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Age of entitlement:
age-based tax breaks

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Overview

With deficits running at about $40 billion a year, Australia has a budget problem. The Government's recent omnibus bill improved the budget bottom line by $2 billion a year, but there is a long way to go. Winding back age-based tax breaks could help by saving about $1 billion a year.

The budget is unlikely to drift back to surplus. Predictions that it would do so have not panned out for the last eight years, and many think projections remain unduly optimistic. The Commonwealth needs to make tough decisions to save more than it spends.

Revenue is part of the budget problem. Fewer people paying income tax – the rise of the "taxed nots" – is in part due to increasing age-based tax breaks, made worse by population ageing. Despite rising incomes and workforce participation rates, the proportion of over 65s ("seniors") paying tax has halved in the last 20 years.

Generous policy changes during the last 20 years introduced two age-based tax breaks: the Seniors and Pensioners Tax Offset (SAPTO); and a higher Medicare levy income threshold for senior Australians. They are part of a series of policy choices, made as the electorate was ageing, that have disproportionately benefited older Australians. As a result seniors pay less tax than younger workers on the same income.

The age-based tax breaks for seniors should be wound back. They might have been affordable when they were introduced but no longer. They damage the budget, they exacerbate unsustainable transfers between generations, and they are unfair. They are badly designed for any plausible policy purpose such as to increase participation or to ensure the adequacy of retirement income for poorer Australians. Nor are the tax breaks a fair reward for those who think they have already paid their fair share of taxes over a lifetime. Large tax breaks for seniors are a relatively new invention that were not provided to the previous generation of seniors. The current generation of seniors benefits far more from government spending, particularly on health.

A principled approach to reforming age-based tax breaks would minimise their administration and reduce their budgetary cost, while maintaining the adequacy of retirement incomes and incentives to work. The best balance between these criteria would wind back SAPTO so that it is available only to pensioners, and so that those whose income bars them from receiving a full Age Pension pay some income tax. Seniors should also start paying the Medicare levy at the point where they are liable to pay some income tax. They would then pay a similar amount of tax to younger workers with similar incomes. This package would improve budget balances by about $700 million a year.

Seniors also receive a larger rebate on their private health insurance than do younger workers with similar incomes. This larger rebate has no obvious policy rationale. It does not appear to increase private health insurance take-up. Seniors are already adequately protected from higher private insurance costs by "community rating" arrangements.

The private health insurance rebate for seniors should be reduced to the same level as for younger workers with similar incomes. This reform would improve budget balances by about $250 million a year, after accounting for the additional government health costs as a small number of seniors choose to discontinue private health insurance.

The changes would have little effect on the 40 per cent of seniors who receive a full Age Pension. Seniors affected will predominantly be wealthy enough to receive no pension at all, or only a part pension. They will not pay any more tax than younger households on similar incomes.

Recommendations

Recommendation 1: Wind back SAPTO so that it is available only to pensioners, and so that those who do not qualify for a full Age Pension pay some income tax.

- **Those who receive a full Age Pension should continue to pay no income tax.**
- SAPTO should be reduced so that seniors pay some income tax unless they qualify for a full Age Pension – that is their taxable income from the pension (including supplements) and other sources is less than $27,000 (for singles) or $42,000 (for couples combined). (At present seniors earning up to $32,279 (singles) or $57,948 (couples) pay no income tax.) SAPTO should be set at the tax otherwise payable on this taxable income.
- The offset should continue to be withdrawn from pensioners earning more than these thresholds at the current rate of 12.5 cents for every additional $1 earned. SAPTO would then provide some benefit for singles earning up to $36,360 and couples earning up to $56,240 combined (at present $50,119 for singles and $83,580 for couples combined).
- These changes would reduce the maximum value of SAPTO from $2,230 to $1,160 for singles and from $1,602 to $390 for each member of a couple.
- The changes should also apply to the small number of working-age people who qualify for SAPTO because they receive income support payments, such as single parents and some carers.
- Self-funded retirees would no longer be eligible, and would pay the same income tax as younger workers with similar incomes.

Recommendation 2: Impose the Medicare levy on seniors at the level where they are liable to pay some income tax under Recommendation 1.

- **Those who receive a full Age Pension should continue to pay no Medicare levy.**
- The Medicare levy threshold should be reduced so that only pensioners with income under $27,000 (for singles) or $42,000 (for couples) pay no Medicare levy. (At present seniors earning up to $33,738 (singles) or $46,966 (couples) pay no Medicare levy.)
- Pensioners earning more than these thresholds should pay Medicare levy at the current rate of 10 cents for every additional $1 earned until equal to 2 per cent of taxable income. This would provide some benefit to seniors for singles earning up to $33,750 (at present $42,172) and couples combined earning up to $52,250 (at present $58,707).
- These changes would reduce the maximum value of the higher Medicare levy threshold from $675 to $540 for singles and from $470 to $420 for each member of a couple.
- These changes should also apply to working-age people who qualify for SAPTO and receive income support payments.
- Self-funded retirees would pay the same Medicare levy as younger workers with similar incomes.

Recommendation 3: Provide a Private Health Insurance rebate at the same rate for Australians irrespective of age.

- **The higher Private Health Insurance rebate rates for seniors should be reduced** to the same levels as apply to younger workers with similar incomes.

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1 Introduction

Previous Grattan Institute work shows that the Commonwealth budget has a serious structural deficit.[1] Actual deficits have been 2 to 3 per cent of GDP for eight years. The Commonwealth Government is yet to respond to the scale of this challenge.

The budget problem will not simply be solved by the passage of time. Budget projections are too optimistic, yet have nonetheless been used to justify the softly-softly approach to budget repair over the last eight years. While both sides of politics have made significant savings, they have used pretty much all the proceeds to fund new priorities rather than to reduce the budget deficit. Net savings are few.[2]

1.1 Ending the age of entitlement is a reform priority

This report is the latest in a series of Grattan Institute reports showing that reforms to entitlements and taxation are long overdue.

Our 2013 report, *Balancing budgets: Tough choices we need*, demonstrated that budgetary reform should prioritise substantial changes with minimal adverse consequences to the economy, equity or other policy goals. Applying these criteria, many of the most promising avenues for reform affect senior Australians[3] more than others, such as increasing the age of access to the Age Pension and superannuation, tightening Age Pension means testing, increasing taxes on assets, and reducing superannuation tax breaks. Subsequent work confirms that the policy rationale to repair the budget by these means is stronger than many of the alternatives.

Our 2014 report, *The wealth of generations*, found that older Australians are putting increasing pressure on Australian budgets. They are paying less tax than in the past despite higher incomes, they are receiving higher benefits than previous cohorts, and they have more resources because of a one-off jump in asset values.

Later reports – *Super tax targeting* in 2015, and *A better super system* in 2016 – examined superannuation tax breaks, which primarily benefit those who are older and wealthier. And our 2016 report, *Hot property*, illustrated how reforms to capital gains tax and negative gearing would both reduce distortions in investment and improve budget balances. Again, current rules on asset taxation primarily benefit those who are older and wealthier.

Although the policies examined in these reports benefit senior Australians more, that was not – ostensibly at least – their purpose. Their advocates at the time claimed they had legitimate public policy purposes, such as smoothing lifetime incomes, or taxing real rather than nominal returns to savings. We believe that these policies should not be maintained when budgets are under so much pressure, and now that we know that some of these policies do not do what they say on the tin. This report looks at a set of tax concessions that far from having a public policy rationale, are designed explicitly and simply to benefit those who are older. These are SAPTO, the higher Medicare levy threshold, and higher rebates for private health insurance.

1. See: Daley et al. (2013), Daley et al. (2014) and Daley et al. (2015a).
2. Daley et al. (2016a).
3. In this report we define "senior Australians" as those who are old enough to qualify for an Age Pension, currently age 65.

1.2 Electoral considerations seem to drive the growth of age-based tax breaks

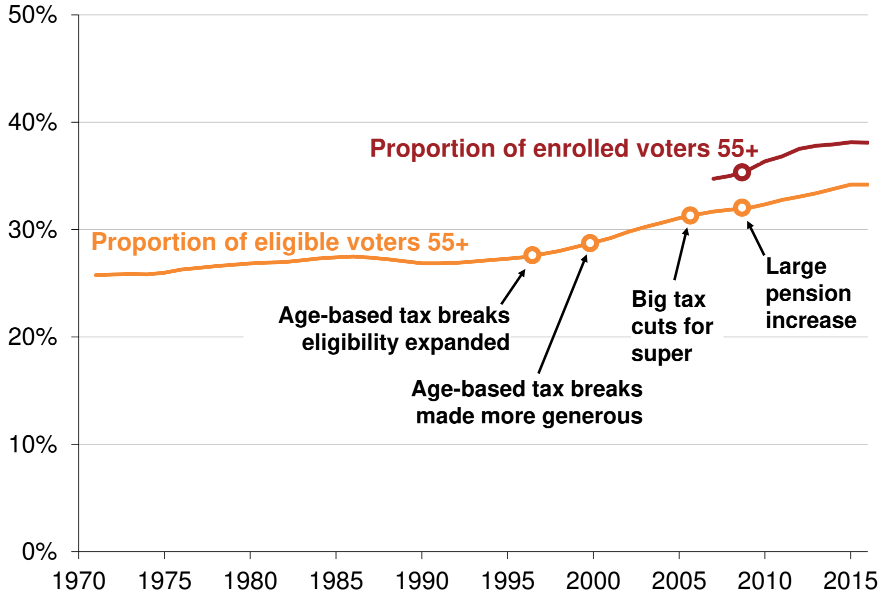
It is no coincidence that so many of the more attractive opportunities for budget repair would wind back tax breaks and welfare payments for older households.

Many of these policy choices were made in happier economic times when Australia's economy boomed and government budgets were boosted – temporarily – by improved prices for Australia's exports.[4] While governments did introduce substantial benefits for middle-class families such as Family Tax Benefit, these have been tightened so that they now provide little to families in the top half.[5] Benefits for middle-class older households, however, have remained relatively untouched. Middle-class welfare in Australia remains, but almost all the recipients are now over the age of 65.

The failure to rein back age-based welfare and tax breaks, despite increasing budget pressure, seems to reflect demographic trends. Policy choices benefiting seniors coincided with the rise in the proportion of voters aged 55 and over, who are retired or planning for it. These included more generous age-base tax breaks from 2000, big tax cuts for superannuation in 2006 and large increases to the pension in 2009, as well as large increases in health spending per older person.[6] From 1995 to 2015, the proportion of *eligible* voters aged 55 and over grew from 27 to 34 per cent. Because younger Australians enrol less, those aged 55 and over are now 38 per cent of *enrolled* voters (Figure 1.1).

Figure 1.1: People over 55 are a large and growing voter bloc

Per cent of electorate



Source: Grattan analysis of ABS (2016a) and AEC (2016).

4. Minifie et al. (2013).
5. Daley et al. (2013, p. 73).
6. Daley et al. (2014, pp. 21–30).

1.3 Older households are putting the most pressure on Australian budgets

Older households have always received more benefits (welfare and in-kind services such as health) from government than they pay in taxes. Government has long acted as a “piggy bank” transferring resources from younger working households to older retired households.

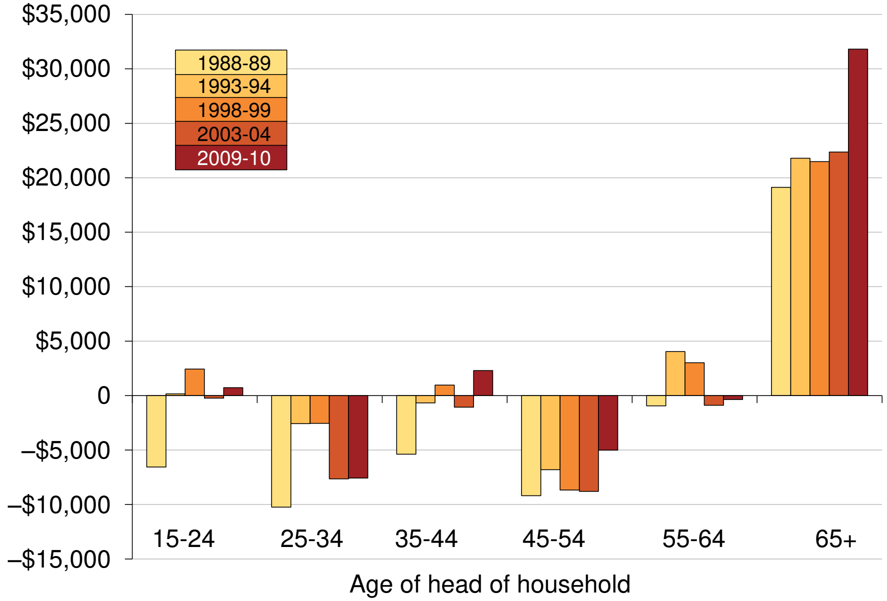
But over the last decade the net transfer to each 65-and-over household increased by almost $10,000 per household, while the changes for other age groups were not material (Figure 1.2).

Between 2004 and 2010 net transfers to older households increased by about $22 billion a year,[7] or about half the Commonwealth government’s budget deficits of recent years. This increase might have seemed affordable while the mining boom boosted government revenues. But persistent budget deficits and much slower economic growth in recent years suggest it is unsustainable. More is being taken from the piggy bank than anyone is contributing. The scale of the transfer between generations must be wound back.

