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Promoting high quality international debate on pension issues

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2 April 2009

PensionReforms comments on taxation treatment of retirement savings

Background

PensionReforms is a website run by the University of Auckland's Retirement Policy and Research Centre with the help of an international board of contributing editors – see here for the list of editors. Started in October 2006, PensionReforms is building an online, searchable, sortable library of reviewed papers on all aspects of pensions (public and private) and retirement issues from around the world. Currently, there are 286 mostly academic research reports and these are being added to at the rate of 2-3 a week.

PensionReforms aims to encourage high quality debate on pension issues by making research easily accessible to anyone with an interest in the area. Not only does PensionReforms summarise the reports covered (and give direct, on-line access to the original paper) but it also says what it thinks of each report's findings and conclusions.

Recent abstract on the cost of tax incentives for retirement saving in Australia

PensionReforms has recently published an abstract that reviews a report from the Australian Institute on the cost and other implications of tax incentives for retirement saving in Australia. What follows is the front page "thumb nail" - the link goes straight to the abstract on the web site.

> Australia is one of the few countries to count the cost of tax incentives for retirement saving. It's now 20% of all tax revenue and totals 92% of the total amount spent on the Tier 1 "Age Pension". The concession is very regressive and almost demands reform. more

Appendix 1 is the full abstract posted on PensionReforms on 16 March 2009.

Abstracts sortable by topic – further papers on taxation

PensionReforms allows all abstracts to be sorted by topic, country, author, institution and year of publication. We have extracted a list of the 12 other abstracts that have "taxation" as a topic. As an aside, there is surprisingly little academic work on the cost to taxpayers of the generally generous tax incentives enjoyed by superannuation schemes.

Based on what little work has been done, PensionReforms suggests that tax incentives are regressive (favour the rich at the expense of all, including the poor), inequitable, complex and incur significant regulatory costs. Worst of all, however, is the seeming absence of evidence that they 'work' (increase saving). Given the cost to taxpayers as a whole, eloquently illustrated in the report by David Ingles, it is even possible that they may reduce national saving.

In the case of Australia, there is another aspect to consider. Australia has a compulsory retirement saving scheme. PensionReforms wonders how *incentives* to save for retirement can be justified in a *compulsory* environment.

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Appendix 1

Title: **The great superannuation tax concession rort**

Author: David Ingles

Institution: Australian Institute

2009

Posted: 16 March 2009

Topics Pension scheme reform
Public policy
Taxation
Tier 2 schemes

Link to full report: https://www.tai.org.au/?q=node/9

Front page thumbnail
Australia is one of the few countries to count the cost of tax incentives for retirement saving. It's now 20% of all tax revenue and totals 92% of the total amount spent on the Tier 1 "Age Pension". The concession is very regressive and almost demands reform.

PensionReforms' summary and comments
All developed countries (and many others) offer tax concessions for retirement saving schemes but not many countries count their cost, never mind ask whether they are good value or even whether they actually achieve anything (do they actually work?). Australia at least counts the cost - Ireland and the United Kingdom also do that:
"Superannuation tax concessions will cost the budget $24.6 billion in 2008–09 ..., rivalling the $26.7 billion annual cost of the age pension and constituting a fifth of income tax revenue ($130 billion per annum). Tax expenditures ... of which the super tax concession is by far the largest, are one of the fast-growing areas of total government spending" [all dollar amounts reported in this abstract are in Australian dollars].

The report notes that, as the assets of the compulsory Tier 2 arrangements build, the cost will inevitably rise unless something is done.

The fact that tax concessions are regressive (benefit the rich at the expense, at least in part of the poor) is well known. The report's evidence from Australia shows just how regressive:

"• The paper demonstrates that the tax concessions flow overwhelmingly towards the well-off, with those earning less than $34,000 per annum receiving almost no assistance and those earning over $180,000 per annum receiving the most.

Astonishingly, the top five percent of individuals account for 37 per cent of concessional contributions.

“• The current concessions provide almost no benefit to low- income earners, including women working part-time, but an executive earning $300,000 per annum with a million dollar retirement account can receive $37,000 of concessions, 2.5 times the value of the age pension, for every year of their working life.

“• Tax concessions for superannuation provide substantially greater benefits for men than women and this disparity will continue under current arrangements.

“• Allowable contributions are such that high- income earners could easily retire with $5 million in assets, which would then allow them to draw down around $500,000 a year in retirement, all tax- free.

“• The system has become so skewed that the annual cost of providing superannuation tax concessions to high-income earners is much greater than the cost of simply paying those same individuals the age pension. Providing tax concessions for superannuation as a mechanism to help insulate the budget from the cost of providing for an ageing population is not sensible.”

This last comment is significant in the Australian context because the Tier 1 “Age Pension” is both income and asset-tested. Part of the policy justification for tax concessions is to encourage richer Australians to self-provide. The report suggests the rich do somewhat better from the concessions than the amount they lose from their Tier 1 pensions.

PensionReforms notes, in this connection, that the cost of the concessions is measured against the tax that would otherwise have been paid. Australia’s relatively high top marginal personal rate of 48.5% magnifies the ‘losses’ at the top end of the income scale. Simply reducing the top rate would make the concessions seem less expensive.

