# Taxation of Pensions

## Australia's Retirement Income Policy: Means Testing and Taxation of Pensions

George Kudrna[1]

### Introduction

Most OECD countries rely on pay-as-you-go social insurance systems designed to provide certain living standards in retirement that correlate with pre-retirement income (OECD 2015). These earnings-related systems with defined benefits are usually accompanied by a basic flat-rate pension paid to each retiree or a minimum pension to prevent retirement income from falling below some minimum level. Australia's retirement income policy differs from this OECD prototype, consisting of a non-contributory and means tested public pension,[2] and a mandated private retirement saving scheme, known as the Superannuation Guarantee. These two publically-stipulated pillars are supplemented by voluntary private retirement savings.

Australia's multi-pillar pension system is considered among the best in the world. Mercer's 2015 Global Pension Index (Mercer 2015), which compares 25 countries' retirement systems in terms of sustainability, integrity and adequacy, ranks Australia's system third, behind those of Denmark and the Netherlands. The means tested public pension and increasing self-provision in retirement make the system relatively robust in coping with demographic change – making this a model for reforming other countries' social security systems facing large fiscal burdens. Nevertheless, the generous pension means testing and large tax breaks for superannuation (Australia's term for private pensions) have come under increasing scrutiny and are the main focus of this article.

In this article, we begin by discussing key features of Australia's retirement income pillars. We then focus on means testing of the age pension and the taxation of superannuation – introducing the policy design and considering economic implications of these two features of Australia's retirement income policy. Finally, the article closes with some concluding remarks on the advantages and shortcomings of the system and suggests several lessons to be learned for other countries.

### The pillars of Australia's retirement income policy

Australia's retirement income policy consists of three pillars. The first is a mandatory, publically-managed "safety net" pillar comprising the age pension. The second pillar is also mandatory, but is a privately-managed Superannuation Guarantee scheme based on defined contributions made by employers. The third pillar consists of voluntary and privately-managed voluntary superannuation and other long-term savings. The main aspects of these three pension pillars are featured in Table 1 and discussed below.

***First pillar - The age pension.***

Since its commencement in 1909, the age pension has been a means tested payment, with eligibility for the pension based on age and residency, but not, like in many other developed countries, on work history. At present, a claimant for the pension must be in Australia at the time of application and have been an Australian resident for at least ten years. The pension access age is currently 65 years, but it will gradually increase to 67 years between 2017 and 2023.

The age pension is an expenditure of the federal government and thus financed through general tax revenues. It is benchmarked to wages, with the maximum rate set at 27.7 percent of male total average weekly earnings (MTAWE) for single pensioners and 41.3 percent for couples. To ensure it stays aligned with average standards of living, the pension rates are adjusted twice a year to the greater of the movement of MTAWE, consumer price index (CPI) or pensioner and beneficiary living costs index (PBLCI). Although the age pension

[1] Centre of Excellence in Population Ageing Research (CEPAR), UNSW.

[2] Means testing refers to targeting public pensions to seniors with limited private means. Note that the Australian *age pension* is assessed against both pensioner's private income and assets.

**Table 1**

**Features of Australia's three pension pillars**

| | Age Pension | Superannuation Guarantee | Voluntary Superannuation |
|---|---|---|---|
| Commenced | 1909 | 1992 | 1850s |
| Residency | Yes (at least 10 years) | No | No |
| Access age | 65, increasing to 67 by 2023 | 55, increasing to 60 by 2025 | 55, increasing to 60 by 2025 |
| Coverage | Means tested (against both income and asset; owner-occupied housing fully exempt) | Employees aged 18–75 with earnings in access of $A450/month | Voluntary; tax incentives for contributions, subject to contribution caps |
| Funding | General tax revenues | Fully funded; individual accounts | Fully funded; individual accounts |
| Contributions | Non-contributory | Minimum employer contributions at 9.5% of gross wages (increasing to 12% by 2025) | Voluntary employer and personal contributions; government co-contributions |
| Benefits | Maximum single (couple) rate at 27.7% (41.3%) of MTAWE; indexed to wages | Mostly based on defined contributions; choice of lump sum, annuity or phased withdrawal | Mostly based on defined contributions; choice of lump sum, annuity or phased withdrawal |
| Other benefits/ features | Pensioner supplement, rent allowance, concession card | Vested and portable, choice of fund by employees | Vested and portable, choice of fund by employees |

