An Opt-in, Universal (non-means-tested) Pension

can fix several Super problems.

Allowing all retirees to opt to receive a non-means-tested age pension, which would trigger application of a different tax schedule for wealthier retirees (let's call it the retiree tax schedule (RTS)) could solve several current problems with our current super system without breaking the government budget.

Some Super Problems

What problems could it solve? First, there is an enormous waste of resources in the financial planning industry aimed at enabling individuals to structure their financial affairs so as to access the means-tested age pension. Second, managing a means-tested pension system involves considerable government resources (and subjects individuals to lots of hassle). Third, superannuation tax concessions in retirement create an un-level playing field favouring superannuation funds, and reducing external competitive forces, in the market for the management of retiree wealth. Fourth, the Howard government introduction of a zero tax rate for super earnings in retirement was a major policy mistake which is politically infeasible to reverse – unless combined with some offset such as the Opt-in Universal Pension to make it palatable to voters.

The Mechanics of an Opt-in Universal Pension

How would such a system work? First, at retirement (or later if the option has not yet been exercised) individuals would be able to elect to receive the non-means-tested pension (which is set at the same level as the means-tested pension). However, in doing so, the retiree agrees to be subject to a different tax schedule (the RTS) which has two main features.

First, superannuation account earnings would be included in the retiree's taxable income and subject to personal income tax at the rate specified in the RTS. Second, the RTS would be no different to the normal tax schedule up to some income level – such as that which enables a retiree to currently receive (say) a 25 percent part-pension. Above that income level the RTS would involve a higher marginal tax rate than the normal tax schedule, designed to offset the additional income to be received by wealthier retirees from the universal pension.

For those currently on full or significant part-pensions, opting into the universal pension can leave their after-tax position no worse-off, and avoids the costs of tax-driven financial advice and hassles of means-testing. For the wealthier, the decision to opt-in requires some analysis – but no more than could be readily available from web-based calculators. The information required is: superannuation balances and their expected annual return; other financial assets outside of super and expected earnings therefrom; other (part-time employment) income; and the RTS and normal tax schedules.

A Simple Example

A simple example (obviously ignoring many complications, such as uncertainty of returns) may be useful. Take a retiree with $500,000 in super which generates a pre-tax return of $30,000 p.a. (untaxed). The retiree has $400,000 in other assets generating a pre-tax return of $25,000. Under the current system (with super earnings tax-exempt), no pension is received and tax of $1, 292 is levied (at 19% marginal rate on income over $18,200). After tax income is thus $30,000 + $23,708 = $53,708

Under the opt-in alternative, the full $55,000 of earnings (inside and outside super) plus the universal pension amount of $25,000 (approximately) would be taxable, giving taxable income of $80,000. To leave the retiree equally well-off from opting in, the RTS would involve levying $26,292 of tax on that income to leave $53,708 after tax. The current (non-RTS) tax schedule would levy $16,467 on that income, indicating that the RTS needs to be set above the normal tax schedule to leave such an individual indifferent.

The exact specification of the RTS would reflect government objectives regarding budgetary considerations and possibly weaning retirees off the super-subsidy teat. Once set, and fixed for all time at specified margins above the normal tax schedule, retirees could make a decision to opt-in or not depending on their individual circumstances.

Political Feasibility

Could it be sold politically – yes, individuals are given a choice to stay with the status quo or opt into an alternative system, rather than simply having a tax-break taken away from them. Would it be difficult to implement – no! Would it be difficult for retirees to understand and make sensible decisions – not with the aid of web-based calculators! Would the super industry and financial advice industry support it – no, because it goes against their self-interest, even though it has social merits!

The Scheme’s Social Merits

What are the social merits?

Less resources spent on financial advice aimed at maximizing pension income.

Less public sector resources spent on means-testing (and less hassles for individuals subject to means testing) and other activities associated with implementing a means-based pension scheme.

A level playing field for the management of post-retirement wealth by removing the tax concession only applied to super earnings in retirement. Unless super funds can provide higher pre-tax returns, or design better retirement products, than others they will be subject to loss of funds via the competitive process.

A politically feasible method of watering down the zero-tax subsidization of retirement earnings which primarily benefits the wealthier members of society, and which would also reduce the tax incentive for not running down superannuation balances in retirement due to bequest motives.

It would be a major policy change, and invoke howls of protest from vested interests in the financial sector – but one well worth considering.

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