Younger households have not benefited as much from government budgets, yet they will pay substantially higher future taxes to repay accumulated deficits. Each year of deficit between 2010 and 2016 has increased the tax burden on younger households by about $10,000 over their lifetime.[8]

Figure 1.2: Seniors benefited most from increased government transfers

Average net benefits per household, 2010$



Notes: Net benefits are cash welfare benefits, plus the value of government services provided in-kind such as health and education, minus income and sales taxes paid. Households are grouped by age of reference person. Throughout this paper, the ABS CPI Index is used to convert nominal dollars into real amounts.

Source: Daley et al. (2014, Figure 3.1).

7. Ibid. (p. 22).
8. Ibid. (p. 9).

1.4 Older Australians are paying less tax despite higher incomes

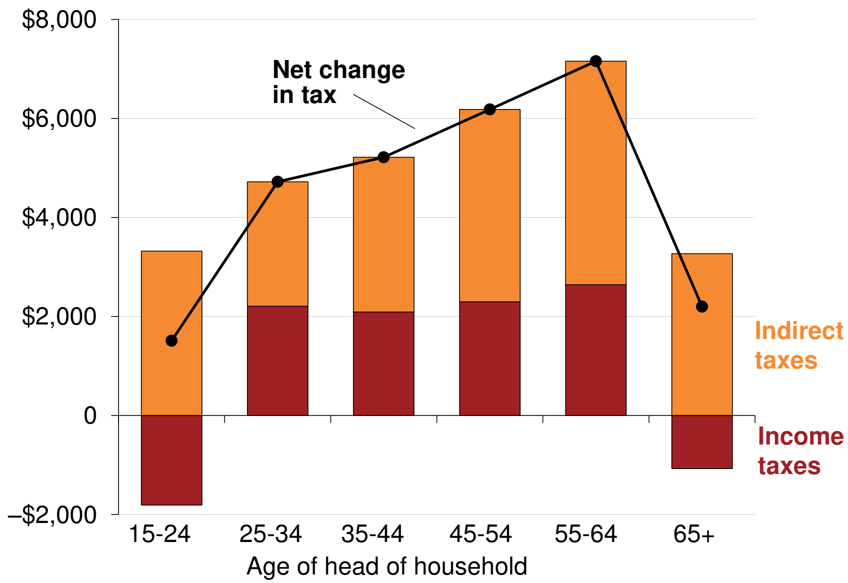
Age-based tax breaks overwhelmingly favour senior households and are a major cause of the increased net transfers to them. Senior households pay less income tax in real terms today than did households of the same age 20 years ago, even though both their workforce participation rates and their incomes have jumped.[9] Decisions by the former Coalition Government to abolish taxes on superannuation withdrawals for those aged over 60 years in 2007,[10] together with generous tax offsets only available to older Australians – such as SAPTO – have reduced the income tax bills of older Australians (Figure 1.3).

Currently proposed changes to superannuation are a step in the right direction, but super will continue to provide larger tax breaks for high-income seniors than other households.[11]

Aside from households aged under 25 (who now earn less because they are more likely to participate in higher education[12]), senior Australians are the only age group to pay less personal income tax today than they did 20 years ago.[13]

Senior Australians also benefit more from tax expenditures than younger Australians. For example, previous Grattan work has found that senior Australians are much more likely to sell assets and thereby benefit from significant capital gains tax exemptions.[14] Super tax breaks also overwhelming favour older Australians.[15]

Figure 1.3: Older households are paying less income tax
Change in taxes per household, 1988-89 to 2009-10, $2010



Source: Daley et al. (2014, Figure 3.6).

9. Ibid. (p. 27).
10. Daley et al. (2016b, p. 8).
11. Ibid.
12. Norton et al. (2016, p. 22).
13. Daley et al. (2014, p. 27).
14. Daley et al. (2016c).
15. Daley et al. (2015b).

1.5 Fewer older Australians are paying tax

The introduction of tax offsets for seniors and the decision to make super withdrawals tax-free for over 60s has also increased the number of income “taxed nots” aged over 65 (Figure 1.4).[16]

In 1995, before special tax offsets were introduced for senior Australians, about 27 per cent of seniors paid income tax. After the introduction of the Low Income Aged Persons Rebate in 1996 and then the Senior Australians Tax Offset (a precursor to SAPTO) in 2000, only 15 per cent of seniors paid income tax.

In 2007, the abolition of taxes on superannuation withdrawals further reduced the proportion of seniors paying income tax.

The effects of these changes were compounded by large general income tax cuts in the mid-2000s and by the global financial crisis. As a result just 13 per cent of seniors paid personal income tax in 2009-10. The proportion of seniors paying income tax rose to 16 per cent in 2013-14 as financial markets recovered, and bracket creep increased the number of people of all ages paying tax.

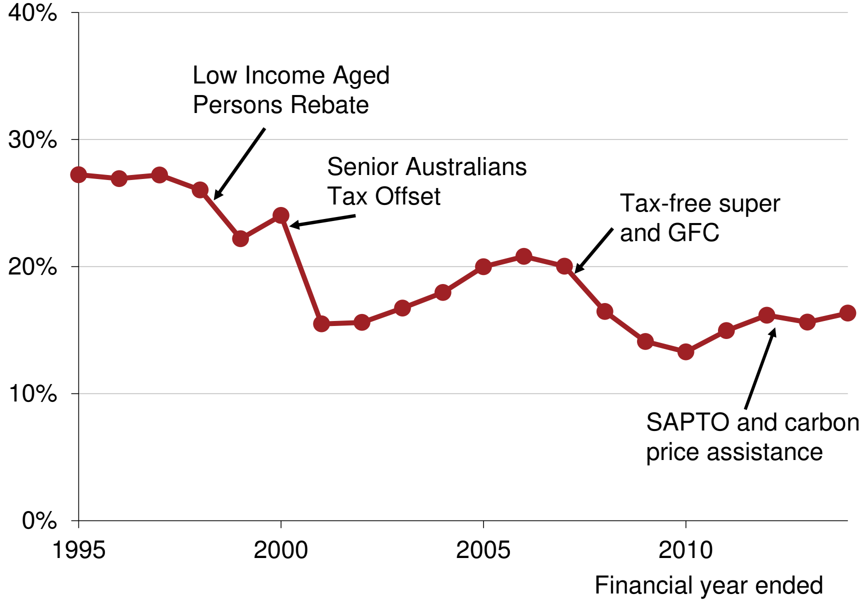
1.6 Older Australian households have more resources

The increase of budgetary transfers – more benefits and lower taxes – to senior households might have been justified if those households had been facing increased financial pressures. But in fact, these transfers came just as older households were capturing an increased share of the nation’s resources.

Over the ten years to 2013-14, average household wealth grew by 32 per cent.[17] Older households captured most of this growth while younger households’ wealth stagnated. Despite the global financial

Figure 1.4: Age-based tax offsets and generous super tax breaks for seniors have increased the number of “taxed nots”

Proportion of seniors paying personal income tax, per cent



Source: Grattan analysis of ATO (2000–2016).

16. Morrison (2016).
17. ABS (2015, Table 2.1).

crisis, households aged between 65 and 74 years today are $400,000 (or 47 per cent) wealthier in real terms than households of that age ten years ago (Figure 1.5). Of the cohort of households aged between 55 and 64 in 2004, the average household increased its wealth by about $300,000 over the subsequent decade.[18] Older households already had substantial assets that increased in value when interest rates fell.[19] By contrast, households aged 25 to 34 years are no more wealthy than the equivalent households a decade before.[20]

1.7 This report examines reforms to three age-based tax breaks that would support budget repair and the intergenerational bargain

This report focuses on reforms to three age-based tax breaks:

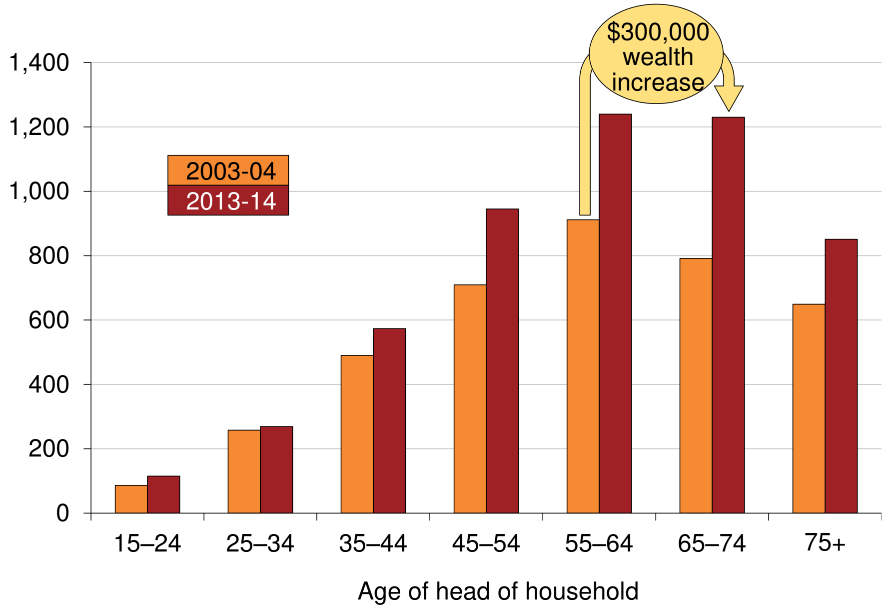
1. **the Seniors and Pensioners Tax Offset (SAPTO)**;
2. **the higher Medicare levy thresholds** for older Australians; and
3. the more generous **Private Health Insurance rebate** available to seniors.

These tax breaks should be wound back. The budget cannot afford them, they exacerbate unsustainable transfers between younger and older taxpayers, and they are poorly designed for either supporting the most vulnerable or for increasing older age workforce participation.

Tax breaks from SAPTO and the higher Medicare levy income threshold are provided through the personal income tax system. They are investigated in Chapters 2 to 4. The higher private health insurance rebate can either reduce tax or the Commonwealth Government can pay to reduce a person's premium. This benefit is investigated in Chapter 5.

18. ABS (Various years).
19. Daley et al. (2016d, p. 8).
20. Daley et al. (2014, p. 13).

Figure 1.5: The wealth of older households has increased
Wealth per household, $2014 thousands



Source: ABS (Various years).

1.8 What this report does not do

This report does not consider the **concessional tax treatment of superannuation**, the subject of previous Grattan Institute reports.[21]

Nor does the report consider reforms to **other components of Australia's retirement income system**. Previous Grattan reports have identified other potential reforms to better target pensions and superannuation policy. These include targeting the Age Pension by assessing the owner-occupied home in the means test, and aligning the ages at which people can start to access their super and the Age Pension.[22] A more comprehensive review of the complex array of income support, concessions and tax benefits for seniors is a project for another day.

This report also does not canvass in detail **broader reforms to the Private Health Insurance rebate**. A comprehensive review of government support for private health insurance is warranted, but beyond the scope of this report.[23]

1.9 How the rest of this report is organised

The following chapters describe in more detail the age-based tax breaks in Australia's personal income tax system, and why and how they should be reformed.

Chapter 2 explains the mechanics of two **age-based tax breaks** in the personal income tax system: SAPTO and the higher Medicare levy income threshold for senior Australians.

Chapter 3 considers whether SAPTO and the higher Medicare levy income threshold for seniors serve any **justifiable policy purposes**.

Chapter 4 **considers potential options for reforming** SAPTO and the higher Medicare levy income threshold for seniors.

Chapter 5 examines the **higher Private Health Insurance rebates** available to seniors and proposes reforms.

21. Daley et al. (2015b); and Daley et al. (2016b).
22. Daley et al. (2013).
23. Ibid. (p. 71).

2 The mechanics of Australia's age-based tax breaks

2.1 Our personal income tax system includes two age-based tax breaks

The personal income tax system includes two age-based tax breaks: SAPTO; and the higher Medicare levy income thresholds for senior Australians. These tax breaks mean that senior Australians pay less tax than a working-age Australian on the same income.

Introduced in 1996, these tax breaks became significantly more generous in 2000, when budgets were projected to be in substantial surplus and debt levels were much lower. Since then the gap has widened between the tax paid by seniors and the tax paid by younger Australians with similar incomes.

