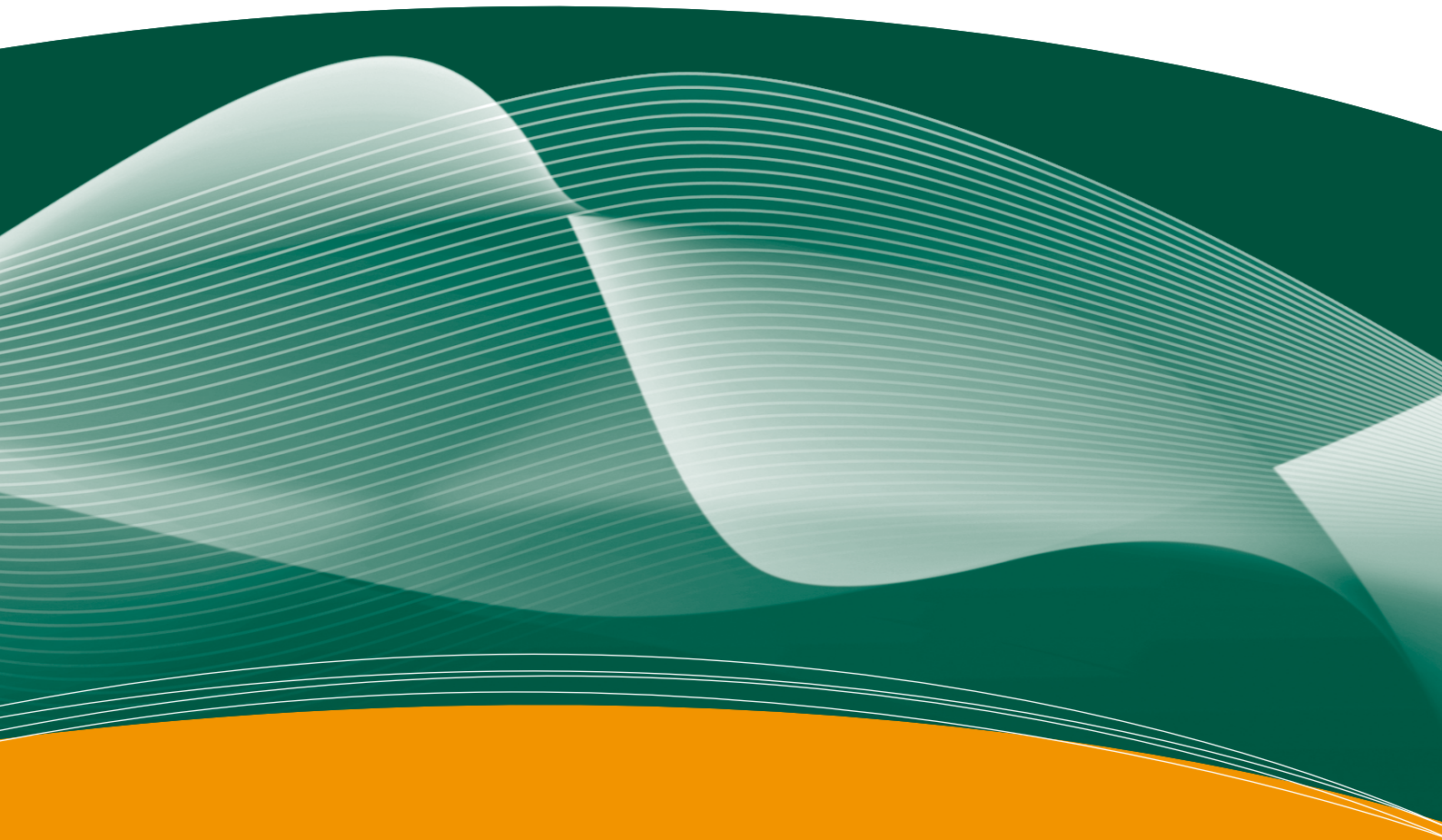
POLICYMONOGRAPHS

The Unfinished Business of Australian Income Tax Reform

Robert Carling



THE CENTRE FOR INDEPENDENT STUDIES

The Unfinished Business of Australian Income Tax Reform

Robert Carling

CIS Policy Monograph 108

THE CENTRE FOR INDEPENDENT STUDIES

2010

Carling, Robert.

The unfinished business of income tax reform / Robert Carling.

ISBN: 9781864322170 (pbk.)

Series: CIS policy monographs ; 108

1. Income tax--Australia.

Other Authors/Contributors:
Centre for Independent Studies (Australia)

336.2420994

Contents

Executive Summary

Tax reform is once again squarely on the Australian policy agenda, with the review of Australia's Future Tax System (the Henry Review or the review) now under consideration. Although personal income tax has been reshaped over many years and undoubtedly lightened over the past 10 years, those changes have left some of the major failings of the personal income tax system in place. Personal income tax reform should be a result of the Henry Review along with the other policy areas it is targeting.

A look back at the cumulative effect of changes since 2000 reveals that although tax brackets have been adjusted through large increases in thresholds and low income tax offset (LITO), marginal rates have not been cut by much, while selective tax breaks have proliferated. The reform agenda is clear: cut marginal rates; implement automatic indexation of thresholds for inflation; scale back the selective breaks; and simplify.

While the economic and budget landscape has changed dramatically since the review was launched, the global financial crisis has strengthened the case for reform instead of weakening it. Amidst calls for a more robust framework for future growth, tax reform should be used as a microeconomic policy tool to boost productivity growth and expand the economy's productive capacity. Personal income tax reform has an important role to play in this effort, as do reforms in other parts of the tax system such as business and state taxation.

Tax reform can have any effect on budget revenue that policymakers choose, but there is a strong economic case to further lighten the personal income tax load. If, as seems likely and realistic, this cost to the budget cannot be fully offset elsewhere in the tax system, there are ways to manage the cost through phased implementation of reform and slower growth in government spending over the next several years.

The case for personal income tax reform rests on the heavy economic costs of high marginal tax rates, abundant selective tax breaks, and system complexity. Those who would reshape personal income tax to make after-tax income more equally distributed need to explain why those economic costs should be tolerated or increased further, and why the total tax/transfer system should be made even more redistributive when it is already one of the most redistributive in the world.

