ALL THIS — AND A PENSION TOO?
WHY SUPER CONCESSIONS SHOULD BE AXED

by JOHN CORBETT

A different twist in the debate about superannuation tax concessions: why not abolish them entirely, eliminate lump-sum payouts and give everyone an automatic, untested age pension?

Just what has been achieved, over the four decades since the Second World War, in regard to equitable retirement income and the reduction of overall government costs for social security benefits for the aged? Very little, it seems.

The present mess could be cleaned up by granting age pensions to all over the age of 65 and by completely removing tax concessions for superannuation funds.

This paper looks at:
- what has been done;
- what could be done;
- how it could be done;
- the advantages of the suggested changes.

Tax deductions for superannuation contributions (from employer or employee or both, and from self-employed), freedom from taxation of investment income of superannuation funds, and concessional tax rates on lump sum benefits were, it seems, supposed to reduce dependency on social security age pensions.

Effectively, the only funds paying pensions, rather than lump sums, are those for certain Government (particularly Federal) employees. While the reason for this may have been claimed to be the Government’s determination to reduce social security benefits where it could, one could also claim that the real reason had to do with avoiding the need to fund these benefits, and the adverse effect on Budgets if Government schemes either paid lump sums or were funded. It is noted that in respect of the funded portion — i.e., that provided by employee contributions — lump-sum benefits are paid.

Lump-sum benefits have been, in many cases, directed into everything other than providing for living costs in retirement without receipt of the age pension. Purchase of a home (a more expensive one, the discharge of an existing mortgage, improvements to present home, or the purchase of a holiday home, etc), the purchase of new cars, boats or furniture, travel in Australia and overseas, gifts or interest-free loans to family — such expenditure is used by individual retirees to guarantee they will have an age pension despite having received a superannuation lump sum, and the decision to take this action has been reached largely without “professional” outside advice.

As for the “investment” of the remainder of the lump sum, “professional” advice has been irresistible to many retirees, even when it is doubtful if the advice is sensible investment guidance.

This advice has included purchase of investments producing low income (by direct gearing or through a geared property trust, or by the purchase of friendly society or life insurance bonds or imputation trust units, etc). The reason for making these investments has been solely or principally to enable the

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The retiree to receive an age pension even when the assets, if otherwise invested, could have produced a satisfactory income without reliance on the pension.

In an attempt to eliminate the worst abuses, and to raise taxation revenue, the Government has introduced a tax on superannuation contributions and on the investment income of superannuation funds.

It has reintroduced the assets test, modified the income test, changed the tax rate on lump-sum benefits, introduced approved deposit funds and tried to encourage annuities and other benefits.

The end result of all this seems to be little real long-term change; and one may be forgiven for thinking that to our Government the long term means the period between now and the next Budget or mini-Budget, when the rules can be assumed to change again.

The real consequences of all that has been done seem to be:
- Confusion and greater confusion, particularly for the aged, who are least able to cope with the changes financially or mentally.
- No deterioration in the situation of Federal public servants and members of parliament — i.e., those who plan, decide and implement the changes and who, it seems, look after themselves very well.
- A multiplicity of "artificial" investment schemes which produce very attractive income for their sponsors and those who sell them, but generally give unattractive returns to the investors, whose only real reward is presumably a decrease in tax payable directly (even if it is increased indirectly) and an increase in social security benefits received.
- Higher taxation, which the Government has sought to call lower taxation, and a social security system which absorbs an increasing proportion of total tax revenue.

The common answers to the problem are:
1. To provide incentive for private provision through superannuation.
2. To make pensions compulsory and eliminate (largely, if not completely) lump sums, other than a return of individual contributions and interest.

The idea is to use tax concessions to force people to accept a pension rather than a lump sum, and at the same time (hopefully) eliminate qualification for the age pension. (But it is not suggested that all also receive the balance of the package given to public servants and parliamentarians of, say, an indexed pension of 50 per cent of final salary paid in full by the Government.)

Is it satisfactory or desirable to eliminate lump sums and substitute pensions? It could be claimed that most people now wish to receive a lump sum and also an age pension (and, indeed, many are managing to do just that).

