Squeezing the wealthy more complicated than it looks

Tax policy
Imagining that revenue can be wrung from the rich ignores real issues in how tax changes economic activity.

Richard Holden

Alexandria Ocasio-Cortez, the young left-wing firebrand member of the US House of Representatives, has become notable for two things. The first was the revelation that, as a college student, she danced on a rooftop in a YouTube video. The second was more consequential – she called for a top marginal personal income tax rate of around 70 per cent.

This was met with the kind of response one has come to expect in our politics. Anti-tax lobbyist Grover Norquist described it as "the opening shot in a renewed war against middle-class taxpayers". Fox News' Sean Hannity decried her "radical platform". And Paul Krugman of *The New York Times* defended the tax policy as mainstream economics with a sound logical basis, saying "AOC, far from showing her craziness, is fully in line with serious economic research".

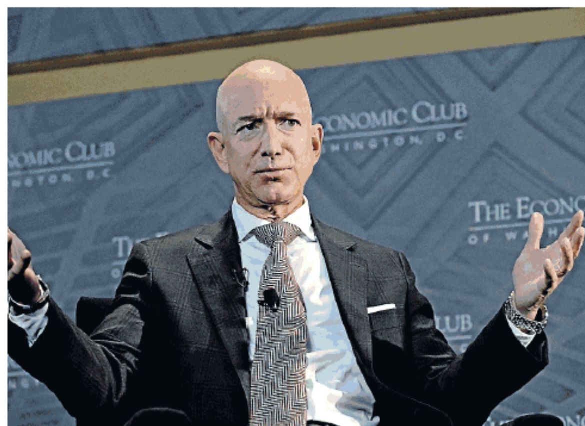
To Ocasio-Cortez's credit, the 70 per cent number is consistent with an estimate from a 2011 paper by perhaps the two leading tax economists in the world, Peter Diamond (a Nobel laureate) and Emmanuel Saez (a John Bates Clark Medallist).

There are a few important things to point out about the Diamond-Saez calculation. The first is that it is for all taxes – including state and local taxes, levies, property taxes, sales taxes, estate taxes, and the individual share of corporate taxes (that come, for instance, through higher prices). We also have to include the phase out of benefits such as childcare and family support.

So, in Australia one would add to the prospective top income rate of 47 per cent the 2 per cent Medicare levy, 10 per cent GST on relevant consumption, stamp duty and land tax (which are on property values and thus multiples of income), taxes on superannuation contributions (30 per cent for those earning more than $250,000 per annum), the implied share of corporate taxes, and more.

One can get to 70 per cent pretty quickly. Perhaps the Ocasio-Cortez plan actually involves a tax cut for some high-income earners.

Diamond and Saez also consider at what income level this top rate should kick in. The short answer is a pretty high level. Indeed, the authors perform their calculation by making sure that the number of people who pay the top rate is small enough that the impact on those folks can be more or less ignored.



Amazon CEO Jeff Bezos: Are taxes on the rich a tax on ideas? PHOTO: BLOOMBERG

There is some complexity involved in this but, being generous to the authors, it would be about $US435,000 ($608,000) per year in today's dollars.

Two crucial factors that Diamond and Saez also discuss are tax avoidance and how responsive people's labour supply is to tax rates. On avoidance, they are uncharacteristically glib, suggesting that avoidance would lead to a lower top rate, but that it is better to crack down on such behaviour. This reminds me of the 16th-century English nursery rhyme "If wishes were horses, beggars would ride," which incidentally may be the last time tax authorities achieved that kind of enforcement.

As much as Krugman and Ocasio-Cortez might like to point to the high top-tax rates

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of the 1950s, it is openly acknowledged that nobody actually paid such rates and that the purpose of the high rates was not even to raise revenue for redistribution. As President Kennedy said in calling for lower rates in his 1963 State of the Union address, "our obsolete tax system exerts too heavy a drag on private purchasing power, profits and employment. Designed to check inflation in earlier years, it now checks growth instead."

This brings us to the central philosophical and economic question underlying all these sorts of calculations – how much do high tax rates deter productive economic activity? There is a long debate about this, and to their credit Diamond and Saez use fairly reasonable labour-supply elasticities.

What they don't factor in is the notion that what some, perhaps many, top income earners produce is ideas. Consider for a second how much contemporary wealth in society has been generated by innovation and ideas. Think Apple, Amazon, Uber, Intel, Facebook, Google, and on and on.

The key point about ideas is that they benefit not just the inventors, but everyone who uses the idea. They are, in the language of 2018 economic laureate Paul Romer, "non-rival". The Nobel committee's recognition of the work of Romer and other "endogenous growth theorists" is itself a direct acknowledgment of how much economic prosperity in the last century has been generated by innovation and ideas.

A recent paper by Stanford economist Chad Jones provocatively suggested that when ideas are included in the analysis optimal top-marginal tax rates might even be negative – ie, we should subsidise innovation. Indeed, we do just that through tax breaks for R&D, the award of patents and so on. Putting a heavy tax on ideas hurts everyone, not just the innovators.