The cornerstone of the major reforms proposed here is a new marginal rate scale with a top rate of 35%, most taxpayers facing a rate of 27%, and no Medicare or other levies. Serious consideration should also be given to a dual system, under which the above scale would apply to labour income but a flat rate equivalent to a reduced company tax rate (say 25%) would apply to capital income.

LITO has created an effective tax-free threshold of $16,000 (from July 2010), with the amount between $6,000 and $16,000 clawed back through a 4 percentage point surcharge on headline marginal rates above $30,000. This is a clumsy arrangement that adds to complexity and obfuscates the marginal rate scale. LITO should be converted to a conventional tax-free threshold of $16,000 with no claw-back. This can be funded partly by reducing government cash benefits above a certain income level. Otherwise, the existing thresholds for the various tax brackets do not need to change, only subject to automatic indexation.

Elimination of the Medicare levy and LITO would achieve some simplification, as would a flat rate capital income tax under a dual system, but greater simplification would require a major cut-back in selective tax breaks. This would also advance horizontal equity (equal treatment of equals), reduce tax-induced distortion of private sector decisions, and help fund cuts in marginal rates.

Australia last saw personal income tax reform of the base broadening/rate cutting kind in the 1980s. Since then, reform has concentrated on adjusting bracket thresholds, while selective breaks have crept back into the system. It is time to cut rates and broaden the base again.

Introduction

Australia's personal income tax system has undergone sporadic change under all governments since the 1970s. Cumulatively, the effect has been to 'reform' the system in the true sense of that much overused word. But the reform job is still only partly done. The current episode of change will come to an end on 1 July 2010, when the final instalment of the tax cuts initiated by the Howard government in 2007, and mostly confirmed by the Rudd government, are implemented.[1] Beyond that, further changes will depend on the recommendations of the major review of the tax/transfer system initiated by the Rudd government and its responses to them. Past reforms have generally cut into future tax revenue streams, but in the current circumstances a revenue-neutral or revenue-positive package appears to be favoured within government and by some outside commentators. This approach would seriously restrict the room to manoeuvre.

Serious flaws remain in the personal income tax system, and any attempt at tax reform will be incomplete if those flaws are left in place.

Serious flaws remain in the personal income tax system, and any attempt at tax reform will be incomplete if those flaws are left in place. For a start, personal income tax rates will remain high after the current round of cuts is completed in 2010. Cuts in tax rates can make a substantial contribution to the economic reform effort needed to strengthen Australia's economic prospects. Cutting tax rates need not involve simply disgorging government revenue, as has been the case in recent years, because reform more broadly defined can also involve measures that add to revenue. However, policymakers should not be closed to some further overall loss of revenue in the years ahead as part of the drive for economic reform. In contrast to the macroeconomic demand management mindset that has dominated thinking about tax in recent times, changes to personal income tax (and related changes to transfer payments) should be thought of as a microeconomic reform aimed at strengthening the supply side through faster productivity growth.

The remaining problems in the personal income tax system are not confined to high marginal tax rates. Complexity and lack of transparency plague the system as much as ever. Tax breaks in all their forms have long been part of the system, but in recent years there has been a trend to more and larger tax offsets of various kinds that have added to complexity and require taxpayers to wade through many pages of Tax Pack if they are to have any chance of understanding their tax obligations and entitlements to offsets and rebates. There is also the long-standing issue of how the tax system interacts with welfare payments to produce effective marginal tax rates that vary greatly from the statutory rates. The same can now be said of the various tax offsets that are withdrawn as income increases.

These issues were canvassed in a collection of papers on the case for income tax reform published by The Centre for Independent Studies.[2] The problems highlighted by that volume have been remedied only partially or not at all by the subsequent changes to the system, and the case for reform remains intact.

The focus of this paper does not imply that personal income tax is the only part of the tax system in need of reform. To the contrary, there is a strong case for reform in other areas such as company income tax and state taxation.[3]

Purpose, principles, context

Purpose

People's ideas for tax reform can differ because of genuine disagreements about the changes needed to achieve given objectives. Such differences can be addressed, at least in principle, through empirical evidence. But often, differences between policy prescriptions reflect fundamental differences of view about what the tax system should be aiming to achieve and the principles that should guide its design. These differences may be reduced through a more informed debate, but value judgments are also involved. There will always be irreconcilable differences between peoples' value judgments, particularly about what constitutes 'fairness' in taxation.

I have explored these issues of principle elsewhere and put forward a values-based set of guiding principles for tax reform.[4] Building on that approach, this paper sees tax reform as an economic

reform, aimed at lifting productivity growth and efficient use of labour, capital, and land-based resources. Australia's economic reform effort since the 1980s is often credited with having boosted productivity growth, economic growth, and living standards beyond what would otherwise have been achievable. Tax reform has been one part of the economic reform story, principally through the reforms implemented by the Hawke government in the mid-1980s and the Howard government since the late 1990s.

At the same time, it is now recognised that the reform effort has run out of puff and that productivity growth—which is the key to rising living standards and the capacity to satisfy community expectations—has sagged since the stellar performance of the 1990s.[5] The reform effort needs to be revived. Although there is much attention being paid to policies that support aggregate demand, the emphasis needs to switch to expanding the economy's productive capacity—or from boosting aggregate demand to boosting aggregate supply. As the Governor of the Reserve Bank recently commented, Australia is emerging from the recession with a narrower margin of excess capacity than from other recessions and will reach capacity relatively quickly.[6]

Tax policy is by no means the only instrument of economic reform capable of influencing productivity growth, but it is an important one. It has powerful effects on relative prices, resource allocation and the reward for investment and work effort. This needs to be the theme of tax reform, and it is one that can sit very comfortably with the subsidiary objective of simplifying what has become a very complex tax system.

The Prime Minister appears to be in tune with the idea of re-focusing tax policy on economic reform. He recently wrote that restoring growth to its average level over the last cycle '... will be achieved only through a responsible agenda of future economic reform ... (and) ... we need to begin laying the foundations for a stronger, more productive and more competitive Australia today.'[7] He went on to advocate reform 'consistent with achieving a modern tax system that is internationally competitive, provides maximum reward for effort, supports job creation and encourages productive investment.' In January 2010, the Prime Minister spoke of the need to lift Australia's productivity growth rate to at least 2% per year.

