AUSTRALIA'S FUTURE TAX SYSTEM

A submission from Donald Steel

The taxation system embraces the terms and conditions of social security in respect of which the age pension is noted as a major component, and Medicare.

The taxation system should be sufficiently robust to respond to changes in economic conditions without revision beyond changing the rates of taxation.

The Nation is facing the worst financial crisis since the Great Depression. The World generally is facing a broad-based collapse of the banking system which Australia is likely to be spared. Nevertheless, bad debts will rise and place strains on all lending institutions and property owners. Tax revenues will fall and welfare payments will increase. This is no time to further strain the Nation's budgetary position by decreasing taxes. The already legislated income tax reductions to apply from I July 2009 and 1 July 2010 must be scrapped. Those tax reductions, predicated on an economic scene entirely different from that which is being experienced and which will continue for some years, would heap further advantages on the well to do. Middle and low income earners will be better assisted by increasing their job security than by tax reductions. I would prefer no tax reductions in the current and expected environment but any that are given should be focused on low income earners who could be expected to spend the reductions. The well to do would be likely to save tax reductions. Two income families would be likely to benefit and to save from tax reductions for low income eraners.

The Government has been backed into a comer in respect of proposed increases in age pensions. Age pensioners have far greater security of income than many in the work force. The changes in age pensions from 20 September 2007 mean that many well to do persons qualify for some age pension. It would be a disgrace to increase their pensions, even by small amounts, in the present economic conditions. The proposals to increase age pensions should also be scrapped.

Cash handouts before Christmas and the further cash handouts to be made from April 2009 are wrongly targeted with large payments in total going to citizens who will save the money, not spend it. The darkening clouds in an already dark climate will cause many recipients to strengthen their savings rather than spend the money. The outcome of these handouts will be hard to measure. What has been done cannot be reversed but please no more cash handouts. The Nation is facing budgetary deficits that must not be exacerbated by cash handouts. It is disturbing that the Government's inherited Budget surplus has been given away in handouts, much of it to persons who did not and do not need the money.

It is reasonable to expect the economy to face increasing stress. Many projects, investment initiatives and spending plans were too advanced to be cancelled when the storm struck. The full force of slowdown can be expected to strike as these commenced initiatives reach completion. The Government must keep more powder dry than it is presently doing. The announced plans have a distinct odour of too much too soon. I do not think that what we are facing calls for "kill it stone dead before it gets a grip".

The need for infrastructure projects to be fast tracked is at last being recognized. These are the conditions when essential infrastructure can be built without placing labour and materials strains on the economy. Health and education services can also be improved at this time. Great care is needed to ensure that funds are not wasted on expenditure for expenditure's sake. The cooperation of the States is of course essential but the track records of some are not all that one would wish. Infrastructure projects that will increase employment and alleviate contraction in a number of sectors should have priority. Infrastructure restoration in the wake of the Victorian bushfires and the Queensland and New South Wales floods should be capable of fast track responses. Restoration of land degraded by salt and clearing would be in the long term national interest. Some farmers have shown what can be done. So many of these things are easier said than done. Decision makers can easily flounder when confronted with unquantifiable forces pulling in opposite directions.

It is important, even imperative, that serious effort be mounted to reverse the ever spreading menace of cane toads. These toads threaten the environment including native fauna. The toads have reached the Kimberley and pose real dangers of devastation. Scientific research must be funded adequately and urgently.

I have advocated water recycling and diversion of treated water to the inland river systems. It is not a great distance from Sydney to the Abercrombie River, or a great altitude for water to be raised, presenting an opportunity to feed recycled grey water into Wyangala Dam and thence to the Lachlan River. It is even less distance from Melbourne to the Goulburn River and the altitude problem is lesser. Of course I do not have the technical expertise to assess the practicality of such projects which might be totally impractical. However, I believe that one Senator managed to extract a storm water harvesting undertaking and increased spending on the Murray Darling from the Government as a condition for his support of the $42 billion package.