Source: Author's compilation based on Bateman, Chomik and Piggott (2012) and Chomik and Piggott (2014).

is a taxable income, the availability of the Seniors and Pensioners Tax Offset (SAPTO) for senior Australians ensures that those receiving the maximum (part) pension pay no (reduced) income tax. In addition to this explicit pension taxation, the means test acts as an implicit tax for some pensioners due to a withdrawal of the pension benefit. The means test applies to both private income and assets, but is quite generous and fully exempts owner-occupied housing. It effectively excludes the top 20 percent of the age-eligible population from receiving any pension, but sees almost 50 percent of the population receive the full amount. More details on the means testing of the age pension are provided in the next section.

***Second pillar - The Superannuation Guarantee.***

The age pension and voluntary occupational superannuation were the only two pension pillars in Australia until the late 1980s. Despite multiple attempts, Australia has never implemented a national social insurance system similar to those in Europe and the US. The lack of retirement income combined with severe economic problems in the 1980s led to the federal government establishing the Superannuation Guarantee – legislated in 1992.

The Superannuation Guarantee (SG) is a compulsory retirement income scheme that pre-specifies a minimum amount of contributions to be made by employers on behalf of their employees aged 18 to 75 with earnings of at least $A450 in a calendar month. Mandatory contributions must be paid at least quarterly at the current rate of 9.5 percent of gross wages into individual accounts managed by employee-nominated private superannuation funds. Employers who fail to pay the mandatory contributions are subject to the SG charge, consisting of owed contributions plus interest and administrative costs. In 2012, the government legislated further increases in the mandatory SG rate, gradually increasing it to 12 percent of gross wages by 2025.

***Third pillar - Voluntary superannuation.***

Voluntary superannuation and other long-term savings (including housing) form the third pillar.[3] Voluntary superannuation contributions can be made from before-tax and/or after-tax income. The former are known as concessional or employer contributions and the latter are called non-concessional or personal contributions. All contributions (including mandatory employer contributions) are portable and cannot be accessed until the statutory eligibility age is reached.

Superannuation funds place the contributions in individual accounts (after deducting the concessional tax from employer contributions) and invest them on behalf of individuals. Individuals can choose from a range of

[3] Note that as pointed out by Bateman, Chomik and Piggott (2012), housing is the most important non-superannuation asset for most Australians, with over 80 percent of retirees being owner-occupiers, mostly with no mortgage.

investment strategies, including equities and cash. Fund investment earnings (net of the earnings tax) are added to superannuation assets that may be withdrawn upon reaching the statutory superannuation access age, which is currently 55 years, increasing to age 60 in 2025. Superannuation benefits can be taken out in the form of a lump sum or an income stream (annuity or phased withdrawal).

Since the introduction of compulsory superannuation, both superannuation assets and coverage have grown rapidly. Australia now has the fourth largest pension market in the world, with total assets amounting to over AUD 2 trillion in June 2015 or 125 percent of Australia's GDP (APRA 2015). The total superannuation coverage has more than doubled since the 1980s, increasing to 94 percent of all employees (covered by compulsory and voluntary superannuation) by 2007 (ABS 2009).

al disregard of AUD 6,500 for labour income to boost the labour supply of older Australians. Beyond the disregard, the maximum pension is reduced at the taper of 50 percent for every extra dollar of assessable income.

The asset test also distinguishes between homeowners and renters, with the asset disregard being higher for renters who have a greater need to store savings. Beyond the disregard, the maximum annual pension is currently reduced by AUD 39 for every additional AUD 1,000 of assessable assets. At present, the income test applies to most part age pensioners, because the asset test has a large disregard. However, because the asset test has a steeper taper, it affects those pensioners with higher financial wealth. Nevertheless, the means test is fairly generous –as shown in Figure 1– in addition to their home, a couple can hold over AUD 1.1 million in combined financial assets and still receive some pension.

