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Super savings

Practical policies for fairer superannuation and a stronger budget

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Overview

Tax breaks on superannuation mean less tax is paid on super savings than other forms of income. These tax breaks are excessively generous – extending well beyond any plausible purpose for our superannuation system to provide for income in retirement – and their costs are unsustainable.

Super tax breaks cost $45 billion a year – 2 per cent of GDP – and will soon exceed the cost of the Age Pension. Two-thirds of the value of super tax breaks benefit the top 20 per cent of income earners, who are already saving enough for retirement and whose savings choices aren't much affected by tax rates.

As debate flares about what the objective of superannuation should be, everyone seems to agree on what it shouldn't be: a taxpayer-funded inheritance scheme. Yet that is exactly what super has become. Much of the boost to super balances from tax breaks is never spent. By 2060, one-third of all withdrawals from super will be via bequests – up from one-fifth today.

With the federal budget deep in deficit and big spending pressures looming, curbing super tax breaks should be a priority.

Contributions tax breaks should be made more progressive. Raising Division 293 tax from 30 per cent to 35 per cent, and lowering the income threshold from $250,000 to $220,000 a year, would save $1.1 billion a year. The Low-Income Superannuation Tax Offset, which rebates contributions tax paid by low-income earners, should be extended to people earning up to $45,000 a year (from $37,000 now). This would come at a cost of $530 million a year. These changes would mean low- and middle-income earners would receive at least a 15 per cent tax break on their contributions, compared to just 10 per cent for people earning more than $200,000 a year.

Other changes to contributions tax breaks are needed to limit tax minimisation in super. Lowering the cap on pre-tax contributions, from $27,500 to $20,000 a year, would save $1.6 billion a year, mostly by reducing voluntary contributions made by older people with already-high balances. Co-contributions and carry-forward provisions – both intended to encourage catch-up contributions – instead facilitate tax minimisation and should be abolished, saving $1.1 billion a year.

Australians with more than $2 million in super should not benefit from generous tax breaks on earnings that can easily exceed the Age Pension each year. Balances of more than $2 million make up a tiny fraction of all accounts, but hold nearly as much money as the two-thirds of Australians with less than $100,000 in super. Rather than reducing tax breaks on balances above $3 million, as the government proposes, earnings on balances higher than $2 million should be taxed at 30 per cent, saving upwards of $3 billion a year.

Australia's super system won't be sustainable so long as most superannuation earnings remain tax-free in retirement. Nearly 90 per cent of the tax breaks on retirement earnings go to the top 20 per cent of retirees by wealth. All super earnings in retirement should be taxed at 15 per cent – the same as earnings before retirement – saving more than an extra $5.3 billion a year.

These changes are fair. Retirees would pay *some* tax on the earnings from their super – the same as those working today – and much less than younger workers pay on their wages. Taxing super earnings in retirement isn't retrospective because it only applies to future earnings.

Australia's current superannuation system is unfair and unsustainable. The reforms recommended in this report to super tax breaks would make the system fairer and the budget stronger.

Recommendations

Better target contributions tax breaks

1. Tighten Division 293 tax by raising the tax rate on pre-tax super contributions to 35 per cent (from 30 per cent now) and lowering the threshold at which the tax applies to $220,000 a year (from $250,000 now).
2. Expand the Low-Income Superannuation Offset (LISTO) threshold, which offsets the contributions tax paid by low-income earners on their pre-tax super contributions, to cover incomes of up to $45,000 a year (from $37,000 now) and raise the maximum offset to $800 a year (from $500 now).
3. Reduce the pre-tax contributions cap to $20,000 a year, from $27,500 currently.
4. Reduce the post-tax contributions cap to $50,000 a year, from $110,000 a year currently.
5. Abolish government co-contributions.
6. Abolish pre-tax contribution carry-forward provisions which currently allow people with super balances of less than $500,000 to use any unused portion of their pre-tax contributions caps over the past five years to make additional pre-tax contributions.
7. Introduce a system that records taxable components of lump-sum withdrawals and adds them onto the tax-free component of death benefits, to prevent the use of 'super re-contribution strategies' to avoid paying super death benefits tax.
8. Review the capital gains tax and contributions exemptions for small-business owners.

Rein in earnings tax breaks

9. Tax all earnings in retirement at 15 per cent, as already applies to earnings in the accumulation phase.
10. Limit earnings tax breaks for balances of more than $2 million by implementing a High Super Balance Surcharge, whereby earnings on balances in excess of $2 million are taxed at 30 per cent. The $2 million threshold should be indexed to inflation.
    - If the government persists with plans to tax the earnings on super balances in excess of $3 million at 30 per cent, the threshold should not be indexed until at least 2040, by which time it's real (after-inflation) value will have fallen to $2 million.

Case for key recommendations

Recommendation	Rationale	Annual savings	Fairness
Tighten Division 293 tax: a $220,000 threshold and 35 per cent rate (from $250,000 and 30 per cent currently).	• Better restrict contributions tax breaks flowing to high-income earners. • Creates a more progressive distribution of contributions tax breaks.	$1.1 billion	New threshold would affect about 213,000 taxpayers. Higher rate would affect about 707,000 taxpayers. All savings from the top 10 per cent by taxable income.
Expand LISTO: $45,000 threshold and $800 maximum offset (from $37,000 and $500 today).	• Ensures low-income earners continue to get a meaningful tax break on their pre-tax contributions. • Creates a more progressive distribution of contributions tax breaks.	-($530 million)	Would benefit about 1.1 million taxpayers. Benefit goes to low- and middle-income earners.
Reduce the pre-tax contributions cap to $20,000 (from $27,500 today).	• Pre-tax contributions made above this level are mostly made by people with already-high balances who will enjoy a comfortable retirement regardless.	$1.6 billion	Would affect about 1.3 million taxpayers. 75 per cent of savings come from the top 20 per cent of taxpayers.
Eliminate government co-contributions and pre-tax cap carry-forwards.	• Schemes are generally used for tax minimisation by high-income / high-balance households.	$1.1 billion	Would mostly affect high-income / high-balance households.
Tax retirement earnings at 15 per cent (currently tax-free).	• Tax-free retirement earnings turn super into a taxpayer-funded inheritance scheme, since the boost to balances is typically saved not spent. • Tax-free retirement earnings mean an increasing number of retirees are 'checking out' of the tax system, while the budget faces spending pressures associated with an ageing population.	$5.3-to-$7.3 billion	Would affect about 2 million retirees. At least 70 per cent of savings come from the top 20 per cent of retirees by income.
Implement a High Super Balance Surcharge: a 30 per cent tax rate on earnings from balances above $2 million.	• Balances above $2 million benefit from substantial tax breaks that are not needed for comfortable retirements, and will mostly just boost bequests.	$3 billion	All savings would come from the top 1 per cent of balances.
		$11.5-to-$13.5 billion+	

Notes: All costings are in 2024-25 dollars, except the High Super Balance Surcharge, which reflects when the Government expects the policy to be fully operational after the forward estimates period. The '+' indicates that there are a range of other, smaller measures outlined in this report that would also produce savings.

Source: Grattan Institute analysis. See Appendix A for detail on the data and methods.

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1 Why superannuation tax breaks need reform

Superannuation provides a number of tax breaks. Less tax is paid on money saved into superannuation than money saved outside of super, and less tax is paid on the earnings. These tax breaks should exist only where they support a policy aim. But an objective for Australia's $3.3 trillion superannuation system is still to be legislated.

However, both sides of politics agree that superannuation should not provide excessive support to people already saving enough for a comfortable retirement and who will never need the Age Pension. And nor should superannuation be used as a vehicle for tax minimisation and estate planning.

Instead, superannuation tax breaks should be more progressive: they should offer larger tax breaks to low- and middle-income earners, per dollar saved via super, than to high-income earners. Low-income earners are hurt more by government decisions to lock their earnings away until retirement. And generous tax breaks for high-income earners don't encourage them to save more overall.

Existing tax breaks extend well beyond any sensible objective for superannuation. Super tax breaks cost $45 billion a year – about 2 per cent of GDP – and will soon exceed the cost of the Age Pension. Two-thirds of the value of these tax breaks flow to the top 20 per cent of income earners, who already save enough for their retirement and will never receive the Age Pension. Much of the boost to super balances from tax breaks is never spent in retirement. Superannuation has become a taxpayer-funded inheritance scheme.

Past changes to super tax breaks have not gone far enough. With the federal budget facing a structural deficit of 2 per cent of GDP and big spending pressures looming as our population ages, curbing excessive super tax breaks should be an urgent priority.

1.1 Superannuation offers generous tax breaks

There are varying tax treatments for superannuation contributions, earnings (i.e. dividends, interest, and capital gains), and withdrawals (Figure 1.1 on the following page).

Contributions made from pre-tax income (i.e. pre-tax contributions) – up to a current limit of $27,500 a year – are taxed at 15 per cent.[1] Under the Superannuation Guarantee, employers are required to contribute to the retirement savings of their employees by depositing a percentage of their wage (currently 10.5 per cent) into a nominated superannuation fund.[2] Employees can make voluntary pre-tax contributions by salary sacrificing some of their income and self-employed persons can make 'personal deductible' contributions, both also taxed at 15 per cent. People can make voluntary 'post-tax' contributions to their super fund, financed out of their post-tax income.

Earnings from super funds are taxed at 15 per cent in the accumulation phase, up until the money can be used at age 60. Once Australians reach age 60 and begin to draw down on their superannuation savings, earnings on the remaining super balance become tax-free for balances up to $1.7 million ($1.9 million from 1 July 2023).

Withdrawals from superannuation are tax-free once Australians reach the age of 60. Benefits can be paid out either as an income stream or a lump sum.

1. Contributions made by people earning more than $250,000 (including their super contributions) are taxed at 30 per cent due to Division 293 tax.
2. Some workers also receive a higher percentage of their wages in compulsory employer superannuation contributions than the Superannuation Guarantee, where this has been negotiated under a collective agreement.

1.2 Superannuation exists to boost retirement incomes

It is generally agreed that the super system should do two things. First, boost retirement savings to support *income consumption smoothing*, so that people can maintain a consistent standard of living across their lives.[3] And second, reduce the government's future Age Pension liabilities, subject to the budgetary costs of doing so. Higher retirement incomes always come at a cost: either people have lower living standards while working, or taxpayers pay more to fund pensions and super tax breaks. The key challenge for retirement incomes policy is balancing these trade-offs.[4]

The 2014 *Financial System Inquiry* recommended the objective for superannuation should be 'to provide income in retirement to substitute or supplement the Age Pension'. The then Coalition government sought and failed to legislate that objective.[5]

The new Labor government has proposed an alternative objective:

> The objective of superannuation is to preserve savings to deliver income for a dignified retirement, alongside government support, in an equitable and sustainable way.[6]

While a final objective for superannuation has not yet been legislated,[7] both objectives proposed in recent years make clear that the benefits of higher retirement incomes must be balanced against the costs of achieving them. Both objectives imply that superannuation should not support the savings of Australians who are already on track to achieve a 'dignified retirement', or who are unlikely to ever receive the Age

3. People tend to focus too much on the short term, leading many to save less for their retirement than is needed if they want to consume at about the same rate across their lifetime.
4. Coates and Nolan (2020, Chapter 1).
5. Murray et al (2014); and Parliament of Australia (2017).
6. Treasury (2023a, p. 9).
7. Wootten (2023).

Figure 1.1: Superannuation benefits from big tax breaks

	Accumulation	Retirement
Contributions	• Employers must contribute 10.5 per cent of employees' earnings (rising to 12 per cent by 2025); individuals can make extra voluntary contributions • Contributions are taxed at 15 per cent up to $27,500 a year, and 30 per cent for people earning more than $250,000 • The Low-Income Superannuation Tax Offset (LISTO) refunds contributions tax paid, up to $500, for people earning less than $37,000 • Further post-tax contributions can be made up to a cap of $110,000 p.a. if younger than 75 and with a balance less than $1.7 million (rising to $1.9 million by mid-2023)	• All contributions allowed until age 74 (pre-tax contributions subject to employment requirements) • Only mandated employer contributions and 'downsizer' contributions allowed if aged 75+
Earnings	• Super contributions are invested, earning returns • Those earnings are taxed at 15 per cent in the fund (10 per cent for capital gains)	• Earnings in retirement are untaxed up to a maximum balance of $1.7 million (rising to $1.9 million by mid-2023)
Withdrawals	• No withdrawals until preservation age (60 for future retirees) • Early release for financial hardship is taxed between 17 per cent and 22 per cent if younger than 60	• Payouts are untaxed past preservation age • Bequests taxed depending on the beneficiary, and the share of contributions that were pre-tax

Note: People with balances of less than $500,000 can access 'unused' pre-tax contributions cap space from up to five years prior to make additional pre-tax super contributions.

Source: ATO.

Pension. And both objectives imply that superannuation should not support tax minimisation and estate planning.

Some commentators – particularly those associated with the superannuation sector – advocate using super to help low-income Australians, especially women, to avoid poverty in retirement.[8] These calls are well motivated. But super is often poorly placed to boost retirement incomes for low-income Australians at risk of poverty, or to achieve broader equity goals. Guessing who may have low lifetime incomes on the basis of the incomes they have in a given year will never be as well targeted as using the Age Pension or Commonwealth Rent Assistance to provide support to people otherwise at risk of poverty in retirement.

Equity goals should be achieved by the retirement incomes system as a whole. For the vast majority of people, adequate retirement incomes are achieved by multiple pillars working together. Specifically, the interaction of private savings (including superannuation and housing), the Age Pension, and in-kind support from the government such as healthcare.

This view was supported by the 2020 *Retirement Income Review*, which proposed that the primary objective of the retirement income system – as a whole – should be 'to deliver adequate standards of living in retirement in an equitable, sustainable, and cohesive way'.[9]

The gender gap in retirement incomes is much narrower than the gender gap in superannuation savings, reflecting the role of the Age Pension in redistributing income at retirement. Closing the gender gap in lifetime earnings is the best way to close the gender gap in retirement incomes.[10]

1.3 Super tax breaks have a number of different rationales

Superannuation is taxed much more concessionally than other savings vehicles, including the family home, especially for higher-income earners (Figure 1.2 on the next page). Most taxpayers who contribute to superannuation from their earnings *before tax* have more to spend in retirement than if they had saved their wages after tax, but paid no tax on the returns from their savings.[11]

People who put money into super from pre-tax income just before retirement receive an even larger benefit, since they avoid income tax on the money saved, and then benefit from tax-free super earnings and withdrawals once they retire.

Even where superannuation contributions are made from post-tax income (i.e. post-tax contributions), the taxation on super savings is generally lower than on savings outside super.

However, boosting retirement incomes via super tax breaks is not costless. Ultimately super tax breaks mean that other taxes have to be higher to make up the forgone revenue. Given the structure of the current tax system, this means higher income taxes and company taxes, which come with real economic costs.[12] Therefore, superannuation tax breaks should be offered only where they support a policy purpose, beyond mechanically boosting the super balances of the people who receive them.

8. Women in Super (2022).
9. The Review also proposed nine sub-objectives that provided more detail: Callaghan et al (2020, Section 1C).
10. See Wood et al (2021) and Callaghan et al (2020, Section 3B) for more complete discussions of the gender gap in retirement.
11. Also known as a 'pre-paid expenditure tax benchmark'. See: Daley et al (2015, Box 1).
12. Henry (2010, Chart 1.5).

1.3.1 Super tax breaks increase incentives to save for retirement, but don't affect savings behaviour much

Superannuation tax breaks are supposed to encourage additional savings, over and above compulsory contributions. Taxing savings makes future consumption more 'expensive', since people will have less than otherwise to consume in the future if they save a dollar today.[13]

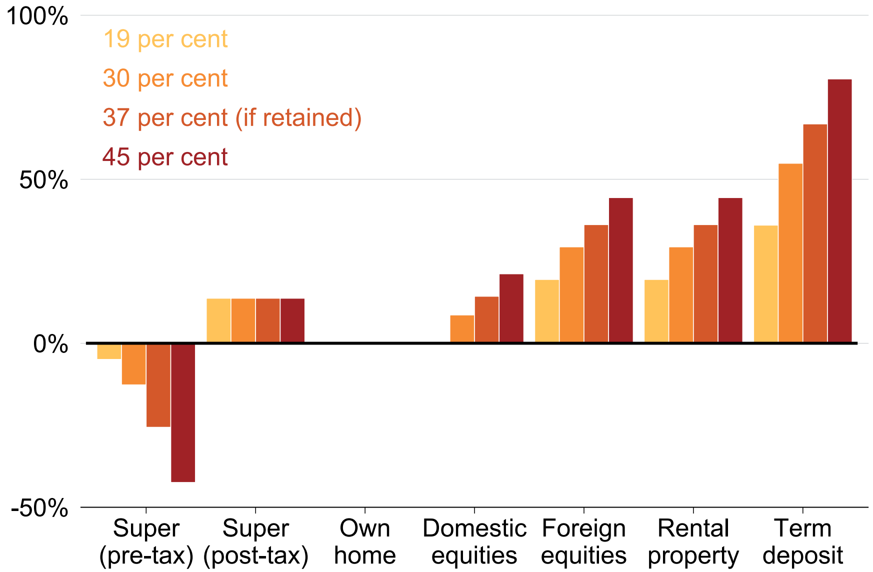
The impact of taxes on savings compounds over time, so the impact on future consumption can be much larger than the headline rate of tax. Therefore, taxes on savings can lead to people making very different choices to the choices they would prefer to make in the absence of taxation.[14] Taxes on savings can also reduce incentives to work today in part to save for the future.[15]

Some argue that all savings should be exempt from tax, and super tax breaks are therefore a necessary first step.[16] Yet the optimal tax treatment of savings remains contested. The UK's Mirrlees tax review concluded that to avoid bias against savings, only the risk-free component of investment returns need be tax free.[17] However, even that is contested. Recent analyses have concluded that even the risk-free return on savings should be taxed, albeit at a lower rate than other income.[18]

In any case, super is taxed much more generously than other savings vehicles (Figure 1.2). Tax breaks on both contributions and earnings combine for a negative *marginal effective tax rate* for most income

Figure 1.2: The taxation of super is substantially more generous than the taxation of other savings vehicles

Real effective marginal tax rate on long-term (25 years) savings vehicles by marginal income tax rate



Notes: Grattan Institute recommends retaining the 37 per cent bracket for incomes between $120,000 and $200,000. Real effective marginal tax rates calculated against a expenditure tax benchmark.

Source: Grattan analysis. See Appendix A for details.

13. Ibid (p. 32).
14. Mirrlees et al (2011, p. 295).
15. Chan et al (2022a) found this effect particularly matters for high-income people who are close to retirement.
16. Carling (2015).
17. Mirrlees et al (2011, p. 284).
18. Banks and Diamond (2010). Breunig et al (2020, p. 52) recommended a universal tax rate of between 5 per cent and 20 per cent on all savings.

earners, compared to if tax were paid on income when earned, and then both dividends and withdrawals were tax free. The fact super remains concessionally taxed against such an 'expenditure tax benchmark', which is widely recognised as an amply generous tax treatment for taxing retirement savings, shows just how generous tax breaks on super are.[19]

And tax rates on superannuation savings are often even lower than shown in Figure 1.2 on the previous page, because that figure doesn't take into account the fact that earnings on superannuation attract no tax after retirement. This is important for the large portion of voluntary contributions to superannuation that are made close to retirement (Section 2.3.2 on page 27).

