Taxing the return to savings

How does the Australian tax system compare with 'best practice'?

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Purpose of the paper

- Targeted literature review aimed at government policy:
  - As an academic/policy community, can we agree on some policy advice that would improve tax policy in this area?
- Secondary goal of identifying research questions for the TTPI
  - What information is key to guiding government policy but is empirically unclear?
- Part of a TTPI policy series:
  - Kristen Sobeck will be presenting a paper on the corporate income tax (Date TBC).

Structure of the paper

- Part 1: Economic Theory: How should savings be taxed?
- Part 2: How are savings currently taxed in Australia?
  - including Effective Marginal Tax Rate calculations
- Part 3: Policy recommendations
- Appendix A: Econometric summaries
  - To what extent do savings taxes reduce the level of savings?
  - Is the marginal dollar of investment in Australia foreign?
  - To what extent do people adjust their portfolio in response to tax rates?
- Appendix B: List of future research priorities

Sneak peak at conclusions

- Four policy rules coming from tax theory. Taxes should be levied:
  - At a rate less than labour income, but more than zero
  - At a similar rate for all asset types
  - Independently from the personal income tax system
  - Savings taxes should continue to be based around the return to savings.
- The existing system is a long way from this ideal:
  - The effective tax rate on savings varies wildly across asset classes
  - Creates significant complexity by integrating these taxes with the progressive personal income tax, and yet taken as a whole, these taxes are regressive.
- The existing system is so bad that reforming the system can make it more efficient, simpler and more progressive.
  - The report identifies a duel income tax as the ideal policy and one that can be achieved within a reasonable period of time
  - The report also identifies several policy measures that move towards this goal.

Part 1: Economic theory and policy rules

- Can we convert the large literature on savings tax into a set of design ‘rules of thumb’ that can be used to guide tax design?

Policy rule no. 1

- Savings should be taxed at a lower rate than other income, but at a rate greater than zero.
  - A relatively wide range of tax rates (10-25%) could be considered appropriate, with lower rates being more efficient, but higher rate raising more revenue and having a greater redistributive impact.
  - The results in the literature recommending a zero tax rate on capital results should **not** be directly applied to policy.

Policy rule no. 2

- Different types of savings should be taxed at close to the same effective rate:
  - Superannuation should be taxed at a rate less than other savings measures, but not at rates as low as are currently observed in the Australian economy.
  - Land should be taxed at a higher rate than other savings vehicles, however, this argument only applies to taxes that directly target land (such as council rates), and not to other property taxes.

Policy Rule no. 3

- Taxes on savings should be taxed independently of other personal income.
  - The current system of integrating savings taxes with the personal income tax adds significant complexity to the tax system and achieves little.