Equity considerations

One of the main challenges to an emphasis on designing the tax system to maximise economic growth and productivity comes from those who demand greater equity or 'fairness.' There are two dimensions to equity: horizontal (concerning the comparative treatment of taxpayers with the same capacities to pay) and vertical (the treatment of those with different capacities to pay). Pursuing greater horizontal equity can be consistent with economic efficiency and simplification to the extent that it involves removing selective concessions, anomalies and disparities in the tax system that distort private sector decisions. But any attempt to increase vertical equity—in other words, to reduce income inequality—through the tax system would quickly conflict with improving economic efficiency.

One of the main challenges to an emphasis on designing the tax system to maximise economic growth and productivity comes from those who demand greater equity or 'fairness.'

While 'fairness' will always be a matter of personal choice, and individuals can make rational choices in favour of more vertical equity at the expense of some economic growth, the following points respond to those who demand more income redistribution through the tax system.

First, the impact of public policy on equity depends on the whole tax/transfer system (and even other policies such as health and education), not just personal income tax. The sum of all policy interventions can be highly redistributive without any one part of it necessarily being redistributive. If there is a strong economic case for making personal income tax lower and flatter, that case can be taken up without necessarily frustrating distribution objectives. Other policy instruments, such as transfer payments, lend themselves better to redistribution without imposing the high economic cost that comes with a redistributive income tax.

Second, the Australian tax/transfer system is already highly redistributive by international standards, with only one or two Scandinavian countries being more redistributive.[8] Given this fact, do we really want more redistribution? Don't we already have too much, in that policy is

paying too much attention to re-slicing the economic pie at the expense of making it larger? If the degree of income inequality is still unacceptably high, the answer may well rest with policies that tackle pre-tax inequality—such as education and training polices—rather than making the tax system work even harder to correct for inequality.

Third, contrary to popular belief, the changes in personal income tax over the last 10 years have actually redistributed the tax burden in favour of lower income earners. Certainly, higher earners have gained more in dollar terms, but that is only because they pay much more tax in the first place. In percentage terms, which is the only sensible way to look at the tax burden at different income levels, the cuts have been largest at low incomes and then gradually decline as incomes rise.[9] The system was 'progressive' to begin with and has become more so. In 2006–07, the top 25% of income earners earned 51% of total income but paid 66% of total income tax; the latter share was 61% 10 years earlier.[10]

Do we really want more redistribution? Don't we already have too much, in that policy is paying too much attention to re-slicing the economic pie at the expense of making it larger?

The trade-off between equity and economic efficiency is a balancing act, and where society chooses to strike the balance is subject to change over time. There is a view that the global financial crisis of 2008–09 has tilted the balance towards greater equity. This is based on a questioning of pre-crisis assessments of the economic benefits of a lower tax environment, a drive for more government revenue in the context of measures to reduce unemployment and protect low income households, and even a sense of revenge towards the wealthy for allegedly having 'caused' the crisis. Such sentiments are more evident in the developed northern hemisphere countries, which have been most affected by the crisis, than in Australia; in fact, a number of those countries have increased top marginal tax rates.

Be that as it may, it is dubious in the extreme to argue that the crisis justifies more redistributive tax policies. What the countries most affected need most is a strong economic recovery that will evolve into durable long-term growth, a goal that higher tax rates would frustrate. Higher top tax rates will also do little to help reduce budget deficits because they raise relatively little revenue; as an instrument of 'revenge' against the alleged culprits in the crisis, they would be exceedingly blunt and poorly targeted.

Budgetary context

When the current tax review was launched in April 2008, the outlook for the federal budget was vastly different from that seen now. Sizeable surpluses were in prospect as far as the eye could see. Now, the budget is heavily in deficit and a surplus is not expected to reappear until 2015–16. So should tax reform aim to increase tax revenue, reduce it, or be neutral? More precisely, the benchmark for the effects of tax reform is a growing revenue yield in line with the economy; the question is whether tax reform should make it grow faster or slower. At issue is not only whether the budget should be restored more quickly to balance or surplus but whether taxes should be set to finance a slower or faster rate of growth in public expenditure.

The onset of the global financial and economic crisis and the associated dramatic downward revisions to projected Commonwealth budget revenue from 2008–09 onwards have led many commentators to predict that the scheduled 2010 tax cuts will be the last for many years as the government will need to retain all its projected revenue (and then some) if it is to restore the budget to balance. Some of these same commentators have gone further and advocated cancelling the 2010 instalment, having previously proposed the same fate for the 2008 and 2009 instalments. In 2008, the argument was that tax cuts were inflationary; in 2009 and 2010, tax cuts are unaffordable.

Whether out of conviction or political calculation, the Rudd government has implemented the promised tax cuts to date and looks likely to do so again in 2010. Beyond that, however, its focus is on reducing the budget deficit and, to that end, it has said that it will 'bank' the automatic growth in revenue as the economy recovers, at least until the budget returns to surplus. Although political considerations can easily give such commitments a short shelf-life, taken at face value the government's words are a prescription for unchanged tax rates and thresholds, and for reaping the

proceeds of bracket creep, for many years beyond 2010. The government has quietly abandoned its so-called 'aspirational' tax scale, which had a top marginal rate of 40%.

In a sense, the question as to how revenue considerations should constrain overall tax reform is not one that needs to be answered in this paper, which deals with only part of the tax system. A reduction in overall personal income tax, which this paper advocates, could be funded from other parts of the tax system. In practice, however, it is difficult to see how that would be achieved and, therefore, the reforms advocated in this paper are likely to curb the growth of revenue over time. Even in the current circumstances of a large budget deficit, this should not be seen as an obstacle to reform.

Tax reform need not be approached from the perspective that it has to be revenue-neutral or positive. There is a strong case, as will be argued below, for the overall tax burden to be reduced and reconciled with the budget outlook. The case is not only economic but also political in that reform is more easily achieved and sustained if there is a net overall reduction in tax. The key to reconciling this with fiscal responsibility is to view tax reform from a dynamic rather than a static perspective. Clearly, implementing a revenue-reducing tax reform immediately would be fiscally irresponsible in the current circumstances, but doing so over a period of years is another matter. This long-term approach sits comfortably with the long-term horizon of the government's tax review.

