THE AUSTRALIAN

Retiree tax just one more bone-headed idea

HENRY ERGAS THE AUSTRALIAN APRIL 15, 2013 12:00AM

ACCORDING to the government, taxing retirees' superannuation earnings above $100,000 will "enhance the sustainability of retirement incomes" while only affecting 0.5 per cent of retirees who are "fabulously wealthy". Those claims are demonstrably false: should it ever be legislated, the tax would eventually hit millions of Australians and make the superannuation system increasingly unsustainable.

As for the calculations in support of the government's claims, they show it has lost the will to live: even its excuses are second rate. To arrive at 0.5 per cent, the calculations ignore the fact that the tax can affect very low income retirees who realise capital gains, for instance, on a property held in their super fund.

And to determine the level of super savings above which the tax will be paid, they assume returns to superannuation funds are constant, rather than varying greatly from year to year.

Because of that variability, super portfolios have terrific earnings in some years but incur losses in others. The tax will fall on the good years, while allowing no offset for the hard times.

The effects of that asymmetry are anything but trivial. Assuming volatile rates of return, a super portfolio of $1.5 million at retirement should expect to pay the tax in 10 years out of 20, even though its average earnings (taking account of the ongoing decline in the amount invested) will be only $30,000. And initial portfolios as low as $800,000 are highly likely to experience at least one year in which they exceed the tax threshold, despite average annual earnings below $16,000.

But it is the long-term consequences that are truly far-reaching: because real incomes are rising, while the $100,000 threshold above which the tax is payable is constant in real terms, an ever higher share of retirees will pay the tax.

The impacts will be particularly marked on today's young people, who will be in the system for their entire working lives.

Assuming historical levels of income growth and rates of return, fully 20 per cent of them will pay the tax for 10 or more of their retirement years.

Moreover, that 20 per cent is a gross underestimate of the numbers who will ever pay the tax because it ignores variability in returns. Taking variability into account, by 2050, the tax will affect about 55 per cent of super savings. Nor will those taxpayers be "fabulously wealthy": their average income from all sources will (in 2013 dollars) be less than $70,000.

The overall impact will be to increase tax rates on super, as earnings in super funds are taxed for more years.

Indeed, lengthening the period in which taxes are paid will drive effective tax rates on super above the top marginal income tax rate. And variability in returns will further increase those effective rates, making them among the highest tax rates on retirement savings in the developed world.

The disincentives that creates to saving for retirement are obvious; but they are worsened by the interaction with the aged pension. The pension is means tested, with the means test indexed to CPI. But because average incomes grow more rapidly than CPI, the threshold level above which the full pension is lost falls as a proportion of incomes over time, making the pension test ever tougher: this year, assets three times the average income make a retiree ineligible for the full pension; by 2050, that multiple will be down to two.

That means each per cent of income retained in super will be punished twice: first, by being taxed more heavily under the government's proposed new tax, and second, by more rapidly reducing pension eligibility.

That the pension is indexed to earnings (which grow more rapidly than CPI), just makes the punishment greater, as not qualifying for the pension imposes a bigger loss. The result will be to discourage and distort voluntary retirement savings.

To begin with, savers will face heightened incentives to shift savings into the family home, which is exempted from the pension assets test. That shift will further distort housing markets, increase the number of people on the pension, and make savers' portfolios less diversified, increasing the risks to which they are exposed.

At the same time, those savings that do stay in the super system will shift into lower volatility investments, even if they yield lower returns to savers and to the economy. That is because earnings from the more volatile investments are more likely to exceed the new tax's threshold and so be more heavily taxed. And the super funds will presumably encourage that shift by developing products that, at some cost, smooth yearly super earnings to just below the taxable threshold.

As those possibly unintended, but entirely predictable, consequences eventuate, pressures will mount to close off the avoidance opportunities and tax savers even more heavily. That virtually nothing has been said about how the new tax would actually work only makes such further meddling more certain. Little wonder confidence in the superannuation system has reached all-time lows.

But that merely mirrors a broader collapse of confidence in government. According to the latest World Values Survey, the proportion of Australians with a high level of confidence in government has fallen 20 per cent since the Howard years. With bone-headed policies like these announced virtually every day, what else could one expect?