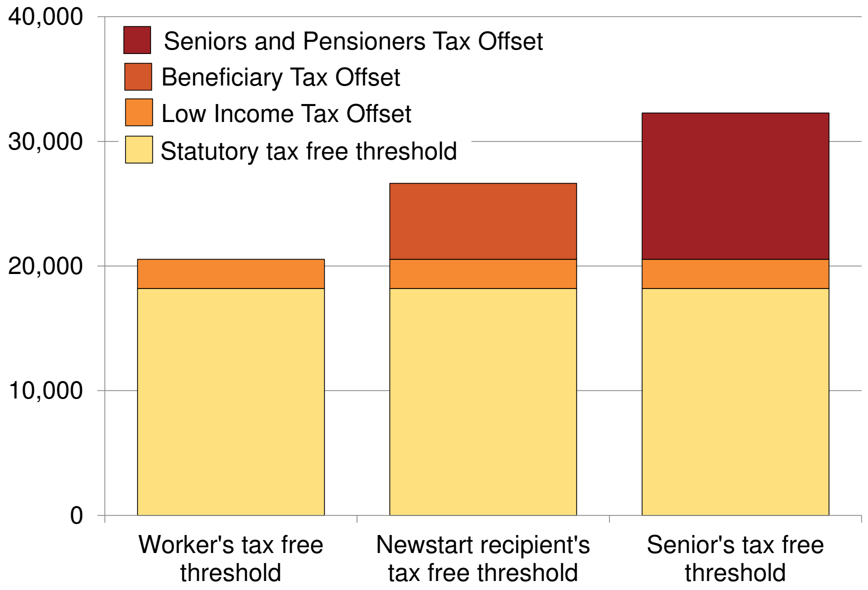
The Seniors and Pensioners Tax Offset (SAPTO)

SAPTO is a tax offset that reduces the personal income tax paid by senior Australians. Its maximum value in 2016-17 is $2230 for a single or $1602 for each member of a couple.[24] SAPTO is available to people who have reached the current Age Pension age of 65, whether or not they qualify for the Age Pension. It is also available to some people under Age Pension age who receive taxable pensions such as Parenting Payment (Single), and to war veterans over the age of 60.

Tax offsets such as SAPTO increase how much income a person can earn before they pay any tax. A senior can have income of $32,279 before paying any tax, almost 60 per cent higher than the income at which a working Australian starts to pay income tax ($20,542) (Figure 2.1).

Figure 2.1: Seniors can earn more before they begin to pay personal income tax

Effective tax-free thresholds, single person, $ per year



Notes: The Low Income Tax Offset applies to all Australian with incomes below $37,000, and reduces tax payable by up to $445. The Beneficiary Tax Offset applies to people receiving income support payments such as Newstart Allowance. The Beneficiary Tax Offset is based on the maximum Newstart rate for a single person over age 22.

Source: Grattan analysis.

24. Any unused portion of SAPTO can be transferred from one member of a couple to a spouse to reduce their personal income tax liability. ATO (2016a).

The value of SAPTO reduces as singles earn above $32,279 (or $57,948 for couples combined). There is no offset for singles with incomes above $50,119 ($83,580 for couples combined). Importantly for seniors, income from superannuation does not reduce an individual's entitlement to SAPTO.

Higher Medicare levy income thresholds for senior Australians

People with income under a specified threshold do not have to pay the 2 per cent Medicare levy on incomes.[25] The thresholds are set on the principle that people who do not pay income tax should not pay any Medicare levy.[26]

As senior Australians have a higher effective tax-free threshold, they can also earn more than working-age Australians before they must pay any Medicare levy. The levy is only payable if the taxable income of a senior is more than $33,738, compared to $21,335 for a working-age Australian (or $46,966 for a senior couple combined compared to $36,001 for a working-age couple combined). A senior only pays the full 2 per cent Medicare levy if his or her taxable income is more than $42,172. A working Australian, by contrast, pays in full after earning $26,668 (or $58,707 for a senior couple combined compared to $45,001 for a working-age couple combined).[27]

25. ATO (2016b).
26. Costello (2001).
27. ATO (2016b). The age for eligibility for the higher Medicare levy is tied to the eligibility age for SAPTO, which is the eligibility age for the Age Pension. These eligibility ages are expected to rise from 65 years to 67 years, starting with a six-month increase from 1 July 2017, and reaching 67 years by 1 July 2023.

2.2 The history of age-based tax breaks and their increasing generosity

The tax breaks for seniors have evolved beyond their original policy purposes. Over time they have become increasingly generous, with eligibility extended to higher income seniors.

Policy decisions increased the scope and value of tax offsets for senior Australians

Policy changes over the last two decades have created tax offsets that are substantially higher than what is required to ensure that a full Age Pensioner does not pay tax. Eligibility for the offsets has expanded from pension recipients to self-funded retirees on higher incomes (Figure 2.2 on the next page). As a result, these offsets no longer have an agreed policy purpose.

Tax offsets for seniors have existed in various forms for almost as long as the Commonwealth has collected income tax. Allowances for seniors to earn a little more than those of working age before paying tax have existed since at least the 1950s.[28] The Age Allowance allowed full-rate pensioners to earn some extra income outside their pension and still pay no income tax. The Pensioners Tax Offset, introduced in 1983, likewise ensured that recipients of the full Age Pension who did not earn much other income did not pay tax. (See Figure 2.2.) In the early 1990s, the Government expanded the Pensioner Tax Offset to ensure that all full Age Pensioners did not pay tax no matter their income.[29]

28. The 1951-52 tax scales exempted those of pensionable age from paying tax if their income was less than £234 – an offset equivalent to $230 today. (ATO (2016c) and ABS (2016b).)
29. Grattan analysis of ATO (2016c)

In 1996, the Howard Government introduced the Low Income Aged Persons Rebate, extending the favourable tax treatment of the Pensioner Tax Offset to low-income but asset-rich senior Australians who were ineligible to receive the Age Pension.[30]

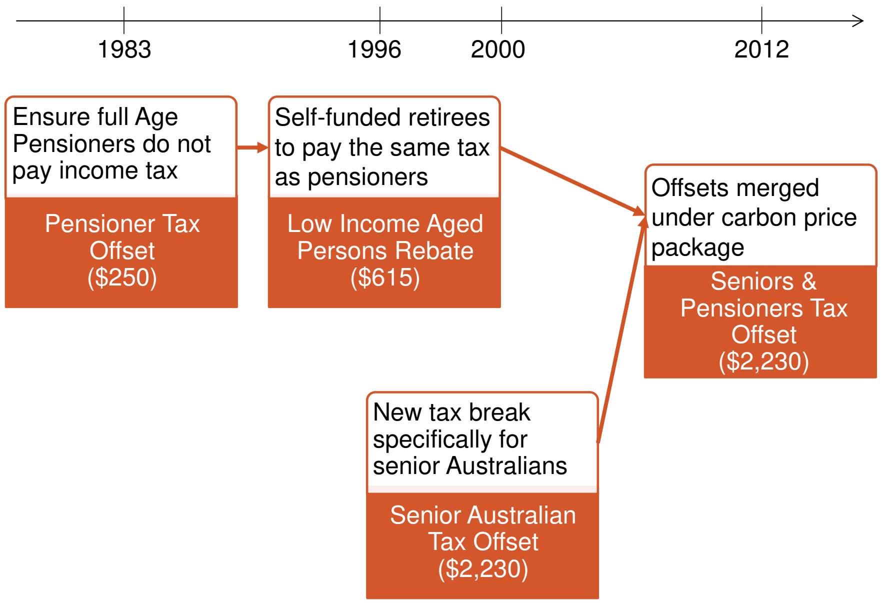
In the May 2000 Budget, the Howard Government introduced the Senior Australians Tax Offset (SATO). This change increased the tax-free threshold for all seniors above the threshold for working-age Australians. But the budget speech did not articulate any policy rationale.[31] It was not explained why senior Australians deserved a tax break and younger Australians did not.

In 2012, the Pensioner Tax Offset and SATO were combined into a single seniors' offset: SAPTO. The goal was to reduce the number of tax offsets as part of a larger tax reform package. The change did not alter the offsets' value, or extend their eligibility.

Because none of these changes aimed to compensate for the introduction of the GST or the carbon price, there is no argument that winding them back would impair any historic deal. Instead, GST compensation was provided in 2001 through a package of tax cuts across the population, and welfare payment increases. Similarly, in 2012 assistance for the now abolished carbon price was provided through general tax cuts and welfare increases.[32] Of course, to the extent that these compensation packages changed the point at which a pensioner was not liable to pay any tax, they changed the impact of the various rebates and offsets accordingly.

Figure 2.2: Tax offsets for seniors have built up through a series of policy decisions

Rationale and value of tax offsets for seniors, nominal dollars



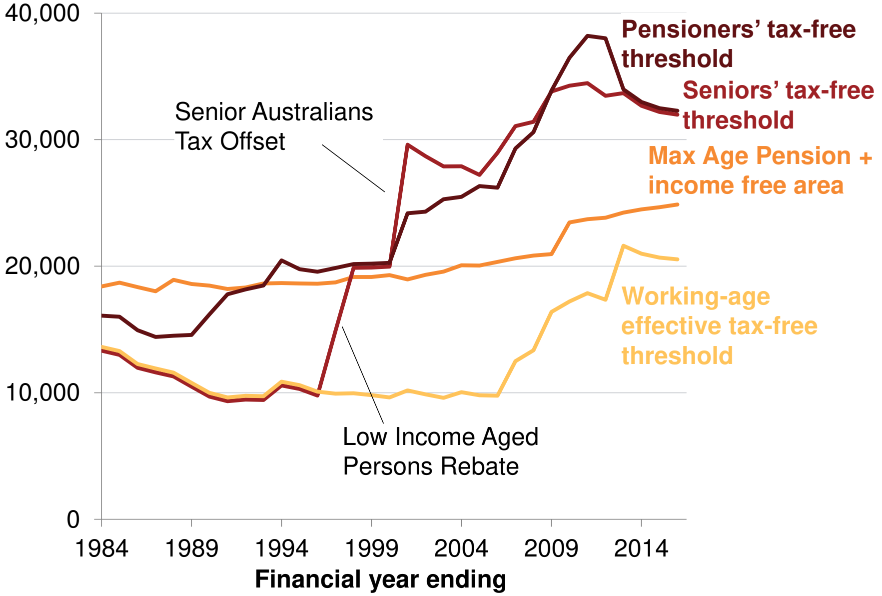
Notes: The dollar value refers to the maximum level of the offset when introduced.

Source: Grattan analysis.

30. Costello (1996).
31. Costello (2001).
32. Treasury (2011).

Figure 2.3: The tax-free threshold increased much faster for pensioners than the working-aged

Effective tax-free thresholds, $2016



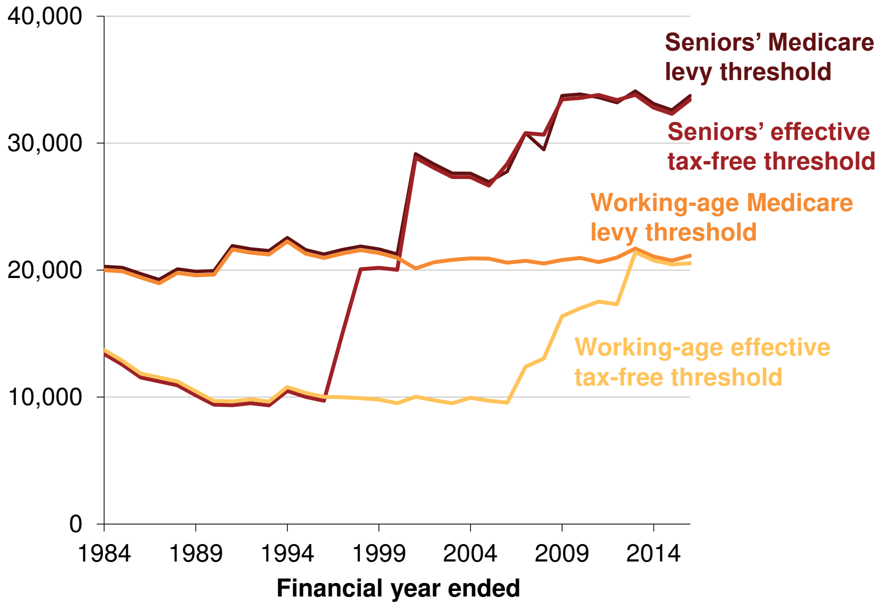
Source: Grattan analysis of ATO (2016c) and ABS (2016b).

Thanks to these policy changes, during the 2000s the value of tax offsets for senior Australians grew well beyond the level at which a full Age Pensioner paid no tax (Figure 2.3).

The value of the offsets also increased because, between 2005 and 2012, personal income tax cuts collectively doubled the effective tax-free threshold for workers in real terms. These tax cuts raised the tax-free threshold for younger Australians. Given how SAPTO is calculated, the cuts created an even higher effective tax-free threshold for senior Australians. These changes have more than tripled the real value of the effective tax-free threshold for senior Australians since 1990.

Figure 2.4: Seniors can earn more before paying the Medicare levy

Tax thresholds, $2016



Source: Grattan analysis of ATO (2016c) and ABS (2016b).

The gap between the Medicare levy income thresholds for seniors and for working-age Australians has also increased

Historically, the Medicare levy income threshold for all Australians was the same, and was maintained in real terms. But in 2000 a higher Medicare levy threshold for seniors was introduced alongside SATO.[33] This higher threshold for seniors has since tracked their effective tax-free threshold, so that seniors who do not pay tax are also not liable for the Medicare levy (Figure 2.4). The Medicare levy income thresholds for seniors and younger Australians have diverged.

33. Costello (2001).

3 Why age-based tax breaks should be wound back

Age-based tax breaks hurt the Commonwealth budget. They make already unsustainable transfers between generations worse, and they are unfair to younger households. They are not a fair reward for a life-time of paying tax because these benefits were not available to previous seniors, and seniors today receive much more from government services than in the past. In their current form they serve no plausible policy purpose: they are poorly targeted, and do little to increase either retirement incomes, seniors' workforce participation, or savings.

