TAX AND TRANSFER POLICY INSTITUTE

The taxation of savings in Australia

Theory, current practice and future policy directions

Executive Summary

Household savings are a vital component of our economy. They enable individuals to achieve the consumption they desire, including through retirement, while insuring against adverse life events or periods of low income. The intergenerational transfer of savings is a means for families to assist their children. Household savings also contribute to the pool of capital that finances business investment and infrastructure, supporting national productivity and living standards.

Taxes influence how much people save and the types of assets in which they choose to invest. In Australia, there is no consistency between the taxation of different forms of savings, with some savings vehicles, like the family home or superannuation taxed lightly or subsidised, while others, like bank deposits, taxed heavily.

Some savings income, such as bank interest or rental income, is taxed as personal income at an individual's marginal rate while others have special arrangements, such as stamp duties on property sales, dividend imputation for domestic shares or the concessional tax regime for superannuation.

Some savings tax arrangements are progressive, taxing higher incomes more heavily, and some are regressive. Some favour the old but are punitive for the young.

The current tax arrangements are inefficient, inequitable and distort the flow of savings. The system is complex and encourages Australians to engage in costly tax planning schemes.

The goal of this report is to provide a framework for improving the taxation of savings in Australia over the medium to long term and to demonstrate a consistent approach for evaluating policy proposals to change existing savings taxes. It does so by tackling three questions:

- **What is the ideal arrangement for taxing savings (chapter 2)?** The paper outlines the findings of the optimal tax literature and the major government tax reviews in Australia and abroad (e.g., Henry Tax Review (Commonwealth of Australia 2010), the 2015 Tax White Paper (Commonwealth of Australia 2015) and the Mirrlees Tax Review in the UK (Mirrlees et al. 2011)) and develops a set of four 'policy rules' that can be used to evaluate savings tax design and policies.
- **How does the current system of taxing savings measure up against that ideal (chapter 3)?** The existing system is assessed against those principles, with the Marginal Effective Tax Rates (METRs) calculated for the major types of savings held by Australians. METRs quantify the extent to which distinct forms of savings are taxed differently.
- **How should the current system be reformed (chapter 4)?** This report argues the best approach to taxing savings is a dual income tax system, where the income from most forms of savings is taxed at a low, flat rate, separate to taxes on labour income (which is taxed through the personal tax system). While that should be the long-term goal, the report identifies reforms that can be implemented in the short-term, that improve the existing system and would form intermediate steps towards a dual system of income taxation. Further investigation of these reforms should be a priority for both federal and state governments.

Four key principles for taxing savings

- **Savings should be taxed at a lower rate than labour income.** Savings demand a different tax treatment to income from wages, since they have usually already been taxed once as wages.

  The impact of savings taxes compounds over time, thus the impact of savings taxes on future consumption can be much larger than the headline rate of tax. For long-term savings, such as investments intended to fund retirement, the erosion from the compounding effect of tax on financial returns is significant. In addition, savings taxes are generally applied to nominal income, rather than to the real return after inflation. This generates an effective tax rate on the real return of savings far greater than when a similar rate is levied on personal earnings. In this way, inflation exacerbates the compounding effect of taxes over time.

  Although the public finance literature includes two famous studies that draw on these principles to show that savings should not be taxed at all, this report does not come to this conclusion – in part because the theoretical results are derived in a highly stylised framework, and in part due to specific features of the Australian economy (such as Australia's openness to international capital flows and the compulsory nature of the Australian superannuation system). Instead, this report concludes that a range of tax rates from 5 per cent to 20 per cent on the return to savings could be appropriate, with lower rates being more efficient but higher rates raising more revenue and achieving more short-term redistribution.

