Towards a Stronger, More Equitable and Efficient Tax-Social Security System:

Report on the Proceedings of the Castles Tax and Social Security Roundtable

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Introduction

The Henry Report on Australia's tax-transfer system provides a wide-ranging review of the whole framework of taxes by all Australian governments, and of cash transfers by governments to individuals and households. It is pitched to the longer-term, setting out what the Henry Committee considered should be the broad architecture of the system in future, rather than presenting recommendations for specific, early action. The earlier Harmer Report, by contrast, had far narrower terms of reference, focused solely on age and disability pensions and carer payments with particular attention to the adequacy of the single rate of pension. It did not cover pensions and benefits for other categories of people wholly reliant on government for income support nor the broader social security system or related tax arrangements.

The Castles Roundtable, in examining both reports, went well beyond Harmer but not as wide as Henry. It focused on the redistributive elements of the tax-transfer system, in particular the personal income tax system, superannuation tax arrangements and the social security system. While narrower than the whole tax-transfer system, this is still a very wide focus, particularly as current arrangements are extraordinarily complex and full of inconsistencies and confusions.

The challenge for the experts gathered at the Roundtable was to find their way through this maze, aided by the Henry and Harmer Reports. They were encouraged to apply a critical eye to the reports, with a view both to identify some priorities for shorter-term reform and to test whether the longer-term architecture proposed would indeed provide the coherence so sorely needed.

Encouragement was provided by Andrew Podger's description of Ian Castles' contribution to policy development and debate in this field from the 1970s to the 1990s. Castles had a unique ability to see the wood from the trees, to appreciate the tax-social security system as a whole and to promote a more coherent approach to meeting the underlying purposes of the government's role in income redistribution.

a) Principles for a coherent tax-social security system today

Discussion was opened by Jeff Harmer (involved in both the Harmer and Henry Reviews) and John Piggott from the Henry Committee. They drew attention to the key reasons for reviewing the whole tax-transfer system set out in the Henry Report, including the impact of globalisation and the increasing importance of environmental issues. Of particular relevance to the tax-social security elements are:

- the impending demographic changes in Australia, with the proportion of the population aged over 65 expected to nearly double by 2050; and
- technology change, opening up new ways to manage personal tax and transfers.

Another major reason is the complexity of the system and serious doubts that it is effective in meeting its underlying objectives (which are not always entirely clear).

Piggott identified the values the Henry Committee members brought to their task:

- a desire to encourage workforce participation;

- the need to promote human capital investment through improved childcare and education opportunities;
- an outward approach to Australia's place in the world;
- pragmatism, recognising the need for an incremental approach to reform;
- an appreciation of the need to balance the standard objectives of the tax-transfer system.

Harmer and Piggott also identified the principles adopted by the Henry Committee. These included the standard objectives of the tax-transfer system:

- *equity* – which the Committee concluded should be achieved by personal income tax and transfers, not by other parts of the tax system;
- *efficiency* – encompassing economic, administrative and compliance efficiency, leading the Committee to support broadening labour income tax, lowering capital income tax, taxing economic rents and relying more heavily on consumption taxes; and
- *simplicity* – making it easier for people to understand and comply with the law, leading the Committee to propose removing tax filing requirements for many people and making transfers tax-free.

To these were added *sustainability* in terms of raising sufficient revenues and meeting social needs, *predictability* in face of demographic change, and *internal consistency*.

Amongst the key debates within the Henry Committee about trade-offs between these objectives were: whether the tax and social system could be more fully integrated (pragmatism won out, with the Committee focusing more on coherence than integration); the balance between equity and efficiency (the pro-participation emphasis leading to a clear distinction between payments for working age people and those for people not expected to work); and the associated balance between horizontal and vertical equity (the latter being considered more important than the former, even though this would lead to proposals for family assistance that were not as simple as a more universal system which recognised the additional costs of families at all income levels).

In broad terms, Harmer suggested, the Committee was pretty positive about the existing transfer system, its recommendations involving mostly incremental if still important modifications. He commented nonetheless that further work is needed in the area of housing, not only to pursue the Committee's proposals for rent assistance and public housing reform, but also to address problems of housing supply.

Another debate Piggott referred to was about whether the way the system supports the spreading of lifetime earnings through superannuation should involve taxing contributions but exempting benefits, or exempting contributions and taxing benefits. The Committee pursued the first approach (partly because their terms of reference precluded any recommendation to tax superannuation benefits) while also attempting to achieve an outcome broadly similar to that of the more orthodox second approach by proposing a flat rate refundable tax offset. Their recommendations would certainly improve equity, but may leave open problems of sustainability with an ageing population. The associated age pension means test recommendations also represent a pragmatic compromise, being a second-best tax on retirement leisure (by at least restricting access to age pensions for those choosing to retire and having the resources to do so from superannuation or other savings).

There was considerable sympathy amongst roundtable participants for the values and principles set by the Henry Committee, and the discussion corresponded quite closely to the debates the Committee itself had, but not always with the same conclusions. Not surprisingly, there was not always a consensus.

Some were not convinced that the pragmatic approach to balancing equity and efficiency reflected sufficiently the literature on optimal tax strategies by leaving leisure largely untaxed, giving insufficient attention to the costs of caring for children and setting effective marginal tax rates that do not take account of different workforce participation elasticities (i.e. the extent to which people are actually influenced to vary their participation in part-time or full-time work). These participants preferred a more universal approach to family assistance and a more progressive income tax scale.

The Committee's pragmatic approach, of course, reflected continuation of the Australian tradition which gives far more emphasis to means tests than other nations, but also much lower social security budgets and no direct social security contributions. As the background papers from Peter Whiteford demonstrate, this means that Australia's system is the most targeted in the OECD by a long way, though a number of other countries are more redistributive because they spend more.