While theory suggests that taxes on savings reduce the incentive to save, the weight of literature suggests that tax breaks for retirement savings have little impact on the total amount saved. Grattan Institute's 2015 report, *Super tax targeting*, reported that the empirical evidence from around the world demonstrates that people on higher incomes are more likely to save, and they tend to save about the same amount irrespective of tax rates. Most studies have found that tax incentives for retirement savings have little effect on the total amount saved.[20]

Superannuation has supported higher savings overall, but mostly thanks to compulsory contributions rather than tax incentives to save. As the 2020 *Retirement Income Review* concluded:

> The Superannuation Guarantee is effective in increasing savings for retirement, while tax concessions appear to have a weak influence on overall savings behaviour.[21]

However, people with higher incomes and older savers tend to switch their savings into whichever investment vehicle pays the least tax. Tax breaks on superannuation fund earnings may be a strong motivation for those making voluntary post-tax contributions, but many of these contributions appear to be prompted by tax minimisation strategies rather than additional retirement savings (Chapter 2). Whereas tax breaks for savings are more likely to generate additional savings for people on low and middle incomes.[22]

1.3.2 Super tax breaks also compensate for deferring consumption, which hits lower-income earners harder

Superannuation tax breaks also arguably compensate people for being compelled to lock up their savings in superannuation until retirement. But the 'value' of this compensation is very unequally distributed, since high-income earners receive a large tax break (in terms of tax avoided) per dollar of compulsory superannuation contributions, whereas low-income earners receive little compensation.

Yet low-income earners are more likely to be adversely affected by forced saving via superannuation than higher-income earners. Compulsory contributions force many low-income earners to give up part of their wages to save for a higher living standard in retirement than they have while working.[23] For middle-income earners, much of the value of forced saving via compulsory superannuation is offset by a smaller Age Pension entitlement, leaving them no better off in

19. Past estimates showed that Australia's superannuation tax breaks cost $11 billion more in forgone tax revenue in 2013 (and would cost more today) than if Australia adopted a system for taxing superannuation savings where contributions are taxed at full marginal rates of personal income tax, while earnings and withdrawals are exempt from tax (i.e. a Taxed, Exempt, Exempt, or TEE, benchmark). But there is no justification for taxing super more generously than an expenditure tax benchmark. Super tax breaks benchmarked against such a system should be zero, or negative. See Daley et al (2015, p. 25).
20. See Daley et al (ibid, pp. 19–22). See also Callaghan et al (2020, pp. 420–423) for a more recent literature review.
21. Callaghan et al (ibid, p. 58).
22. For a more detailed discussion, see Daley et al (2015, p. 21).
23. After factoring in Age Pension entitlements. See Coates and Nolan (2020) and Callaghan et al (2020).

retirement, but at the expense of forgoing part of their wages while working.[24] There is also good evidence that people on higher incomes are more patient and tend to save more.[25]

Low-income earners also tend to live shorter lives, and are therefore less likely to reach preservation age. And those who do reach preservation age are likely to have less time to spend their superannuation.[26] In particular, life expectancy at birth for Indigenous Australian men is nine years lower, at 71.6 years, than for non-Indigenous Australian men (80.5 years).[27]

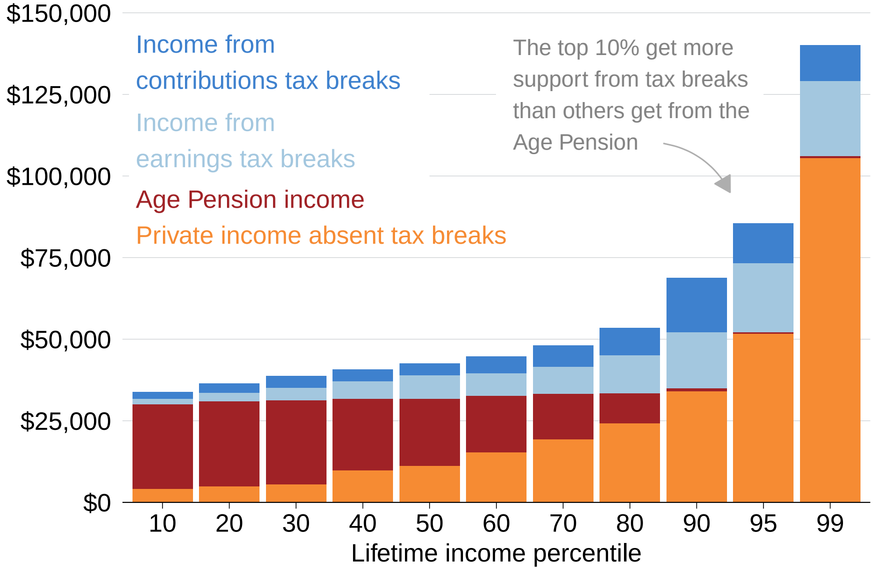
Since the costs of deferring consumption are felt more heavily by low-income earners, and their savings choices are more responsive to tax rates on savings, the tax break offered on each dollar of superannuation savings should be higher for lower-income earners than high-income earners.[28]

Unfortunately, Australia's current system does the opposite, offering tax breaks on savings that provide the most benefit to high-income earners while offering less support, per dollar contributed to super, to low- and middle-income earners (Figure 1.3). In short, much of the value of super tax breaks offered today is inconsistent with the broadly-agreed objective of Australia's superannuation system to provide retirement income for adequate retirements.

At the same time, superannuation tax breaks must be balanced against the costs – not least the budgetary costs, and the costs of other taxes being higher. Therefore, a more progressive distribution of tax breaks within super should be achieved by reining in tax breaks for high-income earners. Doing this would also help with budget repair, with little impact on economic growth.

Figure 1.3: Super tax breaks end up boosting the retirement incomes of high-income earners the most

Individual projected annual average retirement income by source and income percentile



Notes: Private income includes that from super and non-super savings. The 'income from tax breaks' components were estimated by projecting retirement incomes with contributions and earnings taxed at individual marginal tax rates.

Source: Callaghan et al (2020, Chart 4A-20).

24. Coates and Nolan (2020, Figure 5.4).
25. Banks and Diamond (2010, pp. 616–623).
26. Welsh et al (2021) and Leigh and Clarke (2011).
27. Callaghan et al (2020, p. 338).
28. In contrast, the Henry Tax Review recommended that individuals should make all contributions from post-tax income and then receive a flat-rate refundable offset: Henry (2010, p. 100).

1.4 Superannuation tax breaks need to be reined in

Existing tax breaks for superannuation are expensive, unfair, and unsustainable. They currently cost the budget about $45 billion a year. This amounts to about 2 per cent of GDP and 17 per cent of total income tax revenue.[29]

These tax breaks heavily favour people who don't need them – about two-thirds of all super tax breaks flow to the top 20 per cent of income earners (Figure 1.4 on the next page).[30] These high-income earners receiving most of the superannuation tax breaks are likely to save enough for their retirement even without government incentives to do so. After all, the top 20 per cent of households by income at age 55 usually already have net wealth approaching $3 million.[31]

Reining in excessive super tax breaks would help close the gender gap in retirement savings and incomes.[32] Excessive tax breaks on super contributions and fund balances, facilitated by generous caps on annual super contributions, are more likely to be exploited by men, who have higher incomes and therefore greater capacity to make contributions.[33]

Super tax breaks are also unsustainable. They are the largest and fastest-growing leaks from our income tax system, growing faster than the economy. By 2036, super tax breaks will cost the budget more than the Age Pension (Figure 1.5 on the following page).

With the rise of the compulsory Superannuation Guarantee to 12 per cent by 2025, the growth of the system is set to accelerate further. The 2021 Intergenerational Report projected that the super system will double as a share of the economy over the next 40 years.[34] Super tax breaks are expected to cost almost 3 per cent of GDP by 2060, driven by earnings tax breaks almost doubling as a share of GDP over the next 40 years.

Nor do super tax breaks materially reduce Age Pension spending. That's because the cost of super tax breaks far outweighs the Age Pension savings they produce, with the bulk of the benefits going to higher-income earners who would never receive the Age Pension (Figure 1.6 on page 15).[35]

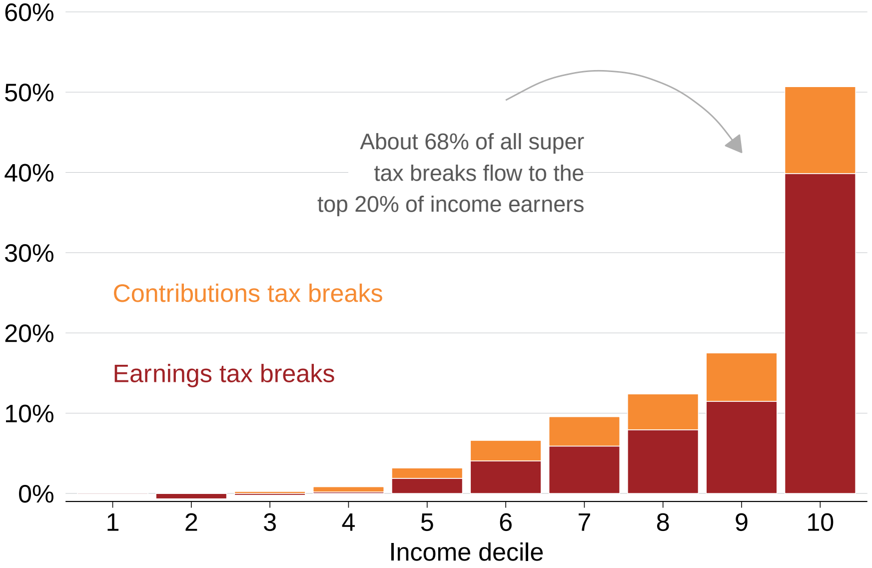
1.4.1 Superannuation has become a taxpayer-funded inheritance scheme

Much of what is accumulated in super is never spent in retirement, including the boost to super balances from generous tax breaks. The 2020 *Retirement Income Review* projected that by 2059, $1 in every $3

29. Grattan analysis of Treasury (2022a), ABS (2022a, Table 1) and Treasury (2022b, Table 1.3). Tax breaks are measured against a comprehensive income tax benchmark on a revenue gain basis (i.e. adjusted for behavioural change). Earnings and contributions tax breaks are adjusted downward to reflect interactions between the separate estimates of the cost of contributions and earnings tax breaks (see note on Figure 1.4 on the following page). Some commentators argue that an income tax benchmark is not appropriate for measuring savings tax breaks, instead preferring a 'pre-paid' expenditure tax benchmark, where earnings and benefits are untaxed but contributions are fully taxed at marginal tax rates. However, the income tax benchmark remains the best measure of how much tax breaks cost. See Daley et al (2015, Box 1).
30. This estimate is higher than reported by Treasury in the *Tax Expenditures and Insights Statement* – Treasury (2023b). We use total income, including super contributions and returns, whereas Treasury uses taxable income. Individuals with high total incomes, particularly driven by super earnings, receive large super tax breaks but can report lower taxable incomes.
31. Grattan analysis of ABS (2022b). Measures average equivalised household net wealth using the age of the household reference person.
32. Coates (2018).
33. Callaghan et al (2020).
34. Australian Government (2021, Chart 7.4.2).
35. For example, modelling for the recent review shows that lifting compulsory super from today's 9.5 per cent to 12 per cent would cost taxpayers more in super tax breaks than they would save from spending on the Age Pension through until 2055. See: Callaghan et al (2020, Chart 2D-10).

Figure 1.4: High-income earners get the bulk of super tax breaks

Share of total super tax breaks by type and income decile

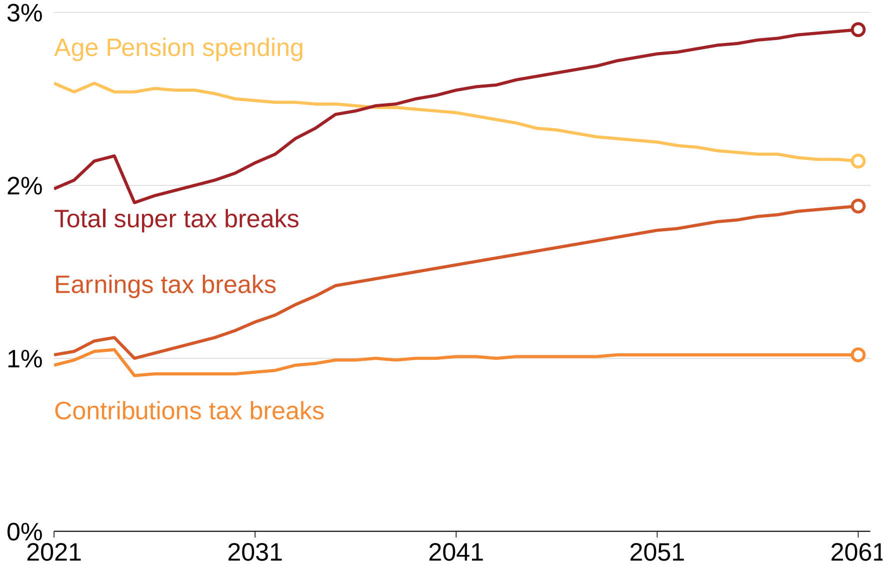


Notes: Income deciles are total income, pre-tax contributions, and deemed super returns. Unlike other estimates in this report, contributions tax breaks are calculated using pre-tax contributions and income from the ABS Survey of Income and Housing Basic Confidentialised Unit Record File (CURF), so that income deciles could be calculated on a consistent basis with earnings tax breaks. Given interactions between separate contributions and earnings tax break estimates, the cost of these tax breaks have been adjusted when combining them here. Callaghan et al (2020, p. 381) estimated that trimming the extra tax off the flow of contributions into the stock would result in the dollar value of earnings tax breaks falling by only about 0.5 per cent for any given year. We make this adjustment.

Source: Grattan analysis of ABS (2022b). See Appendix A for detail on the data and methods.

Figure 1.5: Super tax breaks will soon cost more than the Age Pension

Projected cost of the retirement income system, per cent of GDP

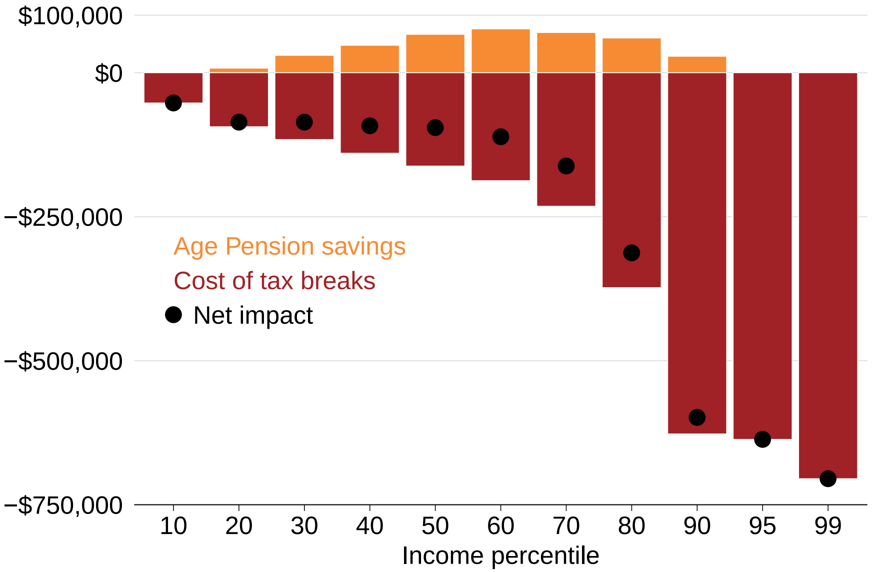


Notes: Tax breaks are measured against a comprehensive income tax benchmark. See footnote on Figure 1.4.

Source: Australian Government (2021, Figure 7.4.6).

Figure 1.6: The cost of super tax breaks far outweighs the corresponding Age Pension savings

Projected tax breaks and Age Pension savings from tax breaks over a lifetime, by income percentile

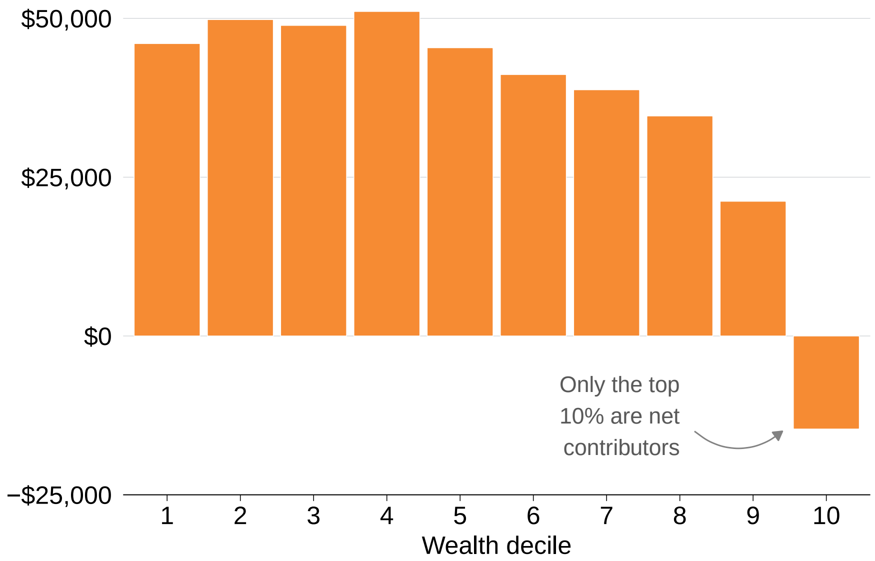


Note: Tax breaks are measured against a comprehensive income tax benchmark.

Source: Callaghan et al (2020, Chart 4A-23).

Figure 1.7: The vast majority of retirees draw more from the budget than they pay in each year

Average net benefits (transfers and services, less taxes paid) for households aged 65+ by wealth decile, 2015-16



Notes: Net benefits are social assistance benefits in cash plus support in kind minus income and sales taxes. Households older than 65 are by age of household reference person.

Source: Wood et al (2019, Figure 5.8).

that's paid out of the super system will be a death benefit, compared to $1 in $5 today.[36]

Well-off Australians, who benefit most from super tax breaks, are less likely to draw down on their superannuation balances in retirement.[37] Without reform, super tax breaks will increasingly just end up boosting the inheritances received by children of well-off parents.

Inheritances tend to transmit wealth to people who are already well-off. Big inheritances boost the jackpot from the birth lottery. Richer parents tend to have richer children. A generation more reliant on inheritances for building wealth is therefore one in which wealth is even less equally shared.[38]

Among those who received an inheritance over the past decade, the wealthiest 20 per cent received on average three times as much as the bottom 20 per cent.[39] One recent study estimates that 10 per cent of all bequests will account for as much as half the value of bequests from today's retirees.[40]

1.4.2 Super tax breaks threaten the intergenerational fiscal bargain

Super tax breaks are also a major cause of the increasing intergenerational unfairness in our tax system. The ageing of the population means higher government spending on health, aged care, and pensions. But there will be fewer working-age people for every person over 65 to pay for it.[41]

36. Death benefits include money left to dependent spouses, but inheritances to children will probably grow at a similar pace: Callaghan et al (2020, p. 435).
37. Coates and Nolan (2020, Figure 3.7) showed that the spending needs of high-income people fall the most in retirement.
38. Wood et al (2019).
39. Wood et al (ibid).
40. Productivity Commission (2021, Figure 3.2).
41. Treasury (2022c); and Australian Government (2021).

