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Exploring the Personal Income Tax System

Paper Two – Separate taxation of labour and capital income

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This short paper is the second in a three part series that explores opportunities to reform the Australian personal income tax system.

Many of the policy propositions for the reform of personal tax recently debated in Australia have been framed within the current structure of our personal income tax system.

The intent of these short papers is to examine some elements of that structure and to ask whether they should be subject to reform.

Should we rely upon our current 'tax bracket regime?' Is our taxation treatment of capital income and labour income optimal? Should we allow some individuals to be entirely outside the personal income system through an elevated tax-free threshold?

There are many other elements of the personal tax system, and Australia's broader tax system that warrant review. By inquiring into these few issues, we seek to expand the scope of our tax reform debate.

Introduction

If you seek to picture an Australian household, you may imagine a household that has two adults each employed and earning a salary or wage, residing in a house they own but which is partially funded by a mortgage, with some savings earning interest from a bank account or credit union and with a superannuation account funded by annual employer contributions.

In broad terms, the salary and wages earned will comprise the 'labour' income of these two individuals while the earnings on their savings and superannuation and the imputed benefit of the equity in their house will compromise their 'capital' income.

Each of these forms of income is separately addressed by our personal tax system. How that currently occurs and how it could occur are the subject of this short paper.

Our personal income tax system should seek to tax each form of income in a manner that is, as far as possible, optimal for the individuals, our Federal Government and the broader economy.

How is labour and capital income taxed?

Under our personal income tax system, salary and wage income is taxed at progressive marginal rates using Australia's 'tax bracket regime'. The rates are described as progressive because they rise as the level of income subject to tax rises. These rates seek to introduce an element of 'vertical' fairness between taxpayers by imposing higher marginal rates on better paid individuals.

By contrast, our personal income tax system currently applies a wide range of tax treatments to different forms of capital income. Consider the diverse treatment of superannuation income, interest income and capital gains. Much of the income from what the Henry Tax Review called 'lifetime savings', particularly the imputed income or benefit related to the ownership of a home and superannuation income, is effectively subject to a flat tax rate of nil – although most superannuation income earned prior to the pension phase attracts a flat tax rate of 15 per cent.

Capital gains earned by individuals are subject to progressive tax rates but, due to the 50 per cent 'capital gains tax' (CGT) discount, this tax is effectively applied at reduced progressive tax rates. In contrast, savings income enjoys no concession and is taxed at full progressive rates.

For working individuals who do not earn salary and wages such as tradesmen, contractors or small business owners, the return earned on both their labour and any invested capital is taxed at full marginal rates.

What are the problems?

There are numerous sound economic and equity arguments in favour of a progressive tax rate system for labour income, as demonstrated by its almost global application.

However, many criticisms have be levelled at the tax treatment of capital (or savings) income in Australia, including that:

- The capital income tax base is too narrow
- There is inconsistency in the way that different categories of capital income are taxed
- The level of taxation of capital income is inappropriate.

One problem is the current ability to arbitrage highly taxed labour income into future capital income taxed at reduced progressive rates, due to the CGT discount. This is the negative gearing conundrum that the Labor Party's current policy seeks to address: using labour income to meet excess finance costs because a later capital gain will attract the 50 per cent CGT discount.

Some commentators assert that tax rates on capital income are too high while others maintain that tax rates are too low. Arguments presented in favour of lower tax rates include that capital income can incorporate an element of inflation which should not be taxed, and that only income tax on labour income should be used to promote greater equality through progressive rates. According to the former argument, the current Australian tax rules discriminate against some forms of savings (which they do). There is also an efficiency argument that capital income should attract lower taxation than labour income because capital is more mobile than labour and its supply is more elastic than that of labour.

Arguments against the lower taxation of capital income are generally based on notions of fairness – that capital income is largely 'unearned' and that it represents a higher proportion of the income of high income earners than it does of low income earners. Proponents of such arguments frequently contend that the current 50 per cent CGT discount is too concessional and results in capital gains being inadequately taxed. Again, this is the current view of the Labor Party which proposes to reduce the discount to 25 per cent.