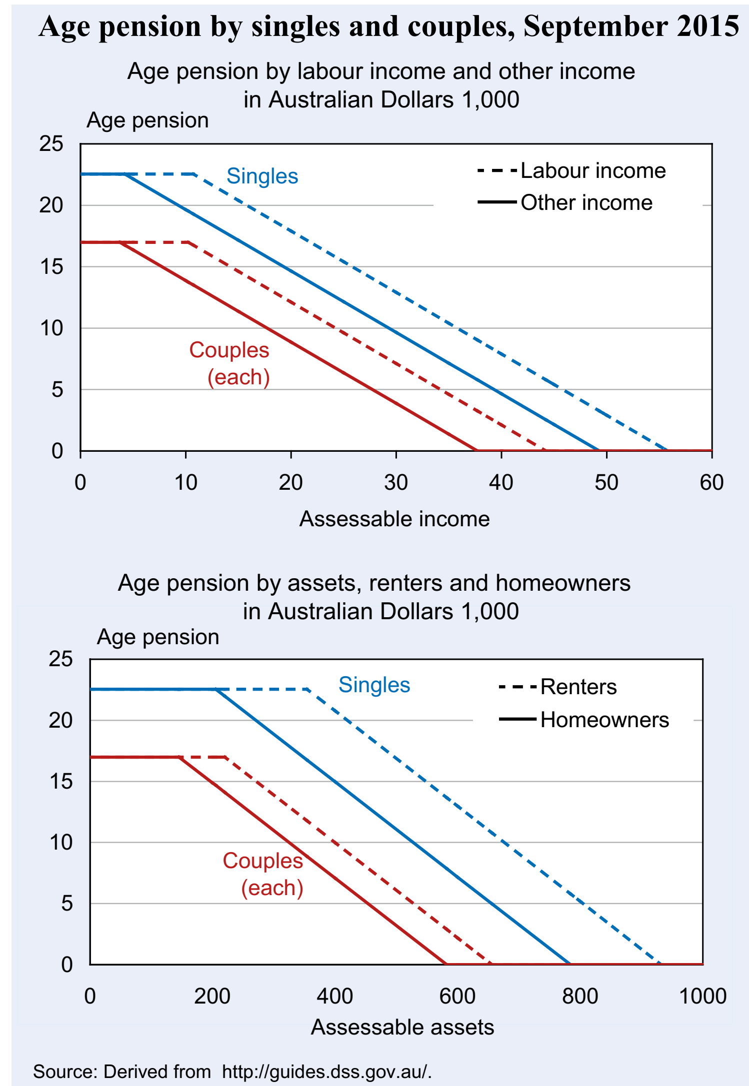
## Means testing of the age pension

*Means test design.*

Many OECD countries have a means tested pension scheme, but Australia's age pension is unusual in that it applies both the income and asset tests. Each test includes the following parameters: (i) the maximum benefit (that differs for single and couple pensioners); (ii) the disregard (income and asset thresholds up to which the maximum benefit is paid); and (iii) the taper (rate at which the pension benefit is withdrawn). The pension benefit paid to an eligible individual or household is then determined by either the income or asset test that results in a lower pension amount.

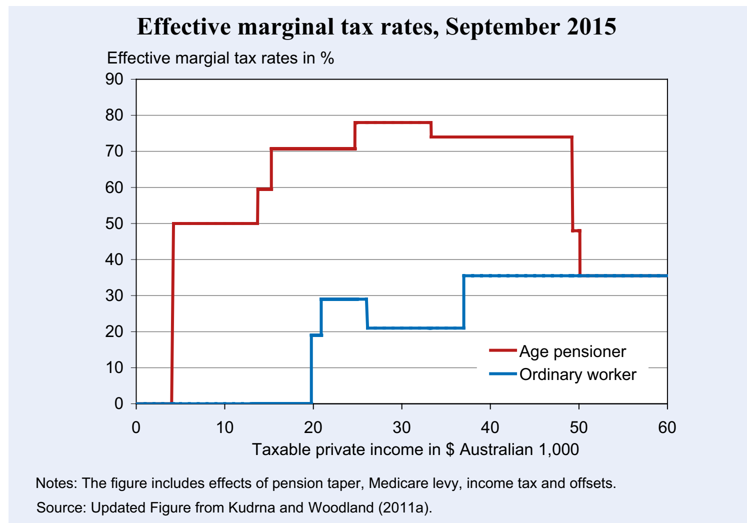
The pension payments due to the income and asset tests for different household types are plotted in Figure 1. Under the income test, a single pensioner with annual private income of up to AUD 4,212 (the income disregard) receives the maximum annual pension of AUD 22,542. There is an addition-

**Figure 1**



Source: Derived from http://guides.dss.gov.au/.