Governments have supercharged these demographic pressures by introducing generous tax concessions for older people. A 'self-funded' retiree couple can have, from 1 July this year, $3.8 million in super, unlimited home equity, and income outside super up to about $66,000 a year, and pay no income tax. The share of households older than 65 paying tax has halved over the past two decades, and average income tax paid has barely changed for people older than 65, despite strong growth in their incomes and wealth.[42]

Indeed, the notion of the 'self-funded' retiree is largely a myth. The vast majority of older Australians continue to draw heavily on the public purse via government-subsidised health, aged care, and other services, in excess of what they pay in taxes each year (Figure 1.7 on the previous page).

1.4.3 The 2016 reforms were a good start but did not go far enough

Successive governments have sought to rein in superannuation tax breaks, but these changes have made little difference to the total cost of these tax breaks.

Changes announced in the 2016 Budget were the biggest step in the right direction. These changes reduced the pre- and post-tax contributions caps and limited the amount of assets that could receive tax-free earnings in retirement (Figure 1.8 on the following page).

These reforms affected only about 4 per cent of people with super, nearly all of them high-income earners who are unlikely to receive the Age Pension.[43] While specific super tax changes saved more than $2 billion a year, decisions to return the savings to boost the super

42. Daley et al (2016b); and Wood et al (2019).
43. Daley et al (2016c).

Figure 1.8: Summary of the 2016 changes to super tax breaks

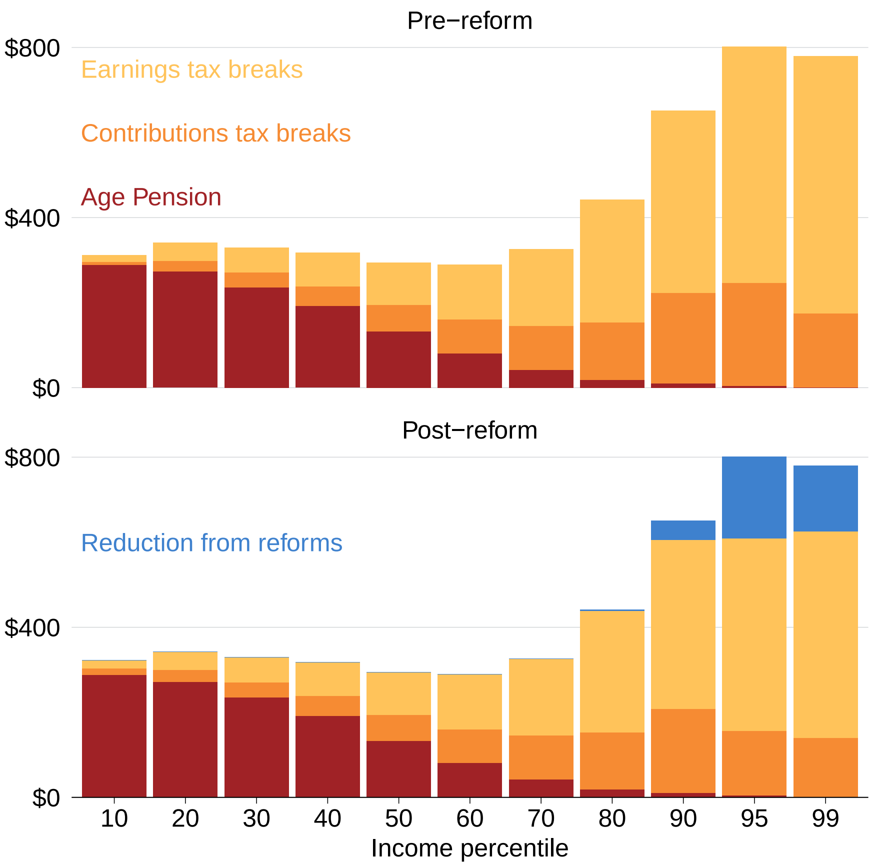
	Change
Pre-tax contributions	• Annual cap lowered from $30,000 p.a. ($35,000 for people aged 49+) to $25,000 p.a. • Pre-tax contributions taxed at 30 per cent instead of 15 per cent for those with income and super contributions higher than $250,000 (previously $300,000). • Unused cap space allowed to be used for 'catch up' contributions for those with balances lower than $500,000.
Post-tax contributions	• Annual cap lowered from $180,000 to $100,000. • Individuals with balances higher than $1.6 million prevented from making post-tax ontributions.
Earnings	• Balance limit for retirement accounts accessing tax-free earnings of $1.6 million – the 'Transfer Balance Cap' (TBC).

Notes: Abstracts from some detail. For example, accompanying changes were made to Transition to Retirement pensions and spouse contributions. See source for additional detail.

Source: Treasury (2016a).

Figure 1.9: The 2016 super tax reforms trimmed only some tax breaks for very high-income earners

Impact of the 2016 reforms on lifetime support for retirement incomes, $2016-17, $000's



Note: Uses a comprehensive income tax benchmark.

Source: Treasury (2016b).

balances of low-income earners resulted in net budget savings of less than $1 billion a year.[44]

But super tax breaks are still unsustainable and flowing mostly to high-income earners who do not need them (Figure 1.9 on the previous page).[45] Therefore, super tax breaks need further reform.

1.4.4 Super tax reforms should be a priority for budget repair

The budget is in deep structural deficit. The latest projections from Treasury are that the deficit will grow over the next four years and settle at about 2 per cent of GDP over the next decade. But even these projections appear optimistic.[46]

Spending and revenue are both expected to increase as a share of the economy over the next decade. But critically, payments are expected to grow more quickly. They are projected to grow from 25.9 per cent of GDP now to 27.9 per cent by 2032-33. Whereas revenues are only expected to grow from 24.5 per cent to 26 per cent.[47]

This growth in spending reflects pressures in a number of important, big-ticket items. Apart from interest costs, by far the largest growth is expected in the National Disability Insurance Scheme (NDIS).[48] Other spending pressures include the ageing of the population. Spending on hospitals, medical benefits and aged care are all expected to grow faster than the economy over the next decade. Government spending on defence is also likely to continue to rise in real terms, given Australia's commitment to AUKUS.[49]

Higher and growing spending on these items is likely with us for good. Longer-term projections in the 2021 Intergenerational Report showed revenue stagnating alongside sustained increases in spending.[50] Using the updated (and more realistic) productivity growth assumption of 1.2 per cent, the deficit is projected to blow out to more than 4 per cent of GDP by 2061.[51]

While there are opportunities to contain costs, higher spending on health, aged care, and disability is inevitable, and in many cases is seen by the community as desirable. In the longer term, extra revenues will be needed, especially if economic growth remains lower for longer.[52]

Raising revenue is hard. There are few popular taxes. But super tax breaks can be wound back without affecting most savers or causing material economic costs. As Treasury Secretary Steven Kennedy recently noted, reining in tax breaks will be necessary to get the budget on a sustainable footing.[53]

An imminent Grattan Institute report will unpack the budget challenge in more depth and canvass a range of options to start the hard work of budget repair, including both tax rises and spending cuts.

44. Treasury (2016a).
45. Callaghan et al (2020, Chart 5A-13).
46. These projections exclude the impact of higher wage bills for aged care workers and higher defence spending from the acquisition of nuclear-powered submarines: Treasury (2022c).
47. Ibid (Chart 3.11).
48. Sustained growth in the number of participants and the average support per participant mean a rapid escalation in costs now and well into the future: Treasury (ibid, p. 87).
49. Wright (2023).
50. Australian Government (2021, Figure 6.2).
51. Australian Government (ibid, Figure 4.6). Australian productivity growth in the past two decades has averaged 1.2 per cent a year, considerably below the 1.5 per cent average of the past 30 years: Treasury (2022c, Box 3.3).
52. The costs to government of an ageing population may be mitigated somewhat by an expansion of 'user pays' arrangements. But a major expansion would require all retirees to 'self-insure', despite only a minority ever needing aged care. This will exacerbate precautionary savings and boost bequests. Additional revenue to cover the ageing population is inevitable. See Coates and Stobart (2021).
53. Kehoe (2022).

1.5 A guide to this report

This report shows how superannuation tax breaks can be better targeted to create a fairer super system and contribute to budget repair.

The rest of this report sets out how super tax breaks should be reformed, and the impact of those changes on the federal budget and Australians' retirement incomes.

Chapter 2 shows how contributions tax breaks cost the budget $20 billion a year, and overwhelmingly benefit those who are already saving enough for their retirement. It shows how contributions tax breaks should be reformed to offer progressively larger tax breaks, for each dollar of super contributions, to lower-income earners, while also offering budget savings. However, it also shows that further changes are needed, such as lowering the annual caps on pre- and post-tax super contributions, to limit tax minimisation and estate planning within super, saving the budget billions more.

Chapter 3 shows how urgent changes to super earnings tax breaks are needed to make them sustainable. Earnings in retirement – currently untaxed – should be taxed at 15 per cent, the same as superannuation earnings before retirement. It also presents a range of alternative, less-ambitious reforms to tighten earnings tax breaks.

Chapter 4 shows why a High Super Balance Surcharge should be introduced on the earnings of balances higher than $2 million, to stop excessive tax breaks being used for tax minimisation and estate planning. Earnings on balances higher than that should be taxed at 30 per cent, saving upwards of $3 billion a year, and more in the long term.

Chapter 5 shows how our practical package of super reforms could contribute substantially to budget repair without imposing high effective tax rates on long-term savings or compromising the adequacy of retirement incomes for current or future retirees.

1.6 What this report is not about

This report is not about the wholesale reform of the taxation of savings in Australia. There is a strong case to harmonise treatment across vehicles (which currently varies widely, as per Figure 1.2 on page 10). But that would be a much larger undertaking and is beyond the scope of this report. In any case, harmonising the tax treatment of all savings would mean higher tax rates on super savings than current levels.[54]

This report is not about the broader design of the retirement incomes system, including the optimal rate of compulsory savings. Previous Grattan Institute work has recommended against lifting the Superannuation Guarantee to 12 per cent. We have recommended instead focusing on the adequacy of income support payments such as Commonwealth Rent Assistance.[55]

1.7 A note on data and methodology

All modelling in this report uses data from the 2019-20 financial year. We use the ATO 2 per cent sample file for contributions tax breaks estimates, and the 2019-20 ABS Survey of Income and Housing Basic Confidentialised Unit Record File (CURF) for earnings tax breaks estimates.

All estimates are done in nominal terms for financial year 2024-25. This is to align with the expected 'settled' state of the personal income tax system as the Stage 3 tax cuts are fully implemented. To this end, we projected the 2019-20 data to 2024-25. This involves inflating incomes, contributions, balances, and population. Policy parameters that are subject to indexation are also accounted for.

54. Breunig et al (2020).
55. Daley et al (2018b); and Coates and Nolan (2020).

Appendix A contains full details on how we did this. It also includes technical detail on each estimate, including how we factored in potential behavioural change when relevant.

2 How to better target contributions tax breaks

Tax breaks on superannuation contributions cost the budget $20 billion a year. Half the value of contributions tax breaks flows to the top 20 per cent of taxpayers, who already save enough for a comfortable retirement and are unlikely to ever receive the Age Pension.

Tax breaks on contributions are skewed to high-income earners because they contribute more dollars. But this skew is exacerbated because high-income earners receive a larger tax break *per dollar contributed* to superannuation. This should be remedied – contributions tax breaks should be made more progressive per dollar contributed.

Division 293 tax, which curbs tax breaks to high-income earners on their pre-tax super contributions, should be raised to 35 per cent (from 30 per cent), and the income threshold lowered to $220,000 a year (from $250,000). This would save $1.1 billion a year. The government should increase the Low-Income Superannuation Tax Offset (LISTO) to $800 (from $500) and raise the threshold to which it applies to $45,000 a year (from $37,000), costing $530 million a year. These changes would mean lower-income earners receive at least a 15 per cent tax break on their contributions, vis-a-vis their marginal tax rate, compared to just 10 per cent for people earning more than $220,000 a year.

Other changes to contributions tax breaks are also needed to limit tax minimisation in super. Most voluntary pre-tax super contributions exceeding $20,000 a year are made by people with already high balances, and appear to be motivated by tax minimisation rather than boosting retirement incomes. Lowering the cap on pre-tax contributions to $20,000 a year would save a further $1.6 billion a year, mostly by reducing voluntary pre-tax contributions made by older people who already save enough for their retirement.

Co-contributions and carry-forward provisions – both intended to encourage catch-up contributions – instead facilitate tax minimisation and should also be abolished, saving $1.1 billion a year.

2.1 Superannuation contributions are made and taxed in a number of ways

Australians contributed about $120 billion to superannuation in 2019-20 (Figure 2.1 on the next page).

Pre-tax contributions, made out of pre-tax income, account for about three-quarters of all super contributions. These are currently taxed at 15 per cent, up to a maximum of $27,500 a year, with that tax being paid once these contributions enter the super fund. People earning more than $250,000 a year are taxed at a 30 per cent rate on their super contributions, due to Division 293 tax.[56]

Most pre-tax contributions are compulsory contributions made by employers via the Superannuation Guarantee (Figure 2.1 on the following page). Employers are required to contribute 10.5 per cent of each employee's salary to their superannuation account, and that figure is legislated to rise steadily to 12 per cent by July 2025.[57] Some employers make super contributions beyond the 10.5 per cent Superannuation Guarantee rate that are negotiated as part of collective agreements.

Individuals can also make additional voluntary pre-tax contributions, by salary-sacrificing part of their salary into super, or directly contributing

56. Income for the purposes of assessing Division 293 also includes pre-tax contributions: ATO (2021).
57. Employers are required to make Superannuation Guarantee contributions on employees' salaries only up to the maximum super contribution base, which is currently $240,800 a year.

funds to super from their post-tax income and claiming a tax deduction on those payments (known as ‘personal deductible contributions’).

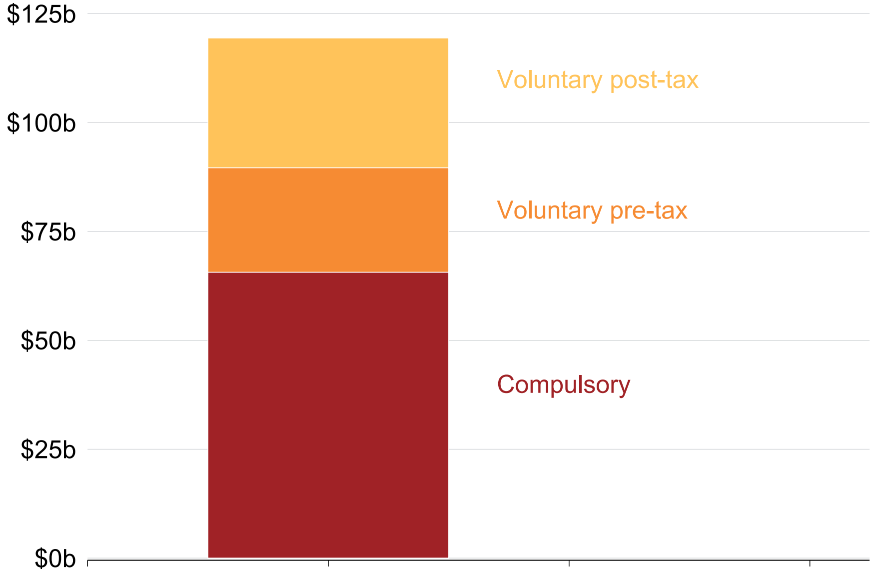
In total, almost half of all super contributions are made on a voluntary basis. The bulk of voluntary super contributions are made out of post-tax income (Figure 2.1).

People earning less than $37,000 a year get most of the contributions tax on their compulsory contributions refunded via the LISTO. LISTO refunds contributions tax paid by super funds on behalf of individuals up to a value of $500 a year for people earning up to $37,000 a year.

From 2024-25, when legislated changes to Australia’s personal income tax schedule take effect (the Stage 3 tax cuts), Australians can expect the following tax breaks on their super contributions, compared to if that income was taxed in the personal income tax system (Figure 2.2 on the following page):

- People earning between $19,000 and $37,000 a year will get a 15-to-19 percentage point tax break on their super contributions.[58]
- People earning between $37,000 and $45,000 will only get a 4 percentage point discount, given the increase in the 19 per cent income tax threshold from $37,000 to $45,000 a year.
- Most Australians – those earning between $45,000 and $200,000 – will get a flat 15 percentage-point tax break on their pre-tax contributions.
- People earning between $200,000 and $250,000 a year will get a discount of up to 30 percentage points.

Figure 2.1: Most super contributions are made from pre-tax income, and just over half of all contributions are compulsory
Total super contributions by type, 2019-20



Notes: Compulsory contributions are not directly observed and are imputed. This uses the 2019-20 Superannuation Guarantee rate of 9.5 per cent and therefore is an underestimate because some employees have a higher compulsory contribution rate.

Source: Grattan Institute analysis of ATO (2022a).

58. This range is due to the maximum offset of LISTO being lower than the expected contributions tax on Superannuation Guarantee payments for someone earning between $30,000 and $37,000.

- People earning more than $250,000 will continue to get a 15 per cent tax break on their super contributions, since they pay 30 per cent tax on super contributions compared to 45 per cent on their other income.

2.2 Current contributions tax settings are expensive and unfair

Currently, super contributions tax breaks cost the budget almost $20 billion per year.[59] Unlike earnings tax breaks, contributions tax breaks are not expected to grow as a share of the economy.[60] However, they remain a significant drain on the budget and overwhelmingly flow to people who don't need them (Figure 1.4 on page 14).

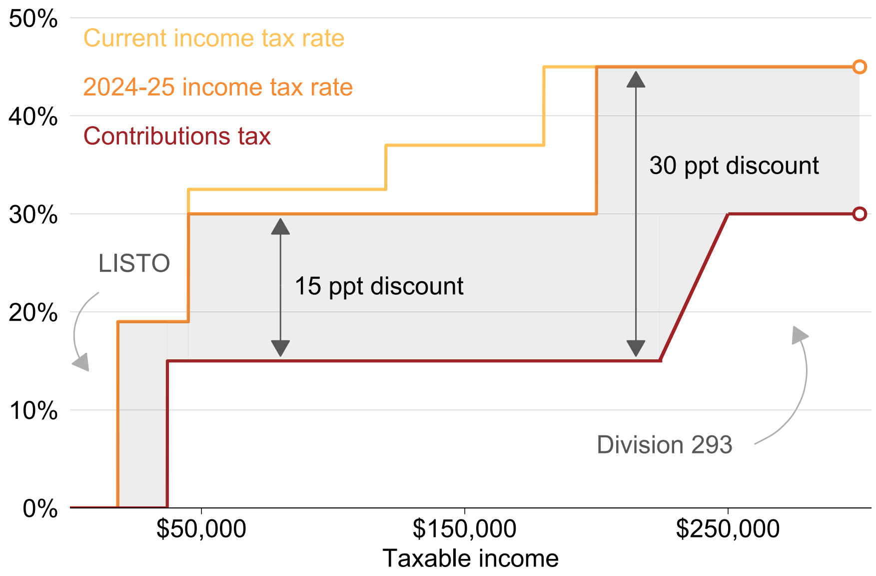
In 2019-20, 53 per cent of the value of contributions tax breaks went to the top 20 per cent of taxpayers, who had an average income of $162,000.[61] Tax breaks on contributions are skewed to high-income earners because they receive a larger tax break per dollar contributed to superannuation, and they contribute more dollars.

