ISN BRIEFING NOTE

BANG FOR YOUR BUCK

ASSESSING THE IMPACT OF THE HENRY TAX PROPOSALS FOR SUPER

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Industry Super Network

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About Industry Super Network

Industry Super Network (ISN) is an umbrella organisation for the industry super movement. ISN manages collective projects on behalf of a number of industry super funds with the objective of maximising the retirement savings of five million industry super members. Please direct questions and comments to:

Matthew Linden

Chief Policy Adviser
Level 3, 39 Brisbane Av
Barton 2600

02 6273 4333

mlinden@industrysuper.com

1. Executive Summary

Australia's Future Tax System Review (Henry Review) proposed a range of taxation reforms to simplify the tax treatment of superannuation and enhance the efficiency and equity of Australia's retirement income system. For the most part these proposals were not taken up by the Government in its initial response to the review. Instead it sought to address a number of the weaknesses identified by the review using different policy levers.

This briefing note considers the detail of the key recommendations made by the Henry Review and identifies a number of issues which would make implementation of the reforms difficult. These issues include the significant budget impact of the proposals, the distributional effects of the reforms, and limitations in existing administrative systems which would likely lead to abrupt impacts on the take home earnings of workers upon implementation.

It is likely that these factors heavily influenced the Government's decision to pursue alternative policy mechanisms to address adequacy and equity, namely by; increasing the Superannuation Guarantee (SG) to 12 percent and rebating the contributions tax paid by lower income earners.

This briefing note finds the Government's proposed reforms will be a relatively efficient means to lift retirement savings by virtue of their more modest budget impact, capacity to be readily implemented using existing administrative systems, and phased introduction which should result in no absolute reduction in the real take home pay of employees.

2. Background to the Henry Tax Proposals for Super

The Henry proposals for superannuation included a number of linked reforms to the existing tax arrangements for superannuation. The reforms included five key proposals:

- The abolition of the existing 15 percent contributions tax, though a requirement that all contributions (SG and voluntary contributions) be made out of after tax income at PAYG marginal tax rates;
- The concession on contributions would be delivered by a 20 percent tax offset paid to the taxpayer;
- The 20 percent tax offset would also replace the existing low income co-contribution scheme, self employed deduction and spouse tax offset;
- These revised contribution tax arrangements were complemented by a halving in the headline earnings tax rate from 15 percent to 7.5 percent;
- However, the zero earnings tax for accounts in the drawdown phase would be removed and replaced with the proposed 7.5 percent earnings tax rate.

The rationale for the reforms was to simplify the existing relatively complex contribution tax concession arrangements, and enhance equity. The Review suggested the changes would move taxation of Australia's retirement income system closer to the expenditure tax benchmark used in other OECD countries.

3. Fiscal impacts

The Henry Review estimated the fiscal impact of its retirement income proposals at approximately $5bn per annum[i] although it didn't identify the component costs of each aspect of the policy.

Since publication of the Review the Treasurer has released additional information on the budget impacts and indicative distributional effects of the policy[ii].

This analysis shows the $5 billion cost growing rapidly into the forward estimates with the largest component cost flowing from the halving in the earnings tax.

3.1 Earnings tax impacts

During the accumulation phase the halving of the earnings tax was estimated to cost revenue $2.8 billion in 2011-12, and increasing to $6.5 billion by 2017-18.

This is partially offset by the effective increase in earnings tax on the drawdown phase which boosts revenue by $850 million in 2011-12 increasing to $1.6 billion in 2017-18 with no grandfathering. With grandfathering the revenue gain is significantly less – only $70 million in 2011-12 increasing to $700 million in 2017-18.

The net effect of both elements shows the cost of the earnings tax measures is $2.0-2.7 billion in 2011-12 (depending on grandfathering) increasing to $5.0-5.8 billion in 2017-18.

What is evident, at least over the forecast period provided, is that the cost to revenue from the halving of earnings tax in the accumulation phase is growing at a much faster pace than the corresponding offset to revenue by imposing a tax on the draw down phase. The revenue impacts suggest the cost of the halving of the earnings tax is outstripping the saving from imposing the earnings tax during drawdown by more than a third.

