still not meeting the expenditure blow-out.

2. Objectives of superannuation

Clearly, the principal purpose of superannuation is to encourage the funding of retirement independent of Government. It is generally accepted internationally that people should be encouraged to save enough to fund a pension equal to 60 – 70% of their pre-retirement after tax income (known as the 'Replacement Rate').

The Treasurer revealed in a recent speech (27 November 2015 to the ASFA conference), while addressing the adequacy of superannuation, that Treasury is modelling replacement rates based on **median** income, currently about $52,000. The implication that can be drawn is that Treasury want contributions to be capped so that no-one can save more in super than just enough to pay a pension equal to 70% of **median** earnings.

We hope this is not the case because all serious students of retirement systems (such as Dr Henry, World Bank and OECD) agree that in a developed economy a fair system would allow most people to save enough to retire on 60 - 70% of **their** pre-retirement income. Caps on contribution should be adequate to allow them to do so, recognising that many are only in a position to contribute extra funds into super in the last 10-15 years of their working life.

In the modelling that supports our Proposal, we have assumed that the Replacement Rate should be 70% for those on lower incomes, falling to 60% for those on higher incomes. A reasonable assumption is that the contributions caps should allow those on incomes up to 3 times Average Weekly Ordinary Time Earnings (AWOTE) to save enough in super to meet this target.

Under the Current system, this would require raising the cap to $60,000 pa and the Government should do this as a matter of urgency if it makes no changes to super. (If the Government moved to our Proposal however, the current annual cap of $30,000 would be adequate to meet this objective because of the removal of all taxation in the super fund and increases in tax efficiency).

We acknowledge the concern that people may use the superannuation system to accumulate funds to leave to their heirs.

There are currently minimum withdrawals levels for super to address this issue. However, these only apply once a pension has commenced although there is currently no imperative to actually commence a pension. Consistent with the main objective of super, the Government could consider setting an age by which the minimum pension withdrawals must start.

However, the Government should also recognise that self-funded retirees are very conscious of their need to ‘self-insure’ against unexpected events – from dramatic reductions in investment income – to extraordinary medical expenses or other unforeseen changes in their circumstances. Their life-expectancy is also uncertain. Until competitively priced products are developed to insure against such risks, it is very reasonable for retirees to want to moderate their spending in retirement – not with the intention of leaving funds to their heirs but to self-insure against such risks.

Such a prudent attitude to expenditure also reduces the risk of calls on Age Pensions and other Government services. Self-funded retirees are presently very conscious of these issues given the reduction in investment earnings and expectations that this position may continue for a number of years.

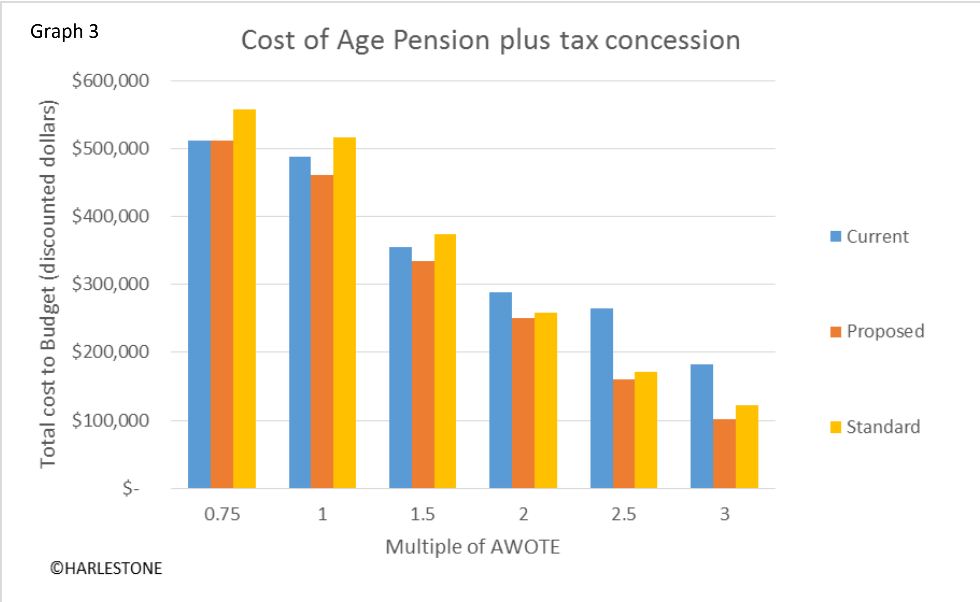
Any super funds left to non-dependants are taxed under the current system but superannuants can currently withdraw substantial funds and gift them to non-dependants before their death without any taxation. If the Government wishes to address this issue, it should not do so in any way which would impact the funds available to retirees for unforeseen issues during their retirement but maybe consider including substantial gifts to non-dependants just prior to death in any taxation of super balances on death.

