

The background of the slide is a dense, overlapping pattern of various US coins, including quarters, dimes, and pennies, in shades of silver and copper. The coins are slightly faded and serve as a decorative backdrop for the text.

Conference on Australia's Future Tax  
System, 18 and 19 June 2009

# Issues in the tax treatment of pensions and housing

Richard Disney

# Australia's pension programme

- Is unusual by international standards:
  - There is no contributory social insurance programme providing universal benefits
  - The publicly-provided Age Pension is subject to income and means tests
  - There is a mandatory 'pillar' of retirement saving – mostly DC (the SG), covering 90%+ of employees
- Tax treatment is complicated by:
  - Interaction of Age Pension with other components of retirement saving and other forms of wealth e.g. housing.
  - And, tax treatment of retirement saving itself; relative generosity of treatment of different assets.

# Plan of presentation

- The overall generosity of Australia's mandatory programme relative to other OECD countries
- The Age Pension: the case for greater or less means-testing.
- The Superannuation Guarantee:
  - What impact on retirement saving?
  - 'Adequacy' of retirement saving
- Tax treatment of retirement saving
- Tax treatment of housing (especially in relation to retirement saving)

## Net replacement rates from OECD pension programmes at various % of average earnings

Country	Multiple of AE	0.5	0.75	1	1.5	2
Australia		0.77	0.61	0.52	0.43	0.37
Austria		0.91	0.93	0.93	0.94	0.79
Belgium		0.83	0.64	0.63	0.51	0.41
Canada		0.89	0.68	0.57	0.4	0.31
Denmark		0.96	0.68	0.54	0.43	0.36
Finland		0.91	0.79	0.79	0.79	0.79
France		0.84	0.71	0.65	0.59	0.55
Greece		1	1	1	1	1
Ireland		0.63	0.47	0.37	0.27	0.22
Italy		0.89	0.88	0.89	0.88	0.89
Japan		0.8	0.66	0.59	0.52	0.44
Netherlands		0.83	0.88	0.84	0.86	0.84
New Zealand		0.77	0.52	0.4	0.28	0.22
Norway		0.86	0.73	0.65	0.58	0.5
Portugal		1.16	0.8	0.8	0.84	0.86
Spain		0.89	0.89	0.88	0.88	0.83
Sweden		0.9	0.76	0.68	0.7	0.74
Switzerland		0.71	0.69	0.67	0.53	0.41
UK		0.78	0.58	0.48	0.38	0.3
US		0.61	0.55	0.51	0.45	0.39

The background of the slide is a dense, overlapping pattern of various coins from different countries, including the United States, New Zealand, and Ireland. The coins are rendered in a light, semi-transparent style, creating a textured, metallic appearance. The colors range from silver to gold and copper.

## Comment on replacement rates

- Despite unique pension programme, Australia delivers very similar distribution of replacement rates to many OECD countries.
- New Zealand and Ireland are even more redistributive (only basic flat pension).