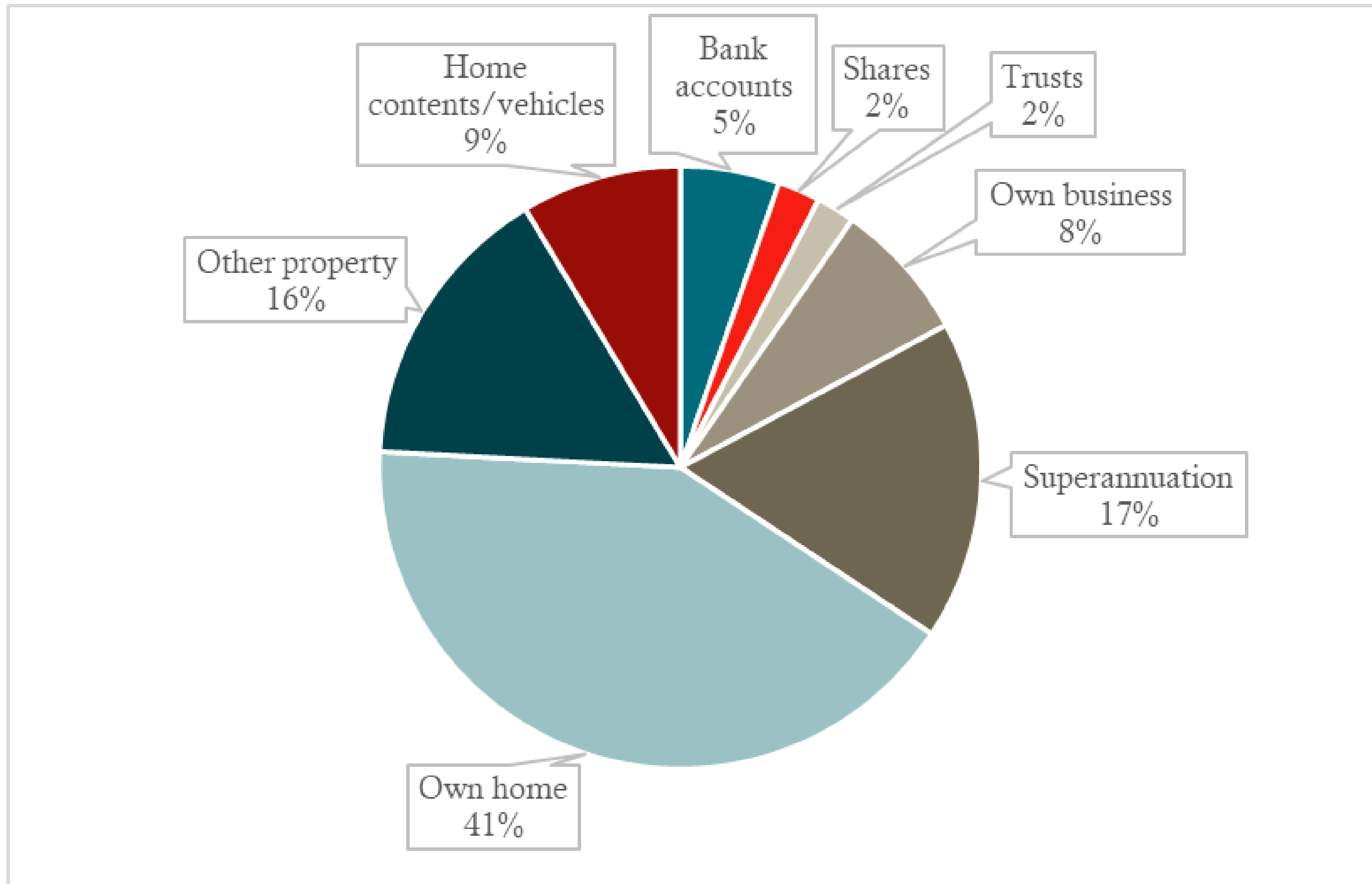
Policy Rule no. 4

- Savings taxes should continue to be based around taxing the return to savings.
  - Taxing the total stock of wealth has a *similar* economic effect to a tax on the return to savings and so significant changes to the existing system are unlikely to generate large improvements.
  - A well designed estate tax could complement a tax on the return to savings. However, given the administrative difficulties experienced by existing estate taxes this would also be unlikely to generate large improvements.
  - Stamp duties on residential property are highly damaging to the Australian economy and should be reduced, and eventually eliminated, as a policy priority.

Section 2: The existing Australian tax system

- And how does it compares to the best practice ‘policy rules’ in the first section?