- **Most different types of savings should be taxed at close to the same effective tax rate.** Individuals should be able to invest in assets that best suit their preferences for risk, return and liquidity rather than to minimise tax. Taxing different asset classes at the same rate also promotes the efficient use of capital throughout the economy, promoting long-term growth. There are arguments for a lower tax rate for superannuation, because it is held long enough for the compounding impact of tax to reduce returns and because of the interaction of superannuation income with the age pension means tests. There are also arguments for higher land taxes. However, these arguments do not justify the very large divergence in tax rates observed in the current Australian tax system.
- **Savings income should be taxed at a rate that is independent of the tax rate on income from other sources**. Internationally, there are two approaches to taxing savings. The comprehensive income tax approach uses a single tax schedule for taxing all sources of income. The modular or dual income tax system taxes income from savings independently of taxes levied on other income, either at a flat rate or according to a second tax schedule. While each has its merits and disadvantages, the modular approach is preferred for Australia because it removes the existing incentives to minimise taxes by shifting savings income from one financial year to the next or splitting it amongst family members.
- **Taxation of savings should focus on the income it generates, not the total stock of assets.** Australia's tax system is built on taxing income and there would be significant transition costs in shifting to a wealth tax. Wealth taxes have a similar economic effect to taxes on savings income but can create difficulties for those who are 'asset rich but income poor'. Estate taxes are a common international exception to this approach. Even when marginal estate tax rates are set very high, they typically raise relatively little revenue. They are best seen as a potential complement to taxes on savings income, rather than as a model for savings tax.

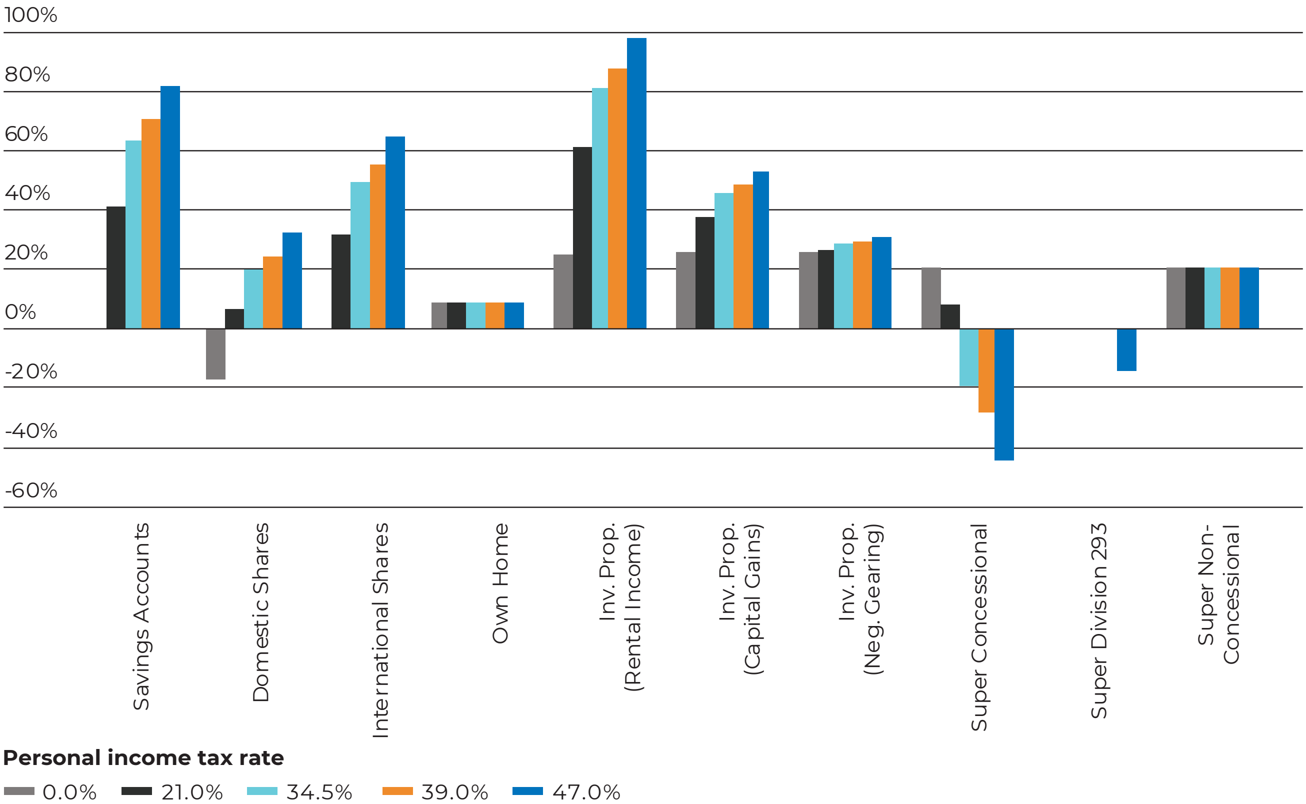
How are savings currently taxed in Australia?