3. Improving superannuation equity

Under the current system, the superannuation tax concessions are greater for those on higher incomes, but these Australians also pay much higher taxes. Indeed the tax concessions fall as a percentage of lifetime taxes paid by those on higher incomes. On this basis the tax concessions do not appear unfair.

Furthermore, such comparison ignores the Government's Age Pension costs which fall dramatically with income.

However, it is generally recognised that our income tax scale is too progressive by international standards. If our upper tax thresholds were to be raised to more reasonable international standards then it would make sense for the Government to concurrently move to a system of progressive taxation of contributions with an equal tax benefit (rebate) for everyone. Our modelling shows that such a system is more efficient in providing the same outcome for more Australians at a lower cost to Government.



Graph 3 shows the total cost to Government (in present value terms) of Age Pension payments plus tax concessions for Australians on a range of incomes (expressed as multiples of AWOTE) achieving a 60-70% replacement rate.

We have modelled this for the Current system (when mature), for our proposed system of equal tax benefit on contributions (i.e. 'progressive' taxation of contributions) and the International Standard which exempts contributions and earnings but taxes pensions at progressive rates.
This graph shows declining cost with income but in particular shows the cost to the Government of our Proposal would – like the Standard – be lower than the Current system across the income range.

4. Ignore the Tax Expenditure Statement – and focus on tax efficiency

The recently published 2015 Tax Expenditures Statement (TES) again illustrates why this document should be ignored for the time being as a basis for policy making.

We were encouraged to be invited by a House of Representatives Committee to provide evidence on the usefulness of the Tax Expenditures Statements published annually by Treasury. We understand that Treasury follows historical precedents in relation to choice of benchmarks to calculate tax expenditures. However, given the number of serious submissions to the Committee criticising this historical approach as being misleading in relation to savings incentives, we are disappointed that no changes to the benchmark have been recommended by this Committee and adopted by Treasury.

However, we note that the Government has yet to respond to the Committee on this issue and so it still has the opportunity to propose changes to the TES for next year that will result in a more meaningful document.

But for now we again have a document that Treasury and the Treasurer have described as providing figures for ‘tax expenditures’ that should **not** be relied upon as an indication of savings in tax if such tax concessions were not available and certainly should not be compared with actual (i.e. real cash) direct expenditures of Government. It also does not give any meaningful guide as to whether the tax expenditures are at an appropriate level to achieve their objective.

We have formed the view that economists will continue to argue about the choice of benchmark in estimating the level of tax concessions. This may be exciting for some but what is really relevant is to get a better understanding of whether the tax incentives granted to superannuation are too large for their purpose or too small – either under the Current system or under any alternative systems the Government wishes to consider.

So we propose a different – and more practical – approach. Almost all commentators on the subject of retirement savings agree that the internationally accepted standard for the ’ideal’ savings incentive system is the one in which contributions and earnings are untaxed but the pension is taxed when drawn.

This is known by economists as the EET system but we’ll refer to it as the International Standard.

Our system used to be this International Standard until a Labor Government introduced a new tax on contributions and earnings back in the late ‘80s.

It is generally recognised that it would now be difficult to revert to this Standard without running two systems in parallel for a generation – and this would be cumbersome and come with large administrative costs.

However, Dr Henry first suggested that taxing contributions at progressive rates and reducing taxes on earnings would get us closer to this International Standard.

We propose that, in assessing the adequacy of tax incentives, the current system and any alternatives could be compared with the International Standard. If the objective of tax reform is to improve efficiency then, in relation to savings, the cost to Government of alternatives could then be measured relative to the International Standard to achieve the same outcome.