A net tax reduction is more easily accomplished over a period of years for two reasons. First, over such a period the growth of government expenditure can be more easily reduced so as to match the diminished revenue flow. Second, the economic benefits of tax reform show up over time as a growth dividend to reform so that the revenue cost is less than in a static framework. The latter proposition does not rest on extreme notions of tax cuts leading to increased revenue, which in the past have been ridiculed as 'voodoo economics.' Rather, the proposition is that some allowance should be made in the estimates for a growth dividend. This was in fact done in the GST reforms.

An arithmetic example may help to illustrate these points. Suppose that trend growth in both revenue and expenditure would be 5.5% per year in the absence of tax reform and, at this rate, would maintain their shares of GDP unchanged.[11] Now suppose that tax reform results in the growth of revenue falling to 4.5% per year. After 10 years, this would result in the tax revenue share of GDP falling from around 30% to 27%. Government expenditure growth would also need to be reduced to 4.5% per year, but this would still represent real growth of 2% per year, and at current population growth rates, it would more than maintain real per capita government expenditure. If a growth dividend from tax reform were factored in, both revenue and expenditure could grow somewhat faster, but their shares of GDP would still decline.

A reduction of just 1 percentage point in the annual growth rate of tax revenue would result in revenue being $43 billion per year lower after 10 years ($34 billion lower in today's prices, after allowance for inflation over the 10 years). $34 billion per year in today's terms would buy a lot of tax reform.

If revenue and expenditure were to grow at the same rates year in, year out, there would be no reduction in the deficit from the current level. However, the above example is based on *trend* growth rates. The elimination of the deficit will largely come from the winding-down of stimulus spending and a period of *above-trend* revenue growth in the recovery years.

What has changed in 10 years: 2000–10

The personal income tax system changed little from 1987—when the Hawke government's 1985 reform package was fully implemented—until the Howard government's New Tax System in 2000, which centred on the Goods and Services Tax (GST). Pressure for reform grew over this period and it was answered with the GST, other indirect tax reforms, and personal income tax cuts with effect from 1 July 2000. Attention returned to the tax system—particularly personal income tax—in the mid-2000s as the government's coffers began to swell from the gathering economic boom conditions, and culminated in the multi-year cuts announced in the 2007 budget and further promises by both government and opposition in the 2007 election campaign. These cuts will be completed in 2010, with the exception of the cut in the top marginal rate from 46.5% to 43.5% that was promised by the Howard government but rejected by the current government.

Rather than focus on the component parts, it is instructive to stand back and take a 10-year view of all the changes since 2000 to see what has changed in the structure of marginal rates, thresholds, and tax offsets.

(a) Marginal tax rates

The personal income tax structure has been based on a tax-free threshold, four graduated marginal rates, and a flat Medicare levy since the 1980s. Prior to the New Tax System reforms in 2000, the tax-free threshold was $5,400 and the marginal rates above that were 20, 34, 43 and 47%. The Medicare levy was superimposed at the rate of 1.5% above a tax-free threshold, but the benefit of this threshold was withdrawn above a certain income level so that, in effect, most taxpayers paid 1.5% from the first dollar of income.

Since 2000 there have been basically two sets of changes to marginal rates. The first, as part of the package that introduced the GST, concentrated on the two lower rates, which were cut by 3 and 4 percentage points respectively to 17% and 30%. The only change to the two upper rates was a 1 percentage point cut to the 43% rate. This concentration on the lower rates was due to the focus at the time on compensating low- and middle-income earners for the increase in indirect tax, at the expense of attention to the incentive aspect of cutting income tax, which would have justified more across-the-board cuts.

The second set of changes since 2000 has occurred since 2005. In that year, the lowest rate was cut further to 15%. That cut brought to 25% the total reduction in the lowest rate since 2000. Apart from that change, all the attention since 2005 has been to the two upper rates. The 42% rate carried forward from the 2000 reforms is being cut in steps to 37% from July 2010, which will bring to 6 percentage points or 14% the total reduction in the second top rate since 2000. In contrast the top rate, which had stood unchanged at 47% since 1989, has only been cut by 2 percentage points or 4%, much less than any of the other marginal rates.

The cuts in the first three marginal rates have totaled 12% to 25%. In contrast, the top rate has been cut by much less, resulting in a more steeply graduated rate scale.

In summary, over 10 years there has been a significant cut in headline marginal rates, although much of it has been in the context of compensating for higher indirect tax. The cuts in the first three marginal rates have totaled 12% to 25%. In contrast, the top rate has been cut by much less, resulting in a more steeply graduated rate scale.

The Medicare levy has remained at 1.5%, so that each of the marginal rates referred to above is actually 1.5 percentage points higher.

The cumulative changes in marginal rates over 10 years are illustrated in Table 1.

Table 1: Headline Marginal Rates (with Medicare levy), 2000 and 2010

	2000	**2010**
$		
0 – 5,400	0%	0%
5,401– 6,000	20%	0%
6,001– 20,700	20%	15%
20,701– 37,000	35.5%	16.5%
37,001– 38,000	35.5%	31.5%
38,001 – 50,000	44.5%	31.5%
50,001 – 80,000	48.5%	31.5%
80,001 – 180,000	48.5%	38.5%
>180,001	48.5%	46.5%

(b) Thresholds

Much of what has been called 'tax cuts' over the last 10 years have been discretionary increases in the thresholds at which the different marginal rates cut in. It is important to remember that Australia—unlike several other developed countries—has not had automatic indexation of thresholds apart from a brief experiment by the Fraser government in the 1970s.[12] Measured by government revenue foregone, discretionary adjustments to thresholds have been at least as significant as cuts in marginal rates over the past 10 years, especially for the top rate threshold.

