National Tax Reform Symposium

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An Issues Paper

Taxation of Personal Income, Assets and Saving:

Some Problems and Options

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TaxWatch

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This Issues Paper has been prepared by TaxWatch for the National Tax Reform Symposium.

TaxWatch is a community information service on tax policy issues which affect social justice. It focuses mainly on issues which have a substantial impact on the lives of low and middle-income Australians and it seeks to provide information in a comprehensible, reliable and up-to-date manner. It does not give advice to individual taxpayers or provide detailed technical information which is already readily available to people who are directly affected.

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TaxWatch

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AN INTRODUCTORY OVERVIEW

This introductory section of the Issues Paper aims to provide a background to discussions at the Symposium by suggesting a principal goal which the Australian tax system should seek to achieve, outlining some aspects of the current system which create problems, and canvassing some possible directions for action which could be pursued to address these problems. It concludes by outlining some key differences between our system and those in most other developed countries.

A Principal Goal

An appropriate overall goal for the taxation system could be to promote sustainable economic and social development which will provide benefits for all Australians on an efficient and equitable basis. This includes generating adequate levels of revenue and exerting appropriate influences on individual and corporate decision-making.

Some Key Problems

Although Australia's taxation system has some very good features, it also has substantial weaknesses. Amongst other things, there are strong grounds for concluding that key aspects of the system

- promote excessive speculation in asset prices (especially in real estate and financial markets), rather than long-term investment in enterprises which generate ongoing profits or other income streams[1];
- encourage excessive borrowing, especially from overseas[2];
- inflate house prices and rents, as well as encouraging inefficient housing use[3];
- unduly discourage and penalise some lower-income people who are trying to re-enter the workforce or increase their working hours[4];
- aggravate environmental damage and lead to patterns of urban development which harm productivity and work/life balance[5];
- exacerbate unfairness and divisive pressures within the community, rather than promoting social inclusion and equity[6];
- discourage important forms of saving for people of modest means[7];
- provide excessive opportunities for tax avoidance and evasion, often involving complex and wasteful processes[8].

These problems reflect substantial biases in the system towards

- assets rather than income;
- financing through debt rather than savings or equity;
- retirement saving rather than saving for other purposes;
- home purchase rather than other forms of investment;
- wealthy people rather than people of more modest means;
- overseas rather than Australian investors;
- income from gifts, bequests and investment rather than wages and salaries;
- cars rather than other forms of transport.

Some Key Directions for Action

These problems require improvements to be made in the efficiency, equity and simplicity of the system. Key directions for action could include

- strengthening the system's capacity to provide sufficient revenue for public investment and other expenditure and to adjust that level for future needs (eg, arising from an aging population);

- removing or reducing unjustifiable distortions in the treatment of different kinds of income, assets and usage (eg, between different types of investment income or different kinds of resource use);
- removing or reducing distortions, concessions or loopholes which unjustifiably aggravate disparities in income and wealth (eg, by putting an upper limit on tax exemptions and providing progressive payments or tax credits rather than regressive concessions);
- simplifying the system, especially its impact on taxpayers' actions (eg, by removing unnecessary variations in tax treatment and closing off avenues for complex tax minimisation);
- ensuring that encouragement or discouragement of particular economic or social activity (eg, home purchase, saving, vehicle use) is provided on a cost-effective, equitable and sustainable basis;
- responding to international tax trends on the basis of objective analysis and long-term perspectives (eg, taking account of all relevant aspects of the tax systems, and stages of development, of the countries with which comparisons are made).

Key reforms are more likely to be achievable if they form part of an integrated and balanced package, possibly including spending initiatives as well as tax measures. This could include

- reducing gaps in the range of income, assets, goods or services to which a particular tax applies (ie, "base broadening") while also reducing the rate at which the tax is levied;
- increasing the base or rate of a tax, or introducing a new tax, while also improving important public services;
- strengthening some taxation of people's assets while also reducing some taxation of their incomes;
- reducing tax benefits for some stages of people's lives while also strengthening benefits for other stages.