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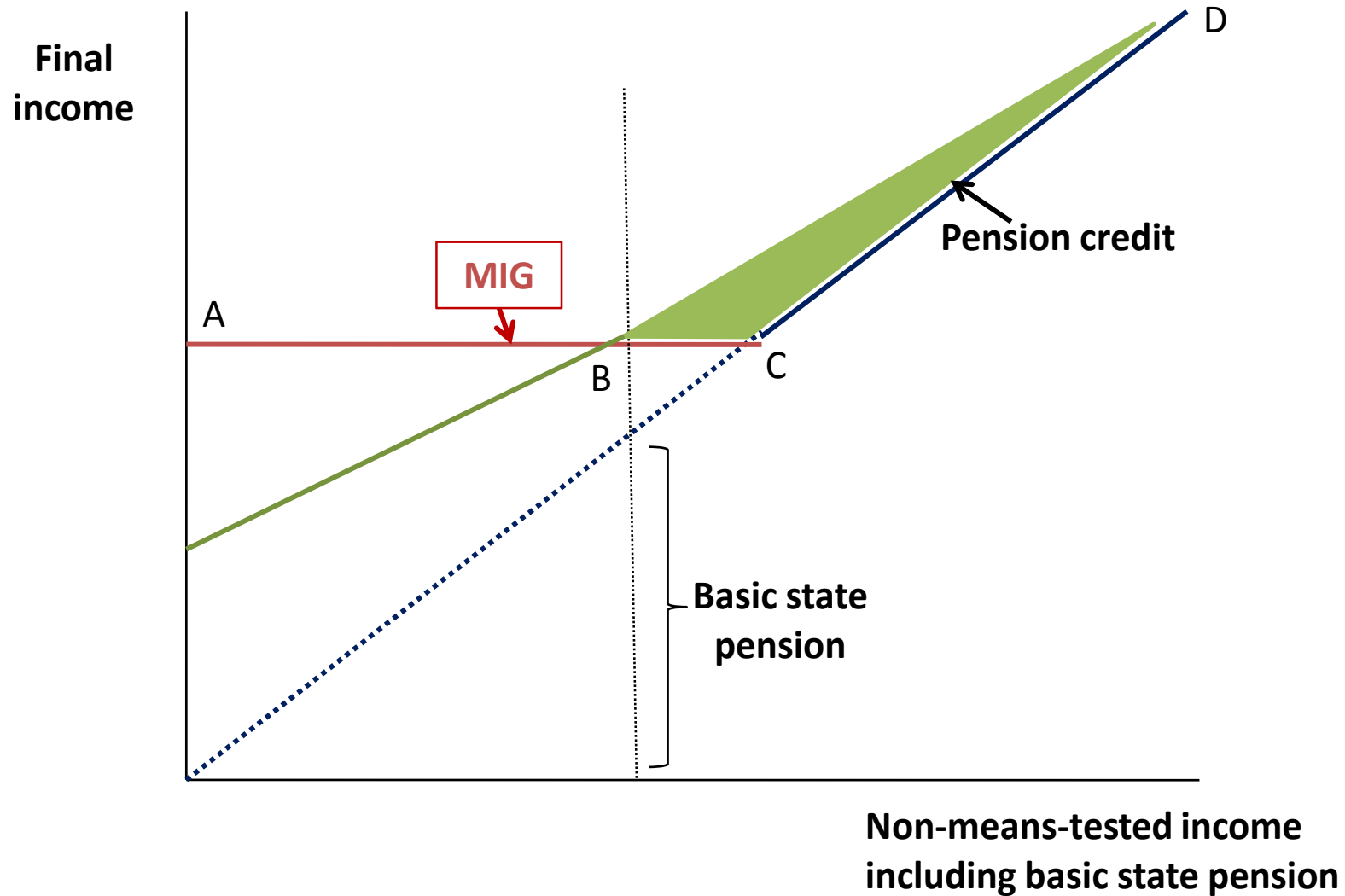
# Comment on replacement rates

- Despite unique pension programme, Australia delivers very similar distribution of replacement rates to many OECD countries.
- New Zealand and Ireland are even more redistributive (only basic flat pension).
- What generates similar RRs across disparate pension programmes?
- Was it a policy choice in Australia, or might we have expected Australia to look different from elsewhere?
- Does it matter which 'route' to the same outcome is chosen? (*there may be deadweight welfare losses attached to particular design*).

# Australia's Age Pension

- Is subject to income and asset tests. **Income taper is 40%.**
- Is the only public pension – **unlike other countries which have 'minimum income guarantees' (MIGs) to supplement social insurance programmes.**
- UK introduced tapered 'Pension Credit' to offset 'disincentive' of MIG with 100% taper.
- The economics of MIGs v. tapers – which is 'better'? **(in fact we can't say)**