3.1 Age-based tax breaks cost the budget about $800 million a year

The budgetary cost of these tax breaks is significant. Together, SAPTO and the higher Medicare levy threshold reduce budget balances by $800 million a year. If the cost of the higher Private Health Insurance rebate (Chapter 5) is included, the budget cost of age-based tax breaks rises to over $1 billion a year.

Treasury estimates that SAPTO costs the budget about $720 million a year.[34] On our calculations, SAPTO allows senior Australians to pay about $650 million less tax. Presumably about $70 million less tax is paid by other (non age) pension recipients, such as carers who also receive a tax offset through SAPTO. This $650 million is about 5 per cent of the $12 billion in personal income tax paid by all people aged over 65.[35]

We estimate that the higher Medicare levy income thresholds for senior Australians costs the budget $150 million a year.

34. Treasury (2016a).
35. ATO (2016d).

These tax breaks for seniors will deprive the Commonwealth budget of more revenue over time. As more Australians reach Age Pension age, work more and have more wealth, SAPTO will reduce more income tax.

Perhaps the budget could afford these tax breaks when they were introduced, but not now. The mining boom, which gave Australia a once-in-a-lifetime lift in government revenue,[36] delivered budget surpluses despite a series of welfare and tax choices that created an underlying structural budget deficit. These tax breaks now contribute to budget deficits that have lasted for eight years (Section 1.1). Reducing age-based tax breaks would help to repair the budget, with fewer undesirable collateral impacts than many other options.[37]

3.2 Age-based tax breaks are unfair

Winding back age-based tax breaks would make the tax system fairer, because it would align the tax treatment of groups with similar incomes. The changes will affect all Australians as they age, not just the current older generation.

Age-based tax breaks mean that senior Australians pay less tax than workers on the same income (Figure 3.1 on the following page). SAPTO allows a senior Australian to pay up to $2230 less tax than a worker with the same income.

Some might argue that age-based tax breaks are a fair reward for seniors for a lifetime of paying tax. But this is a short-sighted view. The age-based tax breaks are a relatively recent invention – they were not

36. Minifie et al. (2013).
37. Daley et al. (2013, p. 20) provides a framework for prioritising budget repair initiatives.

provided to previous cohorts of seniors (who also paid their taxes while working, and many more of them did so when retired). And when today's seniors were working, their taxes provided much less in government services to each senior household. Today's seniors are benefiting from government spending on health that has almost doubled in real terms over twenty years to $11,000 per person in their 70s.[38] It is reasonable to ask seniors to contribute to these costs on the same basis as younger households with comparable incomes.

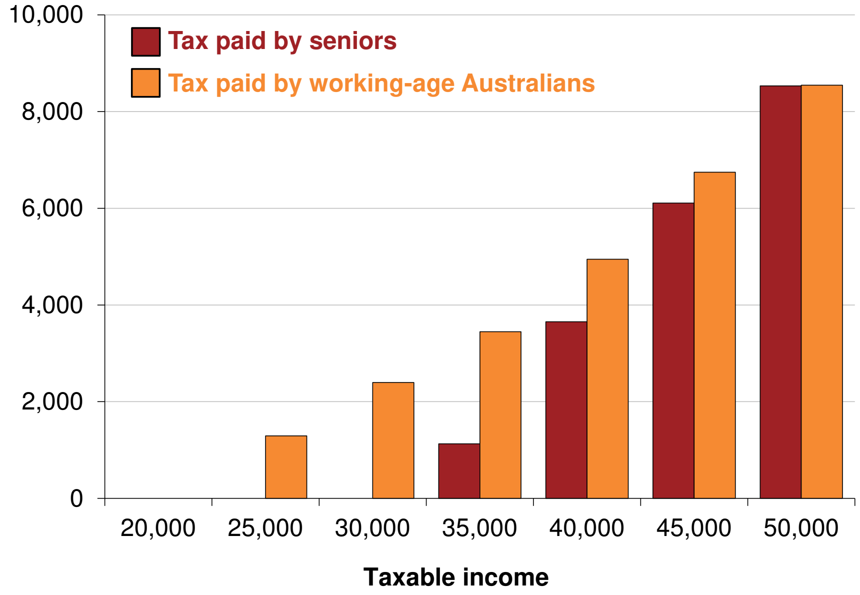
Winding back these measures would also reduce transfers between younger taxpayers and older households (Section 1.3), which are exacerbating the generational divide caused by a one-off shift in the value of homes and other assets (Section 1.6).

Of course, retirees generally have lower incomes than when they were working. Accordingly, they pay less tax under Australia's progressive income tax system. But there is no obvious justification for them to pay even less tax than younger households with the same income – whose retirement incomes are likely to be even lower.

To put this in context, a low-income student with rental expenses pays $1,690 in income tax when a single pensioner with a similar income and who owns her own home pays no income tax (Box 1 on the next page). This situation would continue even under the reforms proposed later in this report.

A couple both working full time on the minimum wage currently pay $2,845 more tax than self-funded retirees who have the same retirement income, but also own their own home and have $1.9 million in other assets that can be drawn down over retirement (Box 2 on the following page). Obviously, a couple who only earn the minimum wage are unlikely to accumulate such assets.

Figure 3.1: Seniors pay less tax than a worker on the same income
Tax liability by taxable income in 2015-16



Notes: Includes personal income tax under rates and threshold, the Low Income Tax Offset and the Medicare levy.

Source: Grattan analysis.

38. Daley et al. (2014, p. 25).

Box 1: Maximum rate pensioners do not pay tax, but a worker on the same income does

Ruth is single pensioner aged 70. She relies on a full Age Pension but also receives a small income from term deposits which gives her a taxable income of $26,645. Currently, *Ruth* **does not pay any tax or Medicare levy** as her income is under the tax-free threshold for a senior. Under recommended changes to SAPTO (see Chapter 4), her income would still be under the proposed tax-free threshold for a senior of $27,000 so she would **continue to pay no tax or Medicare levy**.

Isabella is a 25-year-old, studying a masters degree part-time, and working three days a week at a café. Her wage is $26,645 a year and she does not receive any government assistance. Even though *Isabella* has the same taxable income as *Ruth*, *Isabella's* income is above the tax-free threshold for a working-age Australian. ***Isabella's* income tax bill is $1,690**, including ordinary tax of $1,159 and Medicare levy of $531.

3.3 Age-based tax breaks are poorly targeted at income support

Age-based tax breaks do not appear to serve any other policy objective for the tax-transfer system, such as:

- assisting those unable to support themselves; or
- boosting retirement incomes.

Social security aims to provide adequate income for those unable to support themselves. If social security payments are also taxable, then tax offsets may be necessary to ensure that such assistance remains adequate.

Box 2: SAPTO means wealthy self-funded retirees pay less tax than workers on the minimum wage

James and Linda are a self-funded retiree couple. They don't qualify for a pension because of their assets of $500,000 in superannuation[a] and $1.4 million in shares outside super. They own their home. They still qualify for a Commonwealth Seniors Health Card that entitles them to cheaper pharmaceuticals and other concessions. Their assets earn taxable income of $70,000 and they draw $24,500 from their super fund each year. They pay **$4,049** in income tax combined, including tax of $3,797 and Medicare levy of $252. SAPTO reduces their tax by $1,698.

Michael and Jenny are a couple both aged 40 and working full-time minimum wage jobs, earning a combined $70,000 in taxable income each year. They pay the full Medicare levy and do not benefit from any special tax offset like SAPTO. Their combined income tax bill is **$6,894**, including tax of $5,494 and Medicare levy of $1,400. Even though Michael and Jenny have the same taxable income as *James and Linda*, and are not getting any benefits from superannuation, they pay **$2,845** more tax. And given their income, they are unlikely to accumulate the same wealth at retirement as *James and Linda*.

Under the recommended reforms (see Chapter 4), *James and Linda* would pay more tax. They would not receive any SAPTO or benefit from the Medicare levy threshold. Their tax bill would be **$6,894**, an increase of **$2,845**, including $1,698 from losing SAPTO and $1,148 extra Medicare levy. They would pay the same tax as *Michael and Jenny*.

a. $500,000 is the average super balance for two seniors who each have a taxable income of $35,000: ATO (2016e).

Exempting full Age Pensioners from income tax makes it easier to ensure that income support payments remain adequate. Without the tax offset, the fact that welfare payments are indexed but the tax thresholds are not would lead to full Age Pensioners paying income tax. This would erode the real value of the welfare payments, which indexing is intended to preserve.

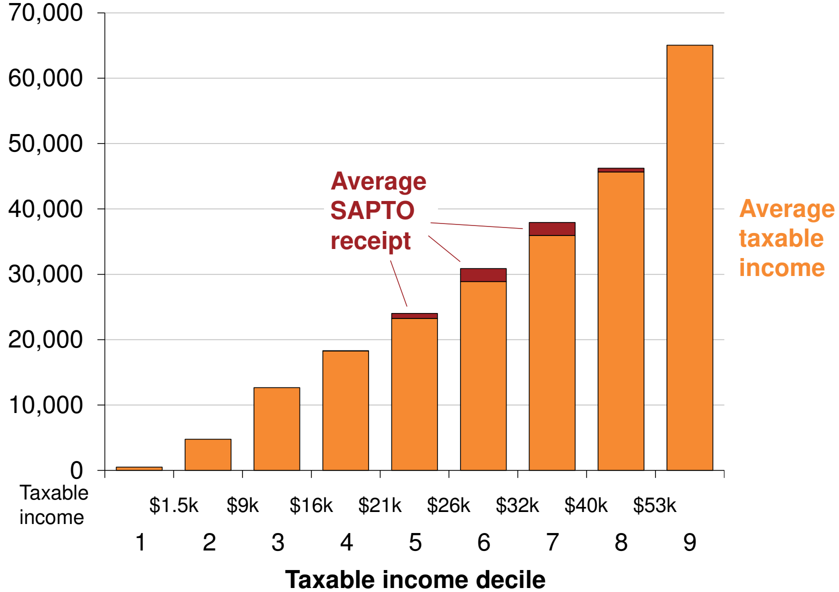
Yet as Section 2.2 notes, the benefits of SAPTO extend well beyond full Age Pensioners. Most of the benefit of SAPTO flows to middle-income seniors who receive only a part Age Pension, or are not eligible for the Age Pension at all (Figure 3.2).

Some argue that age-based tax breaks are justified because they boost retirees' incomes.[39] By definition, they do so. But they are poorly targeted toward maintaining income support for households in need, and they largely benefit middle-income retirees.

As Figure 3.2 shows, seniors with low taxable incomes – seniors who lodge tax returns and in the bottom 3 deciles – do not pay tax, and therefore do not benefit from non-refundable[40] offsets such as SAPTO. Many more seniors have low-incomes but do not lodge tax returns. The top 20 per cent of seniors by income do not receive any SAPTO, which is phased out once income is greater than about $50,000 for singles and $80,000 for couples.[41]

For those who do benefit, SAPTO only slightly boosts their retirement income. A senior receiving the maximum amount through SAPTO has a 7 per cent boost to income from the offset. It is unclear why seniors on such incomes need assistance – their taxable income is about $32,000 (excluding any income from super), almost 40 per cent higher than the

Figure 3.2: Only middle-income seniors benefit from SAPTO
Taxable income, seniors who lodge a tax return, $2014



Notes: Excludes the tenth decile due to scale. Includes only people who lodge a tax return, which excludes many full pensioners who are not required to lodge returns but may choose to do so. Many people with low taxable incomes will have significant superannuation balances that exclude them from receiving a pension, but earnings from superannuation are not included in taxable income.

Source: Grattan analysis of ATO (2016e).

39. Costello (2007).
40. Non-refundable offsets can reduce a tax liability to zero, but any unused offset does not result in a refund.
41. ATO (2015).

maximum rate of pension. A person aged under 65 with this income would generally have higher expenses, and yet would pay $2817 in tax.

Nor is there much evidence that retirement incomes would be inadequate without these age-based tax breaks – especially for those middle-income retirees who benefit most. The non-housing expenditure of retirement-age households today, many of whom did not retire with any super, is typically more than 70 per cent of that of working-age households today.[42] Projecting forward, today's 9.5 per cent Superannuation Guarantee and the Age Pension would provide average workers with retirement incomes equal to 79 per cent of their pre-retirement wage (also known as a replacement rate) – higher than the 70 per cent level endorsed by the OECD.[43]

If a boost to the adequacy of retirement incomes were needed, income support payments would deliver more targeted assistance than a tax offset. Welfare means tests, unlike tax offsets, are inherently better targeted because they take into account all the resources of the entire household. For example, means testing for income support payments such as the Age Pension includes super earnings, whereas tax offset calculations do not (because super earnings are not included in assessable income).[44]

The frequency of social security payments, compared to assistance through the tax system, is also preferable for people with tight budgets. Pensions are paid fortnightly; tax offsets are typically paid only when people lodge their tax return at the end of the financial year.

42. Daley et al. (2016e).
43. Ibid.
44. For example, see Daley et al. (2015b, p. 14).

3.4 Age-based tax breaks are not effective in reducing administration costs

Exempting full Age Pensioners from income tax can reduce the costs of administering and complying with the tax system. Many pensioners earn little private income: about 1.5 million receive a full Age Pension and have private incomes of less than $4264 a year. For full Age Pensioners, the costs of lodging tax returns – including accountancy fees and ATO departmental costs – would be high compared to any tax revenue raised.[45] A tax offset is an appropriate way to relieve low-income seniors from the costs of lodging a tax return. In 2013-14, about 2 million seniors[46] did not lodge tax returns which would have included many of the 1.5 million maximum rate Age Pensioners.

