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Shorten’s squeeze on nest eggs benefits nobody

Illustration: Eric Lobbecke

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When imputation credits were made fully reimbursable, Labor wasn’t merely supportive — it was positively gushing.

Calling attention to the benefits full reimbursement would provide to a “low-income person who earns a little investment income”, Peter Cook, Labor’s then deputy leader in the Senate, claimed paternity for the policy, which Labor had taken to the previous election.

It “is our policy”, Cook said: “It builds on the major reforms accomplished by Labor and improves the current taxation system, especially (for) retired Australians.” Labor therefore had “no difficulty supporting the proposal”.

But Labor’s endorsement of full reimbursement was never likely to hinder Bill Shorten and Treasury spokesman Chris Bowen in their rush to raise taxes.

Implausibly portraying a reform introduced in 1999, four years before there was any sign of a pick-up in commodity prices, as an example of the profligacy induced by the mining boom, Shorten and Bowen now argue that scrapping the full refundability of imputation credits would be “good policy”.

In reality, the move would be starkly inconsistent with the purpose and design of an imputation tax system.

And far from making our tax system stronger, as Bowen has claimed, it would transform the taxation of dividends into a dog’s breakfast. Put at its simplest, the goal of an imputation tax system is to ensure company profits, when they are paid out as dividends, are taxed at, and only at, the personal income tax rate of the person who receives them.

As the Ralph review of business taxation — which endorsed full refundability — recognised, that yields three benefits: by preventing company income from being taxed twice (once when it accrues to the company and then again when it is received as a dividend), it reduces the tax rate on savings and lowers the cost of capital; it ensures all forms of taxable income are taxed at each taxpayer’s marginal rate, avoiding the distortions that arise when income from one source is taxed differently than income from another; and it preserves the progressivity of the tax system, with lower income earners paying less tax on their dividends than do taxpayers who have higher taxable incomes.

Each of those goals would be compromised by Labor’s proposed change. And the consequences would be most severe for that “low-income person who earns a little investment income” Labor so fervently lauded when it endorsed the existing policy.

To begin with, the effective tax rate on the “little investment income” would rise dramatically, with the tax paid by a taxpayer who earned $18,200 from other sources and $10,000 in franked dividends increasing from $1900 to $3000.

To avoid a fall in their standard of living, without eating up some capital, the taxpayer would need to earn a higher pre-tax return, thus raising the cost of capital to Australian firms.

At the same time, instead of paying the same tax rate on all taxable income, that taxpayer would face an effective tax rate on dividends that was almost 60 per cent greater than that on other types of taxable income.

As well as distorting long-term decisions, that difference in tax rates would discriminate among households with the same level of taxable income, penalising those who relied especially heavily on income from dividends.

And to cap it all off, because low-income households would pay a higher effective tax rate on dividends than would many middle-income households, we would end up with a tax system that taxed dividends especially heavily at the bottom of the taxable income distribution.

In short, the tax rate on savings would rise, and the cost of capital with it; taxpayers with exactly the same taxable income would be treated differently, solely because some had a higher share of dividends in their income than others; and tax progressivity would be undermined, as some of the highest effective tax rates fell on low-income earners.

That Labor can maintain its changes would promote fairness and efficiency is consequently a mystery.

But fairness and efficiency are hardly what this tax hike is about. Rather, it is just the latest example of Labor's "pick and hit" approach to tax policy, which seeks to target tax hikes to groups Labor thinks it can demonise — in this case, largely or wholly self-funded retirees, whose savings have been high enough to allow them to provide for themselves but not so high as to place them in the higher tax brackets, where any imputation credits would be offset by tax liabilities.

With Labor preparing a substantial spending splurge, seizing a share of those retirees' savings is obviously attractive.

Whether Labor can get away with it is hard to tell. That there will be collateral damage to myriad other taxpayers is already clear. And Labor has announced so many tax slugs on savings — from halving the capital gains tax discount to the clampdown on negative gearing — that it risks widespread hostility.

What is certain, however, is that if Labor succeeded, the harm would be considerable, and not just to economic efficiency.

After all, unlike their counterparts of working age, who can at least partially offset higher taxes by working longer hours, most retirees have little scope to make up lost income — and the tightening of eligibility tests limits the backstop the age pension used to provide. They will therefore have to run down their savings and reduce their consumption, inflicting significant distress.

That won't cause Shorten or Bowen to lose any sleep. But it says something about the society we are becoming: one in which envy is a trump card. And with envy being the only cardinal sin that yields no pleasure to those who indulge in it, what a diminished society that promises to be.