There was also some unease about the distinction between payments for those of workforce age and those for people not expected to work. While there was universal support to stop the growing gap between the two sets of payments, quite a few participants wanted a common definition of adequacy, thereby setting maximum rates of all the pensions, benefits and allowances concerned at the same rate. This reflected not so much a different view of the right balance between equity and efficiency but a different view of the appropriate means to promote workforce participation – focusing more on work tests and employment and training programs rather than differentiating the payment levels with less-than-adequate minimum income support for some. Some questioned whether the lower rate of payment for the unemployed really reflected the view that they were less deserving than the aged or disabled, rather than the claimed rationale of the need for stronger incentives to work.

Another issue highlighted in the discussion concerned financial sustainability which, while identified in the Henry Report, was possibly understated. It was suggested at the roundtable that, using domestic consumption as the underlying base for revenue-raising, spending demands seem likely to rise from around 35 per cent of gross domestic consumption to above 40 per cent over the next ten years. If this is to be met primarily by the personal income tax system, marginal rates for most must rise to 45 per cent, or more which, with the current GST, implies effective marginal rates of over 50 per cent. Governments will need to consider how best to handle these pressures, including the options to take selected services out of the tax-funded system and to apply more user charges. Roundtable participants considered that the option to rely more heavily on consumption taxes should also not be dismissed. Such options would have significant equity implications.

There was wide support for addressing the equity objective by increasing and indexing the tax threshold as Henry recommends, this being even more important if consumption taxes need to be increased. It was noted, however, that governments had shown unwillingness to commit to this in the past.

b) Personal income tax and family assistance

Relevant Henry Committee Recommendations

- A much higher personal tax-free threshold, around $25,000, should replace the complex array of thresholds and offsets.
- A simple two-step tax scale should apply.
- Progressivity of the tax system should be enhanced by including all forms of work remuneration.
- Family assistance should be paid through a single program principally based on the additional costs of children, in general increasing with age, and means tested in accordance with family taxable income on the same basis as for income tax.

Henry's pragmatic approach led understandably to rejection of full integration of the personal income tax and social security. The different income units (individual versus family) and the different time frames (annual versus current with fortnightly payments) reflect the different primary objectives of the two, so integration would not only lead to winners and losers that would be hard to manage politically but could also have undesirable impacts on poverty alleviation and/or workforce participation incentives. The focus on more coherence, rather than integration, was therefore accepted by roundtable participants as the most sensible approach.

Henry's main means of achieving this is through a large increase in the tax threshold and a single system of income-tested family allowances.

While accepting the need for a pragmatic approach, Rob Bray (ANU and previously FAHCSIA) opened discussion by highlighting how small the labour force participation gains and losses would be under the Henry personal income tax scale and hence how small the likely labour market response despite the Committee's pro-participation stance. Modelling by Hielke Buddelmeyer of the Melbourne Institute using its MITTS model suggests very small changes overall in employment and even smaller changes in hours worked. As illustrated in the table he presented, even amongst the group with the highest labour market response (married women) the effective change in hours worked would be minimal, whilst average hours worked by single men and women and sole parents would fall.

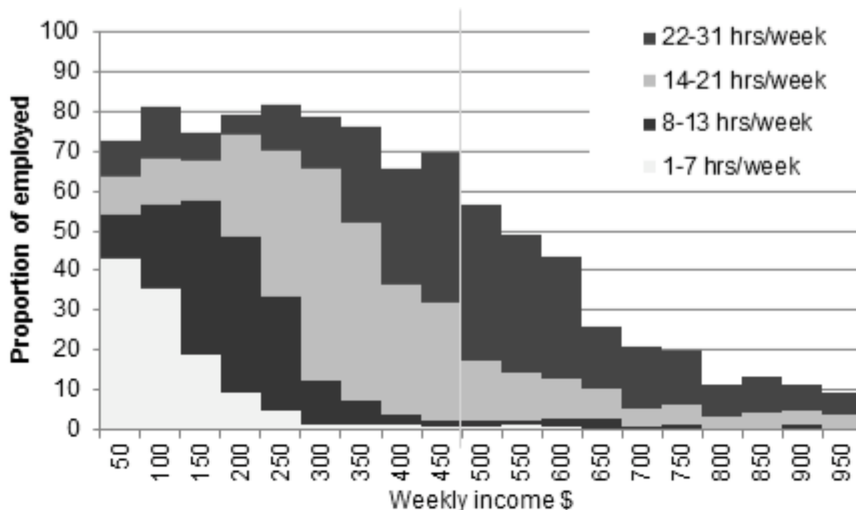
Table 1: Estimated Labour market response

Group	Employ/ pop. Ratio	Jobs	Av hrs/ pop.
Married men	+0.04%	1,921	+.01%
Married women	+0.81%	38,896	+0.2%
Single men	+0.01%	300	-0.03%
Single women	+0.05%	1,399	-0.04%
Single parent	-0.82%	-4,730	-0.4%

Australian National University

A second factor identified by Bray was the extent to which the increase in the threshold would substantially exempt most (68 per cent) of part-time workers from paying personal income tax (as the following graph shows, nearly all those working less than 21 hours a week have incomes below the proposed threshold, and a substantial proportion of those working more than 21 hours but less than 31 hours also have incomes below the proposed threshold).

Figure 1: Personal income tax (PIT) threshold and part-time work



Australian National University

He questioned whether this was a desired outcome, although he noted that the GST (along with any expansion of indirect taxes) would still be payable.

While the story is more complicated when the proposed family allowance changes are taken into account, Bray suggested that Henry had overplayed the role of incentives caused by effective marginal tax rates. For many, including families who make labour supply decisions jointly, considerably greater attention should be paid to income effects more generally and to the value people attach to leisure and home production.