Contributions tax breaks should be better targeted by lowering the value of the tax break offered to high-income earners for each dollar they contribute to super.

The 2010 Henry Review proposed that pre-tax contributions be taxed at an individual's marginal tax rate less a flat-rate refundable offset. Henry proposed that the value of this offset be set to ensure most taxpayers would pay an effective 15 per cent contributions tax rate. At the time this offset was foreseen to be 20 per cent, but it would be more

Figure 2.2: Most people get at least a 15 percentage-point tax break on their pre-tax super contributions

Personal income tax rates and current super contributions tax rates



Notes: LISTO = Low-Income Superannuation Tax Offset and 'ppt' = percentage point. The angled line for contributions tax from $225,000 represents the phase-in of Division 293 due to assessable income for Division 293 purposes including pre-tax contributions (we assume pre-tax contributions made at a 12 per cent Superannuation Guarantee). Excludes additional levies, surcharges, and offsets, for simplicity.

Source: Grattan Institute analysis.

59. On a revenue gain basis, which accounts for likely behavioural change if tax breaks were removed: Treasury (2022a, p. 16).
60. Australian Government (2021, p. 117).
61. Grattan analysis of ATO (2022a). See Appendix A for full details on the data and method.

like 15 per cent today, particularly if the Stage 3 tax cuts go ahead as legislated.[62]

If implemented today, a 15 per cent flat refundable offset would likely be budget-neutral compared to current policy. But a 20 per cent offset would cost the budget more than $5 billion a year, with most of the benefit going to high-income earners.[63]

As discussed in Chapter 1, super tax breaks should not be distributed evenly, per dollar of super contributions made, across the income distribution. Instead, larger tax breaks, per dollar contributed to super, should be offered to low-income earners compared to high-income earners.

2.3 How to redirect contributions tax breaks to people who need them

Contributions tax breaks should be redistributed to create a progressive regime of super contributions tax breaks, which offers lower-income earners a larger tax break per dollar that they contribute to super, while also generating significant budget savings.

Further, the pre-tax contribution cap should be lowered to prevent super being used to support tax minimisation and estate planning.

2.3.1 Creating a more progressive regime of super contributions tax breaks

Two reforms would achieve a more progressive contributions tax regime (Figure 2.3 on the following page):

- Division 293 tax should better restrict contributions tax breaks flowing to high-income earners; and
- The Low-Income Superannuation Tax Offset (LISTO) should be expanded.

Tighten Division 293

Division 293 tax currently levies a higher (30 per cent) contributions tax rate on the pre-tax contributions of people earning more than $250,000 a year (including their pre-tax contributions). The income threshold for this tax was lowered from $300,000 in 2016-17.

This system should be tightened to help make the contributions tax system more progressive. The threshold for Division 293 tax should be lowered to $220,000 a year. And the tax rate applied to super contributions above that threshold should be lifted from 30 per cent to 35 per cent.[64]

These changes would ensure that people earning more than $200,000 a year – the threshold for the top marginal rate of personal income tax from 2024-25 – would receive no more than a 10-percentage-point tax break on their pre-tax super contributions, up to a pre-tax contributions cap of $20,000 a year (Section 2.3.2). Those affected would pay up to an extra $4,125 a year in contributions tax on $27,500 a year in pre-tax super contributions, or $3,000 a year if the cap on pre-tax contributions was lowered to $20,000, as recommended in this chapter.

These changes would affect only the top 5 per cent of Australians by income,[65] and would raise $1.1 billion a year for the federal budget.

62. Henry (2010, pp. 34–36).
63. Grattan analysis of ATO (2022a). See Appendix A for details.
64. Pre-tax contributions should still be included in assessable income, and only pre-tax contributions in excess of the threshold should be taxed at 35 per cent. Assuming a lower pre-tax cap of $20,000 (Section 2.3.2), this would ensure the provision has a 'phase-in' and that taxpayers would not face a threshold 'cliff' on their contributions tax.
65. Projected to be around 707,000 taxpayers in 2024-25. Grattan analysis of ATO (2022a). Earnings calculated consistent with the approach for Division 293 income: ATO (2021). See Appendix A for projection method.

Expand the Low-Income Superannuation Tax Offset

The objective of the Low-Income Superannuation Tax Offset (LISTO) is to refund the tax paid on compulsory contributions by low-to-middle income earners with incomes of up to $37,000 a year. In its absence, these people would get negligible benefits from super tax breaks, since their marginal income tax rate is either lower or only slightly higher than the super contributions tax rate.

However, LISTO has not kept pace with changes to the legislated increases in the rate of compulsory super contributions to 12 per cent of wages by 2025, or with recent changes in the personal income tax system.

LISTO should be expanded to a minimum offset of $800 a year (up from $500 currently), and extended to cover incomes between $37,000 and $45,000 a year. This change would ensure low-income earners received a tax break on their compulsory pre-tax super contributions, creating a more progressive system of super tax breaks. This change would cost the budget $530 million a year.

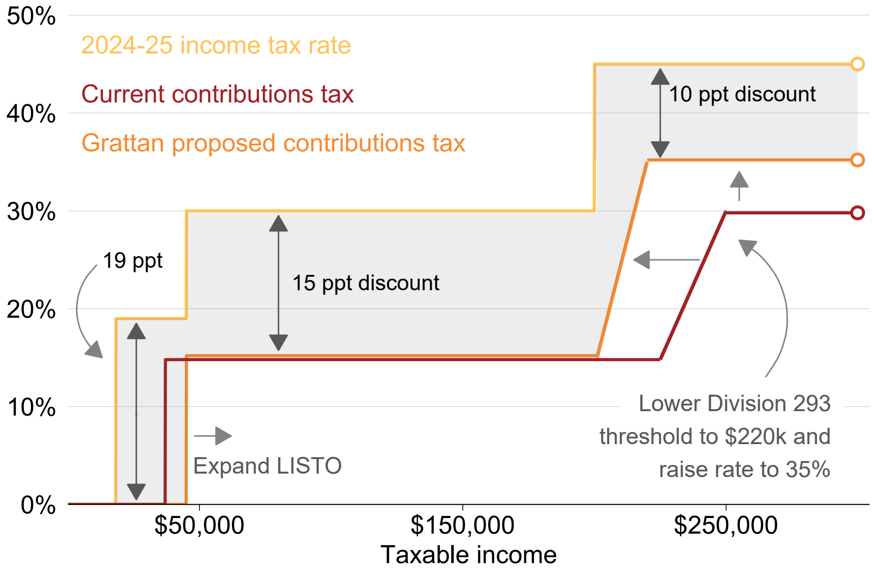
Extending and expanding LISTO would ensure that lower-income earners continued to receive larger contributions tax breaks per dollar contribution than higher-income earners.

Historically, about a quarter of the government's support to low-income earners via LISTO leaks out to support the top half of households by income.[66] Therefore, beyond helping to implement a coherent, progressive regime of super tax breaks across different income levels, the government should avoid using super tax breaks to achieve equity objectives.

This means that the government should avoid making automatic co-contributions to low-income earners.[67] While there is an in-principle

Figure 2.3: Tightening Division 293 and expanding LISTO would make for a more progressive system

2024-25 personal income tax rates, current super contributions tax rates, and Grattan Institute's proposed super contributions tax rates



Notes: LISTO = Low-Income Superannuation Tax Offset and 'ppt' = percentage point. The angled line for contributions tax represents the phase-in of Division 293 due to assessable income for Division 293 purposes including pre-tax contributions (we assume pre-tax contributions made at a 12 per cent Superannuation Guarantee). Excludes additional levies, surcharges, and offsets, for simplicity.

Source: Grattan Institute analysis.

66. Coates and Nolan (2020, p. 13).
67. For example, as in the model proposed by ACOSS (2012).

case for offering a refundable rebate on the pre-tax super contributions of low-income earners, it would have a marginal impact on the retirement incomes of this group, and a sizeable amount of this support would leak out to high-income households.

A scheme whereby co-contributions of 15 per cent of initial contributions are made for people with taxable income below $19,000 would cost about $220 million a year.[68] Instead, the priority for any new spending in the retirement income system should be on an increase in Rent Assistance to help poorer retirees today.

Similarly, while there is a principled case to be made for paying compulsory super contributions on government-funded Paid Parental Leave, doing so is unlikely to make a noticeable difference to the retirement incomes of many middle-income women. Further, it will do nothing for older women who have already had children and are at risk of poverty in retirement.[69]

With the federal budget under pressure, changes to LISTO and paying super on Paid Parental Leave should only proceed once other, more urgent, changes are made to improve equity in the retirement income system, such as by boosting Commonwealth Rent Assistance and JobSeeker.[70]

68. Grattan analysis of ATO (2022a).
69. Coates and Emslie (2023) showed that a woman earning the median Australian income, who took two stints of leave in her early 30s, would get an extra $73 a year – less than $1.50 a week – from compulsory super on Paid Parental Leave. This would be a boost to her average retirement income of just 0.14 per cent. Most of the value of the extra super contributions would be clawed back by the Age Pension assets test. Low- and high-earning women who took the same leave would end up with retirement incomes up to 0.5 per cent higher. See also Callaghan et al (2020, pp. 269–271).
70. See Coates and Nolan (2020, Section 5.2).

These changes would ensure lower-income earners benefit more from contributions tax breaks

Under these changes, low-to-middle income earners would receive the largest tax break per dollar contributed to superannuation. Following these reforms, from 2024-25 once the Stage 3 tax cuts take effect:

- People earning less than $18,200 a year would pay no income or contributions tax;
- People earning between $18,200 and $45,000 would receive a 19 percentage-point discount on their pre-tax contributions;
- Most Australians – those earning between $45,000 and $200,000 – would receive a 15 percentage-point discount; and
- Very-high income earners (people on more than $200,000 a year) would receive a (phased-in) 10 percentage-point discount.

Together, these two measures – tightening Division 293 and expanding LISTO – would generate a net budget saving of $600 million a year.[71]

Lowering the Division 293 threshold would create an additional administrative burden for people affected. They would receive a notice of assessment from the ATO at the end of the financial year, and could pay either out-of-pocket or from their superannuation account. But by 2024-25, only about 1.5 per cent of taxpayers (about

71. The estimate for tightening Division 293 includes a lower pre-tax contributions cap of $20,000 (Section 2.3.2). This is because the threshold of $220,000 was chosen with respect to a $20,000 cap. The estimate for tightening Division 293 without changing the cap is slightly higher, because there are more contributions to tax at a higher rate. But overall a higher pre-tax cap is a revenue loss, because the lower cap re-routes those contributions to the personal income tax system.

213,000 individuals) would be affected by the change in the Division 293 threshold.[72]

In the long term, switching to a system where the ATO acts as the central clearinghouse for employer super contributions would reduce the administrative burden of applying a higher tax rate on the pre-tax contributions of high-income earners.

Such a system would involve employers paying super contributions alongside pay-as-you-go withholding for personal income tax, with the ATO deducting contributions tax payable by the worker before passing remaining contributions onto super funds.

2.3.2 A $20,000 pre-tax contributions cap is needed to stem the flow of tax breaks to those who do not need them

About 80 per cent of the value of pre-tax contributions of more than $20,000 a year are made voluntarily. Two-thirds of them go into the top 20 per cent of super accounts by balance within each age group (Figure 2.4). Only 22 per cent of all pre-tax super contributions are made voluntarily.

The bulk of these pre-tax contributions, and the tax breaks they receive, go to Australians who are already on track to save enough for their own retirement without expecting to draw on the Age Pension.

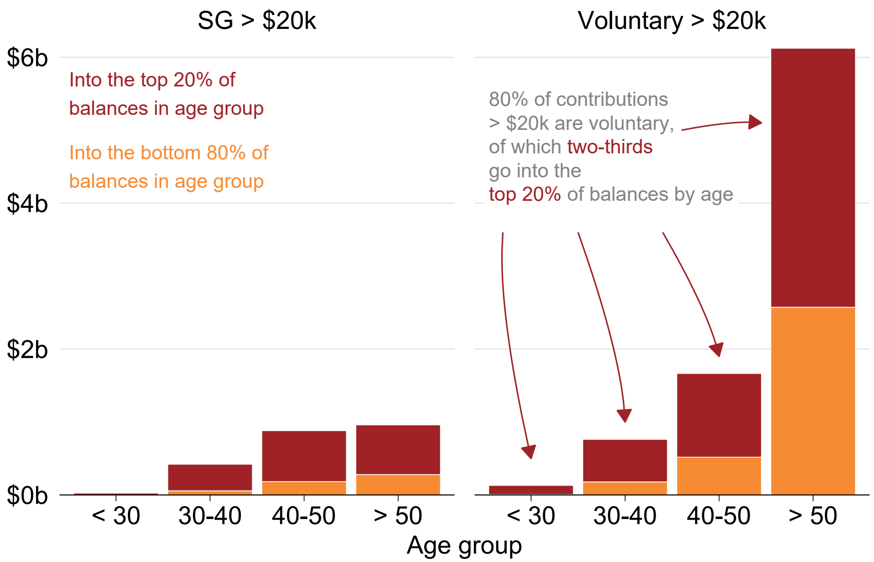
Many large super contributions appear to be motivated by tax minimisation, rather than boosting retirement incomes.

In 2019-20, nearly half of all pre-tax voluntary contributions were made by people in the top 20 per cent of income earners, and nearly half were made by people older than 55.[73]

72. A further 495,000 taxpayers are projected to be above the existing threshold but will be affected by the higher rate: Grattan analysis of ATO (2022a). See Appendix A for projection method.
73. Grattan analysis of ATO (ibid).

Figure 2.4: Contributions higher than $20,000 tend to be voluntary and made into already-high balance accounts

Projected total pre-tax contributions higher than $20,000 by type, age, and balance, $2024-25



Notes: SG = Superannuation Guarantee. Excludes post-tax contributions.

Source: Grattan analysis of ATO (2022a). See Appendix A for detail on the data and methods.

The 'transition to retirement' rules, which allow workers between the ages of 60 and 65 to access their super, were originally designed to allow people to move from full-time to part-time work without reducing their incomes.[74] But many Australians use existing generous caps on pre-tax super contributions to reduce their tax bills. About 30 per cent of voluntary pre-tax contributions are made by people older than 60 and entitled to withdraw their contributions immediately.[75]

People older than 60 can put the maximum amount into superannuation from their pre-tax income, and then withdraw the money immediately, paying less tax than if taxed at full rates of personal income tax.

As a Productivity Commission study concluded:

> The tax concessions embodied in transition to retirement pensions – designed to ease workers to part-time work prior to retirement – appear to be used almost exclusively by people working full-time and as a means to reduce tax liabilities among wealthier Australians.[76]

A $20,000 pre-tax contributions cap would better align tax breaks with the purpose of super and reduce tax minimisation

The pre-tax contributions cap should be lowered further to $20,000.[77] Any contributions made above the $20,000 cap should be treated as post-tax contributions and taxed at full marginal rates of personal income tax.

74. Previously, you could access your super only once you were 65, or retired.
75. Since the 2016-17 super tax changes, withdrawals from 'transition to retirement' pensions are taxed at 15 per cent, rather than being tax free: Treasury (2016a).
76. Productivity Commission (2015).
77. Grattan Institute has previously recommended a pre-tax contributions cap of $15,000 a year: Wood et al (2022, p. 10). But the legislated increase in compulsory superannuation to 12 per cent of wages, combined with indexation of the existing cap to wages growth, makes a $20,000 cap more appropriate today.

A lower cap would reduce the super contributions tax breaks for high-income earners, and further limit the use of super for tax minimisation and estate planning purposes, while ensuring low- and middle-income Australians can still top up their super by making extra voluntary contributions.

A $20,000 cap on pre-tax contributions would allow someone earning about $167,000 a year – 2.3 times median full time earnings, sitting inside the top 5 per cent of income earners – to get tax breaks on all their compulsory contributions.[78] Even if they make no voluntary contributions, they would retire with a super balance of about $1.35 million in today's dollars – over double the ASFA standard for a single – and be ineligible for any Age Pension.[79] The income from their superannuation savings would fund a lifestyle in retirement of $87,000 a year, a better living standard than more than 90 per cent of retirees today (Figure 3.2 on page 40).[80] In practice, people with superannuation savings of that size are likely to have even more invested outside of superannuation, and will therefore enjoy even higher incomes in retirement.[81]

Few people would be affected by a $20,000 cap, and most of them would be high-income men (Figure 2.5 on page 30). Less than 10 per cent of men and 6 per cent of women are expected to make total

78. Assuming a 12 per cent Superannuation Guarantee. Grattan analysis of ABS (2022c). For federal public servants making compulsory contributions at 15.4 per cent, the cap would affect those earning above $130,000. See Appendix A for full detail on the projection methodology.
79. ASFA (2022). Nominal balance at retirement would be $3.37 million. We deflate by inflation of 2.5 per cent a year. Assumes 37 years of contributions, contributions tax of 15 per cent, wage growth of 3.5 per cent, 6.5 per cent nominal after-fee returns, an effective tax on super fund earnings of 8.5 per cent, and wage-indexation of the pre-tax contributions cap, in $2,500 increments, as per current practice.
80. ASIC Money Smart Calculator, assuming retirement from age 67 until 92.
81. Coates and Nolan (2020).

pre-tax contributions of more than $20,000 by 2024-25. The projected average taxable incomes in 2024-25 for these groups are about $182,000 and $125,000 respectively. Of those who would be expected to be affected, more than a third are men in the top 10 per cent by taxable income.

People affected by the $20,000 contributions cap would pay more tax, irrespective of whether the income was contributed to super or not. People in the top 10 per cent by income (projected to earn more than $145,000 in 2024-25) would pay about $600 extra in tax a year, on average. Combined with changes to Division 293 tax, they would pay about $1,300 extra in tax a year, on average (Figure 2.6 on the following page).

A small number of taxpayers outside the top 10 per cent make pre-tax super contributions of more than $20,000 in a given year, so would also be affected by a lower cap and pay a modest amount of additional tax. However, those with lower incomes typically have little money leftover to contribute to super after paying for housing and other necessities. It's likely that most lower-income earners affected by a lower pre-tax contribution cap are part of high-income households.

Because high pre-tax contributions are mostly made by people with high incomes, about 75 per cent of the revenue from lowering the pre-tax contributions cap to $20,000 a year would come from the top 20 per cent of taxpayers. Together with a lower Division 293 threshold, it would result in about 85 per cent of the revenue coming from the top 20 per cent.