One possible solution

These problems could be addressed by creating a dual income tax system with separate regimes for the taxation of labour income and the taxation of capital income, even though they are earned by the same individual. Each regime would impose tax at different rates using a different structure. This is not a new idea, but it warrants fresh consideration. Indeed, this system is often called the 'Nordic System' due to its adoption by some Nordic countries in the 1990's.

The key to the success of such a system is being able to properly classify all income earned by an individual as falling within one of these two categories.

For salary and wage earners with easily identified investments and pools of capital, the classification of labour and capital income would be straightforward.

For the self-employed and small business owners, arbitrary rules would be required to determine the return to capital, or *vice versa* the return to labour, with the remainder of the income of the individual being attributed to the other source (being labour or capital).

In terms of tax rates for each form of income, there are two broad options – a flat rate or progressive rates. As noted above, progressive rates are generally considered appropriate for labour income due to the equality achieved across income groups.

If a flat rate was adopted for capital income, that rate would depend on a range of factors including government revenue requirements, the elasticity of the supply of capital, and perceptions of fairness. Given the arguments in favour of taxing capital income more lightly than labour income, the flat rate might be in the 20 per cent to 30 per cent range. A higher figure might be more acceptable if, as in many overseas jurisdictions, there was an exemption for a fixed amount of interest income. This would remove many small investors and low-income earners from the capital income system. Under the pure version of the Nordic System, the flat rate is aligned with the company tax rate, which has the benefit of removing incentives for shifting capital income into a corporate vehicle.

If progressive rates were adopted for capital income, the appropriate rate and threshold structure would turn on the same factors relevant in setting a flat rate of tax.

Under both flat and progressive rate options, all expenses attributable to the generation of capital income would be deductible under normal rules but deductibility would be quarantined to the capital income system i.e. they could not be claimed against labour income. The Labor Party's proposal to restrict negative gearing is a step in this direction; expenses attributed to earning labour income would be deductible in calculating the taxable amount of labour income.

What could this solution look like?

One possible dual system for Australia would be to tax labour income at similar progressive rates to the present system and to tax capital income at a flat rate of 30 per cent in line with the full company tax rate.

This is the approach adopted in the modelling shown below, supported by a number of specific assumptions:

- Progressive labour tax rates have been set to result in total collections remaining the same as in the 2018-19 Budget estimate. As the modelled scenario taxes labour and capital income separately and does not allow deductions or losses incurred earning one form of income to be offset against the other form of income, it extends the base of total taxable income by approximately 1 per cent and consequently, effective rates can be slightly lower.
- Only the five major personal tax arrangements – the basic tax brackets, the Medicare Levy, the Low Income Tax Offset (LITO), the Low and Middle Income Tax Offset (LMITO) and the Seniors and Pensioners Tax Offset (SAPTO) – have been modelled, with other exceptions and levies dealt with in adjustments to the totals.
- The modelled arrangements for the LITO are set so that the full benefit of offsetting all tax is felt by the same taxpayer (set at labour income of $21,595 and no savings income). The modelled LITO is $725 available for labour income earners under $37,000, reducing at 2.5 cents per dollar of income up to $66,667. This LITO is only applied to labour income for the purposes of this model.
- SAPTO payments have remained unchanged in dollar amounts but similarly only apply to labour income.

The resultant modelled schedule of rates are shown in Table 1, with the budgetary impact shown in Table 2.