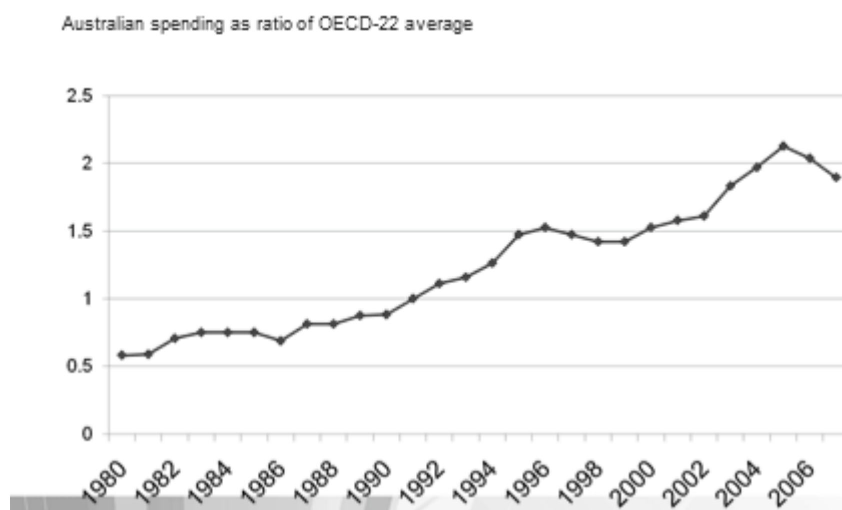
Bray also drew attention to Henry's acceptance of the proposition that family payments should fully cover the direct cost of children in low-income families. While this had been built into the system in the 1980s, it remains a large step to say that this is a state responsibility. Setting such a high maximum payment inevitably raises costs and broadens the impact of the means tests that must be applied.

Accordingly, Bray concluded that Henry's attempt to clean up personal income tax scales had left the transfer system, particularly with respect to family payments, very messy. He saw considerable benefit in some of the tax changes, including the removal of terms such as 'dependent spouse rebate' and 'low income tax offset' which can lead to misleading and counter-productive perceptions of dependency and exclusion (the 'low income tax offset' for example applies up to middle range incomes). He thought that more consideration, however, was needed of Henry's proposed family payments arrangements. Changed banking and credit processes, for example, might provide the opportunity for new payment processes that would rid family payments of its badging

problem (as ‘Centrelink’ or ‘welfare’ payments), a problem which, like ‘dependent spouse’ and ‘low income tax offset’, is much more than simply presentational.

Peter Whiteford, the other discussant in this session of the roundtable, focused on family payments, highlighting Australia’s unique arrangements. Over the last 30 years, spending on family allowances has increased from around 60 per cent of the OECD average to around double the average.

Figure 2: Trends in spending on family allowances, 1980 to 2007



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Notwithstanding media criticism of Bob Hawke’s promise that by 1990 no child would need to live in poverty, the number of children in poverty (as defined relative to median community incomes) did fall dramatically by 1990 (by between 43 and 47 per cent) with the poverty gap also being reduced (by 50 per cent to 55 per cent). That improvement has been largely maintained ever since (despite subsequent increases in family payments, relative poverty has not fallen further but this is a consequence of substantial increases in median incomes since the mid-1990s: if the poverty line was held constant in real 1982 prices, poverty rates would have continued to fall very substantially).

While over this period the payments have become less targeted on the poorest 20 per cent of the working age population, it is still shared predominantly amongst individuals and families with below median income (the shift upwards in incomes covered by family allowances has been driven by more generous payments at low income levels combined with lower rates of income test tapers, raising cut-out points i.e. the income levels where the family allowances payable reduce to zero). Accordingly, as illustrated by Figure 4 (relating to total transfers, not just family payments), Australia’s approach still involves the lowest level of “middle class welfare” in the OECD.

Figure 3: Trends in child poverty in Australia, 1982 to 2007-08

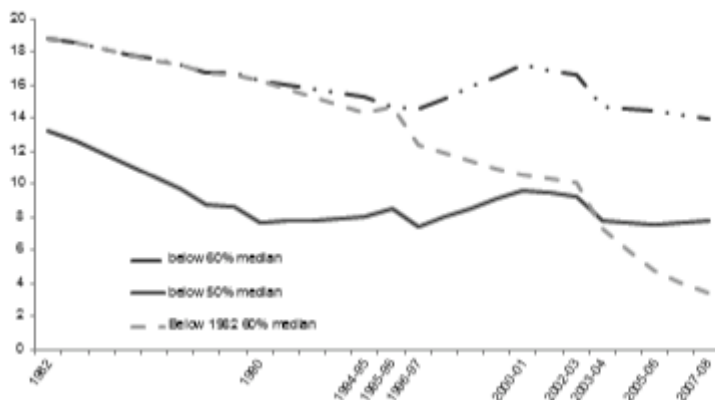

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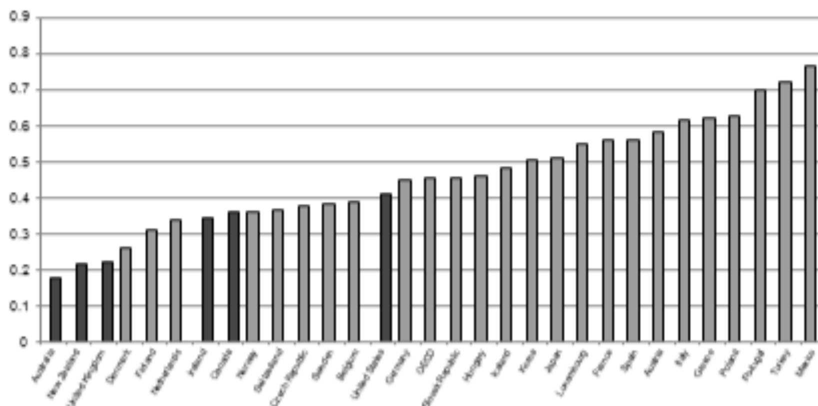
Figure 4: Australia, New Zealand and the UK have the lowest "middle class welfare" in the OECD

Share of transfers received by the richest 50% of the working age population, 2005



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Discussion at the roundtable focused on the balance between horizontal and vertical equity (whether the costs of families should be recognised at all income levels, or whether higher priority should be given to higher payments for families on lower incomes) and the impact of effective marginal tax rates on workforce participation amongst families with children. The Henry recommendation to increase the tax threshold was generally endorsed though there was some debate about other aspects of the personal income tax scale.