Figure 2




Notes: The figure includes effects of pension taper, Medicare levy, income tax and offsets.
Source: Updated Figure from Kudrna and Woodland (2011a).

*Economic effects.*

The means testing of public pensions is often criticised for the high effective marginal tax rates (EMTRs) generated by a withdrawal of the pension benefit. As illustrated by Figure 2, EMTRs in 2015 for single senior Australians are substantially higher than for non-seniors over a wide range of lower incomes. More specifically, as soon as the private income exceeds the income disregard, the EMTR for a single senior Australian is 50 percent (given by the income taper). The EMTR climbs up to 78 percent for a narrow income range. As shown by Kudrna and Woodland (2011), the age pension means test represented a significant labour supply disincentive, but only for some older Australians affected by high EMTRs.

It is important to realise that in addition to high EMTRs for some seniors, means testing reduces public pensions, thus also providing incentives for life-cycle labour supply and savings. Furthermore, while a more aggressive taper generates higher EMTRs, it affects a smaller proportion of the eligible population than a shallower taper. Finally, the tax on workers to finance a means tested programme is much lower than in countries with a universal pension programme. These points highlight important trade-offs between EMTRs, the number of people affected by means testing, and other explicit taxes in the economy.

Kudrna (2015) investigates the impact of further tightening the taper and extending the labour income exemption. Motivated to examine extensions of the 2009 age pension reform, Kudrna showed that further increases in the taper would have positive effects on aggregate labour supply and asset accumulations, as well as on long-term welfare. These effects are mainly due to the reduced income taxes needed to support a pension with tighter withdrawal rates.[4] Relaxing the income test for labour income has a much smaller aggregate effect compared to increasing the taper, but importantly, the policy has largely positive effects on the labour supply at older ages.

To contain increasing pension expenditure and to more effectively target pension benefits to those in need, the Australian government has recently legislated to tighten the asset test by doubling the asset taper from 2017 onwards.

## Taxation of superannuation

*Superannuation tax treatment.*

Tax concessions for private pensions are common among OECD countries. Most member countries employ an expenditure tax approach that exempts contributions and fund earnings from any taxation, but taxes benefits progressively as regular private income. By contrast, Australia taxes superannuation under a comprehensive income tax regime, which sees contributions and fund earnings taxed (at concessional rates), but benefits as generally tax-exempt. However, as shown in Table 2, the existing superannuation taxation is more complex than the simple description provided above.

The tax treatment of contributions differs by their type, amount and tax payer's income. Before-tax contributions that include mandatory and other employer contributions made from gross wages are tax deductible to employers (or self-employed) and are taxed at a concessional rate of 15 percent by superannuation funds. The concessional tax rate for high income earners is 30 percent, and low earners with AUD 37,000 p.a. or less effectively pay no tax on before-tax contributions. Both before-tax and after-tax contributions are subject

[4] Similar results were obtained by Kumru and Piggott (2009) who examined tightening the taper of the means tested pension in the UK.

**Table 2**

**Taxation of Australia's superannuation**

| Contributions [a] | Fund earnings [b] | Benefits [c] |
|---|---|---|
| *Before-tax contributions*<br>(all employer and self-employed tax deductible contributions): taxed at 15% or 30% for those with annual income > $A300,000; Excess contributions taxed at 49% applied above allowable annual limits of $A30,000 for those aged <49 and $A35,000 for those 49+.<br><br>*After-tax contributions*<br>(personal, spouse and child contributions): no tax payable up to allowable limit of $A180,000 p.a. or $A540,000 in a three-year period.<br>Excess contributions taxed 49%.<br><br>*Government co-contributions*<br>(available for low/middle income earners with annual income < $A50,454): No tax payable. | *Interest income:*<br>Taxed at 15%.<br><br>*Dividend income*:<br>Taxed at 15% less imputation credits.<br><br>*Foreign source income*:<br>Taxed at 15%<br>less credits for foreign tax paid.<br><br>*Realised capital gains:*<br>Taxed at 15% or 10% for assets held >12 months<br><br>*Retirement benefits:*<br>Tax free earnings generated by underlying assets if minimum drawdown requirements satisfied. | *Benefits taken by 55-59:*<br>*Lump sums*: Taxed at 17%<br>above tax free threshold of $A195,000.<br><br>*Income streams*: Taxed at marginal income tax rate less 15% tax rebate available.<br><br>*Benefits taken from age 60*<br>*Lump sums*: Tax free<br>*Income streams*: Tax free |

Notes: [a] Taxation differs by type of contribution, amount and income; [b] Taxation differs by type of income and retirement phase; [c] Taxation differs by age and benefit type.