They want the lump sum so they can buy certain things (home, car, travel, etc), help certain people (particularly their children, with gifts or loans), and then have a sizeable amount left to bequeath to their children when they die. If possible, the retirees would also like to receive an attractive income from the investment of the residue of their lump sum to improve their quality of life in retirement.

Retirees want the age pension mainly because they believe they are entitled to it, because they have "paid income tax all their life" and also because receipt of the age pension will increase their total income in retirement.

Can aged people effectively have their cake and eat it too? Can they have a lump and an age pension? Or is this impossible in economic terms?

First, let us dismiss some commonly held erroneous views on the aged population in Australia now and over the next 30 years:
- The proportion of aged (65 years and over) to potential workers (15-64 years) — the so-called aged dependency ratio — is Australia is not high by Western standards; nor will it become high, relative to other Western countries, in the next 30 or even 50 years.
- Although it may become more difficult over the next 30 years for the working population to provide for the aged, as the aged dependency ratio increases, this is only half the picture. The working population is responsible for providing for the aged and also for the young (i.e., those under 15 years). This total group of dependents (measured by its percentage of the total population) has changed little during this century, and will not increase over the next 30 years, according to current demographic projections.

Aged retirees will not be happy with receiving superannuation in the form of a pension, even if they do in addition receive the age pension. What they want is a lump sum and an age pension, and they believe they are entitled to it.

How it could be done.

The age pension could be granted to all aged 65 and over, and all tax concessions on superannuation could be eliminated — and the net cost of the change would be nil at present.

Such a change would:
- Simplify age pension payment and administration.
- If all over the age of 65 received the age pension, irrespective of other income or assets (and if it was taxable income), then much Government expenditure in assessing and reviewing entitlement to age pensions could be saved. Age pensions might even, by choice of the individual, be paid in the form of a rebate of income tax, thus saving the cost of actually making the payments of age pension in these cases — such people would not have to apply for the age pension but simply adjust for it in their income tax returns.
- Increase taxable income from other sources for the retired.
- If all over the age of 65 received the age pension, then any assets held by the pensioner would tend to be invested in a more efficient way than at present, so as to produce income or capital growth. Thus, income tax collections on the investment income of retired people should increase.
- Encourage those over 65 to continue to work.
- If all over the age of 65 received the age pension, then those capable of earning income would be more likely to earn an income either by employment or self-employment, and income tax collections should be greater as a result.
- Remove the need for any tax concessions on superannuation.
- If all over the age of 65 received the age pension, then there would no longer be any compelling argument for tax concessions for superannuation — i.e., there need be no deduction for superannuation contributions, no reduced tax on fund income, no tax at all on lump-sum benefits, and no tax concessions for approved deposit funds or annuities.

But I can hear the uproar! "Impossible," many will say, "and in any event how do you solve the problem of phasing-in benefits, and of handling fringe benefits etc?"

These and other matters would require detailed study, but solutions are likely to be fairly straightforward.

Phasing-in.

Complicated arrangements could be developed with the aim of achieving equity.
Another way would be simply to apply the new rules immediately to all. If employers chose to cease contributing, then all accrued benefits could be payable to members without delay. Otherwise, subject to 100 per cent vesting, the benefits could remain in the fund until retirement or resignation, but the fund would be subject to full tax on investment income and there would be no tax deductions for contributions. Existing pensioners would qualify for the age pension immediately. Government unfunded superannuation schemes would have the promised benefits reduced by, say, 40 per cent for all future service.

**Fringe benefits.**

These could be granted to all over 65 and be taxable. Alternatively, it could be argued that these should be made available only to those in real need. Fringe benefits are granted not only by the Federal Government, but also by public transport, electricity suppliers, local councils etc. Just what each body would decide to do in the future could vary. It is noted that some concessions are now available to all aged, and not just to age pensioners. If benefits were not to be freely available to all, then presumably a very strict assets and income test could be used. In addition, assistance to those in need could be made available through community service and charitable bodies rather than through the Department of Social Security.

