Why we must save more and the government must spend less

Economics & Deregulation | Alan Moran

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As well as establishing the Commission of Audit to ferret out savings, Joe Hockey has foreshadowed a sweeping inquiry to commence next year into Australia's financial system.

Such reviews in the past have focused on how to get a more level playing field between different financial institutions and how to overcome regulatory distortions.

However, in announcing the future inquiry, the Treasurer stressed that, "one of the main terms of reference will be to focus on how we as a nation can fund ourselves without relying on borrowing from the rest of the world".

Matching our aggregate levels of savings and investment (which is different from avoiding foreign investment) is a reasonable approach for a nation at Australia's stage of wealth and development. A recent Deloitte report suggested we are not saving enough in superannuation by about 50 per cent, given retirement lifestyle aspirations and projected longevity.

The Commonwealth has commitments to higher levels of spending on education and disability in addition to the inexorable rise of health spending that an ageing population entails. These factors appear to tilt expenditures further away from saving and towards consumption.

Maybe the Commission of Audit will help reverse this but that would represent a huge turnaround.

On average over the past 30 years, we have supplemented domestic savings by net capital inflows equal to about 4 per cent of national income.

These net capital inflows add to our income levels, though not, of course, as much as if we increase domestic savings by lowering our current levels of consumption. Moreover, although the Australian economy has performed quite well over recent years, it has not done so over the longer term, nor compared with Korea, Taiwan, Singapore or China.

Since 2006, Australia's national investment has averaged a little under 28 per cent of GDP.

This is relatively high by sybaritic Western world standards, but low compared with many less wealthy countries (in China, savings are more than 50 per cent of GDP, while in Korea, Hong Kong and Taiwan they are more than 30 per cent). These high savings levels by both rich and poor nations, contradict assertions that Australians cannot afford to save more. In fact, one implication of the Deloitte's report is that we have to do so.

One reason we are under-saving is that the tax code favours consumption over savings. "Earned" income is taxed at source and income on the part that is saved (representing consumption tomorrow) is taxed again.

A neutral regime would tax income only when it is spent and would not tax the interest or dividends on that part saved.

This was a central issue of the Henry Tax Review.

Ken Henry pointed out, "If you impose a 30 per cent tax on the returns to both work and saving, the effective tax rate on consumption, if you consume immediately, is 30 per cent. But .â€Š.â€Š. if you defer consumption for 10 years, the effective tax rate rises to around 40 per cent. If you defer consumption for 20 years, it rises to around 50 per cent. When inflation is taken into account, the compounding effect of the tax rates is, of course, even more extreme."

Tax concessions feature prominently in those nations with high savings rates. Among other savings incentives, India allows the first 10,000 rupees ($171) tax free, (a significant sum when average incomes are only 72,000 rupees); China has a concessional 20 per cent on interest, dividends etc and Japan, during its high- growth era. effectively had no tax on household savings.

Australia also has lower taxation on certain savings. Superannuation contributions incur a 15 per cent flat rate on voluntary contributions of $25,000 to $35,000 per annum depending on age and on the 9.25 per cent compulsory superannuation levy.

That compulsion on savings is in place because many Australians, like people in other wealthy nations, would choose to save less than they need.

This reflects most people's perceptions that an aged pension will be paid to them from future income earners. Equity issues aside, current income earners' lower savings levels diminish future revenues that would enable this.

To adjust the fiscal regime away from one that taxes savings and future incomes means a considerable but welcome rejigging of the tax system to provide tax shelters for savings.

In addition it would require a marked reduction in government outlays, which are overwhelmingly allocated to current consumption.

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