Whether there is a tension, at least conceptually, between horizontal and vertical equity was questioned on the basis that horizontal equity (through universal family benefits) is aimed to ensure tax properly reflects capacity to pay at all income levels,

after taking into account the costs of children. By doing so, the total revenue collected can be optimised, allowing the government (if it wishes) to allocate more funds towards vertical equity to assist the poor. This line of argument is consistent with Ian Castles' support in the 1970s and 1980s for increased universal family allowances, regarding these as legitimate offsets to tax for taxpaying families with children. On this basis, it was suggested, the real trade-off was between means testing family assistance and having lower (or higher) marginal tax rates at high incomes for taxpayers with or without children.

It was noted that the tension between horizontal and vertical equity became a major issue in practice when family benefits shifted from the revenue side (as deductions or rebates) to the outlays side (as cash payments). The Australian tradition of means testing social security payments then arose in a way that had not applied to tax deductions and rebates. Full integration of social security family benefits and tax-rebated family benefits in the 1990s led to even stronger perceptions of a tension between horizontal and vertical equity. Apart from causing overpayments (as assessable income at the end of the year often exceeded the estimated income during the year), integration locked in the assumption that all low-income families (both pensioner/beneficiary families and other families on low incomes) should receive family assistance covering the total cost of their children. This added greatly to total costs, particularly when income test tapers were reduced to lower effective marginal tax rates, raising questions about whether any family support at high-income levels could be afforded.

The focus amongst many academics and commentators on "Manhattan sky-lines" of effective marginal tax rates was also seriously questioned by roundtable participants. A more nuanced approach was advocated based on the likely real choices over workforce participation faced by different groups of people. Thus, for example, very high effective marginal tax rates (EMTRs) over narrow ranges of income affecting small numbers of people may not be of particular concern if the workforce choice they face is whether to take up a substantial part-time or full-time job, not to increase participation by an hour or two. For them, the net marginal gain may still be worthwhile despite the high EMTRs over some of the income ranges they jump over. Lowering these EMTRs by extending them over much wider income ranges may well have adverse impacts on the many more people affected, some of whom do face more incremental choices over hours of work. This might suggest an alternative to the Henry approach by having a more modest and more universal payment combined with a generous but more tightly income tested supplement.

Another way of considering the incentive effects of transfers was identified, by classifying them as lump sums (such as payments for the aged and unemployed) in lieu of earned income, or as job subsidies (e.g. the payments for sole parents) supplementing earning from part time work. It was suggested that the Henry approach appears to be to press people into the lump sum group (with full benefits for not working or being able to work) or into full time work. Under this policy, EMTRs are not really the issue as they are not so relevant to the practical choice being forced on to people – whether or not to move from no work to full time work, and how to stay in full time work. Work tests and other eligibility criteria may play a much more important role. More generally, policy makers need to consider more carefully the numbers of people in different categories, the real workforce choices they face and how they might respond to different incentives.

While some participants were uneasy about whether the discussion was dismissing economic theory about marginal rates of return and their effect on workforce incentives, others noted that there are both income and substitution effects to be considered, and emphasised that they were not suggesting EMTRs do not matter but that they need to relate to the real life choices different people face at the margin.

The discussion did not lead to agreement on the best approach to family assistance. Supporters of the Henry approach for a simplified but still fully income-tested family payment conceded that it might not rate particularly well against the criteria of efficiency and simplicity (particularly with the parallel assessments of the income of most taxpayers with children for tax and family allowance purposes), but argued it addressed equity well and was aimed to attract wide public support. Others considered there was an alternative approach based on a modest but universal payment supplemented by a more tightly targeted generous payment, possibly combined with higher taxes at high-income levels (either through higher marginal rates or lower tax points). They suggested such an approach would better meet the efficiency and simplicity criteria, as well as the equity criterion. They recommended that such an approach be developed in more detail and tested against the Henry recommendations in terms of Henry's own criteria.

c) Social security pensions and benefits

Relevant Henry Committee Recommendations

- Three levels of primary support payments should be established – pensions for the aged, disabled and carers; lower-rate participation allowances for those of working age; and assistance payments for young people and students – each with means test withdrawal rates reflecting different work expectations.
- Once adequacy benchmarks are reached, they should be preserved by common indexation arrangements applied to each of the main payment types.
- Following the Pension Review changes, the relativity between the single and couple payments should be improved across the other payment types.
- The assets test should be abolished, and a comprehensive means test base established for the main pension and allowance payments (including for Rent Assistance to prevent additive withdrawal rates). Income from savings would take the form of deemed returns from assets.
- All pensions, allowances and other transfer payments should be tax-free.
- Maximum rates of Rent Assistance should be substantially increased and linked to market rents.
- Subject to transitional arrangements, public housing rent concessions should be replaced by Rent Assistance and a new form of assistance for higher needs tenants, to improve equity and work incentives.

Peter Davidson (ACOSS) opened discussion by highlighting the growing gap between payments for those expected to work (unemployed and sole parents in particular) and payments for those not expected to work (aged, disabled, carers), (see Figure 5). Figure 6 shows the high level of deprivation amongst the former group, despite the fact

that reliance on income support amongst those of workforce age has been steadily declining over recent years.