**A number of advantages would flow from such changes:**

- A level playing field for investment.
- Elimination of much of the cost of assessing, reviewing and paying social security age pensions.
- Individuals would provide for themselves those retirement benefits desired in excess of the age pension.
- Increased total income in retirement and removal of the present disincentives to work, save or invest after the age of 65.
- Largely self-funding arrangements, with adjustments being made to tax rates to cater for differences between the increased income tax (from the removal of deduction for superannuation contributions, the removal of concessions on investment income of funds, and the increase in income tax paid by the over-65s who receive the age pension and increased other income) and the actual increase in social security benefits for the aged — less reduced costs for health, education and support for the young.
- Greater mobility of the workforce by removal of the ties to existing employer due to superannuation restrictions, including the lack of full vesting.

Since governments rarely seem to do the logical thing, or really plan long-term — and as whatever is done will, in practice, not be to the disadvantage of members of parliament or senior public servants — perhaps the actual changes (even though not as desirable as those outlined) could be:

- Payment of the age pension to all over 65.
- Change in tax rates for superannuation contributions and investment income of funds, but not complete elimination of concessions.
- No reduction in current pension benefits promised to members of parliament and public servants, except that the members' contributions would not be compulsory (but an indexed pension would be paid, as well as the age pension.

**NOTES**

1. Foster, Chris: “Towards a National Retirement Income Policy”, Social Security Review, Issues Paper No 6, 1988, p145. “Undoubtedly the most important retirement income issue is the interaction of the age pension and superannuation. This is because the major reasons for providing tax concessions for superannuation are that they will improve retirement incomes and also lead to a reduction in age pension outlays.”

2. Foster, Chris: op. cit p 67. In respect of early retirees and occupational superannuation, “nearly half of the lump sums are used in ways which do not provide retirement income”.

3. Foster, Chris: op. cit. p 103. “There is concern with whether high effective marginal tax rates” (which arise due to the overlap of private income increases and income tests reducing income) “stifle private savings for retirement and with the extent to which they affect investment and consumption choices.”

4. Dixon, Daryl: Taxation writer, Sydney Morning Herald, 11.5.1988. “There are many financial traps for the retired people hoping to make the most of pension entitlements.”

5. Dixon, Daryl: op. cit. 17.12.1988. “Any savings taken out before age 55 or above the indexed $60,000 will result in a low income taxpayer [ie one with a tax rate of 25.5 per cent] ultimately paying more tax from using a superannuation scheme than would have been payable from any other form of saving. Even a taxpayer with 30.25 per cent tax rate receives no tax benefit from superannuation savings above the indexed $60,000.”

now has one of the most complex systems of occupational superannuation in the world.”
[Not that their proposals will produce a simple system!]
7. Foster, Chris: op. cit. p.161. “The following measures are necessary to improve the interaction of age pension and superannuation and to ensure that government support of retirement incomes is made more cost-effective and equitable:
• measures to ensure greater preservation of superannuation entitlements to genuine retirement;
• an increased trend toward superannuation benefits being taken in pension or annuity form;
• further extension of the coverage of superannuation to ensure that government support provided through this element of retirement incomes policy is more widely spread.”
8. Horin, Adele: Sydney Morning Herald, 26.11.89. “The three main grievances of the average pensioner: the insecurity caused by the many changes to the pension system; the effects of inflation on a pensioner’s savings; and the effective high marginal rates of tax... 68 per cent due to the punitive interaction of the pension and tax systems.”
9. Chegwidden, F. E: Letter to the Editor, Sydney Morning Herald, 1.12.88. “Australia is now a society which penalises the elderly for their thrift... worst of all, it condones without censure the lifetime support of short-term ‘failed’ politicians, many of whom gorged from the public trough for many years before reaching retirement age via their unfunded parliamentary superannuation scheme.

“Parliamentary rhetoric about providing incentives for the self-provident is sheer hypocrisy. Borne out by the fact that a couple with $30,000 to invest on retirement at 12.5 per cent is marginally better off than a couple with $100,000 to invest. So much for either incentive or justice!

“Nothing less than a national superannuation scheme, written into the Constitution by referendum, can guarantee stability to our senior citizens, present or future.”
10. Mayer, Eric: “A Retirement Income Policy for Australia”, address to Association of Superannuation Funds of Australia Ltd., 3.10.88. “A sensible retirement income policy must... include incentives... The aged pension should become a diminishing provider relatively. It should be no more than a safety net for those who choose not to provide for their retirement or who are unable to do so.”
11. Foster, Chris: op. cit. p.177. “... the combination of means tested age pension and an expanded and reformed occupational superannuation system supported through tax advantages could provide a form of national superannuation for Australia.”
12. Foster, Chris: op. cit pp.154, 157. “The simplest means of achieving greater interaction of the two systems [the pension and the superannuation systems] would be to require that superannuation is paid in a pension form. This is the usual practice overseas and would guarantee that superannuation is used to provide retirement incomes.”