The tax base and tax revenues must be protected to the maximum extent possible so as to minimize the amounts that will have to be borrowed to cover shortfalls of receipts under payments. I have not seen the Government's specific borrowing proposals. I await with much interest, information about sources of capital and the rates of return that will be offered to lenders who hold the trump cards in a capital deficient World. Lenders who take exchange risks will expect to be appropriately rewarded for doing so. It is all very well for central banks to reduce official interest rates. The margins that lenders seek appear to have risen, largely negating the reductions in official rates. Indeed, the implied returns on many listed investments of both equity and debt characteristics have risen dramatically presenting questions about the risk premiums that now apply. What is clear is that those persons who have entrusted savings to Australian banks to qualify for the

Government guarantee are suffering the full impact of the reductions in official rates and the institutions who lost their liquidity because of that guarantee are still reeling.

In my opinion there is nothing more that can be done to assist the motor vehicle manufacturing industry and its components suppliers. The salvation of this sector lies in restoring economic activity to a level where confidence drives people to buy new cars. The past taxpayer investment in the sector is at risk.

Indirect taxes, being flat rates of tax, bear most harshly on the poorest in our community. It is a commonly held view that those on low incomes pay little or no tax but it needs to be borne in mind that these pay GST on a proportion of their expenditure. A reduction in the GST rate would bolster spending and economic activity but my own feeling is that the revenue ought not to bear the strain of any reduction.

User pays strategies also bear harshly on the poorer sections of the community. Road tolls are a case in point. Utility charges also bear harshly on the poorer sections of the workforce. The Emissions Trading Scheme will increase the cost of electricity and the poor will be the most seriously affected. It is noted here that recipients of the age pension receive subsidies in respect of certain utility charges and local government taxes,

Low paid workers struggling to bring up children and meet housing costs are in more difficult positions than the aged.

The taxation system is the most effective tool of government for redistribution of wealth. Redistribution of wealth is essential if Australia is to have an equitable and peaceful society. There will always be debate about how far the redistribution process ought to be carried. Redistribution must not be so draconian as to stifle personal endeavour or to encourage the relocation of business outside Australia.

Taxation lends itself to evasion. The system must be tightly controlled to minimize evasion. Severe penalties must apply to evasion. Traders must issue receipts that show the GST component, for all transactions and a roving inspectorial force with strong powers to inspect records and systems should be permanently employed. The cash economy is alive and well and enables traders to avoid both the GST and income tax.

As an aside, I note that the review document puts average weekly earnings at $1,140 but it does not state whether this is inclusive or exclusive of the Superannuation Guarantee. As a matter of standard practice please ensure that the point is clear whenever average earnings are quoted.

In summary to this point, I submit that the tax base and tax revenue, personal and corporate and from indirect taxes, must be protected. Outlays on the age pension must be reduced by restricting increases to cost of living adjustments, by tightening the rules for eligibility and by increasing the age for entitlement. Essential measures will be unpopular. A task of Government will be to persuade the community that the ills of the times cannot be cured without unpalatable medicine.

This remainder of this submission focuses on the retirement income system and the age pension,

Tax free pensions payable after age 60 from taxed funds and tax rebates for pensions payable from untaxed funds

No.5 of the Terms of Reference states that the Review will reflect the Government's policy that superannuation payments to persons who have attained age 60 will be free of income tax. With respect, tax free pensions is an absurd policy. Dr Henry must state how the system that came into force from 1 July 2007 (from 20 September 2007 in respect of age pensions) would have been altered if the global financial crisis had struck before that system was designed. Dr Henry must also state whether, in the light of the global financial crisis, the basis of Treasury's calculations remains appropriate. I assert that the basis paints a false picture. The illustrative projections in the booklet "Better Super" misled many citizens and failed to recognize that moderate superannuation benefits were tax free under the system that operated prior to 1 July 2007.

The review does not preclude disallowing contributions presently deductible, as deductions from assessable income. However, disallowing contributions as deductions would preserve the huge windfall gains that apply to persons who have already attained age 60 or who are approaching that age. The system of tax free benefits from taxed funds to persons who have attained age 60 and rebates for pensions payable from untaxed funds must be subject to review if the review is to be sensible and meaningful.

Superannuation benefits must be taxed when received and the basis of taxation must reflect the 15% tax applied to deductible contributions. The pre 1 July 1983 and post 30 June 1983 component distinction should be scrapped but the distinction between undeducted contributions and the remainder of benefits retained. The 15% tax rebate on pensions from taxed funds would be applied to pensions other than tax free components attributable to undeducted contributions.