Figure 5: Key payment gaps

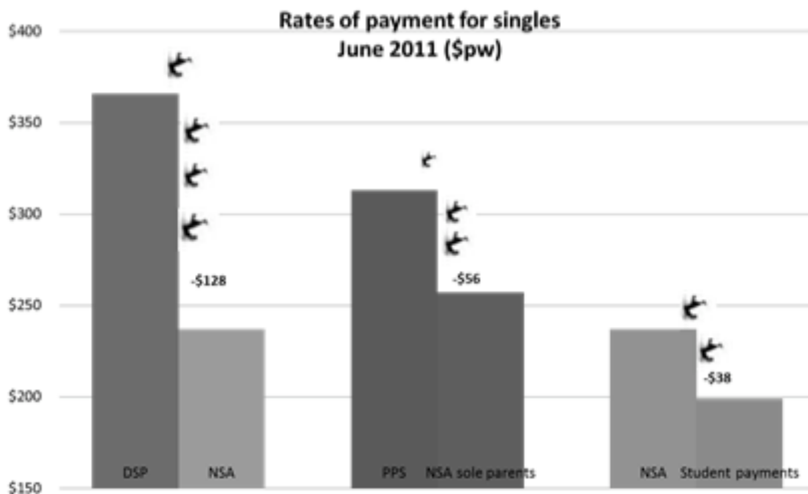

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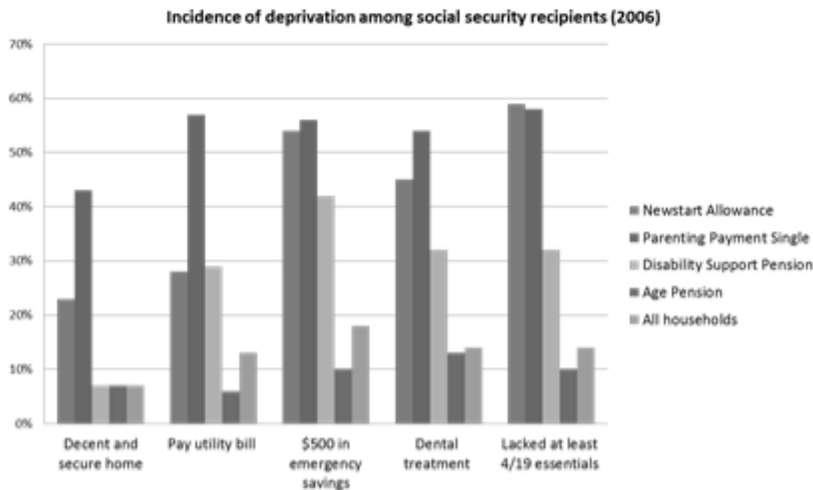
Figure 6: Who's struggling on income support?



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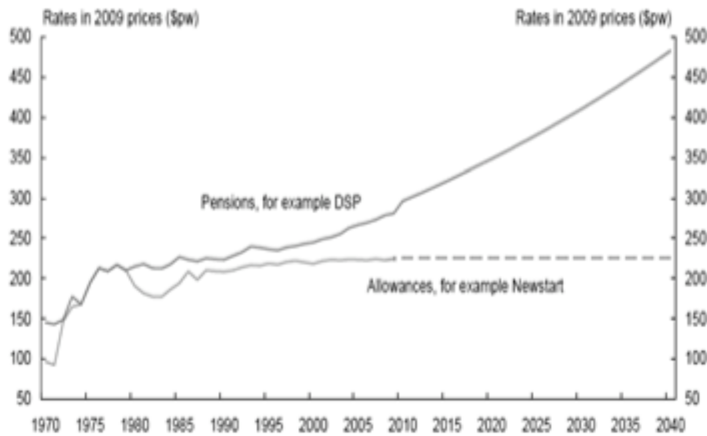
While the Henry Report highlighted the growing gap in payment levels (see Figure 7), and recommended increases in the base rates for single income support recipients in the participation and student categories, the Committee recommended continuing a distinction between payments for working age people and those for people not expected to work, albeit without further widening of the gap by having consistent indexation arrangements.

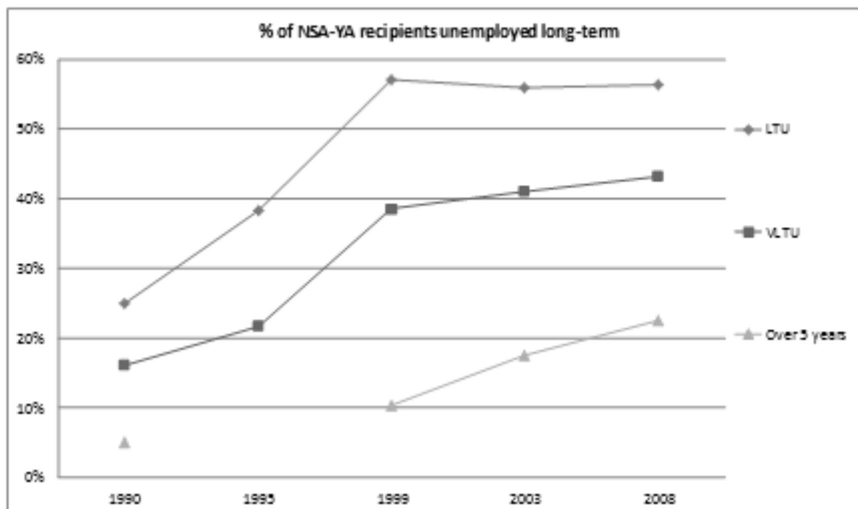
Figure 7: Real value of pension and allowance payments for a single adult (in 2009 dollars)



Australian Council of Social Service (ACOSS)

Davidson strongly questioned the case for such a distinction noting the growing proportion of Newstart recipients who are unemployed long-term (see Figure 8) and their similar needs to and greater lack of personal resources as those on age and disability pensions. One in three are 45 years of older and one in ten are Indigenous.