Given the increase in compulsory super from 10.5 per cent today to 12 per cent of wages by 2025, some high-income earners would be affected by the lower contributions cap on compulsory super contributions. Just 4.4 per cent of men and 1.3 per cent of women are expected to make compulsory super contributions of more than $20,000 a year (Figure 2.5 on the next page).[82]

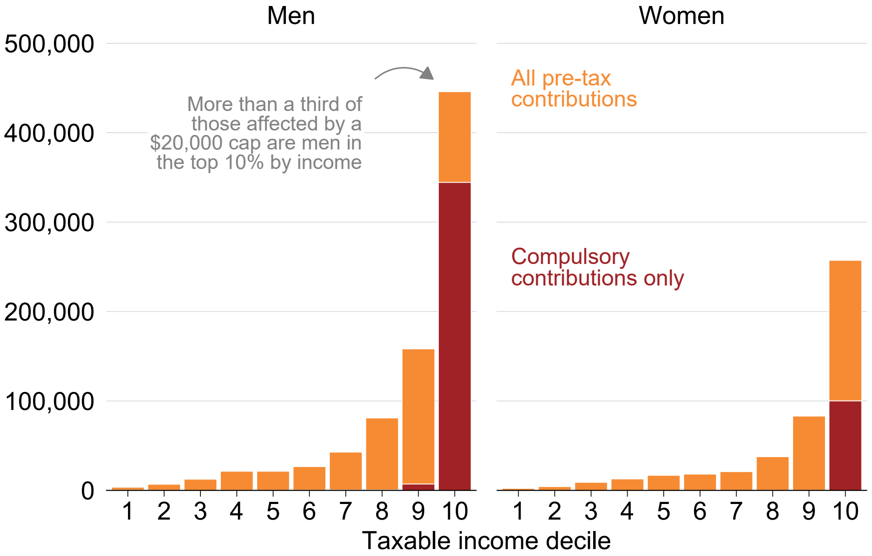
Some commentators have raised concerns that annual limits on contributions can disadvantage people whose income varies a lot from year to year, especially women who take time out of the workforce to have children.[83] But very few women, outside of high-income earners already on track to save enough for retirement to not qualify for the Age Pension, have sufficient resources to contribute more than $20,000 a year to their superannuation. And incomes, especially among those with high incomes, tend to be fairly consistent. So people with high incomes in any given year are likely to have high lifetime incomes.[84]

Despite the low number of people affected, a $20,000 pre-tax contributions cap would save $1.6 billion a year. Therefore the total net savings from lowering the cap combined with tightening Division 293 and expanding LISTO would be nearly $2.2 billion a year.[85]

Ultimately, these proposed changes are modest in the scheme of current contributions tax breaks. They would redistribute the tax break available per dollar of super contributions towards lower-income earners.

82. However, under current legislation, the 'maximum contribution base' for Superannuation Guarantee payments is set with respect to the pre-tax contributions cap. We assume that the 'maximum contribution base' does not automatically lower with the cap, so that Superannuation Guarantee payments above $20,000 can be made in the first instance.
83. For example, see ASFA (2015).
84. Grattan Institute's 2015 report, *Super tax targeting*, showed that people of prime working age who were in the top 10 per cent of income-earners in any single year spent 85 per cent of the 13 years in which data were collected among the top 30 per cent of income-earners: Daley et al (2015, Figure 3.8).
85. If the Stage 3 tax cuts are abandoned, it would save an estimated $1.9 billion a year. Redesigning Stage 3 to keep a 37 per cent tax bracket for income between $120,000 and $200,000 a year (as Grattan Institute has previously advocated) would have a negligible impact on the costing.

Figure 2.5: A $20,000 pre-tax contributions cap would mostly affect high-income men
Projected number of people making pre-tax contributions higher than $20,000, by gender and taxable income decile, 2024-25



Notes: Excludes post-tax contributions. Income deciles are calculated by gender.

Source: Grattan analysis of ATO (2022a). See Appendix A for detail on the data and methods.

Figure 2.6: Our package redistributes tax breaks from high-income earners to lower-income earners
Average extra tax paid by reform and income decile, $2024-25

Note: LISTO = Low-Income Superannuation Tax Offset.

Source: Grattan analysis of ATO (ibid). See Appendix A for detail on the data and methods.

But most of the value of contributions tax breaks would remain in the hands of higher-income earners. As noted earlier, contributions tax breaks will inevitably skew towards high-income earners who have the means to make substantially more contributions to super, including compulsory contributions made on their behalf by their employer (Figure 2.7).

2.4 Co-contributions and carry-forwards do not achieve their objectives and should be scrapped

Government co-contributions and carry-forward provisions have the ostensible objective of boosting the superannuation balances of low- and middle-income earners, particularly women who have lower working-life incomes than men.

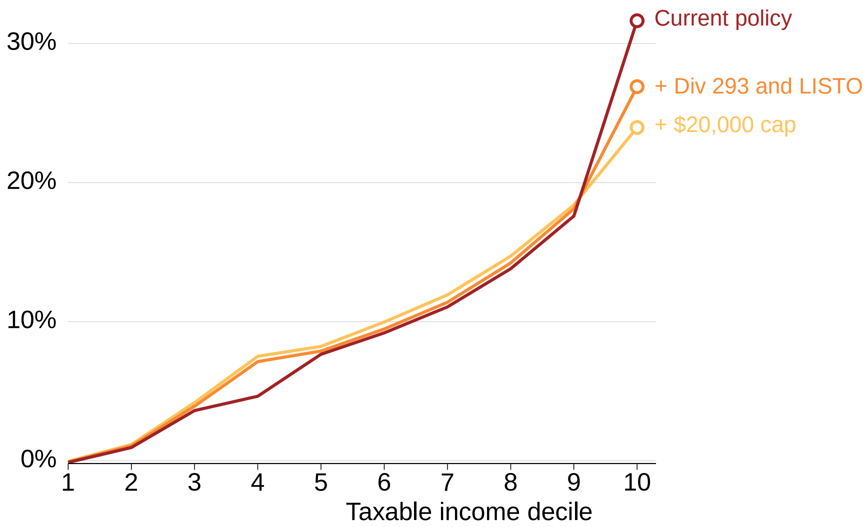
However, neither co-contributions nor carry-forwards are cost-effective policies, and both should be scrapped.

2.4.1 Co-contributions favour high-income earners

Co-contributions are a scheme under which the federal government matches 50 per cent of an individual's post-tax contributions up to a maximum of $500 a year.[86] Eligible individuals are those already receiving the Low-Income Superannuation Tax Offset (LISTO), aged 70 or younger, and with a super balance less than the 'Transfer Balance Cap' (currently $1.7 million, will be $1.9 million from 1 July 2023).[87]

Since the scheme began in 2003-04, the government has spent more than $12.7 billion on it in the hope of boosting the voluntary contributions of low- and middle-income earners.[88]

Figure 2.7: Contributions tax breaks would mostly still go to high-income earners after our proposed reforms
Share of contributions tax breaks by income decile, 2024-25



Note: LISTO = Low-Income Superannuation Tax Offset.

Source: Grattan analysis of ATO (2022a). See Appendix A for detail on the data and methods.

86. The matching amount has changed over the years. In 2004-05 it was increased to $1.50 for every dollar. In 2009-10 the Rudd Government reduced it to $1 and in 2012-13 the Gillard Government cut it to 50 cents: Polidano et al (2022).
87. ATO (2023a).
88. Polidano et al (2022).

But recent research has shown that the scheme has not achieved this objective. It has affected the savings behaviour of only a modest percentage of low- and middle-income earners.[89] And it has largely provided a bonus to people who would have put money into super anyway.

The biggest beneficiaries were high-income earners who happened to qualify in a particular year due to a temporary drop in income, or the partners of high-income earners. Those normally in the top 25 per cent of income-earners were four times more likely to take advantage of the scheme than those normally in the bottom 25 per cent.[90]

This is not surprising. Spending needs are higher in working life than in retirement, when most retirees say they are financially comfortable, even when earning relatively modest incomes.[91] For the vast majority of working-age low- and middle-income earners, it is not rational to voluntarily forgo extra present consumption (on top of that mandated by the Superannuation Guarantee) for extra future consumption.

The government should scrap the co-contributions scheme. This would save at least $100 million a year over the next four years.[92]

2.4.2 Carry-forward rules do not help middle-income people ‘catch up’

People with balances of less than $500,000 can access ‘unused’ pre-tax contributions cap space from up to five years previously to make additional pre-tax super contributions.[93] Treasury has said that the objective is the help people who ‘take time out of work, whose income varies considerably from one year to the next, or who find their circumstances have changed (e.g. mortgage payments or school fees have ceased) and are in a position to increase their contributions to superannuation’.[94]

However, women with low balances who make meaningful voluntary contributions are typically pre-retirees with a partner with a much higher balance.[95] Further, in 2019-20, 60 per cent of people who contributed more than the pre-tax cap of $25,000 and had balances of less than $500,000 were men. This group had an average taxable income of $215,000.[96]

More fundamentally, most people do not experience large fluctuations in income one year to the next. Incomes are generally persistent one year to the next.[97] To the extent that gaps in working-life income are a risk to retirement outcomes, the Age Pension represents a much more robust and efficient insurance mechanism.

Therefore, carry-forward provisions should be abolished. The Parliamentary Budget Office has estimated that abolishing carry-forward provisions would save $10.4 billion over 10 years, with savings increasing every year.[98]

2.5 The post-tax contributions cap needs tightening

Post-tax contributions make up about 25 per cent of all contributions (Figure 2.1 on page 22). The 2020 *Retirement Income Review* showed that far and away the largest post-tax contributions are made by older

89. Bruenig and Sobeck (2020).
90. Chan et al (2022b).
91. Coates and Nolan (2020, Section 3.2).
92. Treasury (2022d, Table 2.1.1).
93. ATO (2023a).
94. Treasury (2016c).
95. Callaghan et al (2020, Chart 6D-11).
96. Grattan analysis of ATO (2022a)
97. Daley et al (2018b, Section C.4.2).
98. This costing was done under the current pre-tax cap arrangements. The saving would be lower if a lower, $20,000 cap were implemented: Parliamentary Budget Office (2019).

people with already large balances.[99] In 2019-20, 88 per cent were made by people with balances in the top 20 per cent (Figure 2.8).

The post-tax contributions regime needs to strike a better balance between allowing people with broken work histories to contribute towards a reasonable superannuation balance, and restricting the opportunities for tax minimisation by people unlikely to qualify for an Age Pension. In reality, very few people stay out of the workforce for an extended period and then have such high earnings that they can make large post-tax contributions to superannuation on top the their pre-tax contribution cap.

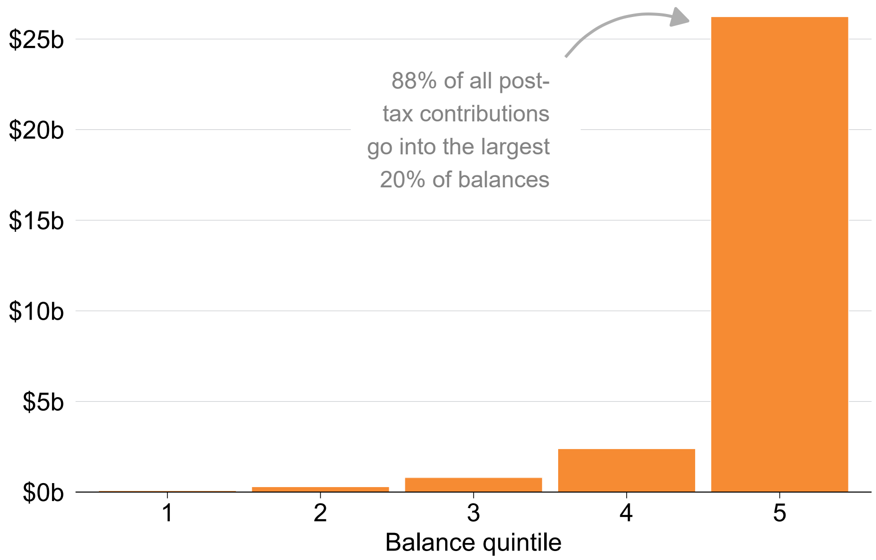
As part of the 2016-17 changes, the annual post-tax contributions limit was lowered from $180,000 to $100,000 (now $110,000 after indexation). In addition, people with a superannuation balance exceeding the Transfer Balance Cap ($1.9 million from 1 July 2023) are prevented from making further post-tax contributions.

These changes are important, but they do not close the door entirely to accumulating larger balances than are necessary for a comfortable retirement. High-income individuals (or those with parents who are well-off) can still make heavy post-tax contributions earlier in working-life, and continue to accumulate via pre-tax contributions. The post-tax contributions cap should be lowered to $50,000 a year (from $110,000 now). This would overwhelmingly affect people with already-high balances who don't need additional earnings tax breaks (Figure 2.8). It should produce savings in excess of $200 million a year.[100]

However, the goal of a post-tax contribution cap is to limit access to earnings tax breaks, not limit post-tax contributions *per se*. Therefore,

Figure 2.8: The vast majority of post-tax contributions go into accounts that already have a high balance

Total post-tax contributions by balance quintile, 2019-20



Source: Grattan analysis of ATO (2022a).

99. Callaghan et al (2020, Chart 6D-10).
100. The Parliamentary Budget Office has previously estimated that lowering the post-tax contribution cap to $75,000 would save $2 billion over 10 years: Parliamentary Budget Office (2019).

if the balance threshold for a higher earnings tax rate of 30 per cent is lowered to $2 million, as recommended in Chapter 4, then a reduction of the post-tax contribution cap would matter much less and should not be a priority.

2.6 The door should be closed on re-contribution strategies to avoid super death benefits

When the beneficiary of a superannuation account dies, any outstanding superannuation balance is paid out as a 'death benefit'. While most super death benefits paid to dependants are not taxed, benefits paid to non-dependants are often taxed.

But the precise tax payable on death benefits also depends on whether the super fund has already paid taxes on contributions and fund earnings. Only the pre-tax contributions portion of a super bequest is taxable, at 17 per cent. The post-tax contributions portion is tax-free.

A common strategy to reduce the taxable portion is to withdraw a lump sum after preservation age (but before the age of 75, when contributions can no longer be made) and re-contribute it as a post-tax contribution. This effectively transforms taxable super into tax-free super, reducing the tax liability on the bequest.

This loophole should be closed. A system could be implemented whereby debits are recorded on lump-sum withdrawals commensurate with the taxable share of the withdrawal, and are factored into the tax-free component of the ultimate bequest if there are subsequent post-tax contributions. This would be a reform for the long-term: most of those re-contributing are aged between 60 and 69, and so can expect to live on average for about another 20 years.

2.7 Small business concessions should be reviewed

Additional concessions are available to the owners of small businesses. These rules allow small business owners to contribute the assets they have accumulated through their business to their retirement savings.

The '15-year exemption' provides a full capital gains tax exemption for small business assets that have been held for at least 15 years when the sale is connected to the retirement of a person aged 55 or older.[101] For people younger than 55, the 'retirement exemption' can exempt up to $500,000 in assets from capital gains tax.[102]

Proceeds from the '15-year exemption' can be contributed to super, while proceeds from the 'retirement exemption' *must* be contributed to super. In both cases, these contributions are subject to a lifetime cap of $1.65 million.[103]

These contributions are tax-free, do not count towards other contributions caps and, unlike post-tax contributions, can be made even if the person has a balance exceeding the Transfer Balance Cap.

In 2016-17, the capital gains exempted from tax through these policies totalled $3.8 billion, resulting in $1.7 billion in tax-free super contributions not subject to general contribution caps or balance restrictions.[104]

Treasury estimates the capital gains tax forgone on these exemptions at more than $1.4 billion in 2022-23,[105] up from $730 million in 2016-17.[106] This does not include the cost of forgone contributions tax.

101. ATO (2017a).
102. ATO (2017b).
103. This is the 2022-23 cap. It is indexed to wages: ATO (2023b) and Callaghan et al (2020, p. 307).
104. Ibid (p. 307).
105. $750 million for the '15-year exemption' and $660 million for the 'retirement' exemption: Treasury (2023b, pp. 130, 134).
106. Treasury (2016d, pp. 66, 69).

There are sound arguments for facilitating transfers of small business assets into superannuation at, or just before, retirement. After all, building capital in a business is an alternative form of retirement saving, and many business owners seek to sell their business to fund their retirement.[107]

But existing tax breaks for small business transfers, especially the capital gains tax exemption, appear to be excessively generous, extending beyond what is necessary to support adequate retirement incomes. Treasury should therefore review these concessions to ensure they are consistent with the objective of the superannuation system.

107. If this were not permitted, small business owners may be encouraged to make larger voluntary contributions while working that displace investing in their business.

3 How to rein in earnings tax breaks

Earnings tax breaks arise because earnings on superannuation balances are taxed less than earnings on most savings held outside super (Figure 1.1 on page 8).

These tax breaks cost the budget more than $22 billion a year.[108] Their costs are expected to almost double as a share of GDP by 2060.[109]

Earnings tax breaks greatly favour high-income Australians. About 72 per cent of all earnings tax breaks flow to the top 20 per cent of income earners. In fact, many people enjoy earnings tax breaks each year that are more valuable than the Age Pension. Tax-free super earnings in retirement mean more of the burden of funding public services falls on younger taxpayers.

Super earnings in retirement – currently untaxed – should be taxed at 15 per cent, the same as superannuation earnings before retirement. This change would save at least $5.3 billion a year today and much more in future, while simplifying tax administration for super funds. Between 70 per cent and 86 per cent of the revenue would come from the top 20 per cent of retirees by income.

Any changes to earnings tax rates would not be retrospective. Instead, like changes to income tax rates which are applied to the returns on savings outside super, they would apply only to future earnings.

108. Calculated on a revenue gain basis for 2021-22 (i.e. factoring in behavioural change): Treasury (2022a).
109. Australian Government (2021).

3.1 Earnings tax breaks are unfair and unsustainable

Super earnings tax breaks cost the budget more than $22 billion a year.[110] The cost of super earnings tax breaks is expected to almost double as a share of the economy by 2060.

The cost of earnings tax breaks will increase as super balances rise, and as a greater proportion of the population enters the retirement phase where no tax is paid on earnings.[111] Rapid growth in earnings tax breaks is the reason super tax breaks are projected to outstrip the cost of the Age Pension by 2036 (Figure 1.5 on page 14).[112]

While the 2020 *Retirement Income Review* found that the costs of Australia's retirement income system are 'broadly sustainable', it cited earnings tax breaks as a key threat.[113]

Earnings tax breaks greatly favour people with large super balances, who are typically high-income earners. About 72 per cent of all earnings tax breaks flow to the top 20 per cent of income earners (Figure 1.4 on page 14). People in the bottom half of the income distribution receive negligible earnings tax breaks.