It would seem this outcome is not fiscally sustainable in the medium and possibly long term depending on the relative size of the earning's tax bases in the accumulation and draw down phases as the system continues to mature.

3.2 Contributions tax impacts

The changes to the contributions tax arrangements would also come at a net additional cost. After taxing at the marginal rate, abolishing the existing 15 percent contributions tax, introducing a 20 percent rebate and abolishing the existing low-income co-contribution and spouse rebate the net cost to revenue is $3.1 billion in 2012-13 increasing to $4.0 billion by 2017-18.

These revenue impacts appear much more sustainable than the earnings tax proposals over the medium term with only modest annual growth evident.

3.3 Combined revenue impacts

The combined impact on revenue of the earnings tax and contribution tax proposals are significant with the cheapest option (no grandfathering of earnings tax on drawdown) costing $6.0 billion in 2012-13 increasing to $8.9 billion by 2017-18.

With grandfathering the combined impact is $7.1 billion in 2012-13 increasing to $9.9 billion by 2017-18.

Clearly the cost of the proposals increases sharply and would be exacerbated by concessions (such as grandfathering and potentially necessary adjustments to the personal income tax rate scale) needed to gain community support.

These Budget impacts compare to the relatively modest $1.07 billion[iii] cost in 2013-14 of the Government's proposed increase in the SG and new low income earners government contribution – though the impact would be in the order of $3.7 billion after allowing for the full phase in of the SG to 12 percent.

Nevertheless compared to the Henry proposals the option proposed by the Government has a revenue cost around one seventh the size at implementation and at least half the cost over the longer term.

It could be argued the recommended Henry proposals would be an unsustainable budget impost given the current fiscal circumstances, and would likely increase sharply in the medium term as the tax base for the earnings tax component of the policy is growing rapidly. In contrast the Government's proposed changes seem much more affordable

4. Distributional impacts

As described in the Review's final report there are a number of distributional issues to consider with the recommended proposals.

Distributional impacts arise from all the key elements of the proposal. The contribution tax changes, earnings tax changes, and the abolition of existing concession arrangements such as the low income co-contribution scheme all have discrete impacts which are highly dependent on individual circumstances such as income, level of existing voluntary contributions, existing fund balance and duration until retirement.

Very broadly the effects can be described as follows:

- The ***contribution tax arrangements*** advantage low income earners to the detriment of higher income earners, however for low income earners who currently make voluntary contributions the proposed treatment is inferior to the status quo due to the abolition of the low income co-contribution;
- The ***earnings tax arrangements*** advantage higher income earners to a greater extent than lower income earners. However the suggested arrangements are likely to disadvantage those close to retirement or in retirement who will pay more tax in the draw down phase.

The most readily identifiable impact for individuals would arise from the new contribution tax arrangements. The model proposes that the minimum 9 percent SG contribution be paid in after tax income at PAYG rates. In effect, this results in an increase in mandatory contributions as the 9 percent SG is currently paid in pre-tax dollars and then taxed on entry into the fund at 15 percent resulting in a net SG contribution of 7.65 percent.

To offset the impact of this the review has proposed a 20 percent tax offset to be paid direct to the taxpayer, however this is insufficient to counter the increased PAYG tax withholdings and higher net contributions to the fund. Treasury analysis suggests the proposal would result in 7.3 million people suffering a loss of current disposable income[iv].

It is estimated that a worker on Average Weekly Earnings of $65,000 would suffer a loss of disposable income of around $16 a week as a consequence of the changes if implemented with current tax scales (see table 1 below). A full summary of workings for individuals at different multiples of AWE can be found at Attachment A.

Table 1 – Impact of Henry proposals on disposable income and net contributions for worker on average weekly earnings (2010-11 tax scales incorporating Medicare Levy and Low Income Tax Offset)

	Current Treatment	Proposed Treatment	Change (annual)	Change (weekly)
Gross earnings	$65,000	$65,000	$0	$0
SG contribution	$5,850	$5,850	$0	$0
PAYG Tax	$12,565	$14,542	$1,977	$38
Contributions Tax	$878	$0	-$878	-$17
Net super contribution	**$4,973**	**$5,850**	**$878**	**$17**
Super Tax Rebate	$0	$1,170	$1,170	$23
Disposable income	**$52,435**	**$51,628**	**-$807**	**-$16**

It also clear that for lower income earners who do make voluntary after tax contributions the proposed 20 percent super tax rebate is less generous than the low income co-contribution scheme which offers a co-contribution of up to 100 percent (capped at $1000 per annum).