Figure 8: The profile of unemployment payments has changed



Australian Council of Social Service (ACOSS)

The main reason Henry maintained the distinction was to retain incentives for those in the participation categories to seek work. Instead, Davidson suggested Australia draw on initiatives in the UK and NZ to introduce a more standard level of minimum income payment but with varying approaches to income tests and conditionality related to expectations of workforce participation.

Bob Gregory (ANU), the second discussant, noted how his views of how people respond to the welfare system have changed dramatically in recent years. Formerly he thought there was a high degree of substitutability, people shifting from one payment to another whenever eligibility rules changed, so that he was pessimistic about the likelihood of moving people off welfare and into jobs by changing eligibility criteria. But it is clear now that eligibility conditions do matter, and can increase the number of people seeking and finding employment. As grandfathering provisions have phased out, the removal of wife's pensions, widows pensions for those without children, and the removal of age pensions for women under 65, have corresponded with a one third reduction in the numbers of older female *and male* recipients of pensions. The changed behaviour of women, for example, has impacted on their husbands' eligibility for disability pensions.

On the other hand, Gregory noted, there is little evidence that rates of payment or EMTRs matter much. Income support for the unemployed is now one third lower than a decade ago, but there is no evidence that this has affected numbers of recipients. Nor do income test changes seem to have had much impact. But eligibility conditions and threats do have an impact. Active programs to help people into work also have an effect, though not greatly for long-term welfare recipients.

Other data mentioned by participants supported Gregory's conclusions. The proportion of older women (aged 60 to 64) on income support has dropped from 68 per cent to 39 per cent over the last decade. The proportion of older men and women on the disability support pension has also dropped with the removal of wife's pensions in particular.

There was considerable support for a single definition of adequacy for those reliant on pensions or benefits. While Henry would stop the gap from growing, many at the roundtable considered that there should be no gap. The increase in age and disability pensions following the Harmer Review had only exacerbated the problem, with the Henry Report's apparent justification of a gap on the grounds of work incentives possibly disguising a political judgement that the unemployed are less deserving than the aged and disabled. Evidence suggested that work incentives could be maintained in other ways.

Maintaining relativities will, of course, require the use of a single indexation factor rather than the current search for indexes related to specific groups' expenditure patterns. While it may not be possible politically to revisit the generosity of the pension indexation factor (based on male average earnings), a strong theoretical case could be made to apply a common price indexation factor to all forms of income support and to provide ad hoc increases to reflect changes in community living standards when this is considered appropriate and as budget circumstances permit. The alternative to apply the current pension indexation factor to all pensions and benefits (in addition to an increase in Newstart Allowance and Single Parenting Payments to reduce or remove the existing gap) may be no less challenging politically (and financially).

One option for reducing the gap is to increase the rent allowance substantially. This was unfortunately not pursued by the Government following the Harmer Review despite it being a less costly and less discriminatory approach (addressing the needs of the most vulnerable of all pensioners and beneficiaries, those in private rental accommodation and paying market rates).

The Henry Review, however, supports such action as part of a wider reform of housing assistance. This would not replace the need to reduce or remove the gap between

different pensions and benefits (and might raise its own challenges such as the risk of facilitating higher rents), but it could ameliorate the most urgent of concerns.

Discussion turned again to the role of EMTRs on work incentives. Some questioned the need for concern about high EMTRs when work tests provide the necessary incentive.

Further, income tests, which promote part time work amongst Newstart recipients, might seem counterproductive to incentives for full time work. A preferable approach might be to ensure incentives for part time work amongst parents of young children, including those on single parenting payments, and to test disabled people for their capacity to undertake part time work, and then to design the relevant income tests and associated active work programs accordingly.

Discussion of the Henry Committee's recommendations that all transfer payments be exempt from tax led to broad agreement that it be re-considered as it may well be inappropriate and unnecessarily expensive. The case for exemption was based on simplicity – many transfers are already exempt so the suggestion would lead to more consistency, and it would also take many more people out of the tax system.

Those questioning the recommendation noted that the proposed major increase in the tax threshold would ensure people fully or largely reliant on pensions or benefits did not have to pay tax anyway, without exempting the payments themselves. Exemptions would only benefit higher income groups, adding to the privileged status of those already having tax-exempt superannuation benefits. For those receiving pensions or benefits for only some of the year, exemptions would have the curious impact of allowing them to gain a substantial tax refund at the end of the year, without providing any help while in receipt of the pension or benefit. Taxing the pensions and benefits would also claw back a little of the moneys paid without the recipients being put into any income difficulty.

In terms of EMTRs, tax exemption reduces the extent to which tax and income tests overlap but, at the point they still do overlap, the EMTR is higher (the sum of the taper and the marginal tax rate). Taxing pensions smooths EMTRs, increasing some because the overlap is wider but reducing others as the EMTR is equal to the taper plus the marginal tax rate's application to the net taxable income remaining.

While the case for pensions and benefits to be taxed is strong, however, there is also a good case for exempting those payments aimed at horizontal equity whether in the tax or transfer systems, in particular, payments for children. (Current arrangements broadly follow this approach, with most social security pensions and benefits being taxable and family payments being exempt.)

d) Retirement incomes

Relevant Henry Committee Recommendations

- The tax on superannuation contributions in the fund should be abolished, increasing saving from currently taxed contributions by 17.5 per cent.
- Instead, employer superannuation contributions in the fund should be included in employee taxable income. Subject to annual limits, all contributions would attract a tax offset payable to contributors.