Together with tax-free superannuation withdrawals, tax-free earnings in retirement mean few people pay *any* income tax in retirement, fraying the intergenerational bargain (see Section 1.4.2).[114] In fact, many

110. Treasury (2022a, p. 16).
111. Total super assets in the retirement phase are projected to rise to 65 per cent of GDP by 2060, from 30 per cent today: Australian Government (2021, Figure 7.4.2).
112. The Treasurer has since suggested that the cost of super tax breaks will exceed the Age Pension by about 2050: Chalmers (2023a).
113. These costs included the Age Pension, which is projected to decrease as a share of GDP: Callaghan et al (2020, pp. 17–20).
114. Wood et al (2019).

people enjoy earnings tax breaks more valuable than the Age Pension. If they face high marginal tax rates outside of super, it's possible for a super fund member with a balance of $1.6 million in the accumulation phase, and a retiree with a balance of $1.3 million, to receive earnings tax breaks exceeding the maximum-rate Age Pension for a single.[115]

The responsibility for earnings tax sits at the fund-level, not the individual. This makes it difficult (but not impossible – see Chapter 4) to implement rates that vary by individual circumstances. A meaningfully progressive earnings tax system is likely to be unimplementable. But changes can be made that can make earnings tax breaks fairer and more sustainable.

3.2 Super earnings should no longer be tax-free in retirement

Excessively-generous tax breaks on super earnings in retirement should be wound back. Tax-free super earnings are a poor way to boost the retirement incomes of low- and middle-income Australians. Half of all current retirees have no super, and so get no earnings tax breaks.[116]

In fact, even for a typical retiree with super, tax-free earnings do not materially boost living standards. Currently, the median retiree enters retirement with only about $125,000 in super, which would produce earnings of only about $6,500 and earnings tax breaks of probably no more than $1,500 a year.[117] But a few retirees have very large balances, and so get substantial earnings tax breaks.

Super earnings tax concessions also open up tax minimisation opportunities that are used more by high-income earners. For example, if an asset is not sold until a person has turned 60, then no tax is payable on any of the capital gain on the asset since it was purchased – potentially many years earlier.[118] This is particularly valuable for Self-Managed Super Funds, where the account-holder can directly control the timing of asset sales. It also provides big benefits to small-business owners, who can move their business into superannuation, and then sell it, without paying any capital gains tax.

In 2019-20, when the Transfer Balance Cap was $1.6 million, the average earnings tax breaks received by people with at least $1.6 million in super totalled nearly $50,000 a year, or more than two-times the value of the maximum-rate Age Pension (Figure 3.1 on the next page).[119] This frays the inter-generational bargain, because it leaves working-age people paying more tax to fund the services enjoyed disproportionately by older Australians.

These tax breaks substantially boost the value of super balances in retirement. But most retirees do not spend much of their savings in retirement, meaning a lot of these assets will end up as heavily taxpayer-subsidised bequests.[120] Treasury projects that by 2060, one in every three dollars withdrawn from super will be in the form of a death benefit.[121]

115. Grattan analysis using the 2023 personal income tax system and single maximum-rate Age Pension. See Appendix A for detail on assumptions. At lower marginal tax rates (19 per cent-32.5 per cent), balances of $2 million for accumulation and $1.8 million for retirees can receive earnings tax breaks more valuable than the Age Pension.
116. Grattan analysis of ABS (2022b).
117. Treasury expects the median retirement balance to increase to $460,000 by 2060, in wage-deflated terms: Australian Government (2021, p. 114).
118. Capital gains on investment assets held in super funds are taxed at 10 per cent during the accumulation phase. But capital gains are tax-free if assets are sold in the retirement phase.
119. Compared to typical earnings tax breaks on the median retirement balance ($125,000) of probably no more than $1,500.
120. See Coates and Nolan (2020, p. 18).
121. Callaghan et al (2020).

3.2.1 Tax all earnings at 15 per cent

We recommend taxing all retirement earnings at the 15 per cent rate faced by accumulation members. This would mostly reduce tax breaks flowing to people who don't need them – improving both intra-generational and inter-generational fairness.[122]

A 15 per cent tax on all super fund earnings, including on earnings in retirement, would still leave super savings taxed lightly, particular given that contributions would not be taxed at full rates of personal income tax (see Chapter 2). As noted in Chapter 1, long-term savings should be taxed at a low but positive rate.

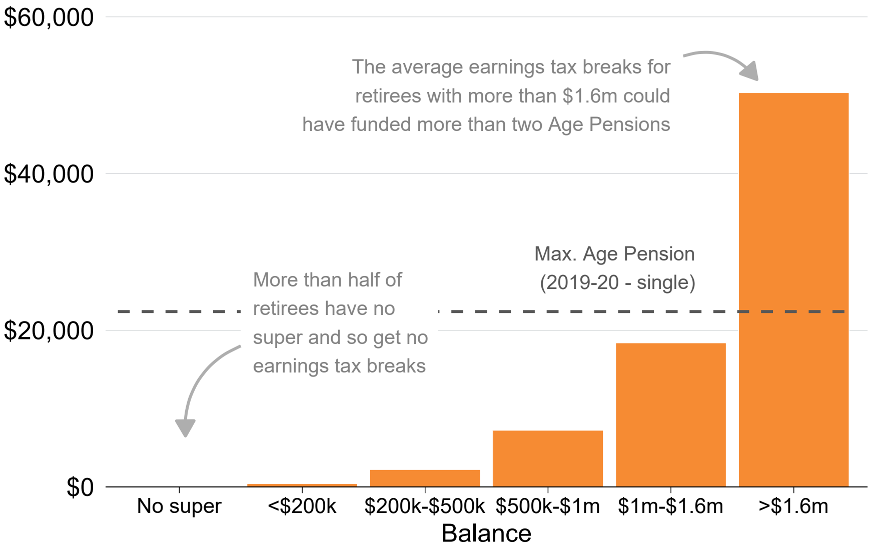
In fact the combination of a 10-to-20 percentage point tax break on pre-tax super contributions, combined with a 15 per cent tax on super fund earnings, would still leave superannuation savings taxed very generously compared to other savings vehicles (Chapter 5).

In contrast, the proposal of the Henry Review to tax all super earnings at just 7.5 per cent is excessively generous, and would make earnings tax breaks even more expensive and unsustainable (Box 1).

3.2.2 Taxing all super fund earnings at 15 per cent would raise substantial revenue

From 2024-25, a 15 per cent tax on earnings in retirement could save the budget between $5.3 billion and $7.3 billion a year, depending

Figure 3.1: Few retirees have large balances, and those who do get substantial earnings tax breaks
Average earnings tax breaks by balance range, people aged 63+, 2019-20



Source: Grattan analysis of ABS (2022b). See Appendix A for detail on the data and methods.

122. Daley et al (2015).

on how retirees' respond.[123] It would raise at least 70 per cent of the revenue from the top 20 per cent of retirees by income.

Assuming no behaviour change, people drawing on their super and in the highest 10 per cent of retirees by income would start to pay an average of $7,500 in tax on their super earnings (Figure 3.3 on the following page).

In contrast, most poorer retirees have comparatively little super, and half of all retirees today have no superannuation whatsoever. The poorest half of all retirees would pay no more than $200 each per year, on average, while most poorer retirees would pay no extra tax whatsoever since they hold no super. In total, the poorest half of all retirees could pay about 5 per cent of the total amount raised (Figure 3.3 on the next page).[124]

Only well-off retirees rely on superannuation to support their living standard in retirement. But even the wealthiest 10 per cent of retirees today rely more on income from outside super than income from super (Figure 3.2 on the following page).

But behaviour change would result in much tighter targeting in practice. Low- and middle-income retirees with modest super balances could avoid paying any super earnings tax by shifting a portion of their savings out of super to make use of the generous tax-free threshold available to older Australians (Figure 3.3 on the next page). Their

123. All savings estimates in this chapter factor in a potential behavioural response. Taxing all or more retiree earnings would make investing outside super more attractive for people with 'room' in their effective tax-free threshold. In practice, it's unlikely many retirees would be able to optimise their asset allocation to fully exploit this. Nonetheless, we estimate costings for no behavioural response and a full behavioural response. See Appendix A for more information about how this is modelled.

124. The distribution of retiree super is closely but not perfectly related to the distribution of retiree income. Some retirees in the poorest half by income have some super, while some in the top half by income have no super.

Box 1: The Henry Review proposals for taxing super earnings are far too generous

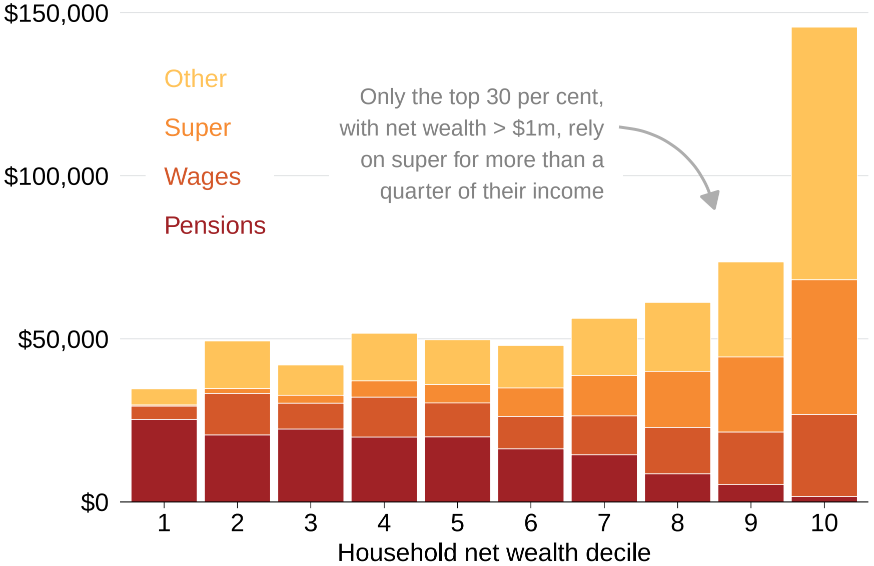
The 2010 Henry Review proposed taxing all super fund earnings at 7.5 per cent, including those in the retirement phase. Super funds would still be able to access franking credits, but the one-third capital gains tax discount for super funds would be removed.[a]

Applying a single tax rate to all super earnings would help simplify the super system, while also preventing Self-Managed Super Funds from arranging their affairs to avoid capital gains tax on their assets once their members retire. And it would mean all retirees paying at least some tax on their super fund earnings.

But a 7.5 per cent tax on all super earnings is far too generous.[b] It would cost the budget between $5.2 and $6.3 billion a year, making super earnings tax breaks even more expensive and unsustainable. While a 7.5 per cent tax on all earnings would collect an extra $2.9-to-$4.1 billion from retirees (depending on the degree of behavioural change), it would collect $9.2 billion *less* tax on the earnings of accumulation-phase members.[c]

a. Henry (2010, Recommendation 19). The report recommended that, should dividend imputation be abolished in the future, the tax on super fund earnings should be reduced to zero.
b. After accounting for franking credits, the effective tax rate on super fund earnings would be close to zero. By comparison, the effective tax rate on super fund earnings before retirement today is about 8 per cent after accounting for the capital gains tax discount and franking credits. See Henry (ibid, p. 107) and Daley et al (2015, Figure 2.3).
c. Grattan analysis of ABS (2022b). See Appendix A for further details.

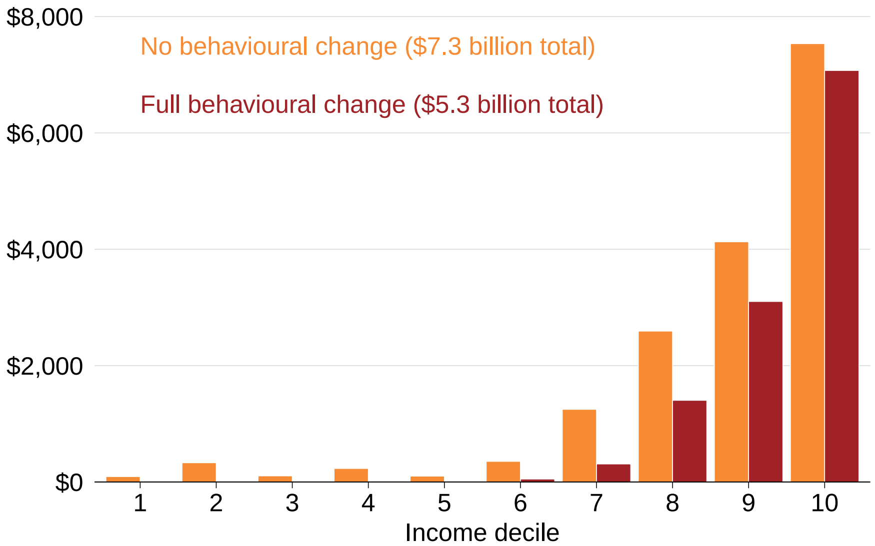
Figure 3.2: Only well-off retirees currently rely on super for income
Average annual income by source and wealth decile, households aged 63+, 2019-20



Notes: 'Other' includes non-super investment and business income. Using a retirement age of 63 ensures the share of assets in the retirement phase in the data used matches the aggregates reported by APRA and the ATO.

Source: Grattan analysis of ABS (2022b).

Figure 3.3: Most current retirees would pay little extra if there was a 15 per cent tax on retirement earnings
Average extra tax paid by income decile, individuals aged 63+, $2024-25



Note: Income excludes super withdrawals but includes deemed super returns.

Source: Grattan analysis of ABS (ibid). See Appendix A for detail on the data and methods.

total taxable earnings would be below the tax-free threshold, which is effectively about $33,800 for people older than 65 who qualify for the Senior Australian and Pensioner Tax Offset (SAPTO). In this scenario, the share of tax raised from the top 20 per cent of retirees by income would rise from 70 per cent to 86 per cent, and the estimated revenue raised would fall from $7.3 billion to $5.3 billion.

A tax on all retirement earnings would simplify super administration

A 15 per cent tax on earnings in retirement would simplify tax arrangements for funds, with no need to distinguish between assets supporting accumulation or retirement accounts. Currently, superannuation funds must maintain two separate pools of funds, with different tax treatments for those in pre-pension and draw-down phases of superannuation. The Henry Tax Review recommended a single tax rate on super fund earnings (Box 1).

The 2015 Financial System Inquiry found that aligning the tax rates in this way would encourage pension product innovation.[125] It would also remove the need for high-balance retirees to retain a separate Transfer Balance Cap super account, which increases the number of accounts and adds to the cost of administering the system.

An alternative approach will be needed to apply tax on super earnings in retirement for defined-benefit income streams. These income streams are typically not tax-free on retirement for over-60s. In these schemes benefits withdrawn are typically still taxable where taxes are liable on contributions and fund earnings have not already been paid in the fund. Fund earnings could remain exempt and benefits paid out each year could be taxable.[126] For example, the government could adopt a similar approach when implementing a tax on all earnings in the retirement phase as has already been applied to implement a tax on earnings for balances above the Transfer Balance Cap.[127]

3.3 Other options to rein in super earnings tax breaks

While taxing all super earnings in retirement is the fairest and simplest way to rein in super tax breaks, other options are also available. These include reducing the Transfer Balance Cap, reducing the capital gains tax discount for super funds, or introducing a levy on all super earnings to guarantee the care needs of older Australians.

Reduce the Transfer Balance Cap

The Transfer Balance Cap was designed to stem earnings tax breaks by restricting the amount of assets that can be taken into a tax-free retirement account. But it was set at such a high level that its effect was limited, only trimming about $750 million of earnings tax breaks of the top 10 per cent by income.[128] Earnings tax breaks are still projected to be unsustainable after this reform (Figure 1.5 on page 14).

As of 1 July 2023, the Transfer Balance Cap will rise to $1.9 million.[129]

By 2024-25, when the cap is expected to be at least $2 million after indexation, only about 2 per cent of people approaching or at retirement age (aged 50 to 65) are expected to have a super balance above this level.[130] The Transfer Balance Cap offers these retirees upwards of $100,000 in earnings each year completely tax free. Whereas younger Australians earning the same income from working are paying $23,000 a year in personal income tax.[131]

125. Murray et al (2014, p. 139).
126. Daley et al (2015, p. 68).
127. For more detail on the tax treatment of super fund benefits that exceed the Transfer Balance Cap today, see ATO (2022b).
128. Daley et al (2016c, Table 1 and Figure 6).
129. The Transfer Balance Cap started at $1.6 million and is indexed to CPI.
130. Grattan analysis of ABS (2022b). See Appendix A for full detail on the data and method.
131. Calculated from ATO (2022c).

A Transfer Balance Cap of $500,000 (or $1 million for a couple) would ensure no full-rate Age Pensioners paid earnings tax. It would save between $2.3 billion and $3.4 billion a year and would affect up to 15 per cent of retirees.[132]

Alternatively, a Transfer Balance Cap of $1 million (or $2 million for a couple) would ensure no pensioners (full and part rate) paid earnings tax. It would save between $1.1 billion and $1.6 billion a year and would affect up to 6 per cent of retirees.[133]

Unsurprisingly, lowering the Transfer Balance Cap would raise revenue almost exclusively from higher-income retirees, as they're the ones with high balances.

Lowering the Transfer Balance Cap may be more political palatable for governments seeking additional budgetary savings while exempting lower-balance retirees. But it would still leave earnings tax breaks growing at an unsustainable rate over the long term, shifting the burden of an ageing population and budget repair onto younger Australians.

Reduce the capital gains tax discount for super funds

Grattan Institute recommends halving the capital gains tax discount for individuals, from 50 per cent to 25 per cent.[134] Super funds currently enjoy a one-third discount, slightly less generous than for investments outside the superannuation system. Super investors, especially in Self-Managed Super Funds, are also able to choose the time of an asset's sale to minimise (or eliminate) taxes on capital gains.

The capital gains tax discount exists to ensure that capital gains tax is applied to real gains only. While inflation is currently high, in the long term a 25 per cent discount is likely to better reflect the share of long-term capital gains that are compensation for inflation.[135] Reducing the capital gains tax discount for super funds to 25 per cent would save about $450 million a year.[136]

A lower discount on capital gains could be phased in over two-to-three years. But no effort should be made to grandfather existing investments from capital gains.[137] Applying different tax treatments to super fund investments depending on when they were acquired would make the super tax system much more complex. Because super funds can hold assets for decades, these dual tax arrangements are long-lived. For example, the decision to grandfather the capital gains tax-free status for assets purchased before 1986 still contributes to the complexity of our capital gains tax regime, nearly four decades later.

Introduce a levy on all super earnings to guarantee the care needs of older Australians

As outlined in Chapter 1, federal government spending on health and aged care will need to rise faster than GDP to ensure all older

132. Currently, single home-owning retirees with assessable assets of less than $280,000 and renters with assets of less than $504,500 are eligible for a maximum-rate Age Pension. Couples can hold assets valued at up to $419,000 (for homeowners) and $643,500 (for renters) and still qualify for the full pension. Assessable assets includes personal effects and motor vehicles, not just financial assets, so $500,000 will in practice exclude all full-rate pensioners.
133. Home-owning singles with assets valued at more than $622,250, and couples with assets above $846,750, are ineligible for a part-rate Age Pension. Couples can hold assets valued at up to $935,000 (for homeowners) and $1,159,500 (for renters) and still qualify for at least some Age Pension.
134. See Daley et al (2016a) and Daley et al (2018a).
135. Daley et al (2016a).
136. For financial year 2022-23. Assumes 78 per cent of system assets are taxable accumulation assets (Australian Government (2021, Chart 7.4.2)), that 74 per cent of accumulation assets are growth assets (Callaghan et al (2020, Chart 6A-23)) returning 7 per cent after fees (Callaghan et al (ibid, Table 6A-23)), with half of that return being a capital gain, and half of the gains being realised in a given year.
137. Daley et al (2016a).

