Labor's tax attack on savings counter-productive

Henry Ergas and Jonathan Pincus 12-00AM May 13, 2019

Illustration: Eric Lobbecke

Australia may find itself next week on the path to the largest peacetime tax increases since Federation. It is not simply the magnitude of the tax rises that makes Labor's plans exceptional — both in historical terms and relative to global trends — it is that they are so heavily focused on penalising saving.

In the debate about those proposals, Labor and its critics have concentrated on who would, and who would not, pay the higher taxes. However, the costs that tax increases impose are never limited to those who sign the cheque.

Rather, as people adjust their behaviour, the economy shrinks. The precise extent of the effects is controversial. What is uncontroversial is

that for each dollar of revenue raised, taxes on savings do more damage than taxes on income or on consumption.

And it is also uncontroversial that the higher the taxes on savings are to begin with, the greater is the harm further increases will cause.

It would, in other words, be one thing if we were starting from a situation where taxes on savings were low, and all that was involved in Labor's plan was to bump them up slightly. It is quite another to begin with tax rates that are already high and drastically increase them.

That is what Labor intends. And given how large its proposed increases are, the tax rates Australians will face on many forms of saving will be far higher than those on income or current consumption, taxing longer-term savings at especially punishing rates.

To understand why, it is crucial to recognise that when savings are taxed as ordinary income, the effective tax rates can be extremely high even if nominal rates seem reasonable.

That is because the amount saved will have already been taxed; then tax will be applied to each year's returns before they are reinvested, with the tax compounding and the rate rising as the amount grows; and finally, when the savings are cashed out and spent, some part of that amount will be taxed too, including through the GST.

To make matters worse, because what is being taxed is the nominal amount, the taxes may deprive the saver of any compensation for inflation, driving real returns to or below zero.

Consider a nurse who takes on additional hours and earns $1000, on which she pays income tax of $190. Assume also that she then invests the remaining $810 in a 20-year term deposit paying 2.2 per cent, each year reinvesting the interest after tax into the same deposit account.

If she remains on the 19 per cent tax rate, in 20 years she will receive $1150 to spend. However, with the inflation rate over that period - averaging 2 per cent, her $1150 after tax will be worth just $780 at today's prices, which is less than the amount she originally deposited. And assuming she pays GST on that spending, the initial $810 she saved will be reduced to barely $700 of buying power.

Thus, through the cumulative effects of tax and inflation, she loses more than she earns in interest: her effective real tax rate exceeds 100 per cent — which will discourage her not only from saving but also from working those hours in the first place.

So as to avoid those effects, every advanced economy protects savers from ordinary income taxes, providing concessions and exemptions through which to save for the long term. Indeed, expanding those protections has been a central element in tax reform almost everywhere.

Labor is going in the opposite direction, either further curtailing existing protections or eliminating them. It would thereby give savers few options but to face the punishing treatment they suffer under ordinary income taxes.

The taxes on capital gains are an important case in point. As things stand, the capital gains realised on the sale of assets that have been held for at least a year are taxed as ordinary income but on a concessional basis: only half the gain is subject to tax. Labor proposes to halve that concession, so that tax would be applied to three-fourths of the amount gained.

Many simplifications need to be made to present readily tractable examples of the impacts. But consider, as an illustration, a taxpayer who is in the 32.5 per cent income tax bracket. Assume that taxpayer faces a choice between spending $1000 now and buying shares in a company that pays no dividends but secures and each year reinvests a 6 per cent

return on the initial investment, with that reinvestment boosting the value of its shares.

For the taxpayer who decides to buy those shares now and sell them after 20 years, company and capital gains taxes would, under today’s arrangements, reduce the payout from $3200 to $2070, imposing an effective tax rate of 55 per cent on future consumption (where the tax rate is calculated as the tax paid for each dollar of final spending power).

Moreover, because of inflation, that $2070 would, at today’s prices, be worth just $1400, slashing the pre-tax 6 per cent return to a real return of just 1.7 per cent a year.

Under Labor, however, the effective tax rate will rise to 63 per cent, further reducing the real return. And even that increase understates the difference between the future under Labor and that under the Coalition.

