Tax White Paper Task Force
The Treasury
Langton Crescent
PARKES ACT 2600

24 July 2015

To whom it may concern,

My submission focuses on the tax treatment of retirement savings and income and responds in part to issues and questions raised in chapter 4 of the *Re:think* Tax Discussion Paper of March 2015 (the *Re:think* Discussion Paper).

Superannuation is obviously a key source of retirement income for many people, but it is difficult to separate the tax treatment of superannuation from the tax treatment of savings more generally, or from eligibility for and the benefits of the Commonwealth Government age pension. I cannot claim to be an expert in any of these areas; this submission has been prepared simply from the perspective of someone making financial and lifestyle decisions with an eye to a future retirement.

The taxation of income from saving raises issues of both equity and efficiency, which I discuss in turn. In examining both sets of issues, the relevant economic benchmark I have adopted is the absence of taxation. The extent to which a tax favours some individuals over others or distorts behaviour can only be properly assessed against a base case of no taxation.

In this context, it is clear that taxes on the returns to savings are a form of 'double taxation' of income saved. As illustrated by Professor Scott Sumner's "two brothers" example, taxes on capital income impose higher burdens on the frugal than the profligate, *at any given level of labour income*.[1] Chapter 4 of the *Re:think* Discussion Paper notes this argument, without expressing any agreement or disagreement. However, it is perhaps telling that the Discussion Paper moves on to provide several 'however' arguments for imposing some tax on incomes from savings. If Treasury accepts that taxing income from savings is indeed double taxation, it would be helpful for Treasury to explicitly acknowledge this important conceptual point before proceeding further.

As many stakeholders and commentators in the media are not aware or do not understand the double taxation effect of taxes on capital income, I believe it is worthwhile to demonstrate the implications of treating capital income identically to labour income through the use of a worked example. For this reason, I commend the analysis prepared by Henry Ergas, which is available at: http://blogs.theaustralian.news.com.au/henryergas/index.php/theaustralian/comments/super_tax/

Ergas's analysis[2] shows that if income saved for retirement were taxed at a high-income taxpayer's marginal tax rate, and the returns on such savings were similarly taxed at marginal tax rates, the ultimate payout after 40 years would only be 15% of what it would have been in the absence of taxation – an effective tax rate of 85%. By contrast, if the same taxpayer simply spent all his or her post-tax income on immediate consumption, he or she would 'only' pay a tax rate of 45% (ignoring

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1 See: http://www.themoneyillusion.com/?p=7091 , accessed 11 July 2015.

2 Ergas's analysis assumed a marginal income tax rate of 45%, a real gross return of 5% pa and inflation of 2.5% pa. His analysis appears to contain minor errors, but they do not affect the results significantly.

consumption taxes in both cases). For savings set aside for shorter periods of time, the effective tax rate would be lower. But Ergas's analysis shows that even income saved for 20 years faces an effective tax rate of 71% and income saved for 10 years faces an effective tax rate of 60%. By comparison, Ergas found that the current concessional tax rates for superannuation result in an effective tax rate on income saved of 43% after 40 years, 30% after 20 years and 23% after 10 years.

Ergas's analysis clearly shows that pre-tax income saved via superannuation receives beneficial tax treatment relative to income spent immediately, at least for higher income-earners and especially for those contributing a relatively short period before retirement. However, it is important to note that concessional contributions to superannuation are now limited to $30,000 pa for those aged under 50 and $35,000 pa for those older. To the extent that higher-income earners wish to save more than these limits, or to the extent that those on more moderate incomes do not wish to lose access to their savings for potentially several decades, people planning to save for retirement are taxed very heavily indeed – well above what most stakeholders and commentators appear to understand. Of course, the effect of higher voluntary savings on a person's eligibility for the age pension worsens the effective marginal rate of tax even more.

In my view, it is no answer to this fact to claim, as the Discussion Paper does, that "individuals with higher incomes tend to have higher levels of income from savings." This may be the case, but the proper way to ensure appropriate progressivity in the tax system is through progressive marginal tax rates on labour income, rather than to penalise those at any given level of labour income who choose to save more rather than less. This constitutes the equity argument in favour of the continued concessional rates of tax on superannuation savings, and/or low or nil rates of tax on capital income more generally. Similarly, to maintain equity, it would be appropriate to increase marginal tax rates on labour income if all taxation of savings were abolished, as I believe it should be.

Chapter 4 of the *Re:think* Discussion Paper acknowledges the conceptual case for income from savings to be taxed at a lower rate than labour income. However, it proceeds to make a three-part efficiency-based argument for why there should be at least some tax on income from savings:

- First, the counterfactual to taxes on savings could be higher taxes on income, particularly labour income.
- Second, it says "the behavioural response to taxing savings is uncertain and may not be significant."
- Third, even if the tax treatment of capital income reduces domestic saving, this is unlikely to affect Australia's overall level of investment, except in the real estate market – and there the effect could be to help avoid ever-higher house prices.