Table 1: Modelled schedule of rates

Band of income	Rate applied
Taxable labour income	
$0 – $15,000	0%
$15,001 – $35,000	11%
$35,001 – $85,000	32%
$85,001 – $175,000	37.5%
$175,001+	45%
Taxable savings income	
All savings income	30%

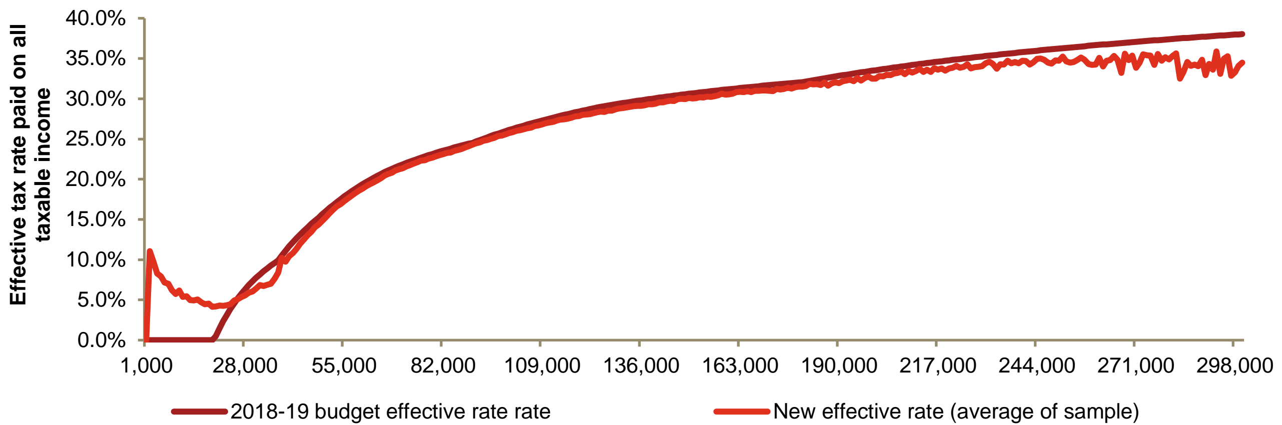
Table 2: Budgetary impact

Collection	2018-19 Budget estimate	2018-19 modelled result
Personal income rate	205,032	198,552
Medicare	17,987	18,117
LITO	(2,771)	–
SAPTO	(4,988)	(1,537)
LMITO	(3,640)	–
New offset	–	(3,587)
Adjustment for other arrangements	6,380	6,377
Total	**218,000**	**217,922**

Individual impact

Figure 1 shows the old effective tax rate against an estimate of the new effective rate. Because the new rate will depend on the mix of labour and income at different rates, Figure 1 shows the average of all taxpayers within a $1,000 band from Australian Taxation Office (ATO) data from 2015-16 taxpayers.

Figure 1: Effective rates paid on individual incomes in 2018-19

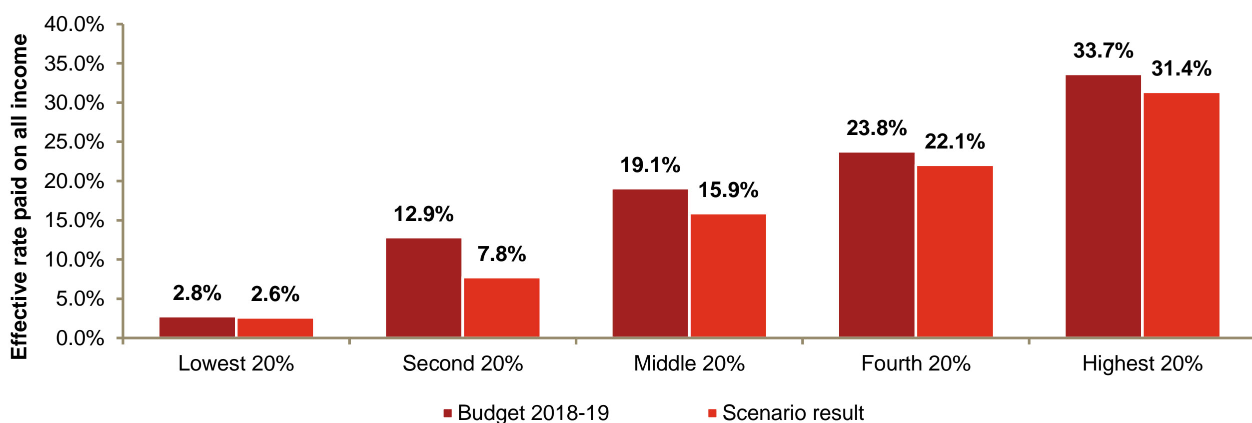


Source: PwC modelling using unpublished ATO data (2015-16 samples files) and parameters from Budget 2018-19.