The Coalition has pledged that by 2024-25, 90 per cent of income tax payers will face a 30 per cent tax rate. Labor does not intend to flatten the income tax structure but to make it yet more progressive. And by including a greater share of the capital gain in taxable income, Labor will ensure more taxpayers who earn capital gains are pushed into its highest tax bracket, despite comparatively modest lifetime incomes.

Assuming then that under the Coalition, the recipient of the capital gains would remain in the 30 per cent bracket, while being pushed under Labor into the top bracket, the relevant comparison is between the Coalition’s already high 54 per cent effective tax rate on capital gains and a positively astronomical 77 per cent under Labor.

Taking into account the US and French tax reforms, which slashed taxes on savings, that will be easily the highest rate of tax on capital gains in the developed world. And its effects on savers will be compounded by the elimination of negative gearing on existing housing, the additional

restrictions on superannuation, the clampdown on trusts and the refusal to refund company tax to low-income earners.

Labor’s mantra is that none of that matters because it is the infamous “1 per cent” who will foot the bill. However, even for capital gains, where it makes that claim most insistently, its argument has no basis in reality.

In effect, tax office data shows that high-income earners already pay capital gains tax at a rate that is only marginally below the top income tax rate.

Thus, in 2016-17, the top 0.32 per cent of individual capital gains taxpayers accounted for 44.2 per cent of the overall capital gains tax revenue collected from individuals. Those taxpayers paid an estimated average tax rate of 46 per cent — a shade less than the top rate.

That the concession has so little effect on those taxpayers’ tax rate is unsurprising: typically, the well-off have a large proportion of their assets in shares that are held for less than a year and so do not benefit from the concession. Rather, it is to the taxpayers who have only a few investments, such as a flat at the coast, that the concession makes the greatest difference.

Labor’s claim that its increase will mainly hit the “1 per cent” is incorrect for another reason. Most high-income earners have large and diversified asset portfolios, along with relatively easy access to credit. As a result, they have considerable discretion about when they realise capital gains and can do so at a time that optimises their tax position.

Middle-income households, with narrow portfolios and constrained access to credit, have little scope to manage the timing of asset sales. They are therefore more likely to find themselves forced to sell an asset when doing so will push them into a higher tax bracket and expose them both to Labor’s halving of the concession and its increased income tax

rate at the top.

It is middle-income earners who will find it more expensive to save. Will that cause them to save much less? Possibly not — but that is not the relevant test. After all, it is obvious that if you increase income taxes, some people may not materially reduce the hours they work. But they will be worse off and are likely to change their behaviour in other ways — for example, by accepting non-monetary benefits as compensation. So even though overall hours worked may not fall much, it would be foolish to claim the tax hikes have a low economic cost.

Equally, while it may be that middle-income earners sacrifice other goals so as to maintain their savings levels, no one could sensibly deny that they have been made materially worse off, all the more so as their pattern of consumption has been so seriously distorted.

Perhaps that doesn't cause Labor to lose any sleep, but the broader consequences should.

Thus, a higher tax rate on capital gains, particularly when it is combined with a steeply progressive income tax structure, increases the incentive to hold on to gains and realise losses. That makes asset markets less efficient — in terms of their ability to settle at a price that reflects long-term value — and more unstable, as the withholding of assets during upswings accentuates the boom, while the rush to realise losses when prices decline aggravates the bust.

At the same time, higher taxes on capital gains will hammer the medium-sized companies that rely on retained earnings — and hence on capital gains — to fund expansion, reducing investment and entrenching the oligopolistic structure of our economy.

There is, in other words, a steep price to pay for Labor's tax offensive on savers. It is difficult to see how the costs it imposes could be justified.

And making them even harder to justify is the fact that while Labor will punish voluntary saving, it will — by raising the superannuation guarantee — force many families who have more pressing calls on their incomes to save. As so often happens, choice will be replaced by coercion as taxes soar.

We can therefore safely conclude that Labor’s plan is not merely the largest peacetime tax increase in our history, it must also rank among the most inefficient. If that is what Australians want, they know how to get it.