Yet SAPTO is not efficient at reducing administrative costs because it goes much further than excluding full Age Pensioners from the tax net.

Many beneficiaries of SAPTO are legally required to lodge a tax return because their income is higher than their tax-free threshold ($32,279 for singles when including SAPTO). About half the benefits of SAPTO are received by seniors who are legally required to lodge a tax return because their income is above their tax-free threshold.

Many other SAPTO recipients also lodge tax returns, either because they had tax deducted from their income (such as wages or dividends), or because they chose to lodge for some other reason. In 2013-14, almost 60 per cent of seniors lodging tax returns – three-quarters of a million people – did not have a net tax liability.[47]

45. For example, without SAPTO a full pensioner with no other income would pay about $200 of income tax under current pension and tax settings, where most tax accountants have fees from $100 upwards.
46. ATO (2016d); and ABS (2016a).
47. ATO (2016d).

Despite substantial budget costs, SAPTO does little to remove many middle-income seniors from the tax system. Restricting the benefits of SAPTO would reduce budget costs while still ensuring full Age Pensioners did not have to lodge a tax return.

3.5 Age-based tax breaks do little to encourage seniors' workforce participation

Another argument for SAPTO and other age-based tax breaks is that they encourage seniors to work.[48] By increasing their post-tax wages, these tax breaks could encourage senior Australians to stay in the workforce for longer. However, SAPTO and the higher Medicare levy threshold are poorly designed for this goal because they mainly benefit non-labour income. And they both reduce and increase marginal tax rates in ways that may in fact discourage workforce participation.

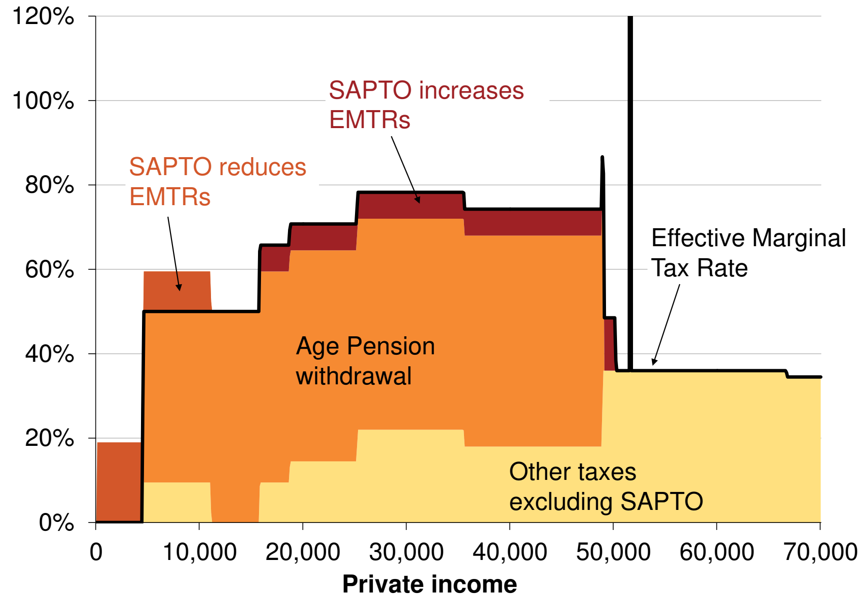
SAPTO mostly reduces tax on non-employment income. For seniors benefiting from it, only one dollar in every three of income comes from salary or business activity. Half the income of SAPTO recipients is passive investment income; one in six dollars is from the pension.[49]

SAPTO also does little – if anything – to improve incentives to work for all seniors. Financial incentives to work are primarily determined by the amount of income a person keeps when they earn an extra dollar, factoring in the extra tax paid and the withdrawal of welfare payments. The percentage of gross income lost to higher taxes and welfare payment withdrawal is known as the Effective Marginal Tax Rate (EMTR).

These rates are both increased and decreased by SAPTO, depending on how much income the senior earns, as Figure 3.3 shows. For those with private income of less than about $15,000, SAPTO decreases their effective marginal tax rate by reducing the tax they would otherwise pay.

Figure 3.3: SAPTO's impact on effective marginal tax rates probably reduces rather than increases incentives to work

Effective marginal tax rate by income, seniors, 2015-16



Notes: Private income is from assets and excludes the pension and superannuation. Assumes all private income is taxable. Includes the Age Pension income test, marginal tax rates, the Low Income Tax Offset, SAPTO and the Medicare levy. The impact of the Work Bonus is not included as most private income for seniors is from assets. Large spikes in effective marginal tax rates occur because of lump sum withdrawal of the Pension Supplement.

Source: Grattan calculations; Plunkett (2016).

48. Warren (2008, p. 10).
49. Grattan analysis of ATO (2016e).

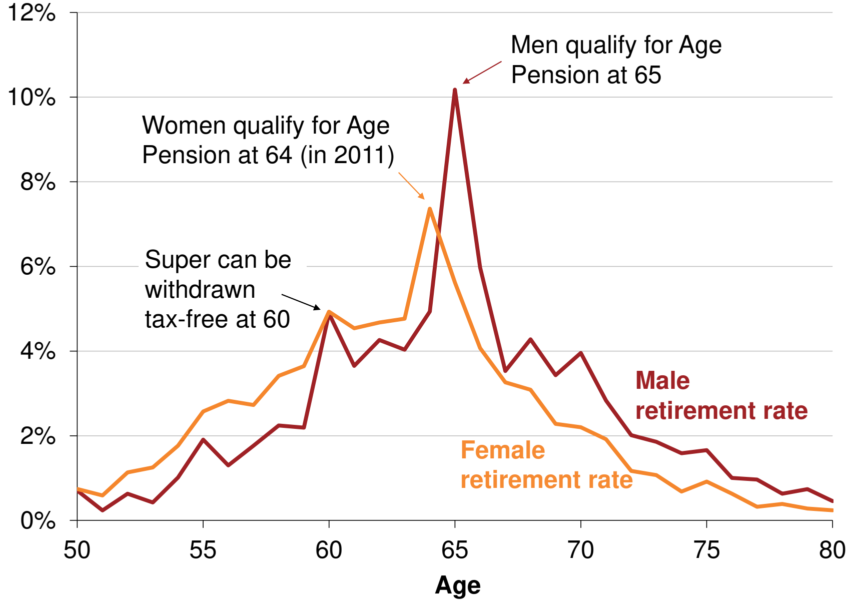
Yet even without SAPTO, their rate would be 60 per cent or less. For those with private income of between about $20,000 and $50,000, the benefits provided by SAPTO are withdrawn which increases their effective marginal tax rate by 12.5 per cent – to 65, 78 or even 98 per cent, depending on private income. The increased progressivity from SAPTO is much more likely to deter workforce participation than the relatively flatter tax rates without SAPTO.[50]

In addition to the ambiguous impact of SAPTO on effective marginal tax rates, evidence about the impact of the effective marginal tax rates on labour force decisions of seniors is unclear. Most Australian studies have focused on how taxes affect the choices to work of Australians under age 65.[51] Other studies have found that increasing after-tax wages for mature age workers has a negligible impact on their work decisions. While higher after-tax wages encourage seniors to work more, the resulting increase to income and savings discourages further work. Anecdotal evidence suggests that many seniors have a wealth target for retirement. Tax cuts help older Australians achieve these targets earlier, increasing the likelihood they would drop out of the workforce.[52]

Governments past and present have acknowledged that tax offsets are an ineffective way to encourage older age workforce participation. The Mature Age Worker Tax Offset (MAWTO) was introduced in 2004-05, providing up to $500 a year to people aged 55 and over with similar incomes to SAPTO recipients. The offset was closed to new entrants in 2012 and abolished in 2014.[53] The Government argued the offset was not a cost-effective way of encouraging older Australians to work – mature age workers were likely to choose to remain in the workforce even without the offset. Funding was redirected to the Government's

50. See KPMG Econtech (2010) for discussion of how more progressive income tax rates have higher disincentives to work and greater economic costs.
51. Dandie et al. (2007).
52. Headey et al. (2010, p. 132).
53. Australian Government (2014).

Figure 3.4: Access ages have a big influence on retirement decisions
Retirement rates by age and gender, 2011



Notes: Retirement rate is calculated as the change in the labour force participation rate.
Source: Grattan analysis of ABS (2011).

Restart scheme. This scheme has also underperformed, with low take-up by older workers.[54] SAPTO whether or not reformed, is likely to be just as ineffective in promoting older workforce participation.

Seniors' workforce participation is much more likely to be affected by changing the age of access to the pension or superannuation. Men are at least twice as likely to retire at age pension age as any other age (Figure 3.4). Women are also more likely to retire at Age Pension age (64 years and six months in 2011) than at any other age.

54. Opray (2015).

The tax-free superannuation age also has a clear impact on the retirement decisions of men, but less so for women. Both the Grattan Institute report, *Balancing budgets: Tough choices we need*, and recent work by the Productivity Commission show that increasing the age of access to the Age Pension or to superannuation would make a much bigger difference than tax incentives provided by SAPTO to retirement decisions and thus both budget repair and economic growth.[55]

3.6 An age-based tax system is a poor way to manage the difficulties in taxing savings

One might argue that lower tax rates for senior Australians would encourage more savings. By taxing the returns to saving, income taxes make future consumption more expensive, since people will have less than otherwise to consume in the future if they save a dollar today.

Retirees' incomes are largely drawn from savings (Section 3.5). Lower income tax rates for seniors could improve their incentives to save while working, by reducing taxes on the long-term returns to those savings.

Yet most studies show that tax rates have little effect on how much people save.[56] In practice, life circumstances and lifetime consumption smoothing often play a much larger role in savings decisions.

Alternatively, one might argue that current tax rates on savings are too high relative to labour. This is a complex argument beyond the scope of this paper; there are powerful arguments that tax rates on savings are too low, particularly for capital gains.[57]

Even if reducing taxes were an effective way to encourage saving and self-provision, or an effective way to adjust the tax rates on savings relative to labour, SAPTO would be a poor mechanism to achieve these policy goals. SAPTO applies not just to income from savings, but also to work and pension income. Moreover, it does nothing to reduce taxes paid on the returns to savings before age 65.

Further, lower tax rates for seniors will only encourage existing workers to save if they believe these arrangements will still be in place when they retire. The Commonwealth Government's well-documented fiscal challenges and the growing cost of age-based tax breaks due to Australia's ageing population mean that few are likely to be so confident.

3.7 Overall, age-based tax breaks lack a policy rationale

Current age-based tax breaks lack a policy purpose. SAPTO is too generous and too expensive, providing tax breaks to groups that do not need them, and fails to meet other policy goals such as encouraging workforce participation. Abolishing it will contribute to budget repair and remove age-based tax breaks that current working-age Australians are unlikely to enjoy in the future.

55. Productivity Commission (2015) estimates that increasing the superannuation preservation age from 60 to 65 would increase Commonwealth Government budget balances by up to $7 billion per annum in the long term (impact in 2055, deflated to 2015 dollars).
56. Daley et al. (2015b, p. 21).
57. Daley et al. (2016c, pp. 11–19).

4 How to reform age-based tax breaks

A principled approach to reforming age-based tax breaks would align them more closely with their policy purpose. It would minimise the budgetary cost, while maintaining adequate retirement incomes and incentives to work. The reform that strikes the best balance among these criteria would **wind back SAPTO** so that only full Age Pensioners do not pay income tax or the Medicare levy. Many more seniors would then pay a similar amount of tax to younger workers with similar incomes. The reform would improve budget balances by at least $700 million a year. There is no reason to grandfather these changes.

4.1 Principles should apply to the reform of age-based tax breaks

A number of principles should apply to any reform of age-based tax breaks:

1. Tax breaks should be aligned with **their policy purpose**.
2. The **budgetary cost** of age-based tax breaks should be minimised unless they are justified by their social benefits.
3. The **adequacy of retirement incomes** should be maintained, especially for low-income earners.
4. Adverse impacts on **incentives to work** for senior Australians should be minimised.
5. The system must be **administratively workable,** taking into account both the starting point of systems in place, as well as any transitional issues.

These principles do not always work in lockstep. For example, some age-based tax breaks may marginally increase retirement savings for low-income earners, but generate very large tax breaks for people who are likely to save enough for their retirement anyway. It is important to look at the balance of likely impacts of any proposed reform.

4.2 SAPTO and the higher Medicare levy threshold could be reformed in a number of ways

Various proposals exist to reform SAPTO and the higher Medicare levy income threshold for senior Australians. This chapter explores three options:

1. **Abolish SAPTO and the higher Medicare levy threshold for all seniors.** Pensioners and seniors would pay the same amount of personal income tax as younger Australians on the same incomes. This change would improve budget balances by about **$850 million** a year.
2. **Wind back SAPTO with a matching Medicare levy income threshold.** Both tax breaks would only be available to pensioners, at a level no higher than would offset the tax otherwise payable by a full Age Pensioner. As a result, seniors who are not full Age Pensioners would pay some income tax, and some Medicare levy. Eligibility would be restricted to people receiving pensions; asset-rich seniors with low incomes would be excluded. This change would improve budget balances by about **$700 million** a year.
3. **Abolish SAPTO and the higher Medicare levy threshold for all seniors and instead make the pension tax-free.** Making the pension tax-free would simplify the income support and tax systems – as would fewer tax offsets. The tax treatment of the Age Pension would align with other tax-free pensions, including the Disability Support Pension. Abolition of SAPTO would lead to middle-income

seniors paying more tax. Some higher income retirees receiving a part Age Pension would pay lower taxes once the pension became tax-free. This change would improve budget balances by about **$350 million** a year.