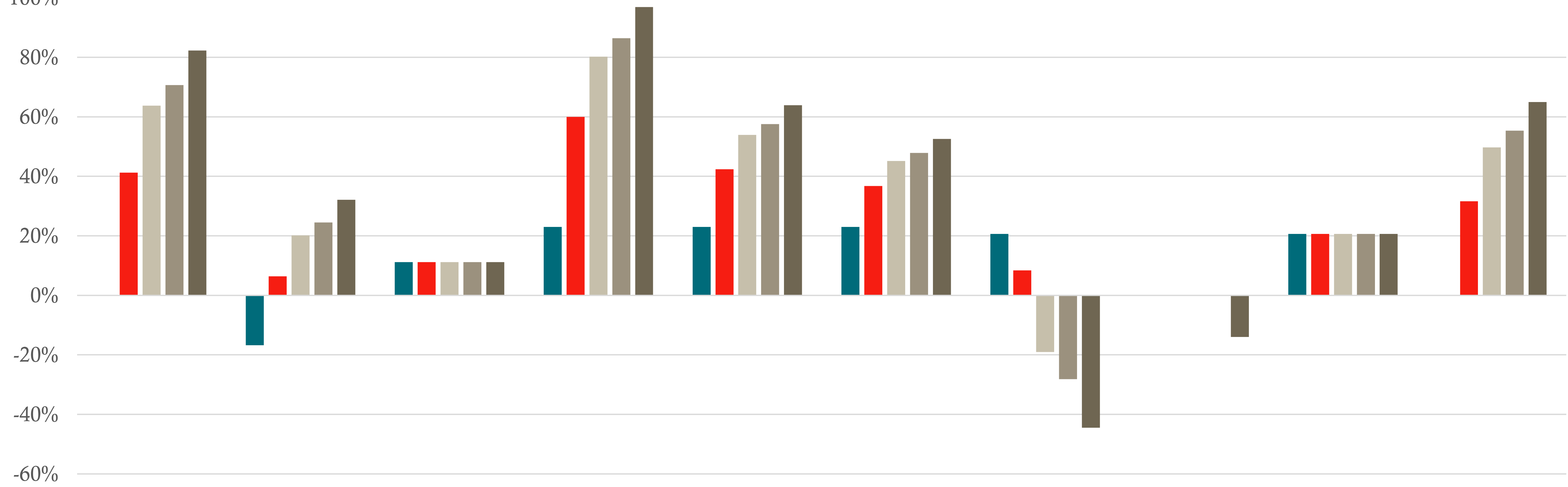
Assets held by Australians (2015-16 SIH)



Asset type	Share of household assets	Tax Treatment
Own home	41.5%	Taxed through stamp duty and council rates. Exemptions for capital gains taxes and pension means tests.
Other real estate	15.6%	Liable for stamp duty, council rates, land taxes.
Superannuation	17.1%	Most contributions are taxed at a flat rate of 15% on pre-tax income. Earnings on investments within super are taxed at a concessional rate.
Own business	7.5%	Non-incorporated businesses are taxed through the personal income tax system.
Home contents and vehicles	8.6%	Taxed through the GST, typically exempt from CGT.
Bank Accounts	5.3%	Taxed through the personal income tax.
Shares	2.3%	Taxed through the personal income tax system with imputation credits to refund corporate income taxes.
Trusts	2.1%	Distributions from trusts are taxed through the personal income tax system. However, the design of the trust can lower the effective tax rate paid.
All Assets (except for owner-occupied housing)	58.5%	Subject to Government payment means tests.

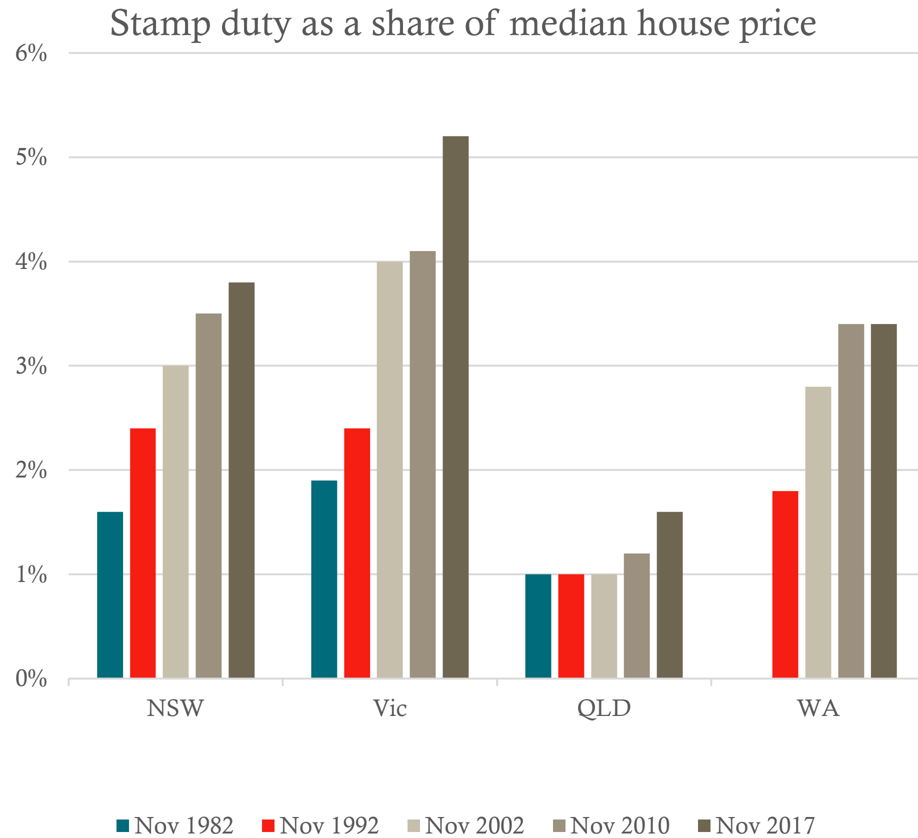
Marginal effective tax rate calculations