“The pension approach, if indexed to inflation, gives greater income security. It would remove the uncertainty created by having to invest lump sums, especially as the bulk of retirees are not used to investing. This would reduce the risk of needlessly dissipating lump sums.”
13. Horin, Adele: op. cit. “The grey power lobby believes it is entitled to it all: the massive tax concessions on superannuation, the non-means tested pension, and the right to pass their wealth to their children unencumbered by death duties.”
14. Foster, Chris: op. cit. p.14. This shows that approximately 75 per cent of the aged population are in receipt of age and service pensions.
15. Foster, Chris: op. cit. p.54, Table 19. The projected aged dependency ratios in 14 selected OECD countries show that for 1980 Australia at 14.8 per cent is larger only than Canada (14.1) and Japan (13.5), while higher ratios include New Zealand (15.4), US (17.1), UK (23.2) and Sweden (25.5).

For the year 2020, Australia at 23.6 is ahead of only New Zealand (23.0). The highest country is Japan at 33.6 and others include US (25.0) and UK (25.5).

For the year 2040, Australia at 32.1 is the lowest of all 14 countries — New Zealand is higher at 37.4 and others include US (32.3), UK (33.1) and Japan (37.8). The highest is Germany at 48.2.
16. Casles, Ian (Australian Statistician); Australian Demographic Trends 1986, published by Australian Bureau of Statistics. This shows that those aged up to 14 plus those aged 65 and over represent the following percentages of the population: 1901 39.1%; 1911 36.0%; 1921 36.0%; 1933 34.0%; 1947 33.1%; 1954 36.8; 1961 38.7%; 1971 37.0%; 1981 34.7%; 1986 33.7%. Projections for the future are: 1991 33.5%; 2001 33.3% to 33.8%; 2011 32.7% to 33.6%; 2021 34.6% to 35.1%.

The figures shown for 1991 and later are the lowest and highest percentages for the four projections published.
17. Foster, Chris: op. cit. p.136. “While we are now beginning to get a better picture of the value and distribution of current lump-sum payments, their contribution to future retirement incomes or living standards is still uncertain.”
18. Derived from Foster, Chris: op. cit. pp15, 146. For 1987/88, outlays on age and service pensions were $9 billion. As 75 per cent of the aged population receive a full pension, the additional cost of paying it to all over 65 would not exceed $3 billion, and probably cost only $2 billion after allowance for savings in administration and for the increased tax paid by pensioners.

The Treasury method of calculating the cost of the tax concessions for superannuation, in terms of revenue forgone, produced a value of $3.1 billion for 1985-6. The Knox approach produced estimates ranging from $1.6 billion to $4.0 billion for the same year. However, Knox suggests that the “true” value would be in the vicinity of $2 billion. Continued Page 35
Alternative Option Adjustments

Stock data:
Stock at $10; Rights (1-for-4) at $8
Theoretical ex-rights price $10 x 4 + 8 x 1 = $9.60
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Rights discount $0.40; Ratio new/old stock price 96%

Option data:
Exercise (strike) price $15; 1 lot = 1,000 options

Current option adjustment for rights issue:
Ex-rights strike price: $15 - 0.40 = $14.60; Ex-rights no. of options: 1,000 x 1 = 1,000

Proposed adjustment:
Ex-rights strike price: $15 x 0.96 = $14.40; Ex-rights no. of options: 1,000 x 0.96 = 1,042

"It is not clear what adjustment might be made in terms of options to protect the holder against loss due to a large dividend on the stock and to ensure that the option value will be the same as if the stock paid no dividend. Currently the exercise price of a call option is generally reduced by the amount of any dividend paid on the stock. A liquidating dividend of all stock-holders.