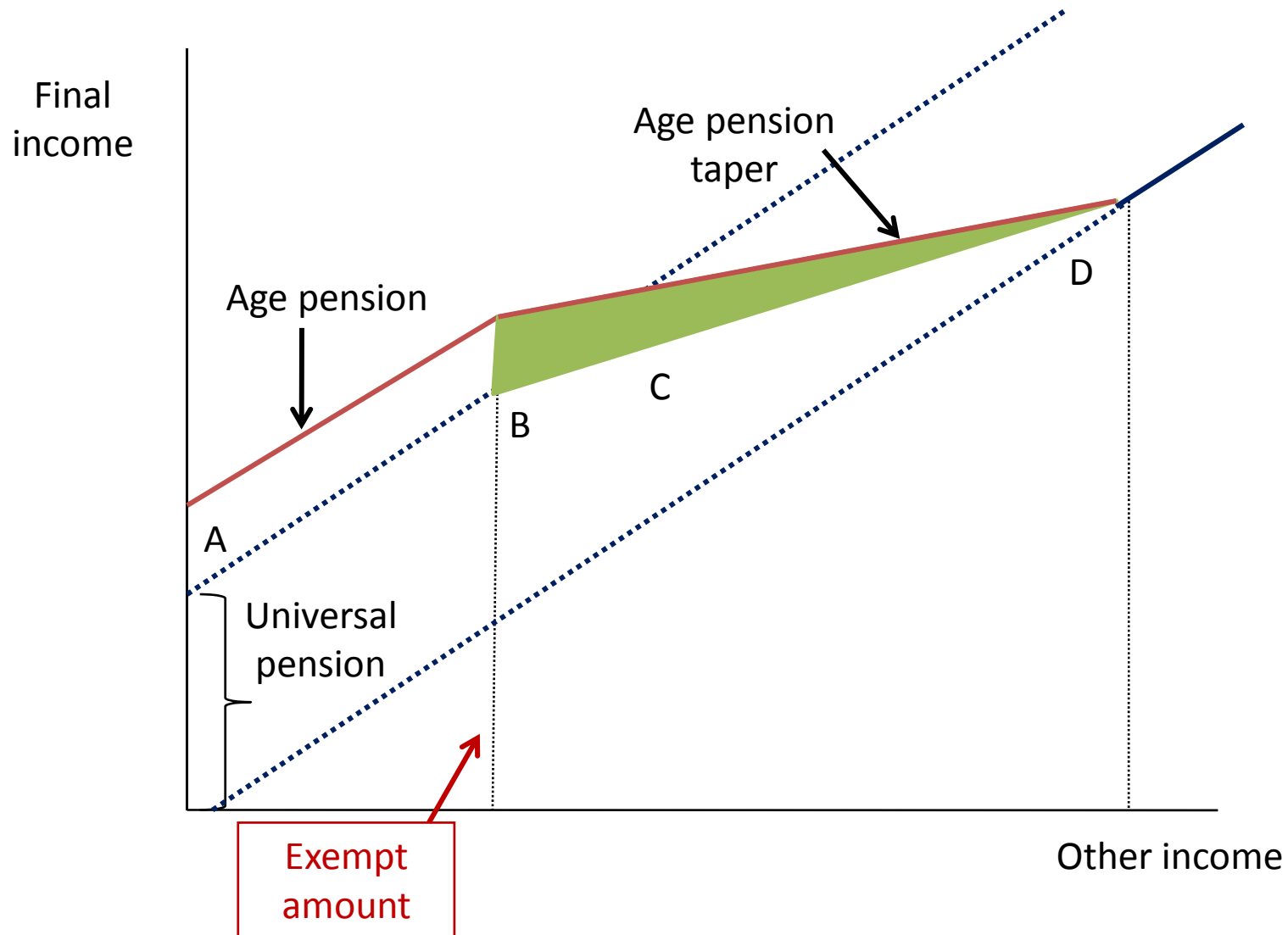
# Stylised budget constraint for a single individual aged 65 under MIG regime and Pension Credit regime in 2005, UK



# A tapered pension credit

- Brings more households into the high MTR 'net' than a MIG. For given cash expenditure, MIG gives more to the poorest.
- In 'static' model of incentives, adverse impact on outside income of greater coverage of population may outweigh withdrawal of 100% tax rate.
- If all households are potential 'life-cyclers', high potential MTRs in retirement against outside income will deter saving/other income.
- This confirmed for US/UK calibrated and statistical savers.
- A high MTR for 'no-savers' and a low MTR on potential savers ***might*** be welfare-enhancing relative to a taper affecting many retired households.
- So would a universal flat benefit (e.g. NZ) be better? – again, hard to say *a priori*.