Under all these options SAPTO and the Medicare levy threshold would be tapered using current withdrawal rates: for every additional dollar earned, a senior would pay an extra 12.5 cents in income tax (as SAPTO is withdrawn) and an extra 10 cents in Medicare levy.

There are other reform options that this report does not consider in detail. For example, SAPTO and the Medicare levy might be reduced from a lower income threshold, such as the first dollar a pensioner earns. Other alternatives could withdraw SAPTO or phase in the Medicare levy income threshold at a faster rate.[58] These changes might be part of broader reforms to the Age Pension, which are beyond the scope of this report.

4.3 Assessing possible reform options

The second option for reform – **winding back SAPTO** with a matching Medicare levy income threshold – provides the best balance among the criteria outlined in Section 4.1, as summarised in Table 4.1, and elaborated below. It would largely reverse the generous changes made in the 2000s.

Table 4.1: Assessment of SAPTO and Medicare levy reform options

Principles	**Abolish SAPTO & higher Medicare levy threshold for seniors**	**Wind back SAPTO & the higher Medicare levy threshold**	**Abolish SAPTO, higher Medicare threshold & make Age Pension tax-free**
Target tax breaks at policy purpose	Larger reduction in tax breaks for part pensioners	Big reduction in tax breaks for part pensioners	Some reduction in tax breaks but some part pensioners get more
Budgetary impact	$850 million	$700 million	$350 million
Preserve adequacy of retirement incomes	More tax paid by full Age Pensioners	No change in tax paid by full Age Pensioners	No change in tax paid by full Age Pensioners
Maintain incentives for workforce participation	Negligible impact	Negligible impact; more consistent EMTRs	Negligible impact
Administrative simplicity	Many more pensioners lodging tax returns; reduces number of tax offsets	Slightly more part pensioners and other retirees lodging tax returns	Fewer pensioners lodging tax returns; fewer tax offsets and simpler tax-transfer system

Principle strongly supported	Principle moderately supported	Principle poorly supported

Source: Grattan analysis.

58. Ingles et al. (2015, p. 45).

Align tax breaks with their policy purpose

Tax concessions should be provided only when the serve a public policy purpose, such as preserving adequate incomes in retirement, or improving workforce participation. Rules should be designed to minimise "leakage" so that benefits are not provided in ways that do not serve the ostensible purpose of the policy.

Either **abolishing SAPTO**, or **winding back SAPTO**, would reduce tax breaks that currently leak to middle- and high-income seniors, as shown in Figure 4.1. **Abolishing SAPTO but making the Age Pension tax-free** would have a similar effect on middle-income earners. But it would provide a windfall for some in the top third of taxpayers over 65 who have substantial earnings and who also receive a part Age Pension.

Preserve adequacy of retirement incomes, especially for low-income earners

There are sound reasons for wanting to ensure that the income tax system does not deprive people in need from adequate income support, as Section 3.3 notes.

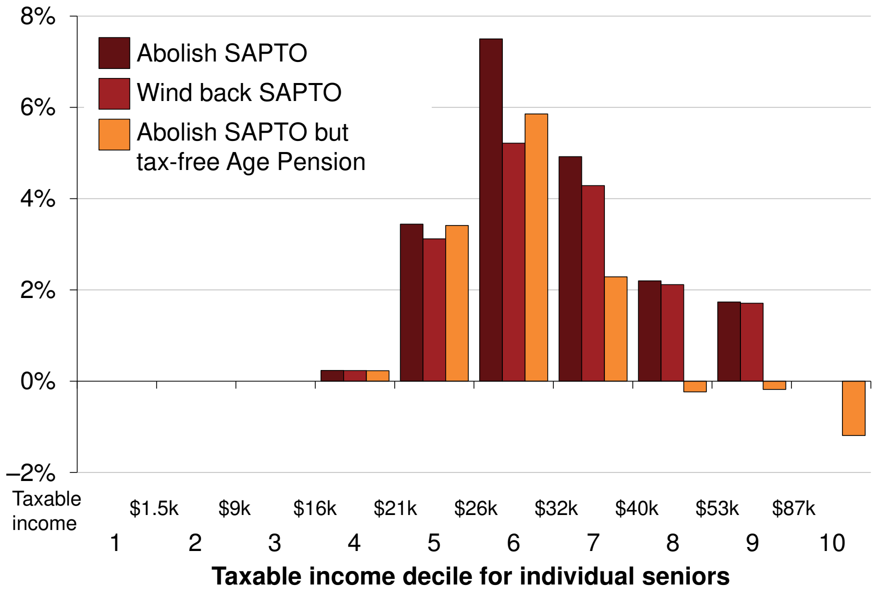
Abolishing SAPTO would mean that full Age Pensioners paid personal income tax and the Medicare levy. Australia's 1.5 million full-rate Age Pensioners would pay up to $1,160 in personal income tax in 2017-18. These bills would rise further unless the personal income tax brackets were adjusted in line with the value of pension payments.

Winding back SAPTO would be better at ensuring adequate income support for those who need it most. The offset would be designed so that a full Age Pensioner pays no tax, with the value and income thresholds adjusted each year accordingly (Table 4.2 on the next page).

For singles, the maximum value of their offset would be the tax they would otherwise pay on an income equivalent to the full Age Pension

Figure 4.1: Middle-income seniors would pay more tax under all options considered

Change in tax paid by individual seniors under each reform scenario, 2017-18, percentage of gross income



Source: Grattan analysis of ATO (2016e).

(taxable value only), plus the maximum private income that does not affect eligibility for a full Age Pension.

For couples, the maximum value of the new offset should be designed so full Age Pensioner couples continue to pay no tax, no matter how their income is split. To do this, the value of the offset should be based on a scenario in which one member of the couple earns all the private income. The value of SAPTO should be transferable between members of the couple, as currently applies.

Under this option, seniors would begin to pay the Medicare levy from the income at which they are no longer full Age Pensioners. That amount is estimated to be $27,000 for singles and $42,000 for couples combined in 2017-18.

Abolishing SAPTO and making the Age Pension tax-free would also maintain the adequacy of income support payments.

Budgetary impacts

All three proposals would improve the budget bottom line by reducing the value of age-based tax breaks (Figure 4.2 on the following page).

Abolishing SAPTO and the higher Medicare levy income threshold for senior Australians would produce the largest budgetary savings, of $850 million a year. Abolishing SAPTO would save $700 million, with a further $150 million saved by removing the higher Medicare levy threshold for seniors. But much of these savings would come from taxing full Age Pensioners, thereby eroding the adequacy of pension payments. Approximately 530,000 seniors who lodge tax returns would pay more tax because of this reform. Many seniors who do not lodge returns would also be affected.

Table 4.2: SAPTO would be wound back so that full Age Pensioners would not pay tax, 2017-18

	Singles	Couples (each)
Current maximum SAPTO value	**$2 230**	**$1 602**
Full Age Pension (taxable amount only)	$22 201	$16 734
Income free area	$4 446	$7 852
Total maximum income for full Age Pension	$26 647	$24 586
Tax paid after LITO	$1 160	$768
New maximum SAPTO value	**$1 160**	**$390**
New income at which SAPTO begins to reduce	$27 000	$42 000 (combined)

Notes: The full Age Pension includes the maximum base rate plus those supplements that are taxable. Age Pensioners also receive payments that are not taxable including the minimum amount of the Pension Supplement ($910 a year for singles) and the Energy Supplement ($366.60 a year). For couples, the maximum value of a wound back SAPTO assumes one partner earns all income, to ensure full Age Pensioner couples do not pay tax no matter how their income is split. The full Age Pension shown is for one member of a couple, while the income free area (which can be transferred between partners) is the combined value for both members of the couple. The maximum value of the offset is rounded to the nearest $10, and the income threshold is rounded to the nearest $1,000.

Source: Grattan analysis.

Winding back SAPTO to offset the tax for full Age Pensioners with a matching Medicare levy threshold would save $700 million a year. Approximately 480,000 seniors would pay more tax because of this reform.

Abolishing SAPTO but making the Age Pension tax-free would yield the smallest budget saving: $350 million a year. The budgetary savings from abolishing SAPTO ($700 million) and abolishing the higher Medicare levy income threshold ($150 million) would be offset by the revenue foregone if the Age Pension were exempt from tax ($500 million). Approximately 350,000 seniors would pay more tax because of this reform.

All three of these reforms may have second-order impacts on the budget. Higher income taxes will encourage some seniors to shift savings into less-taxed investments such as their own home or geared property. But these behavioural changes are likely to be small; most seniors affected will already own their own homes and are likely to have less appetite for riskier investments.

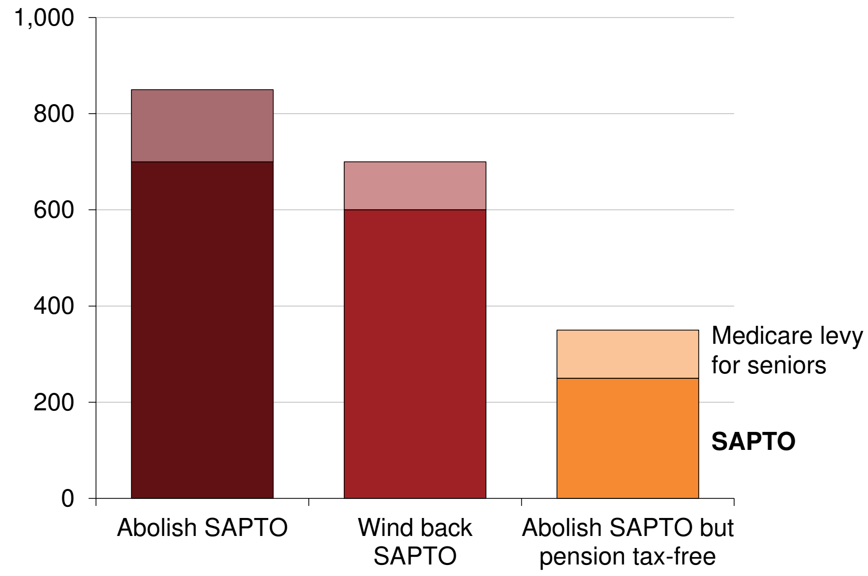
These reforms will also have limited impacts on long-term Age Pension costs. As we have discussed, taxes tend to have limited impacts on savings rates, so savings will not decrease by much. Some retirees may draw down their assets at faster rates to maintain current levels of consumption, but it is appropriate that wealthier retirees use their own means to fund their retirement.

The impact on ATO costs for any option would not be material given ATO departmental costs are typically only about 1 per cent of revenue.

These reform options will probably raise more revenue than stated, particularly if SAPTO is abolished altogether. Our estimates are based on tax returns under current policy, and so do not include additional revenue from some seniors who currently benefit from SAPTO but do not lodge tax returns.

Figure 4.2: All three reforms to age-based tax breaks would help the budget bottom line

Budgetary savings from reform options, 2017-18, $ millions



Source: Grattan analysis of ATO (2016e).

Maintain incentives for workforce participation

All reform options would have modest impacts on the effective marginal tax rates of seniors, and therefore slightly affect their incentives to work (Figure 4.3).

Abolishing SAPTO and the higher Medicare levy income threshold would increase effective marginal tax rates for private incomes from the first dollar of private income up to $16,000, but reduce them after this point, up to about $50,000.

Winding back SAPTO to offset the tax only for full Age Pensioners would create more consistent effective marginal tax rates for seniors across different levels of private income. It would raise them for seniors with private incomes above $5000 and below $20,000, but reduce them for those with incomes between $20,000 and $50,000.

Abolishing SAPTO but making the Age Pension tax-free would have the most varied impact on effective marginal tax rates that are both slightly higher and lower between incomes of $16,000 and $50,000.