Australians can get high-quality care. As the population ages, there will be more demand for aged care places.

Aged Care Royal Commissioner Tony Pagone recommended the federal government increase the Medicare Levy to help meet the costs of improving aged care.[138] But such an approach would impose the full cost of funding that care on working-age Australians.

An Older Australians Care Guarantee Levy, levied on superannuation fund earnings in both the accumulation and retirement phases at a 3 per cent tax rate, would be a fairer way of sharing across the whole community the costs of supporting older Australians. A 3 per cent levy could raise between $5.4 billion and $5.8 billion a year from 2024-25, depending on how retirees responded. In total, $3.9 billion would be levied on super fund members in the accumulation phase, and between a further $1.4 billion and $1.9 billion in the retirement phase.

Despite being a flat tax applied to the earnings of all super fund accounts, a 3 per cent levy would still raise most of the revenue from high-income earners because that's where most of assets are. More than 50 per cent of the additional revenue raised each year would come from the top 20 per cent of income earners.

But a 3 per cent levy on the earnings of all super balances would raise less revenue over the long-term than our preferred option of taxing retirement earnings at 15 per cent. This is because retirement-phase assets are projected to grow faster than the system overall over the long run.[139]

138. Pagone and Briggs (2021). The Medicare Levy is a 2 per cent surcharge on personal income tax rates, which is phased in for incomes between $23,365 and $29,207 for working-age Australians, and between $36,925 and $46,157 for seniors and pensioners (for the 2021-22 financial year).

139. Australian Government (2021, Chart 7.4.2).

3.4 Changes to earnings tax breaks would not be retrospective and should not be grandfathered

The changes to earnings tax breaks recommended in this chapter would not represent retrospective changes to super tax, and should not be grandfathered.

Retrospectivity is a legal concept that applies if government changes the legal consequences of things that happened in the past. Investments might have been made in the past, but their earnings are realised in the present, and are subject to the policy of the day.

For example, if someone buys shares in a company, they expect that the future earnings on those shares will be subject to their marginal income tax rate, which may change in future.[140] Similarly, it is not retrospective to change the asset test for the Age Pension, as the former Coalition government did in 2016, merely because assets accumulated in the past are now assessed differently when determining future Age Pension payments.

Claims of retrospectivity in super – that the 'rules have been changed unfairly' – only appear to be made in response to changes that adversely affect super fund members. Whereas changes that benefit members, such as the Howard Government's 2006 abolition of taxes on super withdrawals, which offered an enormous windfall to well-off older Australians, were not labelled as 'retrospective' by those affected.

And while grandfathering the earnings tax breaks for retirees may be politically expedient, it would be neither prudent nor fair.

For decades, some older savers have benefited from superannuation tax breaks that did little to help younger generations. Understandably, those older savers want to keep receiving these benefits. Exempting older households from the costs of policy changes – such as by

140. Daley (2016).

grandfathering existing benefits and tax breaks – would simply magnify the costs shifted onto younger generations from an ageing population. Younger generations would continue to fund generous tax benefits that they will never be able to access.[141]

141. Daley et al (2015, pp. 68–69).

4 Limit earnings tax breaks on balances bigger than $2 million instead of $3 million

As shown in Chapter 1, superannuation has become a taxpayer-subsidised inheritance scheme. A significant share of superannuation is held in accounts with very large balances that are unlikely to be spent down in retirement.

In February this year, the Federal Government announced that from 2025-26, the earnings on balances bigger than $3 million would be taxed at 30 per cent (instead of 15 per cent). This is projected to affect about 80,000 people and trim earnings tax breaks for those with very-high balances by about $2 billion a year once the policy is fully operational.[142]

But the government should go further – the threshold should be lowered to $2 million. There is no rationale for generous earnings tax breaks on balances between $2 million and $3 million, certainly not one that is consistent with the proposed objective for superannuation to ‘deliver income for a dignified retirement, alongside government support, in an equitable and sustainable way’.[143]

In 2019-20, there were 43,000 super accounts with more than $2 million but less than $3 million. Together they held more than $100 billion of assets. The holders of those accounts can benefit from earnings tax breaks worth as much the Age Pension. It’s unlikely that much of these super balances will be drawn from super to fund members’ retirements.

142. Chalmers (2023b).
143. Treasury (2023a). Further, the 2020 *Retirement Income Review* laid out a set of objectives for the retirement income system as a whole. These related to adequacy, equity, and sustainability. Excessively generous tax breaks for very large super balances conflict with all of them: Callaghan et al (2020).

Balances bigger than $2 million should not continue to enjoy substantial tax breaks on super fund earnings worth hundreds of thousands, and sometimes millions, of dollars a year.

Reducing the balance threshold for a 30 per cent tax rate to $2 million could save the budget about $3 billion a year (compared to a saving of $2 billion under a $3 million threshold).[144]

Setting a High Super Balance Surcharge at $2 million could also make the existing Transfer Balance Cap redundant, which would make administering the super tax system simpler.[145]

4.1 Boosting balances bigger than $2 million via substantial tax breaks is inconsistent with the objective of super

Only a tiny minority of Australians – about 1 in every 200 super fund members in 2019-20 – has accumulated more than $2 million in super. Yet these accounts contain almost one-in-eight dollars in the super system, or almost as much as the accounts of the two-thirds of Australians who have less than $100,000 in super (Figure 4.1 on the next page).[146]

About 85 per cent of the people with balances bigger than $2 million are aged 60 or older. There are 370 people under the age of 30 who report having super balances bigger than $2 million. Treasury has

144. Grattan analysis. Takes the Treasury costing of $2 billion saved from a $3 million threshold and adjusts it upwards proportionally based on the additional assets held in accounts between $2 million and $3 million. Chalmers (2023b).
145. The Transfer Balance Cap is indexed to inflation and is expected to reach $2 million by 1 July 2024.
146. Note that after accounting for the 27 per cent of adults who have no super, the share with balances bigger than $2 million falls to about 1 in every 280 Australian adults: ABS (2022d, Table 12.2).

projected that about 80,000 people will have balances bigger than $3 million by the time the new tax rate takes effect.[147]

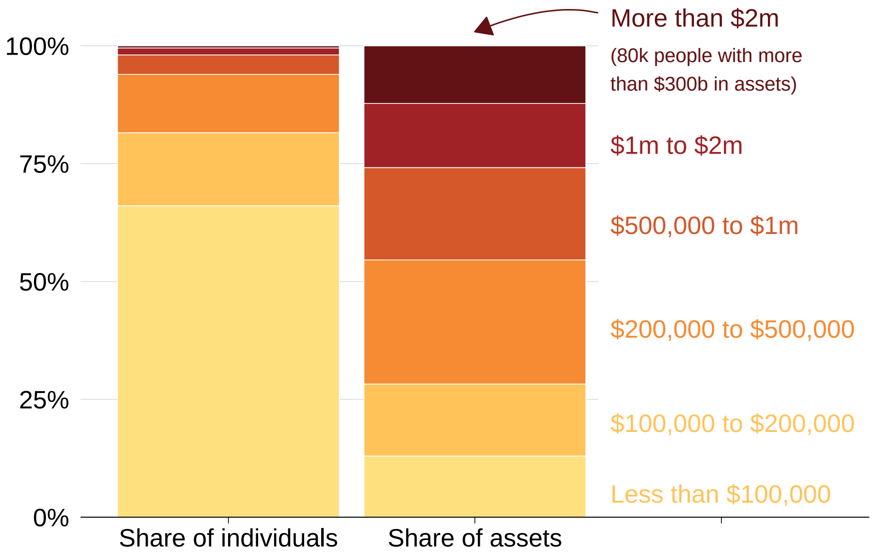
These individuals overwhelmingly have Self-Managed Superannuation Funds (SMSFs). In 2019-20, almost 86 per cent of the people with balances bigger than $2 million were in SMSFs.[148]

These very large balances have benefited enormously from previous changes to superannuation tax policy. Before 2006, there were no limits on how much could be contributed to super. Instead, superannuation withdrawals, beyond a reasonable level, were taxed in retirement. The abolition of taxes on super withdrawals by the Howard Government in 2006, together with the belated introduction of caps on contributions, helped some Australians to accumulate very large super balances and pay little or no tax.[149]

The 2016-17 changes – lowering the post-tax contributions cap to $100,000 (now $110,000) per year and banning further post-tax contributions for balances above the Transfer Balance Cap ($1.9 million) – will help (but not fully) prevent younger generations accumulating very high balances in future. But these measures have done little to curb the excessive (and inter-generationally unfair) earnings tax breaks flowing to the very-high balances of some of today's older generation.

Figure 4.1: Very few people have very large balances, but they hold a significant share of the super system's assets

Share of individuals with super and system assets, by balance range, 2019-20



Source: Grattan analysis of ATO (2022d).

147. Chalmers (2023b).
148. Grattan analysis of ATO (2022e) and ATO (2022d).
149. The former system of Reasonable Benefit Limits (RBLs) was used to determine tax rates on superannuation withdrawals, and placed a limit on how much could be withdrawn tax-free from superannuation in retirement.

4.2 The earnings on super balances bigger than $2 million should be taxed at 30 per cent

The earnings on super balances bigger than $2 million should be taxed at a rate of 30 per cent (the rate the Government has announced for balances bigger than $3 million).

This should be achieved by imposing an additional flat 15 per cent tax rate on the proportion of the earnings corresponding to the funds above $2 million, without applying any capital gains tax discount.[150] This tax would apply on top of the existing 15 per cent earnings tax applied on super fund balances in the accumulation phase.[151] People would have the choice of paying the tax out-of-pocket or from their super funds.[152]

This approach strikes the right balance between the need to apply the tax in line with the income earned (which would normally account for capital gains) and the need to limit the regulatory burden on super funds in order to administer the tax.[153]

Levying a higher tax rate on the earnings of large balances is complicated by the fact existing super earnings taxes are levied at the level of the super fund, not the individual member account.

This approach will impose tax on unrealised capital gains on superannuation, with super fund members offered the choice of paying any tax liable on unrealised gains from within the fund, or from outside super.[154] The Henry Tax Review highlighted a number of benefits to shifting to taxing capital gains on an accrual basis, compared to taxing realised gains, including removing incentives to 'lock in' investments to hold onto untaxed capital gains while moving quickly to realise losses.[155] Some other taxes – such as state land taxes and council rates – are levied accounting for the unrealised portion of capital gains on property assets.

However, requiring tax to be paid on notional gains on an annual basis creates cash flow issues for some Self-Managed Super Fund members holding illiquid assets, such as property, who would be required to pay tax before realising those gains.[156]

As mentioned above, about 85 per cent of individuals with balances over $2 million are aged 60 or older. Therefore, they are likely to have assets in the pension phase subject to minimum drawdown rules. In effect, this means they already face annual liquidity requirements.

Further, under superannuation law, SMSFs are required to have an investment strategy, and that strategy must address liquidity and the ability of the fund to discharge its liabilities.[157] Many super fund members with large balances hold substantial assets outside of superannuation, which could be used to help discharge any tax arising from unrealised capital gains (Figure 3.2 on page 40). Delaying the implementation of the surcharge until 2025-26, as the government

150. Most super fund members with balances bigger than $2 million are likely to face a tax rate higher than 30 per cent outside of super.
151. Given the existing 15 per cent tax rate on super earnings accounts for the one-third capital gains tax discount for super funds, and refundable franking credits, the effective tax rate on superannuation fund earnings for balances exceeding $2 million would be about 23-to-24 per cent. See Daley et al (2015, Figure 2.3).
152. Treasury (2023c).
153. APRA-regulated funds in particular are not currently set up to report on the apportioning of unrealised capital gains and franking credits to individual member accounts.
154. Treasury has proposed that the surcharge apply to the difference in the member's super balance between the start and end of the financial year, net of withdrawals and contributions. Changes in super balances will include unrealised gains (or losses) over the course of the year.
155. Henry (2010, pp. 63–64). Deferring of tax on capital gains on realisation is akin to the government providing the investor with an interest-free loan: Daley et al (2016a, Section 2.2).
156. Although super fund members could also offset any capital losses in a year against other income, or carry them forward to future years to offset income earned in later years.
157. ATO (2022f).

has proposed, could provide SMSFs with the time to manage liquidity issues arising from the surcharge applying to unrealised capital gains.

An alternative approach will be needed to apply the surcharge to defined-benefit income streams with a notional value in excess of $2 million. The government should adopt a similar approach to taxing defined benefit schemes under the surcharge as already applies to taxing earnings for balances above the Transfer Balance Cap.[158] Fund earnings could remain exempt, and benefits paid out each year in retirement could be taxed at a higher rate for income streams where the notional capital value of the income stream exceeds $2 million.[159]

4.3 A $2 million cap should be indexed to inflation

The $2 million threshold for the surcharge should be indexed in line with inflation.

Should the government persist with applying the surcharge only to the earnings of super balances bigger than $3 million, the threshold should not be indexed until the real value of the threshold falls to $2 million due to inflation, which should occur by around 2040.

4.4 A $2 million cap could make the Transfer Balance Cap redundant, making the super system simpler

The Transfer Balance Cap adds complexity to an already complex system. It requires affected retirees to have two separate accounts: one that is subject to no earnings tax in retirement, and a second where earnings are taxed at 15 per cent.[160]

158. For more detail on the tax treatment of super fund benefits that exceed the Transfer Balance Cap today, see ATO (2022b).
159. These income streams are typically not tax-free on retirement for people over the age of 60. In these schemes, benefits withdrawn are typically still taxable where taxes liable on contributions and fund earnings have not already been paid in the fund.
160. See ATO (2022g) for a full explanation.

By matching the level and indexation treatment of the Transfer Balance Cap, a $2 million threshold for the High Super Balance Surcharge would create an opportunity to simplify the system by abolishing the Transfer Balance Cap.

All retirees could hold all their super savings in a single account, just as accumulation-phase members do today.

For accumulation phase members with balances exceeding $2 million, the surcharge would then be applied via a 15 per cent rate on the earnings on balances above $2 million – as the government proposes – on top of the existing 15 per cent headline earnings tax that already applies to all earnings in the accumulation phase.[161]

For super fund members in the retirement phase, a higher surcharge tax rate could apply to the earnings on balances above $2 million, such as 23.5 per cent, to replicate the effective tax rate applying to the earnings of large balances in the accumulation phase.[162]

Obviously, the simplest approach of all – and the one we recommend – is to eliminate the tax distinction between accumulation and retirement by taxing all retirement earnings at 15 per cent (see Chapter 3).

161. Taking the effective tax rate for accumulation-phase members with balances above $2 million to 23-to-24 per cent (see footnote 151).
162. People with balances bigger than $2 million who move into retirement phase during a given year would have had their earnings taxed at 15 per cent for part of the year, and tax-free for the rest. A 'blended' rate somewhere between 15 per cent and the retiree rate could be applied to these individuals. But this would only affect a handful of retirees in a given year. It may be simpler to just apply 15 per cent for such a year (i.e. 'undertax' people who move into retirement for that year). The forgone revenue could well be outweighed by the administrative cost of implementing a blended rate.

5 Our proposed reforms would not create excessive long-term tax rates on super savings or compromise retirement incomes

The reforms to super tax breaks proposed in this report would not create excessive effective tax rates on long-term savings.

Nor would they compromise the adequacy of Australians' retirement incomes, either for current retirees or for workers who will retire in the future. That's because our proposed reforms largely wind back tax breaks that overwhelmingly benefit the top 20 per cent of Australians by wealth, who are already saving enough for their retirement.

5.1 Our reforms would not create excessively-high effective tax rates on long-term savings

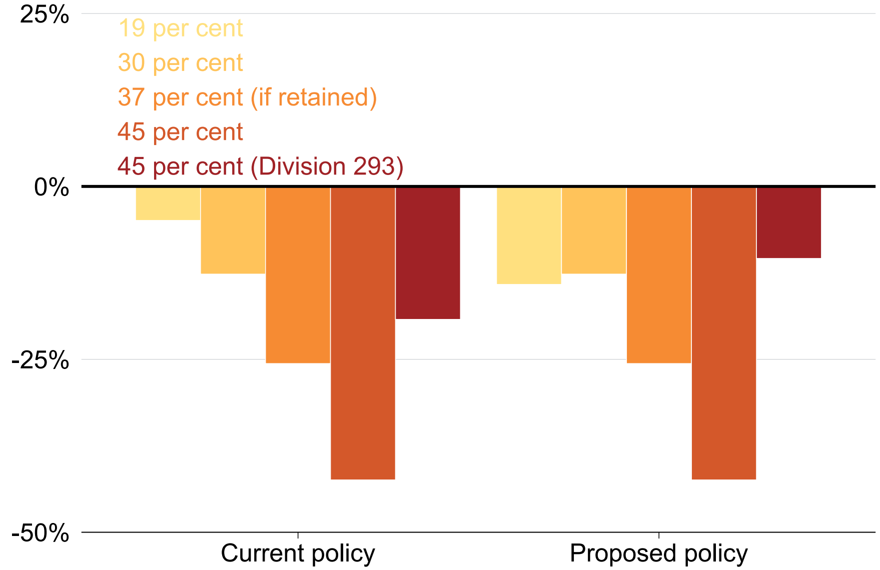
As discussed in Chapter 1, superannuation savings should be taxed, but at a lower rate than wages. And super tax breaks should offer a larger concession, per dollar contributed to super, to low-income earners compared to high-income earners. Our proposed reforms achieve these objectives.

The effective tax rate on superannuation savings would still be low, relative to an expenditure tax benchmark, even after our proposed reforms (Figure 5.1). Most taxpayers who contribute to superannuation from their earnings before tax will still have more to spend in retirement than if they had saved their wages after tax, but paid no tax on the returns to their savings. Even high-income earners would face a negative *marginal effective tax rate* on their long-term super savings, compared to such an expenditure tax benchmark.

Super would remain a highly attractive vehicle for the long-term savings. The biggest impact of our recommended reforms would be to reduce the excessively generous treatment of superannuation savings for wealthier Australians.

Figure 5.1: Effective tax rates on super savings would still be low after our reforms

Current and estimated long-term (25 years) real effective marginal tax rates on super savings



Notes: Grattan Institute recommends retaining the 37 per cent bracket for incomes between $120,000 and $200,000. Real effective marginal tax rates calculated against an expenditure tax benchmark. Proposed policy includes the expansion of LISTO and the increase of the Division 293 tax rate to 35 per cent. Earnings are taxed at 15 per cent in both scenarios.

Source: Grattan analysis. See Appendix A for details.

5.2 Retirees today would still enjoy adequate incomes after our reforms

Retirees today would not be materially affected by our proposed changes to tax breaks on superannuation earnings.

Our proposed High Super Balance Levy would, by design, only affect the retirement savings of people with more than $2 million in superannuation. Retirees with such large balances today would accrue at least $100,000 a year in superannuation earnings.[163] They would be required to draw an income from their super of at least 4 per cent of the outstanding super balance, or $80,000 a year, due to minimum draw-down rules.