# Stylised budget constraint for a single individual aged 65 under Age Pension regime and Flat Benefit regime



# Universality versus tapered credit

- A universal benefit lowers MTR for retired but presumably raises ATRs for contributors.
- Shifting to flat universal benefit has both wealth & substitution effects as before – as households face different MTRs and different wealth effects in the transition.
- Feldstein (1978): Ideally, a 'separating equilibrium' would give 2 types of benefits:
  - Myopics get a MIG or highly tapered benefit
  - 'Life-cyclers' get a retirement saving programme (e.g. the SG)
  - But there's the possibility of moral hazard.
  - *Ultimately the ATR v. MTR issue requires an explicit welfare comparison to be made.*

# The Superannuation Guarantee

- Again, *among OECD countries*, mandatory defined contribution (DC) components are not common.
- So, evidence to guide us on impact of SG largely drawn from economies with *voluntary* saving arrangements.
- Some questions:
  - Has SG raised saving rate (relative to some counterfactual)? **My answer: probably yes but savers will treat assets as highly substitutable.**
  - Is SG at an 'adequate' level? **My answer: I am sceptical about 'undersaving' arguments, and SG should leave room for preferences over saving.**
  - Do individuals respond to retirement saving incentives e.g. tax relief? **My answer (cf UK Pension Commission) is 'yes' insofar as incentives are clear and applied consistently by government.**

# Has SG raised saving rates?

- Opinions differ in (sparse) Australian literature: I cite in paper time series evidence that SG has substituted for other saving; household data that SG is complementary to other saving. So we don't really know.
- The counterfactual – what would household retirement saving be without SG? Look for 'treatments'?
  - Uncovered workers v covered? But poor & self-employed will have different propensities to save/preferences.
  - Before/after? What was saving rate of workers not covered by Superannuation pre-92? But affected by Age Pension tests.
  - Comparable countries? But NZ got rid of retirement saving tax incentives so saving fell to very low levels (now 'Kiwi saver' to recover).

## Is SG at 'appropriate' level?

- Is SG designed to lift workers off Age Pension and/or to provide minimum 'adequate' income? Or to reflect appropriate *average* level of retirement income?
- The debate seems to take both views; coming from a voluntarist country, I largely subscribe to former view.
- The saving adequacy debate (in voluntarist setting):
  - Most policy-makers seem to assume that individuals undersave for retirement; that individuals don't understand programme, myopia etc. Etc.
  - In contrast, *most* statistical evidence suggests that most people save 'enough' given 'realistic' preferences (Scholz et al, 2006 for US; less formally, Banks et al, 2005 for UK, Scobie et al. 2005 for NZ).

# Key issues in 'adequacy' debate

- Do we treat housing wealth and other household assets as potential 'retirement saving', or just wealth in pensions and financial assets?
- Do we look at stocks (wealth) or flows (measured net saving)? If people have target and former is high (e.g. capital gains on houses etc), latter will be low.
- Should we use tax policy to shift saving from one asset to another? E.g. We could tax housing wealth; on the margin, this might cause people to shift into annuities. So are we interested in overall saving or just retirement saving?

# Tax treatment of retirement saving

- Three issues:
  - Interaction of SG and other retirement saving with Age Pension
  - Tax treatment of retirement saving: e.g. At what stage taxes are levied (**contribution, accumulation, disbursement**).
  - Tax treatment of alternative disbursements e.g. Lump sums, fixed and whole-life annuities etc.
- *Obviously these issues are interlinked*