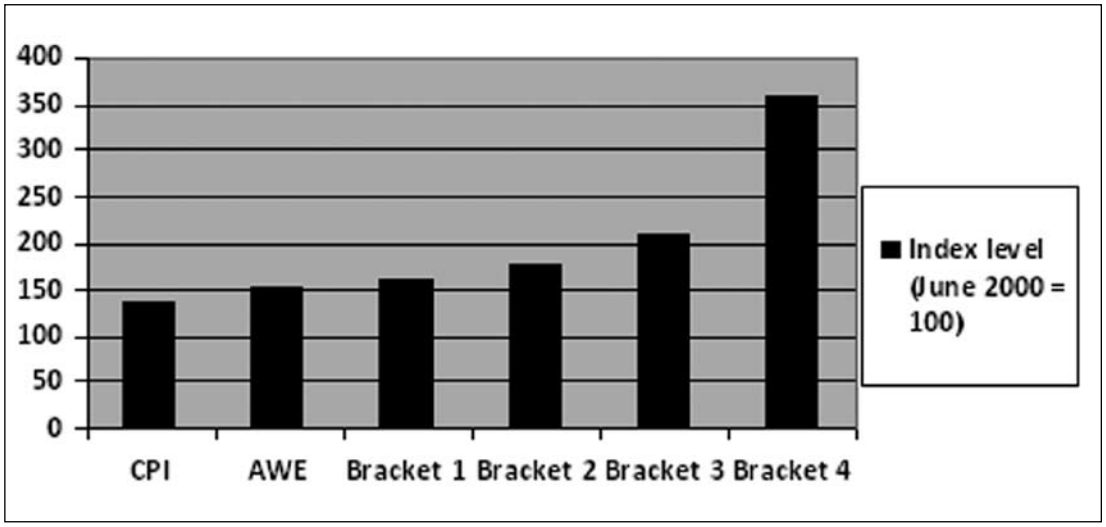
Much of what has been called 'tax cuts' over the last 10 years have been discretionary increases in the thresholds at which the different marginal rates cut in.

Chart 1 illustrates what has actually happened to the four thresholds since 2000 and what would have happened had they been automatically indexed to either the CPI or average weekly earnings.

With one exception, the increase in the threshold has exceeded the increase in consumer prices or average earnings. The thresholds for the second and third marginal rates have been approximately doubled, while that for the top marginal rate has more than trebled. In the case of the lowest threshold (the tax-free threshold), the increase was only 11%, but this is rendered meaningless by LITO, which has been increased from $150 in 2000 to a scheduled $1,500 from July 2010. This will lift the *effective* tax-free threshold to $16,000, representing a near trebling since 2000.

The large increases in thresholds for the upper marginal rates have substantially reduced the number of taxpayers subject to the upper rates and reduced the revenue cost of cutting those rates.

Chart 1: Increases in marginal rate thresholds compared with inflation, 2000 – 10



(c) Low income tax offset (and other offsets)

The above review of marginal tax rates and thresholds refers to the well-understood 'headline' rates and thresholds. In reality, and as recently spelt out by Humphreys,[13] the simplicity and transparency of this structure has been seriously compromised by LITO and other selective offsets that are withdrawn above specified income levels.

It is important to understand the distinction between a tax deduction and a tax offset. A deduction, such as that for donations to charity, reduces taxable income to which statutory tax thresholds and rates apply. An offset is a rebate of tax payable, subject to a cap and, in the case of most offsets, phased out above a specified income level.

LITO, for example, is a maximum of $1,500 (from July 2010) but cannot exceed tax actually payable and begins to be phased out at a rate of 4 cents in the dollar of taxable incomes above $30,000. As discussed above, it results in a higher effective tax-free threshold than the commonly understood $6,000 threshold, but the phase-out mechanism also results in higher effective marginal rates in the phase-out range of income. LITO is essentially a higher tax-free threshold, the benefit of which is clawed back from income earners above $30,000 through an increase in marginal rates applying up to $67,500. It is a means-tested tax-free threshold.

Using July 2010 figures, this mechanism will raise the effective marginal rate over the income range from $30,000 to $37,000 from 16.5% to 20.5% (including Medicare levy in each case), and from $37,000 to $67,500 the marginal rate will be 35.5%, not the 'headline' rate of 31.5%. The claw-back mechanism therefore increases the marginal rate for the majority of wage earners. Above $67,500, marginal rates are not affected, but average rates of tax are slightly higher because of the claw-back of the offset.

The purpose of LITO has been to increase the tax-free threshold while limiting the loss of revenue by clawing back the benefit above a specified income level. Whatever the wisdom or otherwise of that objective, the downside is that the claw-back mechanism adds 4 percentage points to marginal rates over the $37,500 withdrawal range. The resulting increase in the 31.5% rate, for example, negates all of the reduction in this rate implemented since 2000, when the GST was introduced.

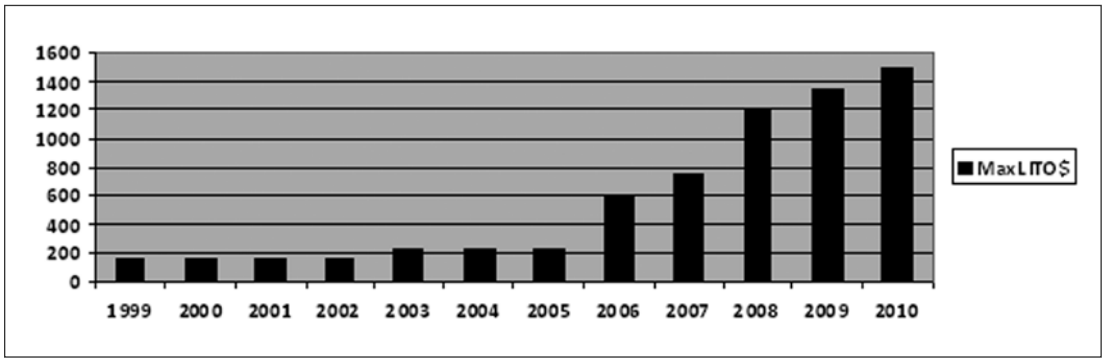
The LITO mechanism is not widely understood, adds to complexity and detracts from the transparency of the tax system.