The review concedes, in spite of the new 20 percent tax offset, that the proposals will have a negative impact on the pre-retirement disposable income of many workers. Indeed the report notes:

> "In this respect, the proposal is similar to requiring employees to make an additional compulsory contribution into superannuation."[v]

The Review's concession about the impact of the proposal on disposable income is somewhat curious given that it cited this reason for declining to support an increase in the SG.

This outcome should not be surprising as increases in retirement income adequacy (apart from efficiency gains within funds or the investment process) can only come from a higher level of contributions or reduced taxation. All things being equal the burden of increased contributions will eventually fall on employees (even if the legal incidence is on employers). Similarly reduced taxation on retirement savings will necessitate a higher level of taxation in other areas (such as wages or consumption) for a government to meet its fiscal objectives. Higher taxes in these areas also impact on the real disposable income of workers. In other words there is no magic pudding to improve the adequacy of post retirement income – it must come, at least in part, through an impact on pre-retirement income.

As noted in the report, over a lifetime these effects are mitigated (particularly for higher income earners) by the halving of the earnings tax rate. However there are significant timing issues which arise. For example for someone near retirement the combined impact could be quite negative (since the reimposition of earnings tax in the retirement phase would be negative without sufficient time to benefit from the halving during the accumulation phase). These effects could be mitigated to an extent through transitional arrangements but the rules would add to complexity.

4.1 Administrative issues:

To complicate matters further there are some administrative issues which would result, at least in the early stages of a policy roll out. These are due to timing differences between the higher PAYG taxation of super contributions and the payment of the proposed 20 percent tax offset. This could produce quite abrupt changes in disposable income for employees.

Until real time PAYG data exchange occurs between employers and the ATO there would be a time lag between when contributions are paid and the tax offset is received by the taxpayer (up to 12 months). Although some transitional measures could be introduced to replicate the effect of the rebate in PAYG tax withholding scales they would not be responsive in instances where contributions are greater than the mandatory level.

Additionally, as noted in the Final Report to Government, as SG contributions would form a component of PAYG taxable income there could be potential impacts on social security and family assistance transfers which have income tests based on taxable income or adjusted taxable income. This effect could be mitigated through making additional adjustments to Adjusted Taxable Income (ATI) to remove the SG component. This solution would be contingent on system changes to enable more timely exchange of data between employers, the ATO and Centrelink and the Family Assistance Office.

In contrast to these difficulties the Government's proposed changes could be introduced readily using existing systems and arrangements. The phased increase in the SG would be a factor in wage negotiations but with an annual upward adjustment of between 0.25 and 0.5 percent it could be factored into annual wage adjustments without any need for real wages to decline from one year to the next noting average real wage growth is around 1.5-2.0 percent per annum.

Similarly the calculation and payment of the proposed Government co-contribution for low income earners could use similar systems already in use for the low income co-contribution scheme.

4.2 Impact on adequacy:

The Review noted that its proposals would have a favourable impact on adequacy – indeed more so than an increase in the SG to 12 percent.

However it is clear that this arises in large part to an increased fiscal impact (approximately twice as great as the Government's proposed mature reforms), as well as a diminution in pre-retirement income through higher mandatory net contributions.

It should also be noted that the 12 per cent SG proposal modelled by the review does not incorporate the Government's proposed low income rebate for those earning under $37,000 p.a. Also as noted above, the adequacy outcomes are unlikely to be favourable for some low income earners who are disciplined voluntary savers and making full use of the existing low-income co-contribution scheme.