Note: Effective tax rate is calculated on taxable income (after consideration of deductions) and includes income tax, Medicare levy, low income tax offset and low and medium tax offset.

Figures 2 and 3 show the impact of this model across income quintiles of individual taxpayers. Although this data is useful to show the new distribution, it is important to note that this new arrangement includes 1 per cent more taxable income (by not allowing capital income related losses to be offset against labour income) and also 26 per cent more taxpayers who are brought within the tax net because there is no tax-free threshold for savings income. This has the effect of including many more low income earners and increases the number of tax payers in each quantile.

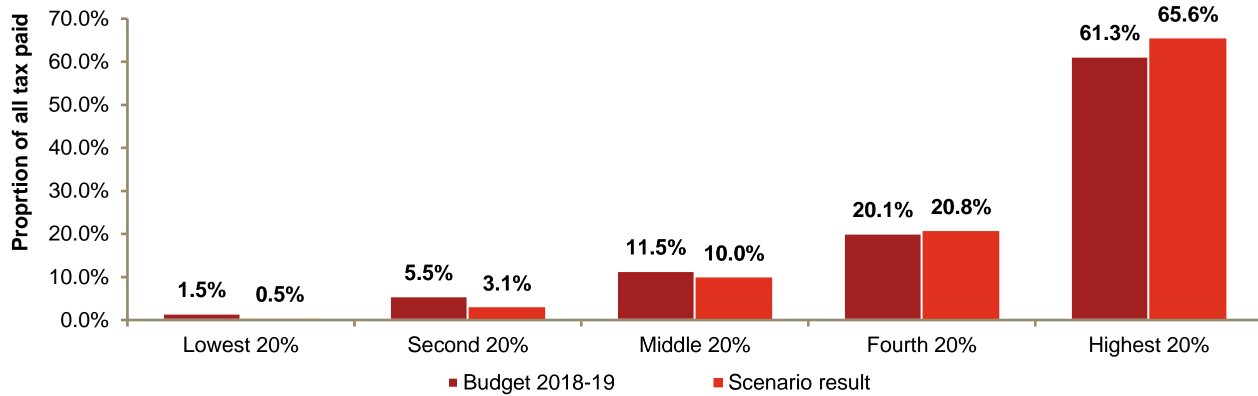
Figure 2: Effective rates paid by quintile of tax payers in 2018-19



Source: PwC modelling using ATO data (2015-16 samples files) and parameters from Budget 2018-19.

Note: Tax paid is calculated on taxable income (after consideration of deductions) and includes income tax, Medicare levy, low income tax offset and low and medium tax offset. Quintiles are calculated by tax paid, including only individuals that pay some tax after offsets.

Figure 3: Proportion of tax paid by quintile of tax payers in 2018-19



Source: PwC modelling using ATO data (2015-16 samples files) and parameters from Budget 2018-19.

Note: Tax paid is calculated on taxable income (after consideration of deductions) and includes income tax, Medicare levy, low income tax offset and low and medium tax offset. Quintiles are calculated by tax paid, including only individuals that pay some tax after offsets.

Conclusion

A tax on capital income is effectively a tax on future consumption and the concessions provided under our current superannuation system are founded upon the desire to increase the capacity of individuals to consume when they cease to work.

However, a substantial portion of the retirement savings of Australians now occurs outside the superannuation system, including via the untaxed family home and other forms of saving which have an inconsistent tax treatment.

While we may accept the embedded regime for personal housing and superannuation should not be subject to reform, there is nevertheless substantial scope to improve the tax regime applicable to other forms of capital income and to labour income. Such reform has potential to generate economic and equity benefits for both individuals and the broader Australian economy.

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