The Australian

Doubling tax on super will blow out distortions

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- From: The Australian
- April 30, 2012 12:00AM

GIVEN just how warped our taxation of superannuation is, one might have thought it difficult to make it worse.

But the government's proposed doubling of the tax rate on superannuation contributions for those with incomes above $300,000 does the trick. That they intend to do it is known but it's not on the record yet.

The result will be a tax structure even more poorly designed than the one we have now, further distorting retirement incomes, reducing savings and undermining the incentives for the boomers to remain in the labour force.

Currently, high-income earners, when they save for retirement, pay a 15 per cent tax rate on their superannuation contributions instead of the 45 per cent marginal income tax rate they would otherwise face, a difference of 30 percentage points.

In contrast, income earners who earn between $37,000 and $80,000 receive a concession of only 17.5 percentage points, which takes the tax rate on their superannuation contributions down from the 32.5 per cent marginal income tax rate to the same 15 per cent level.

That difference between the 30 percentage point concession to high-income earners and the concession of 17.5 percentage points to the lower income bracket is, the government claims, manifestly unfair.

But it is nonsensical to read fairness or unfairness into individual provisions of the tax law. Rather, even from the narrow perspective of social equity, what counts is the overall effectiveness of the tax/transfer system in reducing lifetime disadvantage. The goal, in other words, is to achieve an equitable distribution of the pie as a whole, rather than a false uniformity in the allocation of its underlying ingredients, and to do so without shrinking the pie unnecessarily.

Given that goal, individual components of the tax system should be designed to minimise the distortions taxation inevitably involves while raising sufficient revenue to meet our shared goals and aspirations. Seen in that perspective, substantial income tax concessions for savings, far from being unfair, are crucial to efficiency and to ensuring national income is sufficiently high to fund public goods and the provision of social security.

That is because progressive income tax systems, such as ours, have what the Henry report rightly describes as a "punitive" effect on savings, taxing both the income from which the savings are drawn and the added income those savings generate. While what matters is not the number of times savings are taxed but the total rate those taxes involve, the cumulative impact in practice is taxes well above efficient levels. Moreover, the longer a person saves and reinvests, the greater the implied taxes are. And the resulting distortion to savings increases more than proportionately with the income tax rate and its progressivity.

As a result, any sensible income tax system would provide substantial concessions for long-term savings, and would be particularly vigilant in protecting incentives to save from the distortions inherent in steeply rising marginal tax rates. And the concessions it offers would have to be especially large at the higher brackets, as that is where the distorting effects are most pronounced.

The need for such concessions is made all the greater and more pressing by our aged pension which, despite its obvious merits, further discourages long-term savings, both directly and indirectly. Directly, it substitutes for retirement savings, with the means testing of eligibility increasing the disincentive to save by punishing those who provide for themselves. And indirectly, funding pension outlays requires higher taxes, which themselves discourage savings, and are likely to do so to a growing extent as Australia's population ages.

Those factors mean doubling the tax rate on retirement savings by high-income earners is difficult to justify. But the harm is even greater than those factors suggest.

To begin with, the proposed change will render superannuation yet more opaque, and superannuation planning yet more complex, than they now are. Far from simplifying the tax system, its result will be a sequence of effective tax rates for superannuation contributions that first rises with income, then falls, and then increases sharply. That structure lacks any rational basis, and makes it even harder for taxpayers to design savings strategies that cope sensibly with the variability of income over the course of working life.

At the same time, the change will further distort the allocation of savings among alternative investments. Together with proposed increases in the means testing of aged care, it will make investing in the family home even more attractive, with all the distortions that involves, including to land prices. And since the concession has provided a way of protecting income secured by selling assets, its halving amounts to an increase in capital gains tax, aggravating the damage that tax does to taxpayers' ability to adjust asset mixes as circumstances evolve.

However, it is not only retirement savings that will be affected. Rather, as the concession has at least partly shielded high incomes from the top tax rate, the change is yet another increase in effective marginal tax rates. That is completely contrary to tax reform internationally, which favours flatter, not more steeply rising, rates. And it ignores demographic imperatives, for increasing taxes on contributions makes working less attractive to those approaching retirement, with impacts that could be especially marked on the baby boomers' decisions about the extent of their labour force participation. Since those decisions are already distorted by other taxes and transfers which induce unduly early retirement, the efficiency loss would be all the greater.

In short, the government's proposals will aggravate distortions both to labour supply and to retirement savings. That, however, is not to claim that our current system is perfect, for nothing could be further from the truth. But addressing its deficiencies requires a coherent strategy for tax reform, not the incessant tinkering which has been this government's hallmark.

It is not easy to find constants in that tinkering, other than its chip-on-the-shoulder populism, its junkie-like search for immediate revenue, and its peculiarly numbskull insensibility to the need for efficiency and predictability in taxation.

Its consequences, however, are easier to discern: a sugar-hit to the budget bottom line, bought at the expense of any certainty or confidence in the planning of retirement incomes.

Nor is there any difficulty in identifying the harms that will inevitably cause. But those harms take time to eventuate. And this government's motto is: in the short run, we are all dead. Too bad it has killed tax reform with it.

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