I support the abolition of the so-called Reasonable Benefits Limits (RBL's) provided the benefits are taxed. The RBL system was extremely complex and caused confusion and erroneous decisions by participants in the system. The taxation of benefits was not complex in the vast majority of cases – a high proportion probably in excess of 90% sailed through without problems.

The financial estimates of the tax revenue that was lost as a result of the 1 July 2007 changes should be reviewed. I believe that the loss estimates are grossly understated and do not properly take into account the immaturity of the superannuation system. No one can be definitive about the revenue losses without statistics of the distributions of credits and contributions (deducted and undeducted) classified by age attained. Even with a reliable statistical basis, projections of benefits under the old system is very difficult. Under the new system, the projections are even more difficult because assumptions have to be made about the changes in behaviour that the new system will induce.

The purpose of superannuation is to provide income after participation in the workforce ceases. It is absurd to allow benefits to be drawn, and drawn tax free, before retirement. It is absurd to require minimum drawdowns of pension and allow many pensioners to immediately re-contribute their drawings. Many directors of private companies will not retire before age 75 even if they do no actual work, so that they can enjoy the right to continue to contribute to superannuation with significant gains from deductible contributions and tax free benefits.

The new system erodes the tax base to the advantage of the more well to do segment of the community and heaps huge windfall gains on many well to do persons who are over age 60 or approaching that age.

The new system gained widespread support under the opportunity to comment after the preliminary announcement in the 2006 Federal Budget. The vast majority of those who had some understanding of what was proposed were beneficiaries of the changes. Tax free super sounded great to many in the general work force, not realizing that their super was already free of tax when drawn.

The designers of the new system and the politicians of the major parties should eat a large slice of humble pie, admit their mistakes and correct them.

Social security age pensions

The review must also embrace the terms and conditions of age pensions. The change to the assets test effective from September 2007 provides some pension to persons who on any reasonable basis of reckoning are well to do and also provides those persons with access to a range of ancillary benefits. It is not the function of the social security system to assist those who are well to do. There was a move some decades back to eliminate the means test for age pensions but such a measure was found to be unsustainable. For as far ahead as one can see, the function of the age pension and indeed social security pensions generally will be to alleviate poverty amongst those who are unable to work. The rules must reflect this. Now they do not.

Moving the age for entitlement to the age pension from 65 (or the earlier age for females that is being phased out) to 70 would ease the social security burden on government expenditure. Such a move would cause many persons to remain in the workforce longer, an undesirable consequence in a time of increasing unemployment to levels that are likely to be sustained for several years.

Superannuation benefits - Lump sums or pensions? - Blending superannuation pensions with age pensions

The Australian superannuation system is based on lump sums. Funds that compulsorily pay pensions are few and far between. A relatively small number of funds, including some public sector funds, allow choice between pension and lump sum or part pension with part lump sum.

The fundamental purpose of superannuation is to provide an income in retirement. Politically sensitive as the issues are, drawing while still in employment should be proscribed and rules must be devised for compulsory conversion of lump sums to pensions. It is absurd to allow retirees to take lump sum superannuation, spend it quickly and then become dependent on social security. I cannot be definitive about the rules in the time available to make a submission but the following suggestion indicates a basis for investigation.

The maximum lump sum retirement benefit would be $50,000 (indexed). The balance must be converted to pension with a minimum draw down period of five years or the period remaining to age 70 whichever is the lesser, unless that balance is less than $30,000 (indexed). If less than $30,000 (indexed), the balance could also be taken as a lump sum. However, the rules for entitlement to age pension should encourage retirees to convert all their lump sum superannuation to pension.

There is an adage "the pendulum will swing" the truth of which is amply displayed by the economic changes wrought in the last year. Rules for superannuation benefits that would encourage persons to remain in the workforce for longer than they would otherwise choose came into effect from 1 July 2007. The new rules are massively flawed anyway but the conditions now current and that appear likely to last for a few years at least, or worsen, call for rules that will encourage those who can afford to retire to do so. The unemployment rate is set to soar and company profits to fall, further eroding the tax base so badly eroded by the absurd 2007 changes.

The change in the Nation's financial circumstances gives rise to a dilemma. The social security bill will rise for several reasons

- unemployment
- earlier retirement on account of contraction of business
- depreciation of pensioner assets
- asset depreciation increasing the number eligible for social security.