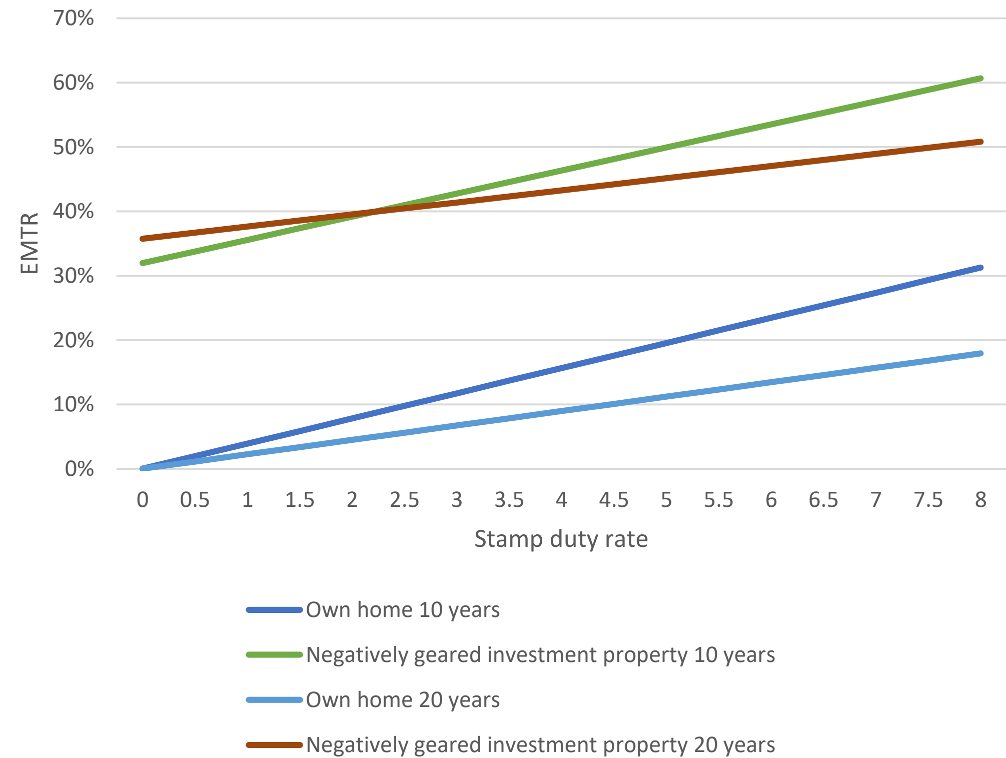
- A way to summarise the total impact of all taxes across different types of savings
  - (Pre-tax return minus post-tax return)/pre-tax return
- Similar to previous analysis done by Henry Tax review/Tax White Paper/Productivity Commission/OECD
- Key assumptions in this study:
  - Assumes a constant pre-tax rate of return of 3% real, (2% inflation)
  - Main calculations are for a 20 year investment
  - Includes stamp duties and land tax, but not council rates