“The paper finds that, while there is no doubt that tax concessions increase retirement incomes, the benefits of these concessions are so skewed towards the well-off that they undermine the redistributive nature of the Australian retirement income system. As a consequence, a situation has been created whereby the retirement income system will increasingly emphasise *income maintenance* after retirement rather than *income support* for retirees on low incomes. There needs to be a more appropriate balance between the two goals.” [author’s emphasis]

What was, until 2005 a “t t t” system (where contributions, investment income on savings and the benefit were all taxed at concessional rates is now a highly concessional “t t E”.

The Australian Treasury concludes that “…the effective marginal tax rate on superannuation savings is highly negative.” Allowing for inflation turns a nominal effective marginal rate of tax (EMTR) of almost a positive 80% in the case of bank deposits into a negative 150% for superannuation. This is said to disadvantage “...the unsophisticated or badly-advised saver.”

On the crucial issue as to the overall effect of the concessions, the report concludes: "The evidence that tax concessions stimulate additional private savings is weak. Because the concessions flow overwhelmingly to the well-off, who would save anyway, the overall effect may be to alter savings patterns without creating a net increase in savings."

It produces an environment that is "...complex, creates arbitrary categories of favoured and non- favoured contributions and makes no economic sense."

The report looks at three possible reforms:

- piecemeal reform;
- increase taxes on contributions and fund earnings to around 30%;
- tax all contributions, including employer contributions, as income to the employee. The deductions available to the self-employed would be abolished. The tax rate on fund earnings could also be increased to 30% and the capital gains concession abolished.

Instead of these possibilities, the report suggests an alternative:
"We propose either a 50 per cent rebate subject to a $2,000 ceiling (Option 3a) or a simple proportionate rebate of around 18 per cent of total contributions with a ceiling of $9,000 (Option 3b). Option 3a is the most redistributive option but even the 18 per cent uniform rebate would remove some of the regressivity of the current system by giving the tax benefit a simple linear relationship to income. The effect of either option would be to create a much simpler and fairer system, raise some monies for tax reform, and reduce the long-term cost of population ageing."

PensionReforms notes that the concessions (to encourage a particular kind of behaviour) are given to the *compulsory* Tier 2 savings. This seems particularly illogical. As Tier 2 obliges employees to save for retirement, it seems odd for them to be tax-favoured.

Also, PensionReforms understands that a significant part of the work of financial planners involves the devising of arrangements that minimise the impact of the income/asset tests associated with the Tier 1 Age Pension. PensionReforms might expect these activities to be undertaken by those who have also benefited from the tax concessions.

PensionReforms has observed previously that tax concessions for retirement saving are very expensive, regressive, complex and inequitable. All of that seems especially so in the case of Australia. It also seems that tax concessions might not be working in Australia (raising saving). Again, tax breaks seem to have failed some basic tests in which case, anything short of their complete removal would seem sub-optimal. Perhaps, Australia should instead engage in a debate about removing the income and asset tests on Tier 1. There are excellent reasons for thinking about that anyway. Using that reform as the price for getting rid of tax concessions would seem to PensionReforms to be a double gain.

The link takes you to "Web papers" – the list is in release date order. This report was issued in February 2009. File size 4.8 MB; 33 pp) 281

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Appendix 2

Abstracts with "taxation" as a topic – 1 April 2009

The "more" link goes straight to the PensionReforms abstract

Not many countries regularly count the cost of tax incentives for retirement saving. The OECD sheds some light on this complex task but doesn't get to some obvious questions more

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Do tax breaks for US 401(k) schemes increase household wealth? This complex question has a surprising answer – possibly. But by a whole lot less than might be expected and perhaps not at all. more

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In a seminal 1992 paper, Alicia Munnell argued for the removal of tax breaks for retirement saving in the US. The logic still stands and things have got worse since. more

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Tax incentives for private provision are as much part of public pension costs as the amounts directly paid to the retired. Counting the costs of incentives might raise awkward questions. more

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In 2005, Australia improved tax incentives for the compulsory Tier 2. It will increase contributions and cost taxpayers more. But why? more

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The housing habits of US 'early' baby boomers and current younger retirees are analysed and compared. There are differences but the similarities are more striking. No particular need to worry about either. more

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The tax advantages conferred in the US on house loans and retirement saving vehicles tend to favour the latter. Reducing debt should therefore take second place but a third of eligible home-owners seem irrational. Or are they? more

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The radical extensions to KiwiSaver by the New Zealand government's 2007 Budget on the eve of its 1 July 2007 start date have raised the issue of whether governments really can change behaviour to increase either total individual or national saving. This carefully worded officials' commentary implies not, or not much. more

Spain introduced tax incentives for retirement saving in 1988. Contemporary data show how they affected consumption behaviour. New saving is at best less than a quarter of money contributed. There are some differences in the impact on consumption at different ages. The oldest show most signs of rearranging existing savings. more

The Irish government is looking at most aspects of state and private pensions. This 252 page strategy paper poses many questions and offers some indication of what's in store for Irish pensioners, savers and employers. Probably more of the same. more

South Africa proposes to replace its existing pension arrangements with a universal Tier 1 pension and a dual, compulsory Tier 2 that is divided between a DB, PAYG arrangement and a DC, pre-funded scheme. The World Bank's thinking has had a significant influence. more

Tax incentives encourage people to save for retirement, don't they? They may not actually do that but that's not their only problem. Most tax benefits go to richer savers, rewarding them for what they may have done anyway. What should the US do about that? more

In the US, the rules governing pre-funding levels in Defined Benefit schemes changed in 2006. After the events of 2008, surpluses may not be the issue they once were but, given the tougher rules, is the tax treatment of 'reversions' to employers fair? Probably not. more