Some Key Differences

Key differences between Australia and other comparable OECD countries include:

- the overall level of tax revenue per capita is much lower than the OECD average and than almost all comparable countries (including the US);
- most other countries require employers and employees to pay social security contributions (often larger than their corporate income taxes and much more than our compulsory superannuation contributions);
- unlike almost all other countries, personal income tax is reduced by the full amount of corporate tax paid on income distributed as dividends ("dividend imputation");
- most other countries have gift and estate duties, and a number have annual taxes on total asset-holdings;
- most other countries have higher GST rates.

Further information about comparisons between the tax systems in Australia and other countries is in one of the Background Papers for the Symposium, *Some Comparative Perspectives on the Australian Tax System,* and in a longer TaxWatch paper, *Aspects of the Australian Tax System: A Preliminary Outline.*

SOME ISSUES FOR THE SYMPOSIUM

This section of the Issues Paper summarises some possible problems and reforms in relation to the sessions of the Symposium relating to

- assets and asset income
- work and work income;
- savings and retirement income.

The problems and reforms are drawn from a wide range of sources but do not aim to be comprehensive or detailed. They are provided principally as an introduction and background to the panel presentations and discussions at the Symposium. They do not necessarily reflect the views of TaxWatch or member organisations of the Community Tax Forum.

A second National Tax Symposium, to be held in April, will concentrate on priorities in relation to housing; the environment and transport; companies and trusts; families; and Commonwealth/State issues.

WORK AND WORK INCOME

INTRODUCTION

This topic includes the following aspects of the current tax and transfer system in Australia:

- the Personal Income Tax scales, Medicare levy, Low Income Tax Offset, Senior Australians Tax Offset;
- the Fringe Benefits Tax and concessions such as motor vehicles and child care, salary sacrificing; deductions for work-related expenses;
- Newstart Allowance rates and means-testing;
- independent contractors, income-splitting.

SOME POSSIBLE PROBLEMS

Work

- payroll tax, superannuation contributions and other liabilities can be avoided by creating an appearance that employees are actually independent contractors;
- many employees have voluntarily set themselves up as apparently independent contractors in the form of a company or trust so that they can avoid tax by, for example, income-splitting, paying income tax at the lower corporate rate, or leaving income in the corporate structure;
- the current level of social security allowances is grossly inadequate, especially because it does not adequately recognise the extra costs of training and searching for work and remaining unemployed for lengthy periods; .
- income tests for people on social security allowances are based on very short periods which tends to discourage people from accepting short-term, casual or part-time opportunities which may be all that is realistically available to them;
- the income test on secondary earners for Family Tax Benefit B unduly discourages some people from undertaking paid work.

Work income

- lower-income earners are more vulnerable than others if tax scales are not promptly adjusted to allow for inflation;
- some lower-income people entering the workforce lose a lot of their wages through the combined effect of income tax and income tests on social security (as well as other support such as child care and public housing);
- some lower-income people without children may be unduly disadvantaged relative to families in similar economic need but receiving Family Tax Benefit;
- many high-income people have opportunities for tax avoidance which enable them to pay at a lower rate than people with much lower incomes;
- the tax scale for very high income-earners is too generous by reference to international standards, capacity to pay, and benefit from public expenditure;
- raising tax rates for high-income earners could be largely ineffective because of the increased incentive to engage in tax avoidance, especially if taxes on companies and assets remain very much lower;
- the allowable deductions for work-related expenses are inconsistent, inefficient and unfair (eg, training expenses are available only for people already in a job);
- the deductions tend to be more readily available and valuable for high-income earners while also be increasing pressure on lower-income workers to meet their own expenses.

Fringe benefits and "salary sacrifice"

- taxation of fringe benefits (FBT) at the top marginal rate is unfair to lower-income workers who may lack bargaining power to insist on wages in lieu;
- the FBT exemptions and concessions tend to be much more valuable, and often more readily available, to middle- and higher-income earners;
- they also distort patterns of investment and usage in the direction of the favoured types of benefit (eg, to private cars rather than public transport; to child care on company premises rather than elsewhere);
- the huge growth in "salary sacrifice" is highly inefficient, inequitable and costly to public revenue;
- for example, it provides opportunities for tax avoidance which tend to be much more readily available and valuable to higher-income people but are not available in practice to many employees on low incomes or in small businesses;
- the special FBT concessions for charities and some other non-profit organisations are much less efficient, equitable and transparent than providing adequate support through direct funding.