Justice Oliver Wendell Holmes was right when he said, "Taxes are what we pay for a civilised society." We should, of course, close tax loopholes and we certainly should not let the wealthy avoid taxes only for the rest of society to pick up the tab. But if we want to have an honest debate about the nature of income taxes then we should engage with the facts and sometimes complicated principles involved.

To her great credit, Congresswoman Ocasio-Cortez did just that. It would be nice if the Australian political debate over taxes were similarly sensible and informed, rather than resembling the intellectual equivalent of chimps hurling faeces at one another.

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'Best in show' is essential if super sector is to ever lift its game

Competition
The super industry has gotten away with the bare minimum for years. That will change if the funds have to fight for members.

Xavier O'Halloran

The superannuation industry collectively gasped last week as the Productivity Commission signalled the end of the gravy train with a raft of timely recommendations.

And who can blame the industry?

When you've had it this good for this long without really having to compete for customers, of course it would be a shock to be asked to ... fight for new members.

Caught unawares, the super spin cycle was soon in overdrive, with strange bedfellows in bankers and unions joining a chorus to criticise the commission's plan to make the super sector competitive.

The superannuation industry has one job – facilitating a safe, fair and secure retirement for Australians. Instead, our financial security in retirement has been siphoned off by a sector completely devoid of market discipline.

This is the heart of the problem in superannuation. In a normal market, if you perform poorly, people stop buying your product, leaving you to improve, merge or go out of business. Normally, this is a clarifying discipline that drives innovation

insurance, complexity and confusion work in their favour, not ours. With more than 200 funds and more than 400,000 investment options, it is patently ridiculous to say it's our fault for not staying on top of it.

Sure, there's a role for Australians to learn more about our super and be more engaged, but we know there are limits on how much information humans can comprehend. We're also a pretty irrational bunch and can make bad decisions due to emotional factors and marketing.

> *Normally, competition is a clarifying discipline which drives innovation and better products.*

Even where we present people with the cold, hard rational facts, they rarely act and make a switch. This is because of another

with your kids. It could be the difference between enjoying European summers in your retirement or living week to week, counting coins to afford a simple luxury like a coffee.

Whether it's retail or industry super, the fees you pay are their wages, and they've got no interest in taking a pay cut.

At a recent superannuation industry conference, the host of one session seemed genuinely flummoxed by the notion of a top 10 "best in show". "What will happen to the funds that don't get in to the top 10?!" he exclaimed. One word ... competition.

One of the main fears is that funds will be forced into a win at all costs, a battle royale for member contributions. To the extent that this makes them better, more efficient and lowers cost funds, mission accomplished! We will have implanted competition that leads to better outcomes for customers, which is what this is ultimately about: lower fees, better quality insurance and an end to unfair systems that leave people with multiple accounts. To the extent that funds might go too far, and ultimately harm consumers, trustees have a

competitive market. Put simply, removing a potential competitor to the top performers is more likely to erode competitive tension than boost it. Best in show is still required to push the top end of the market to keep delivering.

The critics have been getting hot under the collar about the top 10, all mimicking one another to make and stay on the list. This ignores the PC's actual proposal. Of the total number of members, 12.5 million currently don't change their job or voluntarily switch. That's $128 billion, or 85 per cent of new super contributions that stay put each year, not being directed into a best in show fund. That leaves a huge space for funds to keep members by demonstrating they are unique, high value and worthy of people's money. Even among the top 10 funds, we'll see players wanting to stand out from the crowd as it will attract more members. Again these are the fundamentals of competition, which we see play out every day in competitive markets.

The industry response says it all – it's all about them, but taking upwards of $500,000 away from what's meant to be our

and better products.

In superannuation, the poor performance of some funds has gone unchecked for years. You wouldn't accept the bare minimum from a hospital or a school; we shouldn't accept it from this essential service either.

The industry lobby turned the blame around on its customers last week, saying that it's our fault for not shopping around, but if there's anything we've learnt from other markets such as energy and

limit on our capacity. Retirement is so far off in to the future and there are a lot of financial worries to deal with in the now, like buying a home or scraping together next fortnight's rent. We tend to put off the future to deal with the present.

Where does all of this leave us? If you were unlucky enough to be defaulted into one of the worst funds, you could end up with half a million dollars less in retirement. For you, that might mean selling the family home to survive in retirement or moving in

legal duty to act in the best interests of members. Like any business that breaks the law, I'd expect the full weight of the regulator to come down on them.

Reading the tea leaves, it seems there is general support for the idea of lopping off the poor performing tail through an "enhanced outcomes test". This would give the regulator enhanced powers to force funds out if they have chronically underperformed. This response is hard to argue against, but it won't actually create a

golden years isn't acceptable. Sensible initiatives such as best in show bring much needed competition to a sector that has relied on complexity and confusion to keep us in the dark. Superannuation is an essential service for a safe, fair and secure retirement for all Australians – not just the executives of the funds.

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