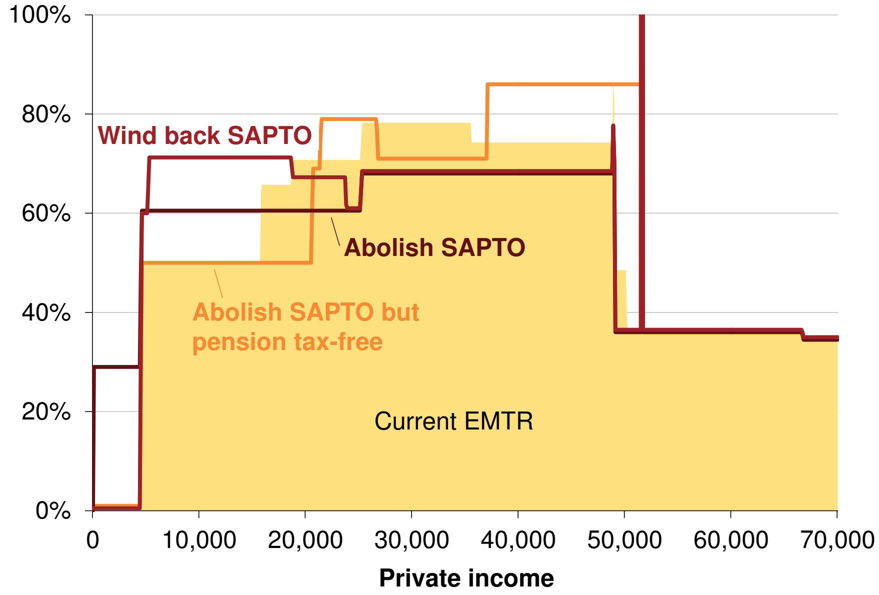
Other options such as withdrawing SAPTO from the first dollar earned, and reducing the Medicare levy threshold similarly, would do more to flatten effective marginal tax rates.[59] But this is not a decisive factor given that marginal tax rates do not seem to be the key driver of older age workforce participation (see Section 3.5).

Administrative issues

Abolishing SAPTO and the higher Medicare levy income threshold for senior Australians would place more administrative burdens on both taxpayers and government. Maximum rate pensioners would need to lodge tax returns, increasing the number of people interacting with the

Figure 4.3: Effective marginal tax rates won't change much

Effective marginal tax rates by reform scenario, 2017-18, per cent



Notes: Private income is from assets and excludes the pension and superannuation. Assumes all private income is taxable. Includes the Age Pension income test, marginal tax rates, the Low Income Tax Offset, reform options for SAPTO and reform options for the Medicare levy. The impact of the Work Bonus is not included as most private income for seniors is from assets. Large spikes in effective marginal tax rates occur because of lump sum withdrawal of the Pension Supplement.

Source: Grattan analysis.

59. Ingles et al. (2015, pp. 46–47).

ATO. A more simple tax system, with fewer tax offsets, would partly counterbalance these higher costs.

Winding back SAPTO would not create large administrative problems. The number of part pensioners needing to lodge personal income tax returns would slightly increase. However, many senior Australians who pay no personal income tax already lodge personal income tax returns.[60]

Abolishing SAPTO and making the Age Pension tax-free would similarly add little to administrative costs. Some part-rate pensioners would begin to pay personal income tax for the first time. Yet these effects would be offset by other part pensioners on higher incomes no longer needing to submit personal income tax returns. The tax system would be simpler, with fewer tax offsets. Making the Age Pension tax-free would align tax treatment with other pensions, including the Disability Support Pension.

Other options might wind back SAPTO from a lower income threshold, such as the first dollar of private income for a full Age Pensioner. A lower threshold would increase income tax revenue, but the costs of compliance for the new taxpayers would be high compared to revenue raised.

4.4 Winding back SAPTO is the best reform overall

Abolishing SAPTO would contribute most to budget repair. But it would result in the tax system interfering with the role of the income support system in assisting those most in need. Full Age Pensioners would have less disposable income and the value of their support would not be maintained over time.

Winding back SAPTO, with corresponding changes to the higher Medicare levy income threshold for senior Australians, is the best option.

60. ATO (2016d, Table 2) shows that 60 per cent the seniors lodging tax returns did not have a net tax liability.

Such a reform best balances the objectives of abolishing age-based tax breaks that have no purpose and repairing the budget, while not interfering with the role of the Age Pension in providing adequate income for those in need. The change also creates effective marginal tax rates that are more consistent for middle-income seniors. It is also administratively straightforward.

Abolishing SAPTO and making the pension tax-free would simplify administration, align the tax treatment of different pensions and remove complex tax and transfer system interactions. But such administrative benefits are not worth the significantly lower contribution to budget repair.

4.5 Transitional issues are straightforward

Changes should not be grandfathered

Existing beneficiaries of SAPTO do not need special treatment when new arrangements are put in place. Changing tax breaks only available to senior Australians may raise concerns about the government retrospectively ‘changing the rules’. Yet proposed changes to the taxation of income for seniors are not retrospective. Conceptually such tax changes are no different to changing personal income tax rates for all Australians.[61]

It might be argued that retirees have less scope to adjust their behaviour in response to the removal of these tax breaks. But the proposed changes need to be seen in context. Some part-rate pensioners and self-funded retirees would simply return to paying the same rates of personal income tax as working-age Australians with similar incomes. This was the case before these age-based breaks were expanded in the late 1990s and early 2000s.

61. Retrospectivity is a legal concept that applies if government changes the legal consequences of things that happened in the past. Daley et al. (2016b).

While grandfathering personal tax arrangements for existing retirees might be the most politically expedient option, it is neither prudent nor fair. Grandfathering would mean that reform would contribute little to the budget for many years. It would also exacerbate intergenerational transfers from existing concessions – younger generations would continue to fund generous tax benefits that they will never receive.[62] In the long-term, the proposed reforms would apply equally to future generations when they approach the end of their working lives, and be similar to previous arrangements for seniors prior to the mining boom.

Non-senior recipients of SAPTO

Some income support recipients other than seniors are also eligible for SAPTO. They include those receiving Parenting Payment Single, Carer Payment (if the recipient of care is old enough to qualify for the Age Pension) and Bereavement Allowances.

Any changes to SAPTO should also apply to these working-age recipients to limit complexity. The budgetary and policy implications will be small, as the vast majority of SAPTO recipients are seniors. The revenue increases from (and reduced incomes for) non-senior pension recipients would be no more than $50 million a year for all three reform options. This revenue is included in the revenue estimates cited in other sections of this report.

If our proposed change would risk leaving working-age recipients of SAPTO with inadequate incomes, the Government should still wind back the offset, but consider increasing the base rates of the relevant welfare payments.

62. Daley et al. (2014, p. 47).

5 Why seniors should get the same Private Health Insurance rebate as younger Australians

The Private Health Insurance (PHI) rebate reduces the cost of private health insurance. Seniors receive a larger rebate than younger workers with similar incomes.

The higher rebate for seniors does not have an obvious policy rationale. It does not appear to increase private health insurance take-up, nor is it needed to protect seniors from high private insurance premiums. The private health costs of seniors are already protected by "community cover" arrangements, under which younger households cross-subsidise the private health insurance costs of older households.

Seniors should receive the same private health insurance rebate as younger workers with similar incomes. This reform would improve budget balances by about $250 million a year, even after accounting for the additional health costs for government as a small number of seniors choose to discontinue private health insurance.

5.1 The higher PHI rebate for senior Australians

The PHI rebate, introduced by the Howard Government in 1999, either reduces the income tax paid by those who purchase Private Health Insurance, or instead reduces health insurance premiums. In effect, government pays part of the cost of private health insurance. The rebate is calculated as a percentage of the insurance premium.

Commonwealth expenditure on the rebate has grown rapidly, increasing from $3 billion in 2005-06[63] to $6.8 billion in 2017-18, at an average of 7 per cent a year in nominal terms.[64]

63. Department of Health and Ageing (2006a).
64. Treasury (2016b).

Before 2005, all Australians received a 30 per cent rebate on their PHI premiums. The rebate rates for seniors (but not those under 65) were raised from April 2005,[65] increasing the rate to 35 per cent for 65 to 69 year olds and 40 per cent for people aged 70 and over.

The higher rebate for seniors was not intended to increase the take-up rates of health insurance of senior Australians. Then Treasurer, Peter Costello, acknowledged that PHI take-up rates for senior Australians were already "much higher" than anybody else.[66] Rather, the higher rebate was a promise made in the lead up to the 2004 election campaign. The Prime Minister, John Howard, said that it aimed to ensure premiums remained affordable, and that senior Australians deserved "a further reward for contributions over the years of their health fund membership".[67]

Since 2012, the rebate has been income-tested, so that the size of the rebate depends on a person's income. Most people claim the rebate as a reduction in their private health insurance premium, and their insurer claims the rebate from government. Alternatively, the rebate can be claimed as a refundable tax offset through tax returns. The rebate is lower for higher income earners.

For a given income, seniors earning less than $140,000 receive a larger rebate than do working-age Australians on similar incomes, as Table 5.1 on the following page shows.

65. Ibid.
66. Costello (2004).
67. Howard (2004).

Table 5.1: Private health insurance rebate entitlements for singles, 2016-17

	Rebate percentage		
Income level	**Working age**	**Aged 65-69**	**Aged 70+**
< $90,000	27%	31%	36%
$90,001 to $105,000	18%	22%	27%
$105,001 to $140,000	9%	13%	18%
over $140,000	0%	0%	0%

Notes: The combined couple income thresholds are double those for singles. Income thresholds are frozen until 2021 but indexed thereafter. Thresholds are higher for families with more than one child.

Source: Private Health Insurance Ombudsman (2016a).

5.2 The rebate in general does not obviously reduce total government health costs

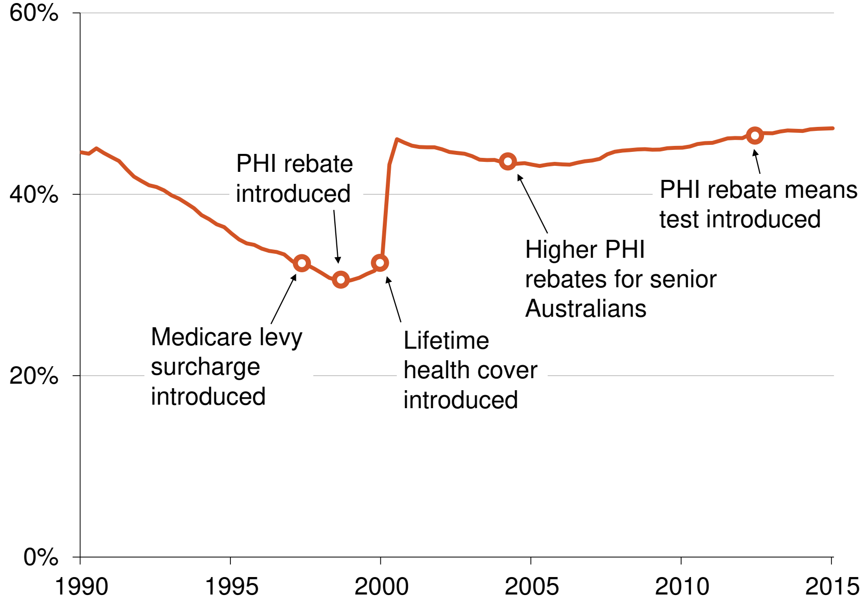
There is little hard evidence that the PHI rebate generally reduces the net cost to government of the health system. It depends on how many people decide to get PHI because of the rebate. It depends on how much the health costs to government of these people reduce because they use private hospitals instead of the public system. And it depends on the budgetary cost of the rebate for all Australians (including those who would have got PHI even without the rebate).

In the past, policy changes that changed effective premiums paid by all Australians with PHI have not had much impact on the take-up rates of private health insurance, and consequently haven't reduced the use of public hospitals much.[68] The budgetary cost of providing additional tax rebates was probably greater than the budgetary savings from the rebate encouraging more patients to use private rather than public hospitals.

68. Segal (2004).

Figure 5.1: The Private Health Insurance rebate did not increase health insurance take-up by much

Take-up of private health insurance in Australia, per cent



Source: APRA (2016a).

It is true that many more people acquired private health insurance in the early 2000s, but both research[69] and history show that the increase was caused by intensive advertising and the approach of the Lifetime Health Cover deadline (Figure 5.1). Under the Lifetime Health Cover regime, the costs of PHI premiums increase by 2 per cent for every year that a person does not have insurance after turning 30.[70]

69. Ellis et al. (2008).

70. People are exempt from this loading if they are born before July 1934 (aged 82 in 2016), or hold a PHI policy for 10 years; it stops increasing from age 65.

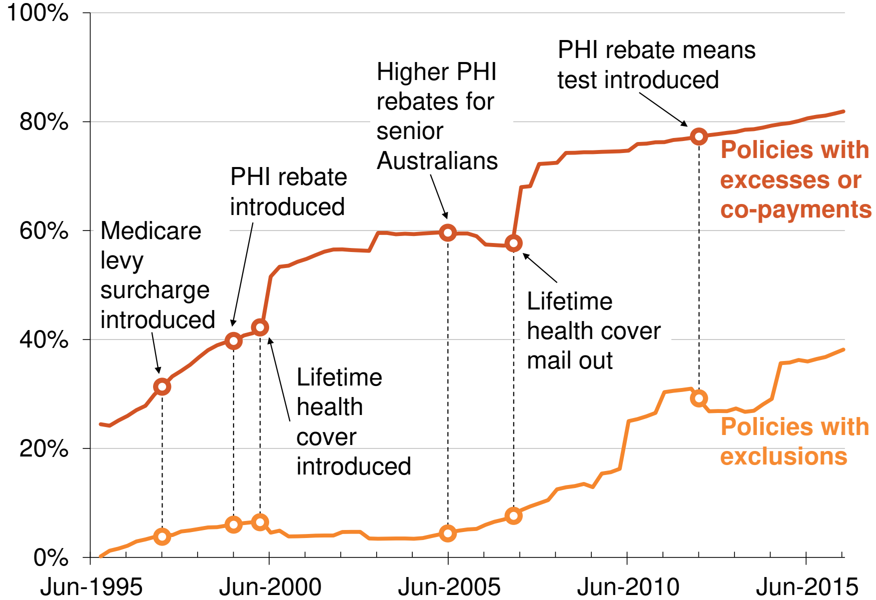
By contrast, financial incentives have had relatively little effect on the take up of PHI. The introduction of the rebate in 1999 only resulted in a minor increase in take-up. The introduction of means testing of the rebate in 2012, which reduced the rebate for higher income earners, did not have a significant impact on overall PHI take-up rates (although the means testing only affected the minority of senior Australians with incomes above $84,000). The Medicare levy surcharge, introduced in 1997, also seems to have had little effect on the take-up rate of PHI.