So Government should be looking for ways to contain the social security bill at these times when tax receipts will fall. There is no question about tax receipts falling. It is not a case of "might fall" - they will fall significantly. There is no question about whether the social security bill will rise - its rise is a certainty.

Immediately obvious ways of containing the age pension bill are to restructure the absurd changes to social security that came into force in September 2007 and to increase the retiring age.

Nearly everyone has some superannuation these days, although the Superannuation Guarantee is very immature and some persons have truncated contribution histories or no superannuation at all. The eligibility age for age pension could be raised to 70 years and rules devised to encourage persons who wish to retire before that age to convert their superannuation to pension. Those retiring before age 70 could use their superannuation to provide an income until reaching the new age pension eligibility age of 70 years.

Guidance would be given by Centrelink and the financial services industry for optimum application of superannuation benefits to provide income support before age 70.

For the general workforce, typical Superannuation Guarantee lump sums emerging at the present and for the next few years are unlikely to provide adequate support for five years even if fully converted to pension with a draw down period of only five years. It might be practicable to subsidize superannuation pensions for periods to age 70 provided the retiree fully converts his or her superannuation to pension payable to age 70.

The full lump sum option for occupational superannuation benefits must be withdrawn when SG benefits are generally sufficient to provide worthwhile account based pensions. The sooner such a change is foreshadowed, the lesser will be the chagrin when it happens.

Maturity of the Superannuation Guarantee (SG)

The Review document acknowledges that the SG is very immature. It states that it will reach maturity in 2037 after 35 years of contributions at 9% of earnings. The 2037 date for maturity is far, far short of the actual time that the system will take to mature properly. The full lump sum option must be discarded when the benefits are sufficient to provide worthwhile pensions. The SG will not be mature, for practical purposes until at least 45 years of 9% contributions have been paid (50 years if the retiring age is raised to 70) and the first cohort of pensioners with mature contribution histories have passed through the pension phase, at least 20 years. Hence, a proper estimate of the time to maturity, as a substantially pension scheme, is about 70 years from 2002 when the SG contribution reached 9%, ie about 2072.

There have been murmurings about increasing the SG to 15% of earnings. Such an increase would set the SG off on another long term march to maturity. I doubt the practicality of increasing the SG even in times of economic prosperity which times will never be permanent.

Absurdity of superannuation contributions being tax deductible (subject to stated limits) and benefits being tax free and certain other current rules

Under the current system, by paying superannuation contributions well to do taxpayers are subsidized by the general body of taxpayers both when the contributions are paid and later, when benefits are drawn.

A taxpayer is permitted to "salary sacrifice" assessable income to bring deductible contributions up to $100,000 for financial years up to 201112012 and $50,000 indexed from 1 July 2007 thereafter. These deductions will attract deductions at the contributor's marginal rate of tax. The amount of personal tax saved will exceed the 15% contribution tax payable on the amount of deducted contributions. Hence there will be a net gain when contributions are made, a concessional rate of tax on investment income until benefits commence to be drawn and no tax after drawdowns commence (after age 60).

Self employed persons are now able to make fully deductible contributions so they do not have to enter into a salary sacrifice arrangement to earn deductions of greater amount that the 15% contributions tax. Self employed persons are in a good position to "potter along" for a number of years after the normal retiring age and so extend the period for which contributions may be paid. I am less concerned about the self employed because they were excluded from the superannuation system for many years.

The following are fundamental taxation theorems.

> Deducted superannuation contributions are a deferral of assessable income that must be taxed when drawn. Even this arrangement is beneficial to most taxpayers because lower income in pension phase means lower rates of tax than applied to the deductions.
>
> Investment income is assessable income that must be taxed when it is received.

The new rules flaunt these fundamental theorems.

I have encountered a surprisingly large number of persons with substantial pensions who are truly delighted with the new rules. I am very confident that my opinion that large numbers of persons already over age 60 and approaching that age have very large superannuation credits that provide, or will provide, pensions measured in hundreds of thousands of dollars per annum. It is ridiculous that these pensions be tax free and carry full refunds of franking credits. It is noted that the 15% tax on deductible contributions applied only to contributions paid after 1 July 1988. For many of those now retired the contributions tax applied for considerably less than their periods of accumulation.