The majority of Australian household savings are in owner occupied housing (41% of total wealth), superannuation (17%) and investment properties (16%). Bank accounts (5% of total wealth) and shares held outside of superannuation (2%) are a relatively small share of existing assets.

Australia has completely different methods of taxing these different assets. Owner occupied housing is subject to stamp duty while new housing is treated as a consumption good through the GST. Rental income from investment properties, by contrast, is captured by personal income tax. Realised capital gains (on both investment properties and shares) are also taxed as personal income, but are discounted by 50%. An entirely separate set of tax arrangements has been constructed for superannuation, which are typically much lower than the taxes on other investments. There are also special rules for the tax treatment of dividends, negative gearing and trusts.

The result is widely varying tax burdens on different investments. This report calculates the Marginal Effective Tax Rate (METR) for each asset type, estimating the total impact of the various taxes on their returns. Figure 1 shows the METRs for major Australian asset types for a 20-year investment.

Figure 1 Marginal Effective Tax Rates (METRs) on different Australian asset classes



Note: This calculation incorporates the effects of the personal income tax (including superannuation taxes, imputation credits and capital gains discounts), land taxes and stamp duties. This calculation is described in detail in Chapter 3.

Source: Authors' calculations.

Superannuation is strongly favoured by the Australian tax system. For someone on the top 47% marginal rate, investment in superannuation receives a large effective subsidy. This reflects the concessional 15% tax on superannuation contributions from pre-tax earnings, as well as the concessional rates on superannuation earnings. People in the bottom two tax brackets pay a positive tax rate for superannuation savings.

Owner occupied housing faces a marginal effective tax rate of 9 per cent, mainly reflecting stamp duty (the calculation does not include council rates which can be considered a fee for service).

Interest income is taxed at a punitive rate, particularly for high income earners. The 82% METR for those in the top tax bracket reflects the compounding impact of savings taxes on returns over a long period. Investment property is subject to personal income tax on both rental income and capital gains, while it also subject to land taxes and stamp duty. For high income earners, the METR on rental income is just under 100%. Negative gearing reduces the METR but it is still above 40% for most income earners.

The tax rate on domestic shares depends on whether the tax system is viewed from a domestic or an international perspective. From a purely domestic viewpoint, dividend imputation credits are simply a refund of the corporate tax paid. The tax paid on shares is equivalent to that paid on interest from a bank account. However, from an international perspective, imputation credits are a subsidy to domestic shareholders over foreign shareholders. As a small open economy, it makes sense to view Australia's taxation of shares from an international perspective and this shows the marginal tax rate is low, ranging from 32% for someone in the top tax bracket to a subsidy of 17% for someone with taxable earnings below the tax-free threshold.

These different tax treatments result in vastly different flows of tax revenue. Superannuation taxes raise $6.8bn but grant concessions to investors worth $16.2bn. Dividends, interest income and capital gains each raise just under $3bn a year while the interest deductions claimed on negatively geared property investment mean there is a net $1.2bn subsidy. The biggest tax on savings is stamp duty on housing sales, which raises $20.6bn, while land taxes raise $7.3bn (see Table 4.2). The net impact on revenue from all savings taxes is $26bn.

Tax principles and Australian savings tax practice

Australia's system for taxing savings is set against the four principles of best practice in the summary Table 1.