SOME POSSIBLE REFORMS

Work

- tighten restrictions on workers and employers seeking to avoid tax and other obligations by creating illusory independent contractor relationships;
- substantially increase Newstart and other social security allowances, especially for long-term recipients and apply income tests on a quarterly rather than fortnightly basis;
- see also reforms in relation to pensioners in *Savings and Retirement Income* below;
- reforms in relation to avoidance of tax and other obligations by receiving work income through a trust or private company will be considered in detail in the second Symposium.

Work income

- adjust PAYG withdrawal rates for low-income earners to make fuller allowance for the Low-Income Tax Offset (LITO);

- index the LITO, and perhaps the income thresholds for the lowest two marginal income tax rates, in the same way as for pensions;
- establish a tax credit for lower-income workers without dependents, analogous to the Family Tax Benefit for working families;
- provide a flat-rate "work and education" rebate in lieu of deductions for work-related expenses, subject to some exceptional claims;
- tighten taxation of eligible termination payments.

Fringe benefits and "salary sacrifice"

- apply Fringe Benefits Tax (FBT) at the marginal income tax rate of the employee, perhaps in conjunction with establishing a "work and education" rebate;
- abolish all or most FBT exemptions and concessions, perhaps in conjunction with establishing a "work and education" rebate or increasing the lowest two marginal income tax thresholds;
- tighten restrictions on salary-sacrificing by limiting the total permissible value per worker and/or the permissible types;
- see also reforms in relation to salary sacrificing for superannuation in *Savings and Retirement Income* below;
- reforms in relation to fringe benefits in the form of motor vehicles and child care, and FBT exemptions for non-profit organisations, will be considered in detail in the second Symposium.

ASSETS AND ASSET INCOME

INTRODUCTION

This topic includes the following aspects of the current tax and transfer system in Australia:

- capital gains tax rates and exemptions (eg, for housing);
- dividend imputation and withholding taxes on dividends and interest payments ;
- rules relating to "negative gearing";
- stamp duties, land tax, council rates;
- superannuation tax concessions;
- social security assets tests.

SOME POSSIBLE PROBLEMS

Asset ownership and transfer

- Australia's light taxation of asset ownership by comparison with other countries increases pressure to rely more on income and consumption taxes in ways which would aggravate inefficiency and inequity;
- it also increases the pressure to rely on taxation of asset transfers (eg, stamp duties) in ways which can discourage efficient use of assets;
- our lack of both some form of gift and inheritance tax and a general tax on asset holdings makes us almost unique amongst OECD countries;
- this lack contributes to inefficient usage of assets, especially land and housing;
- it also contributes to inherited inequity and relatively low levels of philanthropy;
- increases in taxation of asset ownership would need to avoid undesirable pressure on lower-income people to sell assets in order to pay the tax;
- asset tests for social security unduly discourage some forms of saving and asset building in mid-life, especially for lower-income people who cannot afford home purchase;

- the current design of land taxes unduly discourages large-scale investors in residential property;
- unlimited exemptions from land tax for owner-occupied homes encourage tax avoidance, distort investment patterns, inflate house prices and greatly erode revenue.

Asset income (including capital gains)

- Australia's taxation of asset income is not especially high by international standards but care is needed to avoid undue deterrence of both domestic and foreign investors;
- excessive focus on cutting asset income rates can distort the overall tax system and also reduce its ability to finance public investment in human and capital resources;
- our inconsistent tax treatment of different types of asset income unduly distorts investment, aggravates inequity for people and businesses and is a major cause of complexity in business practices and tax compliance;
- bank interest is the form of asset income which lower-income people are most likely to receive (prior to superannuation payouts) but it is taxed much higher than other forms such as dividends and sales of shares;
- our unusually generous system of allowing interest payments to be deductible against income from all other sources provides excessive encouragement for investment to be financed by debt rather than savings;
- it also biases the system in favour of speculative investment in property and shares, rather than longer-term investment in activities which generate profits or other income streams;
- these biases are aggravated by allowing the deductions to be made many years before taxation is paid on any capital gains arising from the investment;
- they are also aggravated by taxing most capital gains at only 50% of the rate on other types of income;
- by encouraging excessive borrowing for speculative purposes, these distortions in the tax system have contributed substantially to our economic vulnerability;
- the excessively generous treatment of assets and interest expenses when assessing tax liabilities is inconsistent with the more rigorous application of assets and income tests for pension entitlements;
- unlimited exemptions from capital gains tax for owner-occupied homes encourage tax avoidance, distort investment patterns, inflate house prices and greatly erode revenue.