Persons in the financial services industry, including banking, are believed to have long recognized the advantages of superannuation under the old rules and to have built up large benefits. Many bankers and financial services operators are paid large salaries. Of course, large salaries and large benefits are by no means confined to those in the financial services industry. Undeducted contributions paid in the years towards retirement have been described as pure gold.

The case of Geoffrey Dixon, the recently retired Chief Executive of Qantas is cited as a particular example because some numbers in relation to his superannuation are in the public arena. The 2006 Qantas annual report showed that a superannuation contribution of $7,660,000 was paid for Mr Dixon in the year ended 30 June 2006. When he retired late last year Qantas made a statement that Mr Dixon's superannuation had been increased by $7,660,000. Was this the same $7,660,000 that was paid in the year ended 30 June 2006 or was it another increase in his benefit? What of the contribution tax on the huge contribution(s)? An increase of $7,660,000 in benefit would call for a gross contribution of $7,660,000/0.85 = $9,011,765. Did Qantas qualify for taxation deductions on such contribution(s)? How did it manage to pay such amounts which flaunt the limits to deductible contributions? The mind boggles when contemplating what Mr Dixon's total benefit might have been and the amount of his pension that is tax free. Under the previous rules, most of Mr Dixon's benefit would have been excessive and the corresponding pension taxed at his marginal rate. The change to entirely tax free represents a massive windfall gain. In response to an assertion that these gains are transitional and should not influence proper planning for the long term, I assert that the periods of these transitional gains are long and that there are large numbers of persons qualifying for them (whilst admitting that neither I nor anyone else has concrete statistics to support opinions).

In any event, it is absurd to accord such huge windfall gains to even a small number of individuals.

A long term friend died several weeks ago. He kept his short term illness under wraps and bore up with remarkable fortitude. I did not know that he was ill until notified that he had passed away. Had I known of his impending passing, I would have suggested that he seek advice about electing to draw his superannuation as a tax free lump sum. I do not know whether anyone advised him to draw, nor do I know anything of the terms of his will but I am certain that he will have bequeathed much to his adult children and his grandchildren. I have reason to believe that most of his superannuation credit was a taxable component. That component will incur tax that would not have been payable if he had executed a simple election to withdraw.

What I am saying here is that taxing death benefits that pass to non dependants is ridiculous when the tax can be avoided by a death bed election to withdraw. The cure for this anomaly is not to make death benefits tax free but instead to make benefits taxable on the basis that applied pre 1 July 2007, with some important simplification adjustments..

I note that many persons who are well to do from inheritances have been able to build up substantial superannuation benefits from a combination of salary sacrifice and undeducted contributions. Salary sacrifice has resulted in very low assessable incomes and payment of little or no tax. These people hardly deserve large tax free superannuation pensions. While noting that undeducted contributions gave rise to deductible amounts under the old system, those deductible amounts were fixed and pensions became progressively taxable with the passage of time.

There are no death or gift duties in Australia. This feature combines with tax free superannuation benefits (with the limited tax on death benefits passing to non dependants) to create dynasties of the rich and well to do whose wealth is largely derived from untaxed sources. I am sure that the financial services industry recommends that the wealthy and well to do transfer wealth to their children's superannuation to take advantage of the permitted undeducted contributions.

The contributions tax brings revenue forward. The need is for revenue to be timed to meet the demands of an ageing population. It is not possible to scrap the contributions tax (I have written about this in other places) but there is certainly a need for taxes on benefits.

There have been suggestions that investment income in pension phase be taxed to claw back something from the massive give-aways that operated from 1 July 2007. The justification for tax free accumulation in pension phase lay in the taxation of drawings. I am opposed to the taxation of investment income in pension phase because it would operate to the detriment of the majority of superannuation pensioners ie., those whose moderate pensions were tax free under the old rules.

The basis of taxation of superannuation calls for complete overhaul.

Co-contributions to superannuation

Government co-contributions to superannuation work to the advantage of part time working partners with adequate family incomes. Many of these part time earnings qualify for the maximum, or near the maximum, Government subsidy. The co-contributions are phased out at about average weekly earnings. Full time workers on low incomes are eligible for only small support by way of co-contributions but few can afford the undeducted contributions needed to qualify for any support at all.