This three-part argument goes to the question of whether a higher rate of tax on income saved verses income spent is likely to reduce overall economic welfare. While I am not familiar with the literature the Discussion Paper refers to in making the second argument, I believe it is likely that high capital income taxes can and do harm overall welfare.

To my mind, the key question is whether a tax on capital income is more or less likely to harm work incentives than a revenue-equivalent increase in tax on the labour income of people who would have a similar lifetime income in a no-tax world. Recall that a nil tax on income from savings treats people with different propensities to save equally – everyone irrespective of their desire to save would face the same implied tax rate on their income and consumption compared to a no tax world. To argue on efficiency grounds in favour of a positive tax on income from savings is to suggest that the willingness to work of those with higher propensities to save (ie those more keen to smooth their lifetime consumption) is less responsive to higher taxes than those with lower propensities to save. This seems unlikely. If anything, those earning a particular annual wage that consume most of their income would appear less likely to reduce their work effort if labour income taxes rose than would those who save a large proportion of their income and faced higher capital income taxes.

For example, consider two workers, A and B, who would each earn $100,000 per annum over a 40 year working life in a no-tax world. Assume that worker A consumed all his or her income each year (relying on the age pension in retirement), while worker B consumed only three-quarters of his or her income each year. Assume two alternative tax regimes that both raised the same revenue assuming no change to work effort:

- One (X) in which labour income was taxed at 50% and there was nil tax on income from savings (such that the implied tax rate on income saved was also 50%)
- Another (Y) in which labour income was taxed at 45% and there was a 20% tax on income from savings (such that the implied tax rate on income saved was 60%).

Assuming no behavioural change, worker A would be better off under regime Y and worker B would be better off under regime X. The question is then which worker would reduce work effort by more under his or her non-preferred tax regime. I submit that worker B would be more likely to reduce lifetime work effort if living under regime Y than worker A would if living under regime X. The fact that worker A consumes all his or her income suggests he or she is unlikely to reduce work effort if faced with higher taxes on labour income. If anything, he or she may *increase* work effort to maintain his or her current levels of consumption. Conversely, worker B has already evinced a willingness to sacrifice present consumption to support future consumption. He or she *could* choose to respond to tax regime Y by consuming more and saving less or by increasing work effort; but I believe it is more likely that worker B would find taking increased leisure more attractive under regime Y than worker A would under regime X. In other words, I submit that other things being equal, those who save more of their income are more likely to respond to higher taxes by reducing work effort than those who save less of their income.

In any case, to sustain an efficiency-based preference for tax regime Y (akin to the current tax system), it would be necessary to show that the labour supply of thrifty workers was *less sensitive* to high taxes than the labour supply of profligate workers. This appears very unlikely. Accordingly, nil or low taxes on income from savings combined with higher taxes on labour incomes are likely to promote more efficient outcomes than the opposite. I submit that it should be those who support the double taxation of savings to justify that this would produce the less distortionary outcomes.

Response to discussion questions 18-21

While consultation on these questions may have closed, in light of the above points, I submit that the starting point for the taxation of savings should be a nil tax. That means no tax on bank interest or debt instruments held by individuals, no capital gains tax at all and full dividend imputation. Without any tax on capital gains, it would be appropriate to abolish negative gearing on all assets.

Response to discussion question 22

I noted above that income saved via concessional contributions to superannuation receives beneficial tax treatment relative to income spent immediately, at least for higher income-earners and especially for those contributing a relatively short period before retirement. However, in light of the punitive tax rates applying to most other forms of saving by middle- and higher-income earners, the treatment of concessional superannuation contributions is not unfair. In particular, I suggest that most people with high propensities to save would prefer a regime of nil taxes on all capital income and higher taxes on labour income than the present mix of superannuation arrangements and extremely high taxes on income from other savings.

Accordingly, if the government wishes to change the tax arrangements on superannuation to make them 'fairer' in a standalone vertical equity sense – say, by providing all taxpayers with a flat 15% rebate on pre-tax contributions as appears to be popular – I submit that concessional contribution caps for superannuation should be abolished entirely. This would at least provide those workers with a desire to save for their retirement savings an option that was not punitive.[3]

Response to discussion question 23

If Australia is to continue to impose taxes on income from saving, a dual income tax of the type the Discussion Paper describes as operating in Norway could be preferable to the current arrangements. However, the adoption of a flat capital income tax would have a similar distributional impact as the current flat tax applying to superannuation contributions and earnings – it would provide less benefit to lower-income savers than higher-income savers. It is unclear given the tone of the Discussion Paper and much current media debate whether such a regime could be sustained in Australia. Even if it could, it would be inferior the abolition of capital income taxes and higher taxes on labour income.

Yours faithfully,

Rajat Sood

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[3] For example, a high-income earner who was taxed 30% on superannuation contributions and 15% on superannuation earnings would face an implied tax rate of 54% after 40 years, 43% after 20 years and 37% after 10 years.