SOME POSSIBLE REFORMS

Asset ownership and transfer

- establish an annual tax on overall assets above a very high threshold;
- re-establish a tax on gifts and estates above a high threshold;
- apply the capital gains tax when property is received by bequest;
- see also reforms in relation to superannuation in *Savings and Retirement Income* below;
- reforms in relation to housing and to business assets will be considered in detail in the second Symposium.

Asset income (including capital gains)

- make interest payments and other expenses deductible only against income from assets of the same type (or only when the asset is transferred, unless perhaps there was a reasonable prospect of a positive income flow prior to transfer, or only on loans below a specified value);

- reduce or remove the 50% discount on capital gains tax for individuals, at least for assets held for less than five years (perhaps with a capped exemption for all gains, including housing, below an overall lifetime total);
- tax all asset income separately from other income (a "dual income" system) with a separate flat rate, subject to a tax-free threshold for individuals, and separate deductibility of expenses;
- tax most or all types of asset income on a deemed rate of income, perhaps with payment deferrable in some circumstances (subject to payment of interest) until the asset is transferred;
- see also reforms in relation to income from bank and superannuation accounts in *Savings and Retirement Income* below;
- reforms in relation to housing will be considered in detail at the second Symposium.

SAVINGS AND RETIREMENT INCOME

INTRODUCTION

This topic includes the following aspects of the current tax and transfer system in Australia:

- Age Pension rates, means tests and eligibility ages;
- compulsory and voluntary superannuation contributions, and government co-contributions;
- superannuation tax exemptions and concessions;
- withdrawal of superannuation benefits before retirement or as lump sums;
- the Senior Australians Tax Offset, eligibility for concession cards and other subsidies for older people.

SOME POSSIBLE PROBLEMS

General savings

- by contrast with a number of other countries, a tax incentive is provided for saving to buy a house or live in retirement but not for mid-life needs such as education, child-rearing, ill-health and unemployment;
- bank accounts, which are the main form of saving for mid-life needs that is available to lower-income people, are effectively taxed more highly than work income (especially in times of significant inflation);
- lack of such incentives aggravates the tendency to borrow for mid-life needs with the intention of repaying from subsequent superannuation benefits, thus reducing positive impacts on income available during retirement, net national saving and pension expenditure;
- the pension assets test unduly discourages mid-life saving by lower-income people, especially those who cannot afford to buy a home (which is exempt from the test).

Superannuation

- the current tax concessions on superannuation contributions provide no benefit to a very large number of low-income people because their general income tax rate is the same as, or lower than, the concessional rate on superannuation;
- yet it is these people who are more likely to need a greater share of their work remuneration to be in the form of wages rather than benefits which are not obtainable until much later in life;

- the current concession structure provides very large and costly benefits for higher-earners, especially through salary sacrificing, thereby aggravating inequity and becoming unsustainably expensive as the proportion of older people increases;
- the current concessions do not efficiently maximise national saving because most benefit goes to higher-income people who would have saved or invested the money anyway but there is little or no incentive for lower-income people;
- the current concessions are highly complex and inconsistent, thereby distorting investment, encouraging avoidance techniques, and unduly increasing needs to obtain professional advice;
- superannuation benefits can be withdrawn at a relatively early age and as a lump sum, thereby unduly encouraging early retirement, dissipation of benefits and increased age pension costs;
- on the other hand, insufficient allowance is made for early withdrawals to meet pressing mid-life needs (without which extra cost is incurred by borrowing, where possible, and repaying when the benefits eventually become available);
- many of these problems are severely aggravated by the recent decision to make benefits tax-free after reaching the age of 60;
- over the longer-term, superannuation may generate rates of return well above inflation but people retiring in a period of economic downturn may suffer very severely;
- unless age pensions are increased, the current rate of compulsory contributions is unlikely to generate a reasonably adequate level of retirement income for people who do not have several decades of contributions;
- but for many lower-income people, especially if they make contributions over several decades, a higher compulsory rate may cause their standard of living to be lower in mid-life than when they retire.