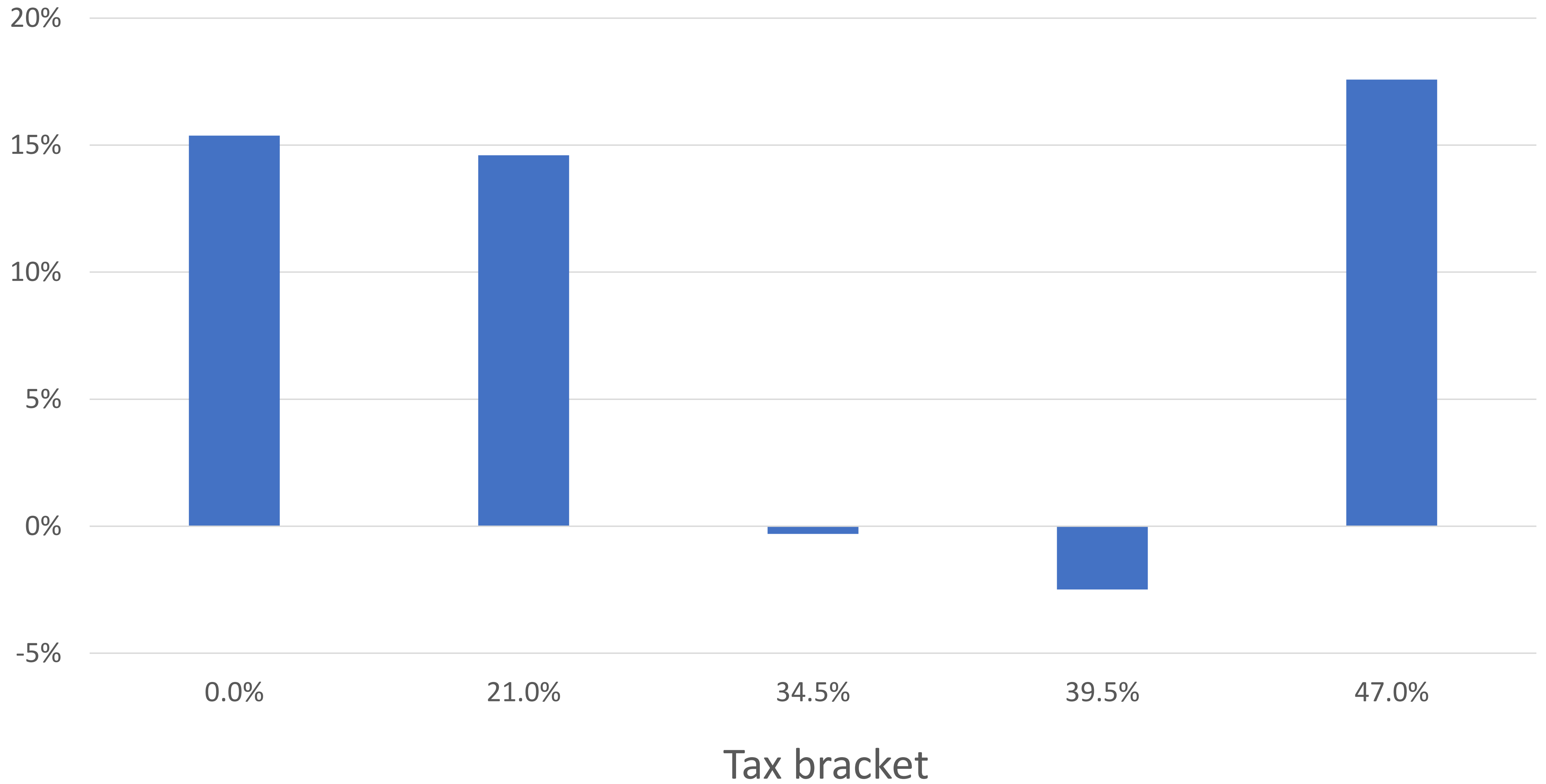

Personal income tax rate
0%
21%
34.5%
39%
47%
120%
100%
80%
60%
40%
20%
0%
-20%
-40%
-60%
Savings account
Domestic shares
Own home
Investment property (Rental income)
Investment property (Capital gains)
Investment property (negative gearing)
Super concessional
Super Division 293
Super non-concessional
International shares

EMTRs over different time horizons (34.5% marginal tax rate)

Increasing stamp duty rates make owner-occupied property less attractive






Weighted average EMTR (excluding housing)
20%
15%
10%
5%
0%
-5%
0.0%
21.0%
34.5%
39.5%
47.0%
Tax bracket