Source: Updated version of Bateman and Kingston (2007).

to caps, with excess contributions being taxed at the top marginal income tax rate of currently 49 percent. The statutory tax rate on fund earnings is 15 percent, but the effective earnings tax rate of average fund is about 7.5 percent because of imputation credits and the capital gains tax discount. In the drawdown stage, earnings generated by the asset supporting an income stream are tax-free. Since 2007, superannuation benefits (both lump sum and income streams) withdrawn by those aged 60 and over are tax-exempt.

***Sustainability and equity concerns.***

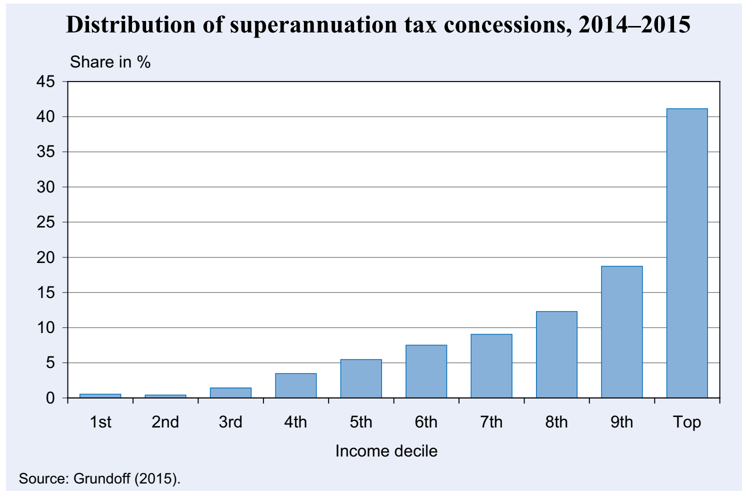
Australia has one of the lowest public pension expenditure levels among developed economies, with the government spending on the age pension currently at 2.9 percent of GDP, rising to 3.6 percent of GDP by 2055 (Australian Treasury 2015a).[5] However, the tax breaks for superannuation (private pensions) in Australia are larger than in any other OECD country (OECD 2015). According to the Australian Treasury (2015b), the size of superannuation tax concessions measured in terms of foregone revenue was AUD 29.7 billion or 1.9 percent of GDP in 2014-15 – growing at an annual rate of 13.6 percent (which is three times faster than spending on the age pension). The treasury forecasts that superannuation tax breaks will grow to AUD 49.5 billion by 2017-19 – exceeding the age pension cost in 2018-19.

The distribution of superannuation tax concessions is an even more pressing issue. According to the Australia Institute (Grudnoff 2015), the wealthiest ten percent of households receive 41 percent of the tax concessions, while the bottom 50 percent of households only get 11 percent of the tax concessions (see Figure 3). Taking into account the age pension, the level of this combined support is more equally distributed (AIST Mercer 2015), but the largest recipients are the top one percent of households with a total government support of AUD 650,000 over their working life (more than double the amount received by a median earner).

Although superannuation balances have increased significantly over the last decade (due in part to tax concessions), with the average balance reaching AUD 76,424 in 2014 (Clare 2015), the superannuation system is still in a transition stage. Once it matures, mandatory contributions together with the age pension are expected to generate a replacement rate well over the OECD benchmark of 70 percent for the full carrier worker on average earnings. However, individuals with broken work pat-

[5] This compares to an average public expenditure of 7.9 percent of GDP on old-age and survivors benefits across the OECD countries (OECD 2015).

**Figure 3**




Source: Grundoff (2015).