Age Pension

- the current age pension rates do not provide a reasonably basic standard of living for older people, especially those who have not had lengthy periods of superannuation contributions and are in rental accommodation;
- savings sought by means-testing age pensions have been substantially offset by providing high-income non-pensioners with many of the concessions that are available to pensioners, a much larger tax offset than is available to younger people, and very costly superannuation concessions for high-earners;
- the current interaction of means tests for age pensions and concession cards, the tax offsets for older people, and the superannuation system is highly complex and inefficient;
- the pension assets test is unduly favourable to home-owners yet rent assistance has fallen far behind increases in market rents;
- the age of eligibility for age pensions may need adjustment to reflect changes in health, life expectancy, access to superannuation and labour markets.

SOME POSSIBLE REFORMS

General savings

- reduce income tax on bank accounts to be more comparable with tax on other forms of saving;
- provide special tax concessions for Lifelong Savings Accounts (LSAs), which are subject to restrictions on the size and source of deposits and on the size, timing and perhaps purpose of withdrawals;
- make matched or unmatched government contributions to LSAs for low-income people;
- see also reforms in relation to reducing tax on asset income in general in *Assets and Asset Income* (above).

Superannuation

- tax superannuation contributions at the contributor's marginal income tax rate but provide progressive tax concessions in the form of a tax credit or a discount on the marginal rates;
- provide a government contribution in lieu of the current tax concessions on contributions, or as additional support for lower-income earners;
- allow mid-life access to accrued benefits in superannuation accounts, subject to tight restrictions on the size, timing and perhaps purpose of withdrawals, while also accelerating increases in the preservation age;
- require superannuation benefits to be taken principally through regular payments rather than lump sums;
- discontinue the exemption of people aged over 60 from tax on superannuation benefits, at least if taken as lump sums rather than regular payments.

Age Pension

- increase the basic rates of age pension (at least for singles) and of rent assistance, while also tightening the pension means test (at least in relation to housing);
- remove or greatly relax means-testing on all or part of the Age Pension, while also removing or reducing the Senior Australians Tax Offset and the superannuation tax concessions for high-earners (see above);
- reforms in relation to the means test for home-owning pensioners will be considered in detail in the second Symposium.

END NOTES

[1] Eg, by taxing capital gains at a much lower rate than other forms of income, exempting all owner-occupied property, providing very generous deductibility for interest on borrowings, and (unlike almost all other countries) not having a tax on general asset-holdings or on gifts and inheritances.

[2] Eg, by providing very generous deductibility for interest on borrowings and [overseas bias]

[3] Eg, by taxing capital gains at a much lower rate than other forms of income, exempting all owner-occupied property, providing very generous deductibility for interest on borrowings, and (unlike almost all other countries) not having a tax on general asset-holdings or on gifts and inheritances.

[4] Eg, by not reducing income tax rates sufficiently for some low-income earners (especially those without dependent children) and not allowing short-term or fluctuating income to be averaged over a longer period than the fortnightly income tests for Newstart allowances.

[5] Eg, by providing fringe benefit tax concessions and salary sacrifice options which greatly encourage purchase and extensive use of private cars rather than use of public transport; also by inflating housing costs and encouraging inefficient use of housing (see footnote 3)

[6] Eg, by providing concessions which are much more available and valuable to wealthy people in relation to housing, superannuation, fringe benefits, work-related expenses; also by adopting a much stricter approach to assets and income in social security means test than is taken in the tax system.

[7] Eg, by failing to provide significant tax concessions for low-income contributors to superannuation benefits or saving for mid-life needs and by over-taxing interest on bank accounts.

[8] Eg, by providing distortions and loopholes in taxation of different types of income, as well as excessive generosity towards some forms of fringe benefits, salary sacrificing, deductibility of expenses and some forms of early access to superannuation benefits.