A liquidating dividend of all stock-holders.

of a call option is generally reduced by value comes capitalised and paid in cash to the

a bonus issue with, say, half of the stock option-holders, a dividend is effectively listing requirements should include such the stock and the value of the option to holder against loss due to a large dividend

would be able to make substantial plays

against a hostile corporate who, at

present, can dividend-strip the company, and protection of the public.

The method I have proposed solves this anomaly. A dividend of, say, one-half of corporate equity will require halving the exercise price and doubling the number of options.

I recommend that stock exchange listing requirements should include such a provision to encourage fair investment and protection of the public.

This would open the way to a mature options market uninhibited by adverse corporate dividend policy. Entrepreneurs would be able to make substantial plays against a hostile corporate who, at present, can dividend-strip the company, leading to disaster for a raider using options weapons.

As a corollary, the concept overcomes a long-standing technical objection to the Black and Scholes option formula (i.e., that it ignores dividend payments) and clears the way to a stable and efficient long-dated options market.

Options can be seen as a cheap source of corporate finance. A company issuing options owes the investor nothing should the exercise price not be reached before the expiry of the options’ life. On the other hand, should the company prove to be a dud, investors would have minimised their losses, compared with full equity investments. But should the

company prove to be a bonanza, both company and investors win. Cast in this light, ordinary shares are beginning to look a little dull.

This approach came to me as a result of analysing venture-capital companies. Surely the stock of such companies is essentially “option stock”; that is, options parading as stock (out of 10 companies, say, an average of eight duds and two bonanzas). Limited upside, unlimited downside, with price heavily discounted for risk.

Option valuation formulas can be applied to a number of issues of major concern to security analysts. Consider bad debt provisions, banking credit analysis and insurance (with salvage). Each of these involves an analysis of the size of a potential loss and the change of that loss occurring. Generally, these two factors move inversely with each other: the greater the loss if a tanker were to go down in the Persian Gulf, the smaller the probability of the event.

This is what option formulas do for us: they convert all such combinations into an average, contingent on some “minimum” circumstances occurring, e.g., the exercise of an option because of a rise above the exercise price. The practical application of this to analysis of company accounts seems unlimited. The technique should be part of the analyst’s standard tool kit.

Finally, I point out that the standard option valuation formula of Black and Scholes is incorrect for two reasons:

The formula includes the market rate of interest. Stocks depend not on interest rates but on the stock earning rate, which the formula ignores. Black and Scholes erred in confusing riskless arbitrage with mere hedging. Absence of arbitrage implies the use of a (riskless) rate of interest, since a riskless hedged position long in stock and short in options is market-neutral. “Hedging merely reduces, but never eliminates, risk,” wrote P. Cootner in The Random Character of Stock Market Prices (Cambridge: M.I.T. Press) in 1964.

The formula gives only a mean value. Since a volatility factor for the variance of stock earnings is included, it must logically follow that variance option prices also exist. For how can a mean value tell all in an uncertain world? Option variance enables rational pricing of the option profit loading demanded by option issuers.

The correct formulas are soon to be published in an article by this author (“Option Theory”) in Econometrika.

PENSIONS AND SUPERANNUATION

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... the Canadian National Council of Welfare” concluded "that tax incentives for superannuation turn logic and equity upside down, favouring those who need help least and driving an additional wedge between the incomes of the have and have-not elderly.”
20. Foster, Chris: op. cit. p113. "A major concern of superannuation pensioners... is that they are disadvantaged because they cannot avoid the fringe benefits income test... Solutions include... providing fringe benefits to all pensioners.”
21. Douglas, Roger: op. cit. “The need to provide some special encouragement for long-term finance was carefully considered by the 1981 (Campbell) Committee of Inquiry into the Australian

Financial System. It recommended the removal of taxation exemption for superannuation net investment income. It concluded that should the Government choose to pursue a policy of greater neutrality between various forms of saving, this would not necessarily mean a reduced overall supply of long-term capital.

22. "Government Economic Statement" (New Zealand), December 1987, Annex 3. "It is sometimes argued that superannuation tax privileges are required to encourage savings, especially for retirement. These arguments have been closely considered. However they do not stand up. There is no rationale for encouraging savings through one particular institutional form. Moreover, much of the savings through superannuation schemes are withdrawn and spent long before retirement. The effect of the existing concessions is more likely to influence the form than the overall level of savings.”