# Interaction of Age Pension and SG

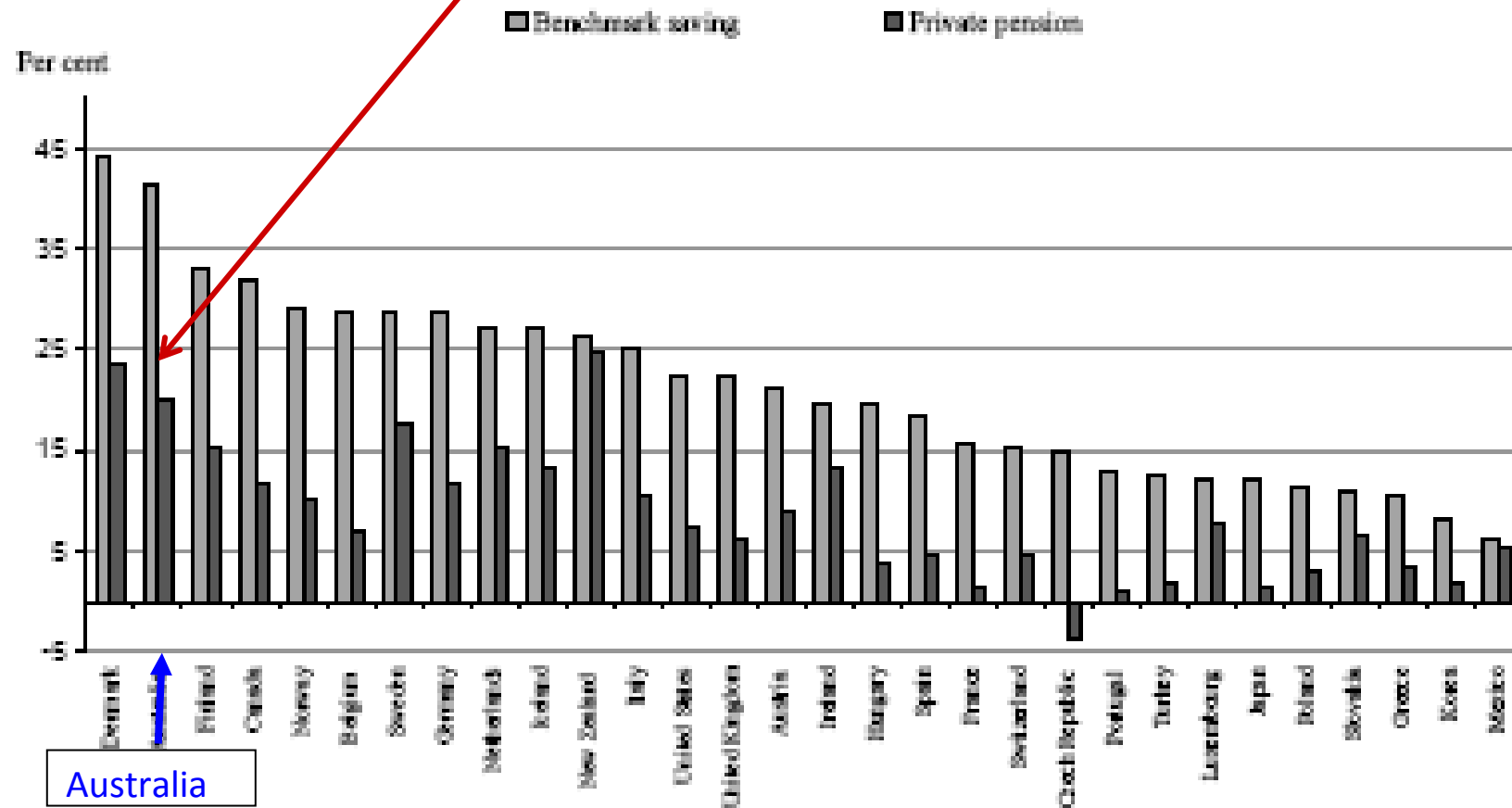
- To avoid dissipating lump sums, proposal to align test for 1<sup>st</sup> receipt of AP and SG:
  - **All** household behaviour is motivated by the tax regime – for example, investing in one's home to avoid capital and income test
  - Aligning first ages of receipt of all pillars of pension programme reduces flexibility of retirement and capacity to smooth consumption.
  - As SG matures, behaviour may change – greater incentive to invest in assets, annuities if larger SG sums (*Bateman and Piggott, 2001 suggest this already happening*).