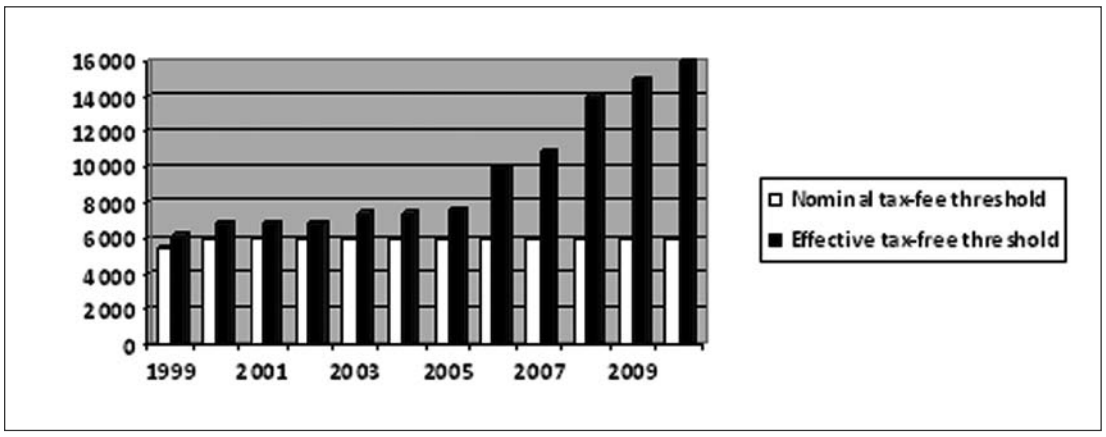
The LITO mechanism is not widely understood, adds to complexity, and detracts from the transparency of the tax system. LITO is not even referred to in the basic tax return form. An ATO computer calculates whether each taxpayer qualifies for any LITO on the basis of the information supplied in the tax return, and it is reflected in the tax assessment issued.

As discussed later, although LITO is by far the biggest tax offset and has the widest relevance to taxpayers, there are numerous other offsets of relevance to selected groups of taxpayers, some of which are applied with the same claw-back mechanism. The seniors' offset and the mature workers' offset are examples. In fact, the selective offset seems to have become the favoured method of delivering a tax 'cut.' The compensation to households under the proposed emissions trading scheme is to take the form of a further increase in LITO.

Chart 2 shows how LITO has grown since 2000, and with it the effective tax-free threshold.

Chart 2: Growth of the Low Income Tax Offset since 2000





(d) The true marginal rate scale

Bringing together the statutory (or 'headline') marginal rates, the basic Medicare levy and LITO, the true marginal rate scale is shown in Table 2 and is contrasted with the headline scale. The true scale would be different again for those affected by the Medicare levy surcharge and other tax offsets such as the mature workers' and seniors' offsets, but Table 2 embodies the rates, levies and offsets that affect all taxpayers.

One of the striking things about Table 2 is that it shows that the true marginal rate scale has a fairly narrow range above $37,000, with true marginal rates falling in the range 35.5% to 46.5% for all income levels except $67,500 to $80,000, where it is 31.5%. The great bulk of taxpayers above $37,000 face a marginal rate of either 35.5% or 38.5%. Moving from there to a flat rate above $37,000 would not be as great a leap as is often thought.

Table 2: Headline and True Marginal Rate Scales from July 2010

Headline Scale		**True Scale (with Medicare levy and LITO)**	
$		$	
0 – 6,000	0%	0 – 16,000	0.0%
6,001 – 37,000	15%	16,001 – 17,794	15.0%
37,001 – 80,000	30%	17,795 – 20,934	25.0%
80,001 – 180,000	37%	20,935 – 30,000	16.5%
>180,000	45%	30,001 – 37,000	20.5%
		37,001 – 67,500	35.5%
		67,501 – 80,000	31.5%
		80,001 – 180,000	38.5%
		>180,000	46.5%

The case for further reform

The above review of developments in the personal income tax scale over 10 years reveals that the thresholds for the various marginal tax rates have been increased very substantially, while most of the marginal rates have been trimmed. At the same time, the operation of LITO (among other tax offsets) and the Medicare levy creates a different and more complex effective rate scale than the headline scale.

Changes in the rate scale and the associated large sum of budget revenue foregone may suggest that the job of personal income tax reform has been finished or at least deserves lower priority now. Far from it, however, personal income tax reform should be a top priority for the next round of tax reforms. Marginal rates were high before the changes of the last 10 years and they remain high. Increases in thresholds—large though they have been—are not a substitute for cuts in marginal rates; they only alter the income ranges over which the various marginal rates apply, and in real terms even this benefit will be eroded over time by inflation in the absence of automatic indexation of thresholds.

Personal income tax reform should be a top priority for the next round of tax reforms.

High marginal tax rates, erosion of the tax base, and complexity are intertwined. High marginal rates create pressure for selective tax relief in the form of deductions, offsets and concessions, which erode the tax base. Selective relief becomes entrenched and comes at a heavy cost in foregone revenue, which creates pressure to keep marginal rates high. At the same time, selective relief makes the system more complex and opaque.

The wedge between headline and effective marginal rates results partly from LITO and its phase-out arrangements, but also from the interaction between the tax system and government cash benefits (transfer payments). Where transfer payments are means-tested, such as the age pension, the withdrawal rate adds to effective marginal rates over the withdrawal range. This effect has been partly ameliorated in recent years through increases in thresholds and reductions in marginal tax rates and benefit withdrawal rates, but high effective marginal rates remain a problem. Harding and colleagues reviewed trends in effective marginal tax rates (EMTRs) over the 10 years to 2006–07 and found little change on average; income tax cuts had reduced EMTRs, but extensions of income-tested welfare payments and tax concessions worked in the opposite direction.[14] The percentage of working-age Australians facing EMTRs greater than 50% actually rose slightly, and that percentage was at or above 10% for the fourth, fifth, sixth and eighth deciles of disposable family income in 2006–07.

There is also the issue of 'churning,' whereby the same people are paying taxes and receiving government cash transfers, resulting in tax rates being higher than they would otherwise be.[15]

The solutions to high EMTRs are complex and beyond the scope of this paper. They cannot be found in tax reform alone, and are intrinsic to a system such as Australia's generous but tightly targeted welfare payments. Tax reform can, however, help by lowering marginal tax rates as much as possible, building in higher tax-free thresholds to replace some middle-class welfare payments, and avoiding claw-back mechanisms such as LITO, which add to effective marginal rates over wide income ranges. Variable tax-free thresholds could be used to reflect family circumstances (such as dependent spouse and children) in place of some cash benefits and tax offsets, as flagged by Saunders and Maley.[16]

In summary, the problems that remain in the personal income tax system include:

- High marginal rates.
- Bracket creep in the absence of indexation of thresholds.
- Erosion of the tax base through deductions, concessions, offsets, rebates, and the like.
- Complexity, which imposes costs and detracts from transparency.
- High effective marginal rates resulting from the interaction between the tax system transfer payments and means-tested tax offsets.

