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Strangling super goose to get its egg

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Illustration: Eric Lobbecke Source: The Australian

BAD enough strangling the goose: they shouldn't get away with also gilding its eggs. For there are myths and there are facts. And while the myth is that superannuation savings are lightly taxed, the fact is that effective tax rates on long-term super savings are close to or even above the top rate of income tax.

But you wouldn't learn that from the redistribution lobby, whose motto is "what's mine is mine, what's yours is everyone's". On this they all agree: tax concessions to high-income earners on superannuation should be drastically reduced.

The ACTU says those concessions amount to "blatant tax evasion and avoidance". For the Australian Council of Social Service, they "enable well-off people to avoid paying tax". As for the Greens, they want high-income earners' concessions halved.

And now Treasury has leapt on the train, arguing the tax concessions go largely to top earners. The suggestion from these fellow travellers, first class, is that super savings are significantly under-taxed.

In reality, however, the headline 15 per cent tax rate on super gives virtually no guidance about how heavily super is actually taxed, as nominal and effective rates can differ greatly for long-term investments. Rather, the question is: if I save a dollar today, how much tax will I pay for each dollar I ultimately receive?

After all, super allows savers to defer consumption. As they accumulate, those savings secure more or less volatile returns and savers pay taxes, including on returns that merely compensate for inflation. The effective tax rate is therefore the tax savers pay for each dollar of future income, adjusted for inflation.

How high are those effective rates? Calculating them requires assumptions about future returns and inflation rates. But if one assumes a real annual return of 5 per cent and an inflation rate of 2.5 per cent, then the effective income tax rate on a dollar invested today and withdrawn in 35 years is 40 per cent.

Effective tax rates on long-term savings in our "concessional" regime are therefore more than twice the notional 15 per cent rate. And that ignores the impact of volatility in returns and the fact that income from super reduces savers' entitlement to the aged pension. When those are factored in, effective rates are likely at or beyond the top income tax rate of 46.5 per cent.

Moreover, the effective tax rate is even higher if evaluated in terms of how much savers have to pay to transfer a dollar of consumption from the present to the future. That "consumption tax rate" is the amount paid in tax for each dollar of consumption, which (assuming again a 5 per cent real return and 2.5 per cent annual inflation) is the 40c in tax divided by the 60c of post-tax income.

The consumption tax rate on super, which is how economists analyse taxes on savings, is consequently 66 per cent, even without the aged pension clawback.

But even more striking is just how punitive those effective rates would be were the concessions significantly reduced. Assume the headline tax rate on super savings by top income earners was doubled to 30 per cent, as the ACTU and the Greens propose. The consumption tax rate would then be 203 per cent: for the privilege of transferring $1 of consumption 35 years into the future, savers would have to pay $2 in tax.

As for the benchmark Treasury uses, which sets rates to current income tax rates, that implies an effective income tax rate on superannuation of over 80 per cent -- though you wouldn't know that from the Treasury paper, which doesn't report the calculations Treasury doubtless made. And little wonder they aren't reported, for the consumption tax rate at the top income bracket would be a staggering 465 per cent: each $1 of future consumption would cost savers nearly $5 in tax.

It is difficult to take such proposals seriously. Their impact would be to make retirement saving completely unattractive: in Treasury's benchmark, an initial $1 in pre-tax income invested at the top rate would, after 35 years, be worth barely 97 cents in post-tax super, implying negative returns. Given that each dollar in super is also offset against the aged pension, only compulsory savings would ever flow into the system. So while effective tax rates might be high, actual tax collections certainly wouldn't be.

And the economic costs would be high too. With contributions compulsory, the system would amount to a supplementary tax on current income: earn an additional dollar and you would be compelled to invest some of it in super, only to be taxed at punitive rates. That would simply discourage work and enterprise, while increasing tax evasion and avoidance.

But that is hardly likely to stop this government. Rather, the moment it thinks it can get away with savaging high-income earners' savings, it will, adding to the slugs inflicted to date. And the consequences will be felt for years to come.

There are lessons to be learned in that respect from the US. Years ago, occupational pensions provided many Americans with income security in old age. But with high marginal income tax rates, tax concessions on private pension plans seemed a gift to the well-off.

Beginning in the 1970s, congress placed ever more stringent limits on voluntary contributions and on tax-sheltered payouts, all in the name of reducing exemptions for higher-income earners. By 2010, the maximum payments a defined benefit plan could make to a retiring worker were worth 50 per cent less than those in 1979, while allowed payments into defined contribution schemes had also been halved.

The effect has been to drive defined benefit schemes towards extinction, leaving millions of Americans, whose defined contribution schemes have had neither the inflows nor the time to accumulate, facing dramatic income falls upon retirement. That not only increases the numbers heavily dependent on the social security system, which is already headed for massive deficits; it also makes reforming social security politically intractable.

But that outcome was entirely predictable: for the magic of compound interest cuts both ways. Steal from retirement savings today and by the time retirement comes, the income shortfall will have been multiplied many times over.

Yet that is exactly what our redistribution lobby now demands. Far from fixing the serious deficiencies in our retirement incomes system, they would plunder it to continue the wasteful public spending of the recent past. That their manifestly erroneous claims have gone virtually unchallenged shows the depths to which policy-making in this country has sunk.