As well as not affecting the level of take-up in the community, financial incentives such as the PHI rebate do not obviously affect the coverage of policies, such as exclusions or requirements for patient co-payments or excesses. Past changes to the rebate have not triggered lower coverage of insurance policies (Figure 5.2). Rather, jumps in the proportion of lower coverage policies were associated with a lot more people taking out PHI when lifetime health cover was introduced in 2000 and a mail out in April 2007 warned people who might have been newly affected by the lifetime health cover loading (such as 30-year olds, migrants and new Medicare card holders).[71]

Reducing the rebate would probably improve Australia's budget position. Estimates of the impact of the rebate on PHI take-up rates vary, and are based on previous policy changes in the context of rising incomes. Assuming that past patterns continue, every dollar cut from the rebate could improve the budget bottom line by between 60 cents[72] and $1.[73]

Figure 5.2: The Private Health Insurance rebate did not significantly affect the coverage of insurance policies

Proportion of PHI policies with excesses, co-payments or exclusions, per cent



Notes: Policies with exclusions and policies with excesses or co-payments are not additive.

Source: APRA (2016a).

71. Department of Health and Ageing (2006b).
72. Cheng (2013) found savings from reducing spending on the PHI rebate outweigh additional public hospital costs by 2.5 : 1.
73. The Parliamentary Budget Office assumed that public hospital expenses would not rise when people cancelled their private health insurance. Instead the increased demand for public hospitals services would be reflected in longer waiting lists in the short term. PBO (2016). Over the longer term, public concern about longer waiting lists might well lead governments to increase hospital spending.

Policy changes to the PHI rebate might have a larger effect on take-up rates or policy coverage – and thus government budgets – when incomes are not growing as fast, or if the effective price change is large. But there is no reason to expect that these factors would be decisive. The introduction of the PHI rebate in 1999 had little obvious impact on take up, even though economic growth was slow at the time, and the change effectively reduced the cost of PHI by 30 per cent. Establishing that future changes to the PHI rebate would have a large effect on take-up rates or policy coverage, in the face of previous experience to the contrary, would require evaluation beyond the scope of this report, such as a fine-grained analysis of customer response to annual price changes.

5.3 The rebate does not obviously serve other public policy purposes

PHI provides a number of benefits relative to being treated through the public hospital system. The patient can choose their doctor. Waiting times for elective surgery are shorter.[74] Facilities may be more comfortable (such as with fewer patients per room). It is difficult to quantify these benefits. It is appropriate for individuals to make their own choices about whether to pay for these benefits, which are by definition more than government provides universally through the public health system.

When the tax system subsidises these services (or insurance for them), government distorts individual choices about whether to purchase health services in preference to other goods and services. On the other hand, these choices are already distorted because individuals have the alternative of using government health services without paying for them directly.

74. Johar et al. (2010).

A strong private health sector that competes with government services can benefit everyone. In the long term, private health services may promote better government services by providing a benchmark and creating pressure to perform. But a strong private health sector is likely to exist without the PHI rebate. The Medicare levy surcharge and lifetime health cover provide ample incentives to purchase PHI that will support a private health sector.

5.4 Rebates for seniors do not obviously reduce government health costs

Given that financial incentives to purchase Private Health Insurance have historically had relatively little effect on take-up by the general population, it is no surprise that the introduction of higher rebates specifically for seniors from April 2005 also had little impact on their take-up of private health insurance (Figure 5.3 on the next page). Rather, PHI take-up rates of senior Australians continued to grow in line with historic trends. Seniors over age 70 received the largest increase in their rebate, but it had little impact on their take-up levels.

A 2006 Health Department review estimated that just 16,000 people – 1.1 per cent of the 1.5 million people aged over 65 with private health insurance – took up insurance because of the higher rebates.[75] At the time, the measure reduced budget revenues by $150 million, meaning each additional senior taking up private health insurance cost government $10,000 a year in lost taxes, or about $20,000 after adjusting for inflation and real growth in private health insurance premiums.[76] This is considerably more than government saved in health costs. Today, people aged 70 and over cost their private health insurer about $5000 per year (Figure 5.4 on page 39). Providing similar services through the public health system might well cost less than this.

75. Department of Health and Ageing (2006b); and APRA (2016b).
76. Department of Health (2016); and Biggs (2009).

Similarly, the introduction of a means test on the PHI rebate in 2012 did not appear to dampen take-up rates by seniors. But this may not be particularly significant: the change only affected 4 per cent of seniors, who had such high incomes that they were affected by the means test (above $84,000 for singles or $168,000 for couples).

Changing the rebate is inherently unlikely to change the take up rate of seniors. As a result of the community health rating, seniors on average receive much more in private health insurance benefits than they pay in premiums (Section 5.5). Because they get such a good deal, they are unlikely to give up PHI, even if their premiums increase a lot.

Reducing the rebate for seniors to the same level as for younger Australians is a moderate change compared to changes in the past that had little impact on take up rates. Providing the same rebate to people of all ages would increase premiums for seniors by about 12 per cent. By contrast, the introduction of the rebate in 1999 reduced net premiums by 30 per cent, and the introduction of a means test increased net premiums for higher income Australians by between 17 and 43 per cent, but neither led to discernible change in take-up.

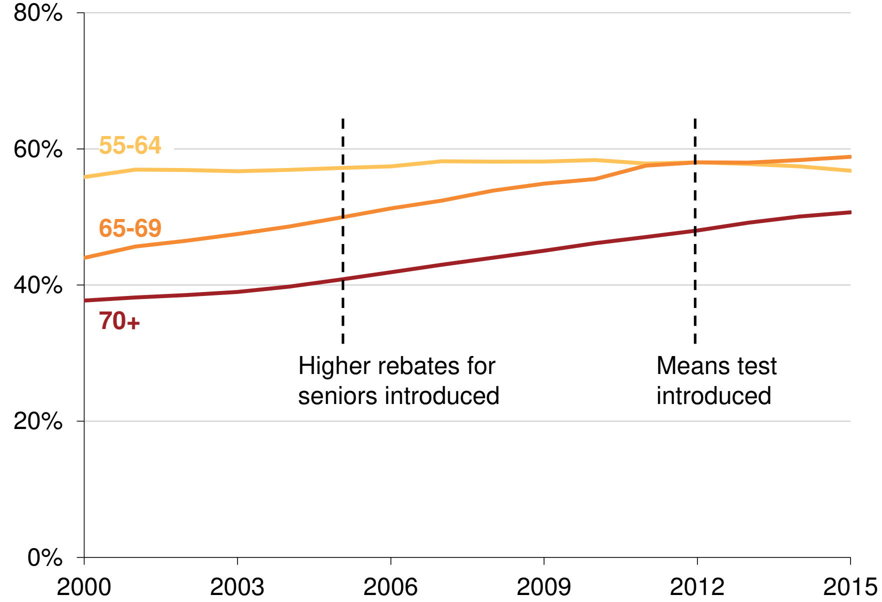
5.5 "Community ratings" sufficiently protect seniors from higher PHI costs

Higher PHI rebates for seniors might be justified on the basis that they help seniors with higher private health costs. Yet other government policies already adequately protect older patients with high health costs.

Under the "community rating" scheme, all households pay the same premium for similar health insurance cover, unless they had a period without private health insurance.[77] Private health insurers must charge customers the same premium regardless of age, gender, or medical

Figure 5.3: Higher rebates for seniors did not obviously affect take-up of Private Health Insurance

Take-up of private health insurance by older Australians, per cent



Source: APRA (2016b) and ABS (2016a).

77. Private Health Insurance Ombudsman (2016b). The Lifetime Health Cover scheme allows higher premiums to be charged to those over the age of 31 who

background. This protects people with higher health needs, such as older Australians, from higher premiums. In contrast, healthier people pay much higher premiums than their actual health costs.

As a result younger people cross-subsidise the private health insurance of seniors who generally have higher health costs (Figure 5.4). The average person aged 80 or over receives about $5700 in benefits from their private health insurer, five times more than the average 40-year old, who receives about $1100 in benefits from their insurer. Due to community ratings, people under the age of 55 are on average partly funding the private health insurance of people aged over 55.

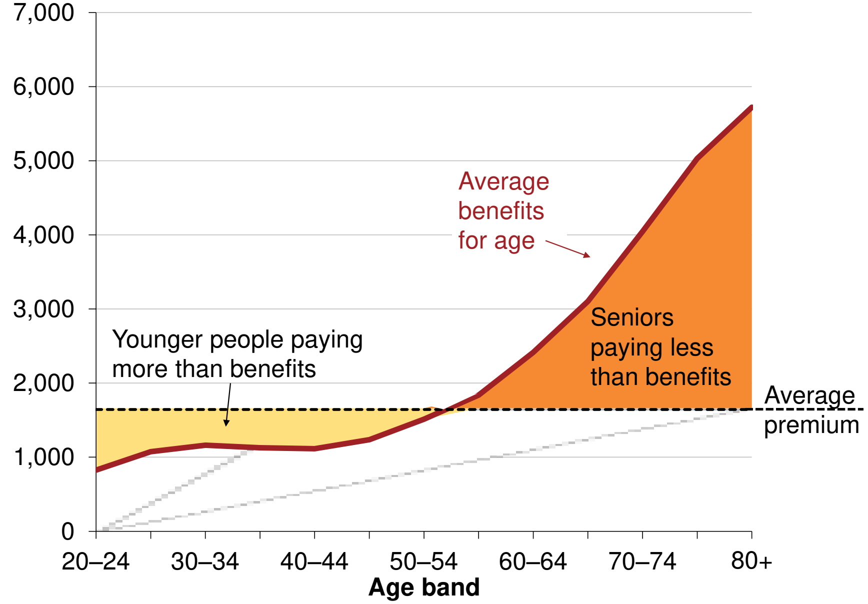
It might be argued that the seniors rebate is appropriate because seniors generally have lower incomes, and so the cost of PHI – constant for all ages – is a larger proportion of their incomes.[78] But this approach is not generally applied in public policy. Younger households have other expenses (particularly housing) that tend to be much higher than for older households,[79] and government does not subsidise these costs for younger households.

5.6 Private health insurance rebates should be the same for Australians of any age

There are plausible arguments for winding back the PHI rebate for people of all ages.[80] It does not obviously reduce overall health costs to government: assuming historical behaviour continues, the cost of the rebate is larger than the additional health costs that governments would incur without it.

Figure 5.4: Community ratings protect seniors from high insurance premiums, and mean younger Australians pay more

Average private health insurance benefits per annum, nominal dollars



Notes: Benefits per year are calculated as the annualised benefits of the June 2016 quarter, scaled to the total 2015-16 benefits as published in APRA (2016c). This figure does not show persons aged under 20.

Source: Grattan analysis of APRA (2016d).

have lived in Australia over the last 10 years, but did not have private health insurance.

78. Lavelle (2005).

79. ABS (Various years).

80. Daley et al. (2013, p. 71).

Nevertheless, if the rebate remains, senior Australians should receive the same rebate rate as working-age Australians. There is no reason for senior Australians to pay less for a given health insurance policy than younger Australians on the same income. Given community ratings, a private health insurer charges all Australians the same premium, regardless of age or their general health. Under a fairer system, the price of private health insurance premiums (net of tax) should be similar for all Australians. Approximately 2 million seniors would begin to pay the same premium as younger Australians under these changes.

If seniors receive the same rebate as younger people with similar incomes, most seniors will retain their private health insurance policies, although a small number may drop out. These seniors will have their needs met by the public health system, but may face longer waiting times for elective surgery.

Government increased the PHI rebates for older Australians when it could afford to do so. That is no longer the case.

Removing the higher rebate rates for older Australians would contribute $250 million to budget repair. Annual PHI rebate expenditure would fall by about $300 million with a small offsetting increase in public hospital expenditure. Using the middle of the band of two other studies, it is reasonable to estimate that public hospital costs would increase by about 20 per cent of the increased premiums – about $50 million a year as a small number of seniors drop their private health insurance.[81] The ratio of the change in public hospital costs to the change in premium costs in this estimate is similar to results from the 2006 Health Department review (Section 5.4).[82]

The change will increase the short-term profitability of the private health insurance industry if some seniors choose to drop their cover. The average 70 year old receives $4,050 in benefits each year yet the average premium is about $1,650. Currently, the shortfall of $2,400 is funded through higher premiums for all policyholders. If fewer seniors are insured, it is likely that the increased profitability will ultimately be passed on to PHI holders of all ages, as their premiums increase by less than they would otherwise. These effects will be small: seniors are only about 15 per cent of all private health insurance holders and few of them will drop their policies.

81. See PBO (2016) and Cheng (2013).
82. Department of Health and Ageing (2006b).

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