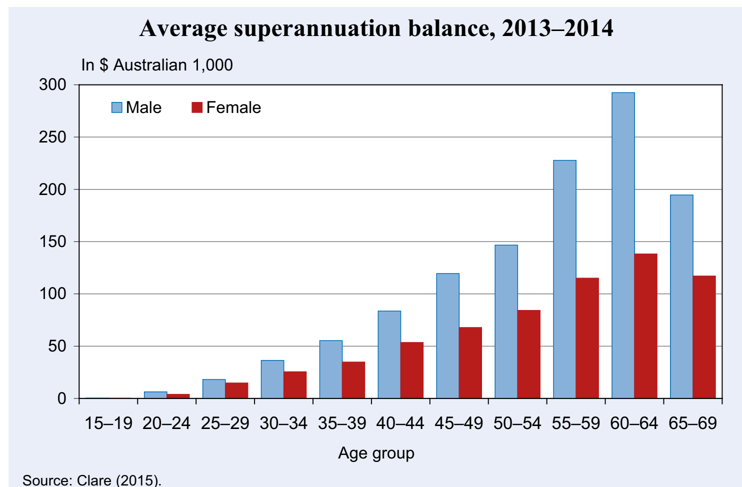
terns, including women, will have much lower retirement incomes. As shown in Figure 4, in 2013-14 women aged 60-64 held, on average, AUD 138,154 in their superannuation compared to the average balance of AUD 292,510 held by men in the same age group. The superannuation gender gap has increased over the last decade partly due to an increasing gender wage gap, but also due to the superannuation taxation that provides large tax breaks for high earners who are, on average, men.

***Proposals and reforms.***

A recent review of the Australian tax system (Australia's Future Tax System (AFTS) 2010) recommended a progressive taxation of contributions, a reduced tax on fund earnings and a flat-rate contribution rebate. The proposal effectively represents a switch to a prepaid expenditure tax approach, with the taxation of contributions linked to the progressive income tax schedule. Using a model-based analysis of the AFTS proposed reforms, Kudrna and Woodland (2015) showed significant improvements in vertical equity, as well as increased private savings and reduced government expenditure on the age pension.

The changes proposed by AFTS (2010), however, were ignored by the government. Instead, in 2012, the government legislated a reform that included gradual increases in mandatory contributions to 12 percent of gross wages and effectively a removal of the 15 percent concessional tax for low income earners. It is worth noting that the latter component of the reform is being phased out, and from 2017 onwards low income earners will pay the 15 percent tax on employer contributions, making the distribution of superannuation tax concessions even more uneven.

**Figure 4**




Source: Clare (2015).

**Conclusion**

This article described and assessed Australia's retirement income system, focusing on the means testing of the public age pension and the taxation of pre-funded superannuation. Most commentators have an overwhelmingly positive view of the Australian pension system because it is above all highly sustainable. In terms of sustainability, the system has one of the lowest pension costs in the OECD – largely due to the flat-rate age pension and the uncommon feature of means testing both income and assets. In addition, it rates relatively well on the accumulation side, as well as increasing self-provision in retirement – all of which limits future growth in public pension expenditure and has positive effects on household and national savings. In relation

to adequacy, the replacement rate is currently below the OECD average, but is expected to increase with the maturity of the superannuation system and eventually exceed the OECD benchmarks – another eventual positive of the system.

However, a key shortcoming of the Australian pension system is the existing taxation of superannuation, which is complex, inequitable and exposed to political risk. Superannuation tax concessions are expensive, mainly benefit high income earners and create unfairness in the system in relation to lower income earners and women. One suggestion to address this inequity, reduce complexity and limit political risk would be to adopt the AFTS (2010) proposal with superannuation contributions taxed in the hands of individuals under the progressive income tax schedule. Another issue, which is not addressed in this article, relates to the decumlation stage of superannuation. In the absence of compulsory annuitisation of superannuation savings and low demand for private annuities, together with high uptake for lump-sum payouts, the superannuation system fails to cover longevity and inflation risks.

So the lessons for any developed country looking to reform its pension system are that: (i) adopting means testing can significantly assist in keeping pension expenditure (and the taxes on workers required to fund a means tested pension) modest as the population ages; and (ii) the use of means testing should exempt earned income to encourage labour force participation among older workers; but (iii) the application of tax concessions for private pensions should be considered carefully to ensure that they are equitable across the range of incomes.

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