Table 1 Principles for tax reform

Principle of tax design	Existing tax system	Principle for reform
Principle 1: Savings should be taxed at a lower rate than labour income, but more than zero.	The average METR across all assets is around 7.5 per cent.	The average METR is about right, so changes should be roughly revenue neutral.
Principle 2: Different types of savings should be taxed at about the same rate.	Significant variation in the tax rate between types.	Changes to the existing tax system should reduce the tax paid on high tax assets (such as investment properties) and increase the tax rate on low tax assets (such as superannuation).
Principle 3: Where possible, the tax rate on income from savings should not depend on income from other sources.	Australia currently has a mixed system where some savings are taxed as personal income while other savings are taxed at a rate that is independent of other personal income.	Where possible, tax the income from savings independently of taxes on other income sources.
Principle 4: Base savings taxes on the return to savings, as opposed to the total stock of assets or taxing estates.	This is the basis of the current tax system.	Continue to use the income from savings as the main tax base. Remove stamp duties.

Source: Authors' compilation.

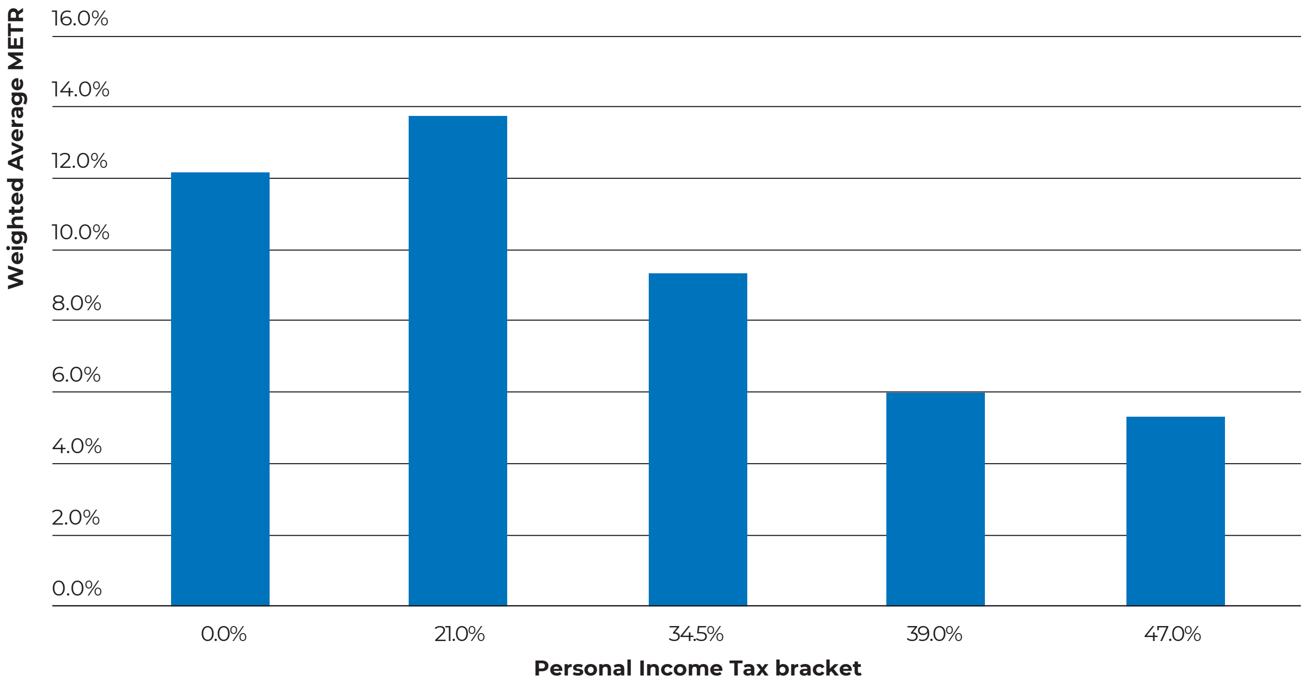
When averaged out across all asset classes, Australian savings face an effective marginal tax rate of 7.5 per cent, which is broadly compatible with the recommendations of the optimal tax literature. This suggests the huge gaps between highly taxed and lowly, or even negatively, taxed savings could be narrowed in a revenue-neutral reform package.

