Savings-exempt income tax (SEI tax)

A scheme to simplify the tax treatment of savings and retirement incomes

by John Ballantyne

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About the author

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The worst way for the Australian government to solve its budget woes would be to slash tax concessions for superannuation. This will impede people's capacity to provide for their retirement and, in the long run, end up making more of them dependent on the public purse.

A better long-term alternative would be to exempt all channels of savings from tax entirely by replacing income tax with a savings-exempt income tax (SEI tax).

The SEI tax is an idea associated with British Nobel prize-winning economist, the late Professor James E. Meade. It is a form of income tax where the tax is levied only on that part of income that is consumed, but exempting the part that is saved or invested. Instead of paying 20 or 40 per cent on whatever you earned, you would pay a progressive rate of tax on whatever you spent.

Taxing personal consumption expenditure in this way would not, as some fear, require hiring an army of taxmen to follow you into supermarkets to check how much you were spending. Instead, you would simply add up your incomes from all sources, take away whatever you had saved (the change in your savings account, shareholdings and so forth), and pay tax on the remainder.

SEI tax would effectively be a tax on personal consumption expenditure, but would have none of the drawbacks of the goods-and-services tax (GST). It would neither add to the cost of living nor hurt the poor.

Like the income tax it would replace, an SEI tax would have a tax-free threshold for low-income earners and special allowances for families with dependants. Above that threshold, people would pay a progressive rate of tax according to their level of consumption expenditure.

The new tax would be especially effective at bringing cross-national electronic commerce into the tax net, without requiring the Australian Tax Office to keep track of millions of individual transactions.

A tax which, in Meade's words, "levied a charge on what people took out of the economic system in high levels of consumption, rather than on what they put into the system through their savings and enterprise", would unlock enormous opportunities for investment, modernisation and economic growth. It would be the entrepreneur's charter.

As all personal savings would be 100 per cent tax-deductible, SEI tax would:

- **Remove** the wedge which income tax inserts between pre-tax and after-tax returns on savings, and would thus ensure that savings and investment decisions were no longer distorted by tax considerations.
- **Abolish** the need for capital gains tax – that is, the sale of capital assets would be taxed only to the extent that the proceeds were used to finance personal consumption, but not if they were re-invested.
- **Remove** income tax's notorious bias – known as the "bunching" effect – against people on irregular or fluctuating incomes, such as writers, farmers, the self-employed or people working overtime. Instead of penalising them, as income tax does, SEI tax would not penalise the receipt of a large lump sum by, say, a best-selling author or inventor, unless he/she spent the windfall all at once.
- **Simplify** the tax treatment of lump-sum retirement pay-outs and annuities. Any income saved – whether in superannuation or in a pension fund – would be tax free, as would all interest earned on these deposits. On one's retirement, it would be the rate of one's spending on personal consumption that would determine how much tax was paid.

Retirees who squandered their savings would incur higher tax rates; retirees who drew on them gradually, spreading their expenditure over many years, would enjoy lower rates.

Such a tax on “dis-saving” would strongly deter recipients of lump-sum super or redundancy pay-outs from “double-dipping” – e.g., a retiree spending his or her lump sum, then claiming a government pension.

If a person squandered, say, a $120,000 lump sum in a single financial year, he/she would immediately be hit with the highest marginal rate of tax; whereas, if he/she salted away this sum in financial assets and drew on it only gradually, spreading his/her expenditure over many years, he/she could be taxed at a far lower rate.

Dr Vince FitzGerald, former head of the Commonwealth government’s Finance Department, declared in his 1993 report on national savings for the Keating Labor government that “the Meade scheme stands as the ideal benchmark for a pro-saving tax regime”.

The SEI tax would simplify our present muddled and inconsistent tax treatment of savings, where different concessions apply according to how much you earn and which savings vehicles you use.

This tax idea has long attracted support from many distinguished economists across the political spectrum, including Britain’s Lord Kaldor and James E. Meade; America’s Martin Feldstein, one-time chairman of President Reagan’s council of economic advisers; and Australia’s Ian Harper.

SEI tax is sometimes known as “expenditure tax” – a misnomer, as it inevitably gets confused with regressive consumption taxes, such as sales tax and GST. Professor Meade, chairman in the late 1970s of a high-powered British committee of inquiry into the tax, later coined the more appealing name, savings-exempt income tax.

American supporters call it the USA (unlimited savings allowance) tax. Laurence Seidman’s 160-page book, *The USA Tax: A Progressive Consumption Tax* (1997), is probably the most lucid and succinct description of the SEI tax and how to phase in and administer it.

Transition

The transition from our present income tax to a savings-exempt income tax need not entail a great administrative upheaval. Our present system of personal taxation already grants tax advantages for at least some channels of savings.

To make our system of personal taxation more consistent, we really have only two options: either (a) move towards a pure income tax, by closing off all tax advantages for savings, or (b) move towards an SEI tax, by consistently exempting all savings from tax.

Under SEI tax, the existing tax system would be left just as it is, except that people would be given an income-tax deduction for any increase in their savings through designated savings vehicles.

Tax revenue

But can today’s cash-strapped Commonwealth government seriously afford to exclude savings from the tax base?