# Tax treatment of retirement saving

- The standard classification describes treatment of contributions, accumulation, disbursement, where E=exempt, T=taxed.
- EET and TEE are common versions of 'expenditure tax' treatment. They are not identical given varying MTRs over life-cycle and inflation.
- TTE and ETT are treated as broadly 'comprehensive income tax (CIT)' treatment – could add a 'tax credit' component to standard tax regime to get this.
- OECD (2005) describes Australia as 'TTT' – however this is extreme as favourable tax treatment at all stages – might best be described as 'ttt' (officially UK is described as 'EET' but is also effectively 'ttt').

## Effective tax rates on private pension and benchmark saving: age group average

**Taxation of private pension preferential because overall saving tax rate is high**



# Tax treatment (continued)

- Rationale for preferential taxing at all stages not clear to outsiders.
- Simpler to apply preferential treatment by exempting one or more stages.
- But this can partially be effected through choice of disbursement strategy by households.
- Complexities invite asset switching strategies by households (unless households don't understand complexity).
- There are other distortions from differential treatment of income from business, employment, incomplete coverage by SG etc.

# Tax treatment of disbursements

- Favours annuities over lump sum disbursements
- This to offset Age Pension test – but exemption on latter extended in 2007
- But is there favourable treatment of annuities relative to investment in home ownership?
- Rising SG accumulated funds means disbursement as annuities & as extensions to housing wealth more likely.
- Want to avoid overinvestment in exempt assets (primarily home equity) unless there is a flourishing home equity withdrawal market

# Tax treatment of housing

- Major aspects of Australia's tax treatment:
  - Imputed rent and capital gains from owner-occupied housing are exempt from income tax
  - Concessional treatment of principal home under income test and exemption from asset test of the Age Pension
  - Tax on moving house (stamp duty)
  - No mortgage interest relief
  - Municipalities levy property taxes
  - Rental properties liable to income tax, shifting to renting at retirement may incur income test
  - Housing equity withdrawal exempt from income test

# Some comments

- Housing has a 'consumption' aspect and an 'investment' aspect.
- If house prices reflect capitalised stream of housing consumption benefits (and this ignores house price 'bubbles') then preferential treatment arises from not taxing imputed rent.
- Taxes on house values are an imperfect proxy for taxing imputed rent.
- **Economic theory suggests little rationale (other than administrative convenience) for:**
  - Taxing house moves (stamp duty)
  - Taxing house purchase (in contrast to consumption of housing services).

# Further comments I

- There are redistributive impacts of housing taxation structure across the population (though some differences will 'wash out' over life cycle).
- These arise from other dimensions of 'preferential treatment':
  - Renting versus owner occupation
  - Mortgage holders versus outright owners
  - Impact of Age Pension income and asset tests
  - MTRs of older households on other income may be higher than on young, so tax preference is higher.

## Further comments II

- Older households disproportionately benefit from home ownership (*and overinvest in it – see Bourassa and Hendershott, 1992*):
  - They face higher potential MTRs so obtain more tax preference
  - They are outright owners (in absence of MIR, mortgagees have less tax preference)
  - They face income and asset tests under Age Pension.
  - But with high housing wealth to total-wealth ratios implied by preferential treatment they are over-exposed to investment risk (capital losses, environmental factors e.g. Loss of property).

# Key messages

1. Care needed when discussing ‘incentive effects’ – for example when increasing/reducing tapers on Age Pension
2. Complex tax treatments invite rational households to adopt strategies to minimise tax liabilities – overall rather than *ad hoc* solutions are required.
3. Retirement ‘window’ should be as flexible as possible.
4. Adequacy of assets in retirement, and whether such assets are given preferential treatment, should be examined by looking at all assets – not just single assets (say, SG funds) in isolation.
5. There are serious risks of portfolio misallocation where preferential treatment is too obviously geared to particular assets – scope for diversification to minimise portfolio risk is then limited.