Policy recommendations - Overview

Policy rule	Existing system	Direction for reform
Savings should be taxed at a rate lower than other income, but more than zero.	About right on average.	Currently raise about the right amount of income from these taxes. Changes should be revenue neutral.
Savings should be taxed at about the same rate	Very large differences between tax rates on different asset types	Increase the tax rate on low taxed assets (super) and decrease the tax rate on high taxed assets.
Taxes on savings should be independent from taxes on personal income	Some taxes on savings are integrated into the personal income tax, while others aren't	Separate taxes on savings from the personal income tax
Taxes should primarily be levied on the income from savings	Taxes are primarily be levied on the income from savings	Estate taxes and wealth taxes can be considered, but are unlikely to be a policy priority.

Ideal Policy reform

- Duel income taxation
  - Labour income is separated from all other income types.
  - Both types of income are subject to a different tax schedule. Savings income is typically much flatter (such as a single flat rate), but can incorporate some form of progressivity (such as a higher tax rate above $1 million)
  - Has been implemented for many years in ‘Nordic’ countries. However, many countries have elements of this system

Benefits of a duel income tax

- It is more efficient
  - Removes the current incentive to invest purely on tax grounds
- It is simpler
  - Existing tax management strategies such as negative gearing and income splitting through trusts are based on the different tax rates on different types of income. A duel income tax removes this
- It is more progressive
  - Given that the existing system is regressive, switching a flat tax system is progressive
- It is compatible with additional subsidies to superannuation or taxes on land
  - Although, these should be relatively small.

Downside of a duel income tax

- Some will be worse off
  - In particular those who are retired and have a personal income tax rate of 0% will pay more tax under such a system
  - Possibilities of grandfathering or compensation schemes
- In principle, it is possible to have a more progressive treatment by incorporating savings taxes with the personal income tax
  - However, this is not true of the existing system
  - If progressivity is important, it is possible to incorporate it into a duel income tax (although the simplicity of the system is reduced if multiple brackets are introduced).

Incremental reform

- Implementing a duel income tax shouldn’t be thought of as an unobtainable ideal. However, it is not the only way to improve the tax treatment of savings.
- The paper identifiers a number of smaller reforms that:
  - Better align the tax system with the best practice principles
  - Can be implemented sequentially and move the tax system towards a duel income tax

Remove some concessions made to superannuation

- Make superannuation payments out of post-tax income. Provide a (small) subsidy for all contributions.
  - Note that this reduces the current concerns about transition to retirement provisions
- Tax compulsory contributions at the full marginal tax rate (and only provide the subsidy for voluntary contributions)
- Tax all earnings on superannuation at 15% i.e. remove the current treatment where income is taxed at 0% in the retirement/pension phase
- Lower the annual concessions cap
- Remove catch-up provisions
  - Intended to be for low/moderate income people to catch up. But disproportionately used by high income/wealth households

Lower the tax rate on interest earned

- For instance, a fifty per cent discount could be applied to all interest income.
  - Reduce the very high effective tax rates on this type of income
  - Relatively inexpensive as there is so little interest income

Replace imputation credits with a final withholding tax

- To the extent that Australia is a ‘small open economy’ the imputation credit system is a subsidy to domestic shareholders.
- Many of the same arguments apply as to the duel income tax
  - Little value in integrating dividend income into the personal income tax
  - Removing dividends simplifies the tax treatment

Reduce and eventually remove stamp duties

- Stamp duties are amongst the worst taxes levied in Australia and cause significant distortions in the housing and labour market
- A ‘bracket creep’ style process has seen them increase significantly over the past 20 years.
- The first step is to lower these taxes to the same effective rate that applied 20 years ago.
- The long-term goal is to reduce these taxes to zero.

Include housing assets in means tests, and allow payment to be deferred until death

- The ideal way to tax savings is strongly linked to budgetary challenges resulting from an ageing population.
- While this report doesn't recommend an estate tax, there is a case for ensuring that people with large estates are partially funding the costs of Aged care/Age Pension and Healthcare.
- The best way to do this is to:
  - Incorporate all assets into the means tests for these services
  - Allow payment to be deferred until death (and the asset is sold) where people have no liquid assets.

Thank you

- All comments and feedback are greatly appreciated