The Rudd government at different times has accepted a case for reform built on these grounds. Its 2007 election platform committed it to an 'aspirational' personal tax scale of three rates—15, 30 and 40%. However, it long ago stopped talking about such a scale and its current focus appears to be narrower, with an emphasis on simplification and greater 'fairness.' Simplification is certainly needed. 'Fairness' is subjective and therefore meaningless without definition by those advocating more of it. Too often, it is a beguiling cover for ulterior motives. If it means removing selective tax concessions that detract from horizontal equity, that is one thing; but if it means making the personal income tax system more 'progressive' (redistributive), that is quite another.

Why should marginal rates be cut?

Income tax cuts are usually thought of as dollars-per-week benefits to the taxpayers' after-tax incomes at various income levels. This is the income effect, which is only part of the economic effect of tax cuts. In the economic case for lower income tax, the income effect is joined by the substitution effect, which is driven by marginal rates. The substitution effect arises because tax rates affect, at the margins, the relative attractiveness of different forms of economic activity, such as work versus leisure. It is possible to structure tax cuts so as to deliver an income effect with little or no substitution effect, but doing so would seriously limit the economic benefits because marginal rates have powerful effects on private sector economic behaviour.

The economic case for reducing marginal tax rates rests on the very high economic costs of high marginal rates, as explained by Robson.[17] Those costs begin with administrative, enforcement and compliance costs. Although any income tax system involves such costs regardless of the rates of tax imposed, they are larger at higher tax rates because of the incentive that high rates create for tax avoidance and evasion. Administrative, enforcement and compliance costs will also be higher the more complex the tax system, and greater complexity tends to accompany higher tax rates.

The economic case for reducing marginal tax rates rests on the very high economic costs of high marginal rates.

But the biggest economic cost, and the one least well understood by non-economists, comes from the distortion of economic activity as individuals and businesses adjust their economic behaviour in response to the taxes imposed on them. This is called the 'excess burden' or 'deadweight loss' of taxation and comes from the fact that taxes, while raising revenue, tend to divert economic resources (labour, capital) from higher valued to lower valued economic uses. The only way to avoid these costs is to have no tax at all, but as that is impossible in a mixed

economy of private and government activity, the challenge is to minimise the costs. That will depend partly on minimising the total tax burden and therefore the scope of government; but for a tax burden of a given overall size, the economic costs depend on how the tax system is designed. This is partly a matter of avoiding heavy reliance on any one tax to produce the revenue. Australia still relies relatively heavily on personal income tax. The deadweight loss can also be minimised by avoiding high tax rates, which have stronger effects on taxpayers' economic behaviour. A marginal rate of 20% imposes a much lower marginal deadweight loss than a rate of 40%, and so on. In fact, the deadweight cost of a 40% marginal rate is more than double that of a 20% marginal rate.

In the context of personal income tax, the source of the deadweight loss is best illustrated with examples. It can come from workers choosing to stay out of the workforce, reducing their hours of work, reducing the intensity of work in other ways, pursuing 'do it yourself' work, engaging in home production for barter, or switching to activities or occupations with significant non-pecuniary benefits. In a longer run context, it can also come from people foregoing investments in human capital (deciding not to upgrade their skills) or devoting more of their income to consumption and less to saving and investment. The fact that not all of these opportunities are available to all individuals is irrelevant; it is sufficient that *some* individuals respond in *some* of these ways for there to be a deadweight loss.

It is sometimes asserted that while these effects are important for lower income earners, high income earners are unresponsive or less responsive and, therefore, high marginal tax rates on high incomes do not impose such a large deadweight loss. Yet high earners have the same incentives—and probably more opportunities—to adjust their behaviour in response to taxation as anybody else. As discussed below, lowering the top marginal rate of tax is an essential part of achieving the full potential benefits of tax reform, even though it seems to have gone out of fashion in policy circles.

Lowering the top marginal rate of tax is an essential part of achieving the full potential benefits of tax reform, even though it seems to have gone out of fashion in policy circles.

Deadweight losses are difficult to measure in practice. In the past, most economists have argued that the elasticity of hours worked in relation to after tax wages is low, and concluded that the deadweight cost could not therefore be high. However, these estimates take a narrow view of the effects of taxation and the sources of the deadweight loss, as discussed by Keane in a paper for the AFTS review.[18] Keane concludes that income tax is likely to have a much higher economic cost (by shrinking the pie) than in the old consensus view because that view has ignored how taxes alter incentives for investment in human capital. As reviewed by Robson, comprehensive estimates of the deadweight cost of personal income tax in the United States show a cost of 20% to 40% and some estimates of the marginal deadweight cost are above 100%. Put another way, the cost to the economy exceeds the revenue raised by these percentages.

There are no estimates of the deadweight cost at different income levels, but another way of looking at behavioural responses to tax is to estimate the elasticity of taxable income with respect to changes in tax rates (the percentage change in taxable income when marginal tax rates change by 1%). Estimates based on US experience suggest that this elasticity is at least 0.4 (that is, taxable income falls by 0.4% for a 1% increase in tax rates), and that it is higher for taxpayers with higher incomes.[19]

Although personal income tax is most often thought of as a tax on wages and salaries, it is much more than that because personal income also includes individual income from saving and investment (interest, dividends, rent, capital gains) and from unincorporated businesses. It is therefore a tax on capital as well as on labour. Capital income, and the economic activities underlying it, is likely to be even more adversely affected by taxation than wage and salary income because capital is more mobile than labour.[20] This has been recognised by some countries that have adopted different (lower) tax rates on capital income, and the same approach is sometimes suggested for Australia. But whether or not tax reform takes us in that direction, the fact that saving, investment and entrepreneurial activity are even more responsive to taxation than labour supply reinforces the case for lower marginal rates. Moreover, as capital income is more concentrated at higher income levels, the case for reductions in the higher marginal rates of income tax is also reinforced.

International competitiveness is often emphasised as a desirable principle of tax policy. In the current global context, there are some signs of a trend back to higher marginal tax rates in developed countries after a long period during which they drifted lower. Should such a trend be confirmed, it will doubtless be argued by some that it weakens the case for lower taxes at home. The economic costs of taxation are certainly magnified in an open economy setting, as the potential for cross-border movements in the factors of production—particularly capital but also labour—provides greater opportunities for the kinds of behavioural responses discussed above. Even in a closed economy, however, there are many opportunities for the behavioural responses that result in deadweight costs. International trends do not, therefore, remove the case for reform at home.