Attachment A

Impact of Henry proposals on disposable income and net contributions for worker on different multiples of average weekly earnings (2010-11 tax scales incorporating Medicare Levy and Low Income Tax Offset)[vi]

1 X AWE

	Current Treatment	Proposed Treatment	Change (annual)	Change (weekly)
Gross earnings	$65,000	$65,000	$0	$0
SG contribution	$5,850	$5,850	$0	$0
PAYG Tax	$12,565	$14,542	$1,977	$38
Contributions Tax	$878	$0	-$878	-$17
Net super contribution	**$4,973**	**$5,850**	**$878**	**$17**
Super Tax Rebate	$0	$1,170	$1,170	$23
Disposable income	**$52,435**	**$51,628**	**-$807**	**-$16**

0.5 X AWE

	Current Treatment	Proposed Treatment	Change (annual)	Change (weekly)
Gross earnings	$32,500	$32,500	$0	$0
SG contribution	$2,925	$2,925	$0	$0
PAYG Tax	$2,823	$3,422	$600	$12
Contributions Tax	$439	$0	-$439	-$8
Net super contribution	**$2,486**	**$2,925**	**$439**	**$8**
Super Tax Rebate	$0	$585	$585	$11
Disposable income	**$29,678**	**$29,663**	**-$15**	**$0**

0.25 X AWE

	Current Treatment	Proposed Treatment	Change (annual)	Change (weekly)
Gross earnings	$16,250	$16,250	$0	$0
SG contribution	$1,463	$1,463	$0	$0
PAYG Tax	$41	$283	$241	$5
Contributions Tax	$219	$0	-$219	-$4
Net super contribution	**$1,243**	**$1,463**	**$219**	**$4**
Super Tax Rebate	$0	$293	$293	$6
Disposable income	**$16,209**	**$16,260**	**$51**	**$1**

1.5 X AWE

	Current Treatment	Proposed Treatment	Change (annual)	Change (weekly)
Gross earnings	$97,500	$97,500	$0	$0
SG contribution	$8,775	$8,775	$0	$0
PAYG Tax	$24,528	$27,906	$3,378	$65
Contributions Tax	$1,316	$0	-$1,316	-$25
Net super contribution	**$7,459**	**$8,775**	**$1,316**	**$25**
Super Tax Rebate	$0	$1,755	$1,755	$34
Disposable income	**$72,973**	**$71,349**	**-$1,623**	**-$31**

2 X AWE

	Current Treatment	Proposed Treatment	Change (annual)	Change (weekly)
Gross earnings	$130,000	$130,000	$0	$0
SG contribution	$11,700	$11,700	$0	$0
PAYG Tax	$37,040	$41,545	$4,505	$87
Contributions Tax	$1,755	$0	-$1,755	-$34
Net super contribution	**$9,945**	**$11,700**	**$1,755**	**$34**
Super Tax Rebate	$0	$2,340	$2,340	$45
Disposable income	**$92,960**	**$90,796**	**-$2,165**	**-$42**

3 X AWE

	Current Treatment	Proposed Treatment	Change (annual)	Change (weekly)
Gross earnings	$195,000	$195,000	$0	$0
SG contribution	$17,550	$17,550	$0	$0
PAYG Tax	$63,265	$71,426	$8,161	$157
Contributions Tax	$2,633	$0	-$2,633	-$51
Net super contribution	**$14,918**	**$17,550**	**$2,633**	**$51**
Super Tax Rebate	$0	$3,510	$3,510	$68
Disposable income	**$131,735**	**$127,084**	**-$4,651**	**-$89**

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[i] 2010 Australia Future Tax System Review, Final report to the Treasurer, Part One, Page 77

[ii] 2010 Treasury, Superannuation - AFTS Summary, Additional material released by Treasurer, 28 October (http://www.treasury.gov.au/contentitem.asp?NavId=035&ContentID=1895)

[iii] 2010 Australian Government, Stronger Fairer Simpler, Overview, Page 14, (SG increase to 12 percent and Low income earners Government contribution)

[iv] 2010 Treasury, Superannuation - AFTS Summary, Additional material released by Treasurer, 28 October, Table 1

[v] 2010 Australia Future Tax System Review, Final report to the Treasurer, Part Two Detailed Analysis, Page 105

[vi] Impacts assume a 9 percent SG only. Distributional outcomes produced by Treasury and released by the Treasurer on 28 October include both SG and voluntary contributions.