Here, it is vitally important to resist the short-sighted view that an SEI tax would be a blow to government finances. The new tax, by giving everyone maximum incentive to become financially self-reliant, would eventually lead to far fewer taxpayers being reliant on the public purse.

Moreover, the new tax could be phased in over five years. If Australia’s economy grows even moderately during this period, there would be no need to raise PAYE rates to offset the deduction of savings from tax, since the expenditure-tax base five years from now could well be equal to, if not greater than, today’s income-tax base.

To prevent the new tax from having a deflationary impact on consumer spending, the government would obviously need to fine-tune the tax rates and the level of public spending to maintain the desired level of overall economic demand.

Several overseas studies have examined important administrative details associated with the SEI tax, including the definition of occupational expenses for tax purposes, how to treat the acquisition of expensive durables such as the family home, as well as proposals to streamline company taxation. The Meade committee report looked into the options of introducing wealth and inheritance taxes in the event that it was felt desirable to disperse excessively large fortunes.

The new tax can be readily designed, as Professor Seidman has shown, to maintain existing levels of tax revenue for the government. Moreover, the government can structure the tax brackets so that each income group will pay approximately the same amount of tax that it pays under our present income tax.

SEI tax would be especially good at bringing cross-national electronic commerce into the tax net. The celebrated GST – once touted as being the ultimate weapon against tax cheats and the black economy – is incapable of taxing items purchased on the Internet when the supplier is overseas. Federal Treasurer Peter Costello admitted in 1999 that e-commerce "is tax-free and you can avoid the taxation system because technology is defeating it". (*The Australian*, June 22, 1999, pp. 1-2, and June 24, 1999, p. 27.)

SEI tax solves this dilemma because it shifts the point at which the government collects revenue from the seller to the buyer. Rather than attempting to keep track of billions of individual tiny transactions, it uses a far more effective measure of a person's personal consumption expenditure: it simply measures the difference between his income and his net savings.

Each taxpayer would be required to provide a careful year-to-year record of (a) his income from all sources, (b) his purchases and sales of assets, and (c) his incurring and discharging of liabilities.

This would, incidentally, make it impossible for dishonest citizens to make a practice of saving one year, thus escaping taxation, and secretly selling out and spending their savings in the next year.

Spending on imports

By controlling the level of total spending more effectively than income tax (which taxes incomes saved as well as incomes spent), an SEI tax would enable steps to be taken to prevent spending during an economic upsurge from getting out of hand and spilling over into a consumer binge on imports.

To date, the Government has relied too much on a single policy instrument – interest rates – with which to steer the economy.

High interest rates give us the worst of both worlds. They cripple our export capacity, by making new investment and modernisation more expensive, and attract speculative money from overseas, causing the Australian dollar to soar in value. This makes exports dearer and imports cheaper, thereby exacerbating our chronic current account deficit.

In good times, when interest rates are low, all too many Australian households borrow heavily to finance increased consumption.

An SEI tax by contrast would go a long way towards discouraging household indebtedness and excessive consumption of imports, and would give taxpayers maximum incentive – a zero marginal rate of tax, in fact – for every dollar saved or invested

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Postscript

Professor JAMES E. MEADE (1907-1995), the British 1977 joint winner of the Nobel Prize for Economics, described the numerous advantages of introducing a savings-exempt income tax (also known as a progressive expenditure tax):

> "[An expenditure tax]... levies a tax on the claims which a taxpayer makes at any one time on the community's resources which he uses up for his own consumption purposes. If he saves his income instead of consuming it, he is putting resources back into the productive pool; if he dissaves, he is taking resources out of the productive pool in addition to his other income. His relatively low consumption in the case of savings and his relatively high consumption in the case of dissavings are measures of what he is appropriating at any one time for his own personal use.
>
> "This expresses what is normally regarded as the essential case for the choice of expenditure on consumption as the base for progressive personal taxation. A *progressive expenditure tax* [i.e., a savings-exempt income tax] falls more heavily than progressive income tax on the wealthy who are financing high levels of consumption out of capital resources, but at the same time it gives much greater opportunity than does a progressive income tax for the finance of the development and growth of private enterprises out of private savings....
>
> ".... By shifting the tax base in this way all forms of enterprise – big or small, privately owned, state owned or labour-managed – would be able to plough back their own profits or to borrow the savings of others free of tax for all forms of economic development. But at the same time wealthy persons who were maintaining a high standard of living by dissaving from their capital wealth would be more heavily taxed than at present.
>
> "A possible political reaction to this would, I suppose, be for the 'left' to reject it because it gave an opportunity for private capitalist enterprise (as well as for state enterprise and labour-managed enterprise) to invest more and to expand employment opportunities, and for the 'right' to reject it because it would hit the rich who were living on inherited property. My hope is that the opposite would happen – that the 'left' would welcome the egalitarian overtones and the 'right' the opening up of opportunities and incentives for all forms of enterprise. Indeed, if we are to find a reasonable base of political consensus for our mixed economy, I can see no better fiscal contribution to this end than a tax structure of this kind."
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> [SOURCE: *The Structure and Reform of Direct Taxation:* Report of a Committee chaired by Professor J.E. Meade (London: Institute for Fiscal Studies / Allen & Unwin, 1978), pp.33 & xvi. Emphasis is Meade's.]

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