Retirees with large superannuation balances also tend to have amassed substantial wealth beyond superannuation and the family home. For example, households aged 60 and older that earn more than $100,000 a year have amassed average net assets worth more than $3 million, with only about 26 per cent sitting in super.[164]

Taxing all super earnings in retirement at 15 per cent would affect retirees with smaller super balances. But even here, taxing all retirement earnings is unlikely to meaningfully affect the retirement incomes of low- and middle-income Australians. As shown in Figure 3.3 on page 40, the poorest half of all retirees would pay no more than $200 each per year, on average, while most poorer retirees would pay no extra tax whatsoever since they hold no super.

A super earnings tax would have a bigger impact on middle- and higher-income retirees with more sizeable super balances, but they would still enjoy adequate incomes in retirement. Any fall in the retirement income of part-rate pensioners, whose super balances fell due to the extra earnings tax, would be effectively offset by an increase in their Age Pension payments due to the pension means test. Given the stringency of the Age Pension assets test, many middle-income retirees would see little or no changes in their retirement incomes even after all earnings in retirement were taxed.[165]

Finally, most retirees, including many pensioners, do not draw down substantially on their super balances.The 2020 *Retirement Income Review* showed that half of retirees drew down on account-based pensions in retirement at the legislated minimum draw-down rates.[166] If retirees continued to draw down on their superannuation savings at legislated minimum draw-down rates, a tax on all super earnings would simply accelerate the pace at which retirees draw down their super (or slow the pace at which super balances grow). For many middle-income retirees on a part pension, such a scenario could result in their retirement incomes rising, because they'd qualify for more Age Pension over time due to the assets test.

5.3 Future retirees would still enjoy adequate incomes after our reforms

Our proposed reforms to both earnings and contributions tax breaks could have a bigger impact on future retirees, especially where the reforms affect amounts ultimately contributed to super after contributions tax has been paid.

Grattan Institute's 2020 report, *Balancing act: Managing the trade-offs in retirement incomes policy*, recommended that the adequacy of Australians' retirement incomes should be evaluated using so-called

163. Assuming an average return on super of at least 5 per cent.
164. Grattan analysis of ABS (2022b).
165. Currently, retirees lose $3 of pension a fortnight, or $78 a year, for every $1,000 in assessable assets they hold. Since super savings typically yield an annual return of less than 7.8 per cent, the effective marginal tax rate on the pension assets test currently exceeds 100 per cent. See Coates and Nolan (2020, pp. 68–69).
166. Callaghan et al (2020, Chart 3B-16).

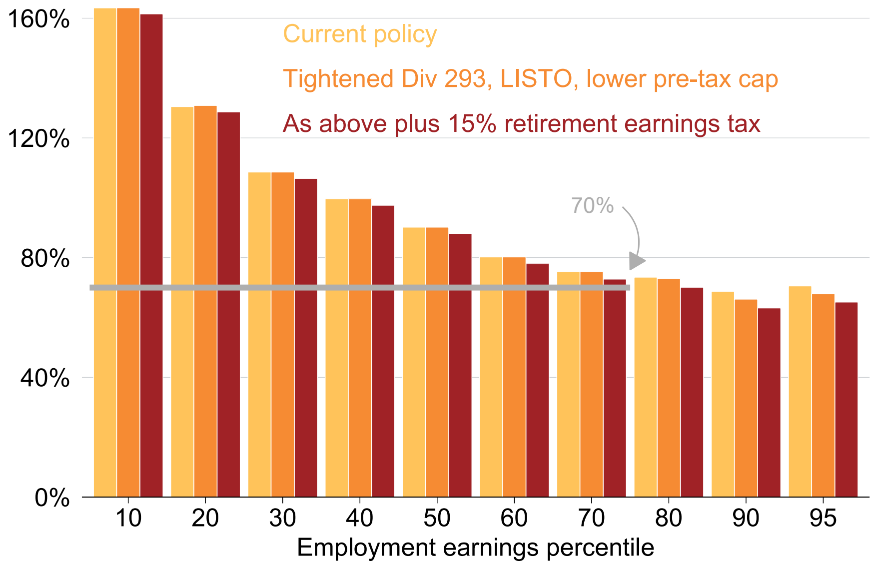
replacement rates.[167] That is, by comparing Australians' retirement incomes against their pre-retirement, post-tax income. *Balancing act* recommended a replacement rate of 70 per cent of pre-retirement, post-tax income as an appropriate benchmark for an adequate retirement income for middle-income earners.[168] The 2020 *Retirement Income Review* adopted a replacement rate benchmark of 65-to-75 per cent of pre-retirement earnings.[169]

Modelling of retirement incomes for younger workers, presented in Figure 5.2, shows that our proposed changes to superannuation tax breaks would not have a material impact on the retirement incomes of low- and middle-income workers.[170] Low-income workers would continue to have a much higher living standard in retirement than they had while working, as would most middle-income earners.

Our proposed changes to earnings tax breaks would have a bigger impact on the retirement incomes of well-off Australians. For instance, young workers at the 80th percentile, earning roughly $120,000 a year today, would replace roughly 70 per cent of their pre-retirement earnings. Workers at the 90th percentile would replace 63 per cent of

Figure 5.2: Our package of reforms would not stop Australian workers enjoying a comfortable retirement in future

Projected replacement rates, by employment earnings percentile, CPI deflated



Notes: Estimates derived from the Grattan Retirement Income Projector. The policies modelled include lowering the Division 293 threshold to $220,000 and raising the rate to 35 per cent, expanding LISTO to a threshold of $45,000 and a maximum offset of $800, lowering the pre-tax contributions cap to $20,000, taxing all retirement earnings at 15 per cent, and taxing earnings on assets above $2 million at 30 per cent (which does not affect any percentile modelled once indexed). Other policy indexation arrangements remain as they are.

Source: Grattan Retirement Income Projector. See Coates and Nolan (2020) for detail of the model.

167. Beyond avoiding poverty in retirement, a core objective of Australia's retirement incomes system is to ensure that most Australians enjoy a similar living standard in retirement as they had while working (also known as lifetime consumption smoothing): Coates and Nolan (2020, p. 30) and Callaghan et al (2020, p. 91).
168. Our benchmark replacement rate is measured by comparing retirement income to disposable income in the five years before retirement. See Coates and Nolan (2020) and Callaghan et al (2020) for a more detailed rationale behind the use of replacement rates and the 70 per cent benchmark.
169. Callaghan et al (ibid).
170. Based on a worker who starts work aged 30, retires at 67, and lives to 92. See Coates and Nolan (2020, Chapter 3) for a full description of the model and key assumptions.

their pre-retirement earnings – but they would still earn about $73,000 a year in retirement.[171]

These replacement rates are conservative, since they assume no behaviour change in response to a 15 per cent tax on super earnings. We assume that low-income earners are subject to the tax, because we assume people do not re-arrange their affairs to take advantage of the tax-free threshold outside super. But in reality those with super on low and middle incomes could maintain a zero tax rate on earnings by moving savings out of super, as discussed in Chapter 3.

171. CPI deflated. Coates and Nolan (2020) and Henry (2010) both aim for a 70 per cent replacement rate for people on median-to-average earnings, or between $60,000 and $90,000 a year.

Appendix A: Data and methods

A.1 Data

Two key data sets underpin the analysis in this report:

1. We use the 2019-20 ATO 2 per cent sample file for contributions tax breaks. This is a random sample of 2 per cent of individual tax returns in 2019-20. It contains details on taxable income, concessional and post-tax contributions, and demographics (among other variables).

2. We use the 2019-20 ABS Survey of Income and Housing (SIH) Basic Confidentialised Unit Record File (CURF) for earnings tax breaks. This is a survey conducted by the ABS in 2019-20 and contains information on balances, incomes, and demographics (among other things). We use the person-level data and the person-level weights for population-level estimates.

Unless noted otherwise in the report, all costings are denoted in 2024-25 dollars. This is to ensure savings are measured against the future personal income tax system as legislated. Modelling against the current income tax system would produce overestimates of savings, given any changes are unlikely to take full effect before 2024-25. Further, we present savings in nominal terms to be consistent with the standard Treasury approach for forward estimates.

To produce estimates for the financial year 2024-25 from 2019-20 data, we compute several inflators and apply them to the data. We also apply indexation of policy parameters where relevant.

A.1.1 Inflation

Our CPI inflator uses historical CPI (to December 2022)[172] and then projected CPI. We project CPI using the assumptions used by Treasury in the 2022 October Budget. The final assumption is total inflation from 2019-20 to 2024-25 of 22 per cent.

A.1.2 Expected income growth

Our income inflator uses historical Average Weekly Ordinary Time Earnings (AWOTE) (to May 2022)[173] and then projected AWOTE. Our projected AWOTE starts with the Wage Price Index (WPI) assumptions used by the Treasury in the 2022 October Budget. Historically, WPI growth is lower than AWOTE, so we make an upward adjustment to Treasury assumptions. We add the average historical difference between AWOTE and the WPI to the Treasury WPI assumptions.

The projection period covers scheduled increases in the Superannuation Guarantee. The best available evidence indicates these increases will suppress wage growth. Our projection assumptions factor this in.[174]

A.1.3 Expected pre-tax contributions growth

We inflate pre-tax contributions in the same way as incomes, but with two adjustments that lead to a slightly higher growth rate than incomes alone. We factor in the scheduled increase in the Superannuation Guarantee, increasing compulsory contributions by more than wages alone. However, as assumed by the 2020 *Retirement Income Review*,

172. ABS (2022e).
173. ABS (2022f).
174. Callaghan et al (2020, pp. 477–485); and Coates et al (2020).

20 per cent of the additional compulsory pre-tax contributions are offset by reduced voluntary pre-tax contributions.[175]

A.1.4 Expected population growth

Our population inflator uses historical population growth (to June 2022)[176] and then projected population growth. We project population using the assumptions used by Treasury in the 2022 October Budget. The final assumption is population growth from 2019-20 to 2024-25 of 5 per cent.

A.1.5 Expected superannuation balance growth

We use two separate inflators to adjust the reported superannuation balances in the ABS SIH Basic CURF.

First, the total (weighted) superannuation assets in the SIH falls short of that reported by APRA in 2019-20 by about 25 per cent.[177] Therefore, we inflate balances by this amount. This assumes that the SIH is broadly representative with respect to the missing assets.

Second, we take three steps to get individual super balances in 2024-25 terms. First, we inflate the 2019-20 total assets reported by APRA by the projected system growth reported in the 2021 Intergenerational Report.[178] Second, we increase the number of people with super from 2019-20 (as reported by the ATO) by expected population growth as detailed above. And third, we compute the individual balance inflator by estimating the difference between average balances in 2019-20 and projected average balances in 2024-25. The final assumption is projected average balance growth from 2019-20 to 2024-25 of about 40 per cent.

175. Callaghan et al (2020, Section 6A).
176. ABS (2022g).
177. APRA (2022a).
178. The IGR values cannot be used directly because they underestimate the size of the system by excluding individuals under the age of 25 and defined-benefit assets (Australian Government (2021)).

A.2 Real effective marginal tax rates

Figure 1.2 on page 10 and Figure 5.1 on page 49 present estimates of real effective marginal tax rates on savings.

Real effective marginal tax rates are calculated as the pre-tax real (after inflation) return minus the post-tax real return, divided by the pre-tax real return. Income tax at each marginal rate on the original principle invested is included in the pre-tax real return (i.e. a TEE, or expenditure tax, benchmark). This means concessions on the original income tax – such as with pre-tax super – can lead to a negative marginal effective tax rates. The Medicare Levy is added to each marginal rate.

Assumptions follow Daley et al (2015, Figure 2.3 and Appendix C), which are consistent with those used by Henry (2010). These include a 6 per cent nominal return, 2.5 per cent inflation, and all investments being held for 25 years. Superannuation earnings are taxed at an average effective rate of 8 per cent in the fund, reflecting the concessional treatment of capital gains (10 per cent tax rate) and dividend imputation for investments in domestic equities. Ignores impacts on qualifying for welfare payments, which increase real effective marginal tax rates on savings.

A.3 Contributions costings

The pre-tax contributions costings in Chapter 2 use the ATO 2019-20 2 per cent sample file. We made adjustments as per above to get costings in 2024-25 terms. Further, the 2 per cent sample file scales to 94 per cent of total pre-tax contributions made in 2019-20.[179] Therefore, we scale up final costings to account for the missing 6 per cent.

179. APRA (2022a).

Our income and contributions tax models broadly match the contributions tax breaks reported by Treasury in the Tax Benchmarks and Variations Statement (TBAV).[180]

For 2019-20, our model estimates total contributions tax breaks of $19.9 billion, compared to $19.5 billion from the TBAV. However, our estimates fall slightly behind those projected in the TBAV for future years, which suggests our estimates are conservative. The TBAV uses a top-down approach, whereas we use a bottom-up approach, so complete alignment was not expected.

The total contributions tax breaks estimated in Figure 1.4 on page 14 use the SIH in order to present income deciles on a consistent basis with the earnings tax breaks. We use reported compulsory, salary sacrificed, and personal deductible contributions for total pre-tax contributions. These data from the SIH scale to just below those in the ATO 2 per cent sample file.

A.3.1 Division 293 tax changes

The income assessable for Division 293 purposes includes taxable income, total reportable fringe benefits, net investment losses (including rental properties), family trust distributions, super lump sum taxed elements with a zero tax rate, and assessable first home super saver released amounts. We use all those observable in the 2 per cent sample file (taxable income, fringe benefits, and net investment losses).

We estimated the costing by computing contributions tax revenue under current policy and comparing it to a scenario where individuals with income for Division 293 purposes above $220,000 pay a 35 per cent tax rate on their pre-tax contributions in excess of the threshold.

180. Treasury (2022a).

A.3.2 Expansion of the Low-Income Superannuation Tax Offset (LISTO)

The income assessable for LISTO purposes includes taxable income, total reportable fringe benefits, net investment losses (including rental properties), and reportable super contributions (salary sacrificed voluntary pre-tax contributions).

We estimate the costing by computing contributions tax revenue under current policy and comparing it to a scenario where individuals are eligible for LISTO if their income for LISTO purposes is up to $45,000 instead of the current $37,000. Further, we expanded the maximum offset from the current $500 to $800.

The goal of LISTO is essentially to refund the contributions tax paid by people in lower tax brackets who don't receive a meaningful concession on their contributions. The 19 per cent tax bracket has been expanded from $37,000 to $45,000, and $800 is the (rounded) amount needed to refund contributions tax for a person earning $45,000 and contributing at a 12 per cent Superannuation Guarantee.

A.3.3 $20,000 pre-tax contributions cap

We estimated this costing by computing contributions and income tax revenue under current policy (an indexed cap of $30,000 by 2024-25) and comparing it to a scenario in which pre-tax contributions above $20,000 are re-directed to taxable income.

However, the 2019-20 ATO 2 per cent sample file has about 2 per cent of tax-filers reporting pre-tax contributions exceeding the 2019-20 cap of $25,000. This is because some people can use carry-forward provisions from previous years where they contributed under the cap. Rather than 'force' all these observations under a $20,000 cap (and therefore effectively cost the removal of carry-forwards as well), our costing simply substracts the difference between the current cap and $20,000 and re-directs it to taxable income.

A.4 Earnings costings

Our earnings costings use the 2019-20 ABS SIH CURF. We made adjustments as per above to get costings in 2024-25 terms.

We assume a net-of-fee rate of return of 6.5 per cent for accumulation and 5.2 per cent for retirement. These are the gross returns used by the 2020 *Retirement Income Review* net of a 1 per cent fee that covers all investment and administration fees, and insurance premiums.[181] The tax base is 90 per cent of the returns in a given year to reflect the fact that some capital gains are ultimately never realised.

We assume that all individuals aged 63 and older are in the retirement phase. This age reconciles the implied share of assets in the retirement phase in the SIH with those reported at the system level by APRA (for institutional funds) and the ATO (for Self-Managed Superannuation Funds).[182]

A.4.1 A 15 per cent tax on retirement earnings and lower Transfer Balance Caps

We assume that the effective tax difference between the retirement and accumulation phases is 13.5 per cent. This assumes that 58 per cent of retirement assets are growth assets, as per the 2020 *Retirement Income Review*,[183] and that half of the return to these assets is in the form of capital gains and therefore subject to a one-third discount.

181. The Review had a more sophisticated set of fixed and asset-based fees and insurance premiums. For our purposes we simplify this into one asset-based deduction: Callaghan et al (2020, Tables 6A-9 and 6A-10).
182. APRA (2022b); and ATO (2022e).
183. Callaghan et al (2020, Figure 6A-23).

These costings involve either all retirement assets (a 15 per cent tax on all retirement earnings) or a larger share (lower Transfer Balance Caps) of them being taxed in the same way as accumulation assets. Our costings compared estimated earnings tax revenue under current headline rates with expected revenue under different headline rates.

Perfectly rational retirees would assess their ‘effective tax-free threshold’ (ETFT) outside of super (about $33,800) and move assets out accordingly. Our estimates that account for behavioural change assume that all individuals with ‘room’ in their ETFT move a share of assets out of super before those assets are subject to a 15 per cent tax rate inside of super. The quantum of assets moved are those for which the expected earnings at our assumed retirement rate of return would result in the individual exhausting their ETFT. At this point, a 15 per cent tax rate inside super is more attractive than a marginal rate of 19 per cent outside of super.

However, this is unlikely to occur at scale in practice. Individuals would have to be financially literate enough to assess the opportunity, invest in a diversified portfolio outside of super, and assess the optimal amount of assets to move. Therefore, our estimates that factor in this behavioural response should be considered a conservative lower bound.

In our full behavioural response scenario for a 15 per cent tax on all retirement earnings (i.e. all affected retirees perfectly optimise their allocation of savings), 69 per cent would withdraw at least some super, and 29 per cent would empty their accounts. Naturally, no retirees empty their accounts under the lower Transfer Balance Cap costings, but smaller proportions of retirees withdraw some of their super.

A.4.2 Older Australians Care Guarantee Levy

This costing involves all earnings – accumulation and retirement – being taxed 3 per cent higher than current policy. Our costing involves comparing estimated earnings tax under current headline rates with estimated revenue if headline rates in both accumulation and retirement were 3 per cent higher.

An adjustment is made for the capital gains discount as per the retirement earnings costing, assuming 58 per cent of retirement assets are growth assets and 74 per cent of accumulation assets are growth assets.[184]

Our full behavioural change scenario is the same as other earnings tax costings, but with accumulation members unable to move assets outside of super due to preservation rules.

A.4.3 The Henry Tax Review earnings tax proposal

The costing involves all earnings being taxed at a headline rate of 7.5 per cent, with no capital gains tax discount. Dividend imputation is retained.

We assume the retirement tax rate goes from 0 per cent to 7.5 per cent. The headline accumulation rate goes from 15 per cent to 7.5 per cent, but the effective rate goes from 13.15 per cent to 7.5 per cent. This is to reflect the removal of the CGT discount, assuming 78 per cent growth assets,[185] with 50 per cent of return on those assets being capital gains.

The behavioural change scenario follows the same assumptions as other earnings tax estimates.

184. Ibid (Figure 6A-23).
185. Ibid (Chart 6A-23).

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