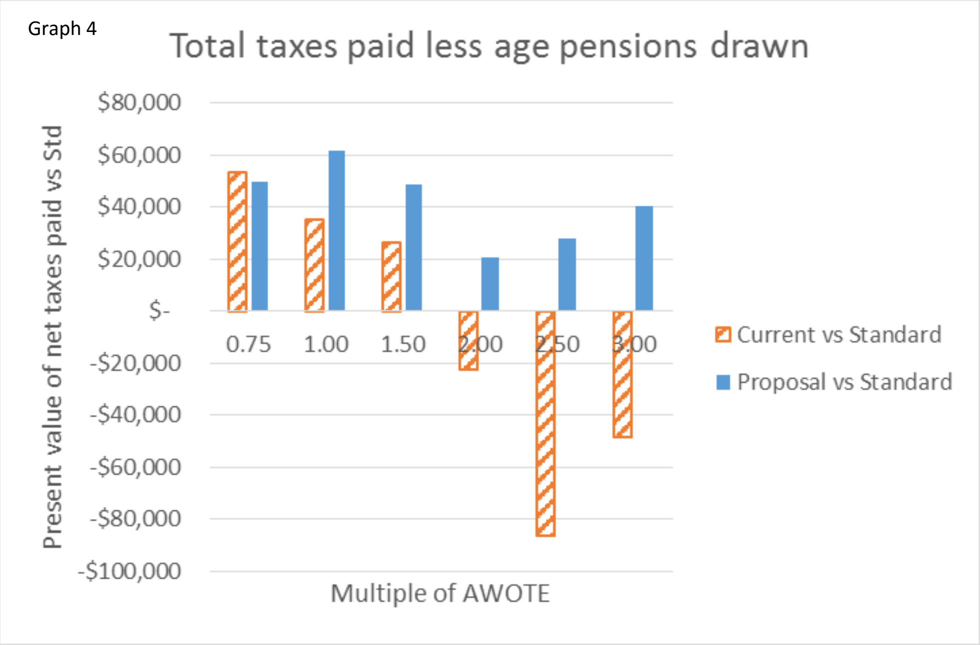
5. Drop superannuation earnings’ taxes

We agree with Dr Henry that introducing progressive taxation of contributions would improve equity in the system if done in conjunction with improving bracket creep.

We also agree that reducing the taxation of superannuation earnings would increase the efficiency of the tax system and bring it closer to the International Standard. We have therefore, in our Proposal, modelled the removal of ALL taxation of superannuation earnings to match the International Standard but then reduced the taxation benefit on contributions to result in a neutral impact on Government revenue.

This latter point is often missed by commentators. To provide a fair comparison of systems one must consider alternative systems **providing the same outcome**. We believe that a reasonable outcome is that superannuation is adequate to provide self-funded pensions equal to 60-70% of pre-retirement income for Australians on incomes of up to, say, 3 x AWOTE.

To prepare this Graph 4, we calculated the present value of total taxes received by Government less Age Pension payments for people on a range of incomes (expressed as multiples of AWOTE) and for the Current system (when mature), our Proposal and the International Standard system we used to have. The graph then shows the extra net taxes that would be received by the Government under the Current system and our Proposal compared with the International Standard.



The Graph shows that the net taxes received by Government under our Proposal are higher than the International Standard across the income range i.e. tax concessions would be lower than if we had the International Standard system. It also illustrates the distortions in the Current system caused by interaction of the flat contributions tax and progressive income tax, showing that for a number of Australians the Government net tax receipts are lower than the International Standard.

Dropping the taxes on superannuation earnings introduced by Labor in the 80s would, together with 'progressive' taxation of contributions, increase Government tax revenue from superannuation.

Our proposal involves taxing the individual rather than the super fund for contributions (with a rebate) and so, with the removal of earnings taxation, the operation of super funds is substantially simplified. The impact on effectiveness of super by the consequential reduction in costs over time would be dramatic. More effective super means more Government tax revenue for Australians to achieve the same self-funded pensions as could be achieved under the Current system.

6. Imputation

Dividend imputation was introduced, correctly in our view, to eliminate double taxation of corporate profits and remove the distortion that this would otherwise cause in the markets.

There has been some suggestion that dividend imputation somehow favours superannuation given that its tax rate, being below the corporate tax rate, leads to the Australian Tax Office providing a net credit to many super funds. This is incorrect.

Other claims that the bond market is disadvantaged by imputation because interest payments (coupons) on bonds do not carry tax credits are also incorrect. This claim ignores the fact that interest payments on bonds are deductible to the issuing corporations, whereas dividends are not, so that the tax impact on cost of capital is neutral with imputation and would be distorted without it.

Removing or reducing the impact of imputation will encourage more leverage in companies and correspondingly increase corporate risk.

It is also incorrect to suggest that the availability of imputation credits to superannuation funds unreasonably reduces Government revenue. Such comments appear to indicate a misunderstanding of how the imputation system works in aggregate.

Dividends distributed to any Australian investor can include two components – a cash dividend and a non-cash “credit” note to be claimed by the investor from the Australian Tax Office. This imputation credit is income to the Australian investor – whether an individual or superannuation fund – and treated as such by auditors and the Australian Tax Office.

All such investors can claim this element of the dividend from the Australian Tax Office. Superannuation funds are treated no differently to other Australian investors in this regard. Investors are then taxed on their income – including this credit – at the relevant tax rate.

It is therefore untrue for some to claim that the refunding of imputation credits to superannuation funds is a benefit that other Australian investors do not share.

Furthermore, removing or reducing this credit would distort and be devastating to the Australian equity market. The value of a company’s shares is the present value of its expected future dividend payments. If imputation is removed then these values for Australian investors would fall by 30% at a stroke! The impact on an already depressed and nervous share market would be catastrophic.

On balance, imputation can be considered to be contributing to the development of a strong domestic funding base for our industry and its removal would cause considerably more distortion by re-introducing double taxation and the bias in favour of debt funding.