Recommendations continued

- All income and gains of superannuation funds should be taxed at a rate of 7.5 per cent, further increasing savings.
- The $50,000 transitional cap for contributors aged 50 or older should be continued indefinitely.
- Superannuation balances should be included in Age Pension means tests on the same basis as other savings.
- The development of longevity insurance products should be encouraged and the government should consider offering such products itself.
- Care services for the aged should in general be separated from accommodation choices and provided on a means tested basis – preferably any future compulsory levies should apply to all personal taxpayers and not be linked only to the superannuation guarantee.

Hazel Bateman (UNSW) opened the discussion, marking the relevant Henry Report recommendations in terms of how well they address the current horrendously complicated and inequitable system of support for superannuation. Henry's superannuation tax proposals deserve three stars (out of three) particularly for addressing equity concerns; there are no stars for action on the demand side and few for the proposals on the supply side; and two stars for Henry's means test proposals, including the treatment of income from superannuation. The Government's response deserves a negative three stars, particularly its decision to increase compulsory contributions to 12 per cent as lobbied by the superannuation industry without addressing the current dysfunctional tax arrangements.

Bateman noted the history of confusing superannuation tax changes, from exempting contributions and fund income while taxing benefits (an EET system), to taxing all three components (TTT), though some concessionally, and then to taxing contributions and fund income only and not benefits (TTE). The tax applying under this last approach is at a flat rate. Henry's proposals would impose progressivity to the system and, while retaining its basic TTE design (as effectively required by the Review's terms of reference as they precluded taxing superannuation benefits), would very broadly replicate an EET system, the more orthodox approach to facilitating the spread of lifetime earnings.

Bateman's main concern is that Henry did not pay enough attention to superannuation benefits, though the Report does identify options for the Government to facilitate the development of a longevity insurance market and recommends consideration be given to the Government selling lifetime annuities (a recommendation initially rejected by the Government). She suggested that the Government's decision to introduce the default My Super fund, because managing investments was too difficult for many people, should be effectively extended to support people to manage their benefits. They need a retirement income plan and, perhaps, some benefits should be required to be in the form of retirement income. She highlighted that, in the first six months of 2011, less than 30 lifetime annuities were sold in the whole of Australia, demonstrating how weak current arrangements for ensuring retirement incomes are. The issues are complex but

there is evidently some market failure, exacerbated perhaps by regulatory arrangements prohibiting deferred and variable annuities. The result is that the age pension has become the basis for longevity insurance; it also provides, at taxpayer expense, insurance against poor investment decisions by those who dissipate their lump sum benefits too quickly.

Deborah Ralston (Monash University) described the Melbourne Mercer Global Pension Index, published by the Australian Centre for Financial Studies, which is a comparative international study of retirement systems. In its 2011 report, Australia's retirement system was rated second only to the Netherlands. Australia's system reflects the World Banks' preferred four or five pillar approach which includes public pensions, mandated and voluntary privately funded pensions, such as superannuation, and private savings. We rate particularly highly on *sustainability* (because of our reliance on defined contributions and funding, and with only the age pension safety net reliant on tax revenues, and because of our private savings through home ownership)) but have also improved our position on *adequacy* with the recent increases in the age pension; we also rate reasonably on *integrity*. Using this analytical framework, the Index suggests Australia could improve its rating (and reach "A grade") by increasing the compulsory contribution rate to 12 per cent (as agreed by the Government), improving labour force participation rates of older workers, improving communications by providing better projections of benefits, and encouraging benefits to be taken as an income stream through the use of annuity-like products.

Ralston's positive portrayal of Australia's arrangements did not sit comfortably with many around the table concerned about the cost, inequities and poor retirement income outcomes of the current superannuation system. There was a danger that the Mercer index would provide an excuse for complacency about the serious weaknesses of current arrangements.

The main concern was the one highlighted by Bateman about de-accumulation, or the form of superannuation benefits. This had occupied much of the time of the Henry Committee and initially, apparently, there were signs of Government interest in better management of longevity risk so as to improve sustainability of the superannuation system. Subsequently, the view that self-funded retirees should manage longevity risk on their own seemed to prevail, with the Government taking responsibility only for age pensions. (However, following the Tax Summit, the Government indicated that it would look again at its possible involvement in annuities.) It was also suggested that the problem had fallen between the responsibilities of different government agencies and was not given priority by any of them. Self-interest of funds and investment advisers has also got in the way of good policy to promote retirement incomes particularly via any sale of government annuities or mandating that part of the benefits be in the form of annuities. The views of potential consumers of these products do not seem to have gained much attention.

There was a strong view around the table that the issue of lifetime annuities needs to be put back on the Government's agenda. Options such as the sale of annuities by the government should not be rejected on the basis of the contingent liability involved, as government is already bearing much of this risk, if not more, through age pensions. The issue is about ensuring better adequacy of income over the whole of retirement.

There was also general support for addressing the inequities of current superannuation tax arrangements. Some highlighted the total costs of superannuation tax concessions

(estimated by Treasury in its Tax Expenditures publication at over $25 billion), which are of a similar order to the direct cost of age pensions. Others considered that this grossly exaggerates the costs involved because it applies, as the benchmark for neutral taxation, the full marginal tax rate to all contributions and to all fund earnings, as would apply now to money people might put into bank accounts. As Henry highlights, this approach to taxing savings amounts to a substantial tax on assets, not just income and, in any case, a more appropriate benchmark might be one attuned to the objective of spreading lifetime earnings, i.e. a tax on final consumption rather than on income. Using this as a benchmark, superannuation tax expenditures would probably be a small fraction of the figure currently quoted. It would, however, be even more skewed towards higher income groups, with lower income groups actually being penalised, demonstrating even more clearly the inequities of current arrangements.