By far the biggest tax concessions are granted to superannuation. While there is an argument for superannuation to be taxed at a lower effective rate than other savings, the existing tax concessions are poorly targeted. The main rationale for a lower rate is that superannuation is typically held for longer time periods. However, the existing tax concessions are primarily targeted towards older workers, who hold superannuation for a shorter period than younger workers. The study demonstrates that the METR for superannuation for someone aged under 20 years with 45 years of working life left is 36%, whereas for someone aged 55 to 59 years, with just five years before reaching the pension phase, there is a tax concession worth 111% of their savings. (See Table 4.4) An obvious direction for reforming the existing system is to increase the tax rate on the lowest taxed savings types (including superannuation) and decrease the tax rate on the most heavily taxed savings types.

In principle, there is a trade-off between equity and efficiency when designing savings taxes. Taxing savings at the same rate for all individuals is efficient as it removes the existing incentives to split savings income among family members or across financial years. On the other hand, taxing the savings of those with higher income or higher net wealth may improve the progressivity of the tax system.

However, as shown in Figure 2, the overall distributional impact of the current savings tax system is already regressive, with the lowest average METR paid by individuals in the highest two tax brackets. Someone in the 21% tax bracket, by contrast faces an average METR of 13.8%. The "partial equilibrium" approach to calculating the METR for different investors and assets has limitations (discussed in detail in Chapter 3), however this analysis suggests that taxing savings at a single flat rate would be both simpler and more progressive than the existing tax system.

Figure 2 Distributional incidence of existing savings taxes



Source: Author's calculations. See Table 3.1 for breakdown of calculation.

Directions for reform

The taxation of savings is politically contentious with strong lobby groups defending particular savings arrangements, whether that is negative gearing of investment property, dividend imputation or superannuation concessions. Yet, it makes no sense to consider the tax implications of these individual savings options without also taking into account how they shape the competitive landscape, how they influence the choices of individuals and how they contribute to the efficient mobilisation of savings across the economy as a whole.

This report has considered this much broader picture of Australia's system of taxing savings and finds that the two main directions for reform are to bring the tax rates on different asset classes closer together and to tax the income from savings independently from income from other sources.

Based on these principles, the ideal way to tax savings in Australia would be to implement a dual income tax. Under such a system, all labour income is taxed under a progressive tax schedule, similar to the existing tax system, while all other income (including interest, dividends, rental income, capital gains and earnings within superannuation) is taxed independently under a second tax schedule (which is either taxed at a single flat rate, or a much less progressive rate than labour income). Dual income taxes are sometimes referred to as 'Nordic tax systems' although elements of a dual income tax have been implemented in several other countries.

A dual income tax is more efficient, simpler, and fairer than the existing (regressive) tax treatment of savings. Implementing a dual income tax should be seen as a realistic policy goal in the medium term. A major attraction of the policy is that it has already been successfully implemented in other countries.

Another attraction of a dual income tax is that it is possible to move towards this system in stages. Each of the following reforms would move towards this goal and deserves a full evaluation.

- Better targeting of the concessional tax treatments currently given to superannuation such as:
  - Making all superannuation contributions from post-tax income (potentially with an upfront subsidy, but a smaller subsidy than currently exists).
  - Taxing earnings in the retirement phase and using the resulting revenue to reduce the tax rate on all superannuation earnings.
  - Taxing superannuation at a lower annual rate for younger Australians (to account for the fact that they hold superannuation assets for a longer period).
  - Removing 'catch-up provisions', which favour older Australians in contrast to the principle of providing incentives to hold superannuation for a long period.
  - Lowering the annual concessional contributions cap.
- Replacing dividend imputation with a flat tax rate on dividends. This will remove the differential tax rate between those working and those retired, as well as the differential between domestic and international shares.
- Removing stamp duties, which significantly distort the decision of when to move house, reducing the ability of people to switch jobs and are a highly inefficient revenue source. Land taxes should be extended to owner-occupied housing with tax free thresholds removed.
- Including owner-occupied housing in means tests for pensions and other age-related spending. The current exemption is unfair, resulting in government support being provided to people with a high level of personal wealth while different levels of support are offered to people with similar levels of total assets.

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