The Henry Committee addressed the equity problem by proposing that the tax on contributions be based on individuals' marginal income tax rates less a standard offset (using a 20 per cent offset to illustrate the approach). Thus higher income contributors would pay around 30 per cent tax on contributions (50 less 20), most would continue to pay 15 per cent (35 less 20) and low income contributors would receive a 20 per cent co-contribution (replacing the existing co-contribution system). The Committee also recommended halving the tax on fund earnings from 15 per cent to 7.5 per cent.

These recommendations were based upon the requirement in the terms of reference that superannuation benefits not be taxed. While some considered that requirement to be politically immutable (and administratively difficult to reverse), others expressed concern about the long-term impact. The move away from a more orthodox EET system began when Paul Keating (as Treasurer) introduced the 15 per cent tax on contributions and fund earnings. The effect was to bring forward tax revenues from future benefits to address immediate budgetary pressures. Completion of the move to a TTE system came when Peter Costello announced that benefits from taxed schemes would in future be fully exempt. Notwithstanding rhetoric from both major parties that the superannuation reforms were intended to improve sustainability and address the ageing population, these measures have exacerbated future fiscal problems by reducing future revenues from benefits and using the moneys brought forward for immediate budgetary purposes.

That said, there is no easy way to return to an EET arrangement. In the meantime, however, there is also no evident political support yet for the Committee's proposals.

The Henry Committee's means test proposals, however, including the treatment of superannuation savings, could be seen to provide a partial solution to the absence of an EET tax arrangement. The proposed comprehensive income test would ensure access to age pensions is reduced on account of superannuation savings however these are drawn down.

This somewhat messy approach will still allow most superannuation beneficiaries to receive a full or part age pension given the still relatively low retirement incomes available from their superannuation savings, adding to the adequacy of their total retirement incomes. As some roundtable participants noted, the two components of the retirement incomes system should not be presented as conflicting – one aimed primarily at reducing the other – but mostly as complementary, together meeting the twin objectives of poverty alleviation amongst the aged and income maintenance at, and through, retirement.

There was little support for the Government's decision to increase compulsory superannuation contributions to 12 per cent, given that the increased employer contributions would be borne effectively by the employees. Concern was expressed about the effective burden on lower income groups with more pressing needs in their working age years particularly when the higher contributions would only yield marginally better retirement incomes given their likely dependence upon age pensions. There was also concern about possible gender imbalance as the higher contribution could impact more adversely on women with intermittent and part time workforce participation. A higher priority might be warranted to extend the existing superannuation guarantee to the 20 per cent not now covered.

On the other hand, some consumer organisations are more favourably disposed towards the decision to increase the guarantee so long as it is part of a broader strategy to address the needs of older Australians including improved aged care, health services, transport and housing. That package might involve bringing the personal home into the financing requirements for aged care as recommended by the Productivity Commission, but only if the trade-offs in terms of increased security and quality of care can be demonstrated. Groups such as Seniors Australia are looking for a stronger consumer focus, with better understanding of the need to address the complexities of current arrangements and the burden of worry placed on people as to how best to manage their finances. Clearer rules on levels of contributions, and forms of retirement benefits would add to their security and peace of mind if combined with firmer guarantees of access to quality services.

The Henry Committee's recommendation to increase the preservation age to the age pension age by 2024 also received mixed views. Apart from the political difficulties involved, many people may find it difficult to continue in full time work to age pension age given their lack of relevant skills and mobility. The ability to draw on superannuation during a more gradual transition to retirement might be more sensible than some artificial approach to try to force people onto Newstart, etc at older ages pending their access to their own-funded superannuation. So long as the system does not encourage excessive draw down of benefits before age pension age (for example, by requiring some to be used to purchase deferred annuities), a less stringent approach to the preservation age might be appropriate.

Conclusions

Dennis Trewin presented an initial overview of the roundtable discussion, identifying areas of broad agreement, the key issues identified and debated and the barriers to genuine reform; he also suggested a way forward including some priorities for early action (see separate paper).

Subsequent discussion confirmed broad agreement with the values and principles adopted by the Henry Committee, and widespread support for much of the direction for long-term reform set out in the Henry Report. This recognised the strengths of Australia's current approach to social security transfers, while giving more emphasis to its sustainability and the importance of promoting workforce participation for both equity and efficiency reasons.

Particular priorities for early action include addressing the growing gap between Newstart and other pensions and benefits, increasing rent assistance, further action to increase the tax threshold and simplify the personal income tax scale, and ensuring more superannuation benefits are in the form of lifetime annuities. There was also

support for some early action to address the inequities involved in current superannuation tax arrangements.

The lack of agreement on two issues in particular suggests there is room for more analysis, including through development of clearer alternatives that might be compared. Regarding family assistance, an alternative to Henry's single income-tested payment involving a modest universal payment with a tightly income-tested supplement might facilitate more careful study of the trade-offs in equity, efficiency and simplicity. Regarding superannuation, while bipartisan commitment to tax-free benefits might preclude any return to an EET regime, more research might be conducted to compare the effect of the Henry approach, including the comprehensive income test on age pensions, with a more orthodox EET regime, to test longer-term revenue/expenditure implications and the incidence of these tax/transfer alternatives.

The discussion also revealed some interesting new insights into the issue of work incentives and the role of EMTRs in the tax/transfer system. A much more nuanced appreciation of the role of EMTRs emerged together with a better understanding of the importance of other design elements, particularly the conditions applying for eligibility for pensions and benefits, to incentives for full and part-time employment.

The roundtable also confirmed the value and continuing relevance of the work done by Ian Castles, emphasising the tax/transfer arrangements as a system, and coming to grips with the underlying issues and the combined impact of its different elements. He would have enjoyed the discussion.

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[1] The Castles Roundtable was held on 12-13 October 2011 at the Australian National University. Participants included some members of the Henry Committee, practitioners from the relevant Commonwealth agencies along with academic experts and several former public servants with considerable experience and expertise in the field. The Chatham House Rule applied. Those mentioned in this report by name have all agreed to the references made.