Tax changes that increase saving, investment and entrepreneurial activity can also be expected to lift the rate of growth permanently.

The economic benefits of lower tax rates can be thought of as static—a one-shot lift in the *level* of national income—or dynamic—an increase in the *rate of growth.* In practice, both are likely to happen. The removal of inefficiencies in resource allocation is likely to produce a one-shot lift, although in may be spread out over a number of years, thereby affecting the growth rate a period of adjustment. Tax changes that increase saving, investment and entrepreneurial activity can also be expected to lift the rate of growth permanently. As illustrated in Box 1, empirical studies have found evidence of the relationship between taxation and the level and rate of growth of GDP.

Box 1: Taxation, GDP and Growth—Some Empirical Evidence*

Asa Johansson and colleagues found corporate taxes to be most harmful for growth, followed by personal income taxes.[21] They found evidence that 'flattening the tax schedule could be beneficial for GDP per capita, notably by favouring entrepreneurship' and that highly progressive income tax schedules have adverse effects on GDP per capita 'through both lower labour utilisation and lower productivity partly reflecting lesser incentives to invest in higher education.'

Christina and David Romer found large effects of tax changes on GDP in their analysis of post-World War II tax reforms in the United States. A tax increase equivalent to 1% of GDP lowered real GDP by 2% to 3% over time.[22]

Fabio Padovano and Emma Galli used data for 23 OECD countries and found that high marginal tax rates and graduated taxes tended to be negatively associated with long-term growth.[23] An increase of 10 percentage points in marginal rates decreased annual economic growth by 0.23 percentage points.

Eric Engen and Jonathan Skinner examined more than 20 studies of the link between tax rates and economic growth and concluded that 'a major tax reform reducing all marginal rates by 5 percentage points, and average rates by 2.5 percentage points, is predicted to increase long-term growth rates by between 0.2 and 0.3 percentage points.'[24]

Reinhard Koester and Roger Kormendi using data for 63 countries found that reducing progressivity in taxation while holding tax revenue constant led to higher levels of national income.[25]

**This summary draws from Milagros Palacios and Kumi Harischandra, 'The Impact of Taxes on Economic Behaviour,' Fraser Forum 02/08 (Fraser Institute, 2*008).

How should the tax scale be reformed?

The above discussion largely addresses issues of principle. It is time to consider how the practical details of how the personal income tax scale should be changed based on those design principles.

(a) Lowering and flattening marginal rates

The economic arguments for lower marginal tax rates outlined above lead logically to the conclusion that the tax scale should be compressed into a single rate rather than the traditional graduated (or 'progressive') scale. If higher earners' economic behaviour is at least as responsive to taxation as that of lower earners, then deadweight economic costs will be minimised if the marginal rate

is the same for higher and lower earners. If there is no tax-free threshold, the single marginal rate is the same as a 'flat' or 'proportional' scale, where tax as a percentage of income is the same at all levels. In most tax systems, however, there is a tax-free threshold, and applying a single marginal rate above that threshold still results in a 'progressive' system in the sense that the *average* rate of tax rises with income.

Although a flat or single rate system applies in a number of emerging market economies such as Russia, Latvia and Estonia, in most countries a graduated scale is the norm and is one of the mechanisms used to reduce pre-tax income inequality. Developed countries tend to have more steeply graduated scales than developing countries, but even in developed countries income tax typically started as a single rate of tax and then evolved over many years into a graduated scale, partly as governments sought more revenue and partly out of a sense of 'fairness,' 'equity,' or 'social justice,' notwithstanding the economic costs.

Fairness and equity, however, are in the eye of the beholder, and there are strong counter-arguments against graduated scales being imposed on these grounds. As Sinclair Davidson points out, 'fairness' in a progressive tax system will always be a matter for arbitrary judgment, and political economists and philosophers such as Adam Smith and John Stuart Mill have argued for several centuries that fairness lies in proportionality.[26] Lachlan Chipman has argued the moral case for a flat, proportionate income tax.[27]

If starting with a clean slate, a flat rate set at a level that would produce only a modest deadweight economic cost would be best from both economic and 'fairness' perspectives. It is a matter of judgment what such a rate would need to be, but the consensus of those who think in these terms is that it should be no higher than about 30%.

If starting with a clean slate, a flat rate set at a level that would produce only a modest deadweight economic cost would be best from both economic and 'fairness' perspectives.

Chipman, however, also acknowledges the formidable political obstacles in the path of a flat tax in Australia.[28] What are advocates of reform to do in these circumstances? The approach taken in this paper is to accept that the principle of a graduated scale has become too entrenched to overcome in the foreseeable future and to propose a revised graduated scale consistent with lower economic costs. The top rate (currently 46.5%) and the second top rate (38.5% from July 2010) need to be aligned at a level of no more than 35% so as to substantially reduce economic costs. The existing 35.5% and 31.5% marginal rates should also be reduced (to say 27%), particularly if reform is to remove some concessions and deductions (as discussed below). The existing 16.5% rate is largely a fiction. As Table 2 shows, over the entire income range from $6,000 to $37,000 to which this rate purportedly applies, the true marginal rates are 0, 15, 25, 16.5 and 20.5%. A sensible reform would collapse this part of the scale to just two rates—zero up to the current effective tax-free threshold of $16,000, and 15% from there to $37,000.

These changes would leave a scale of 0, 15, 27 and 35%.

(b) A dual rate scale?

The above discussion assumes a comprehensive income tax system that, in principle, taxes all income at the same rates regardless of type. Australia, like many countries, uses the comprehensive approach as the starting point but, in practice, allows many departures from it through various forms of tax relief, as discussed in the next section. One of the departures is to tax selected forms of capital income more lightly.

An alternative and more systematic approach is a dual income tax system, as used in the Netherlands and Scandinavian countries. The dual system applies a proportional (flat) tax to all capital income such as interest, dividends and rent, and a graduated scale to labour income, with the flat rate on capital income lower than the top rate on labour income. The Australian tax review has seriously considered a dual system, but at time of writing its conclusion was not known.[29]

The rationale for the dual system is that the economic costs of the income tax are higher for capital income than for labour income due to the higher mobility of capital. A flat rate capital income tax also offers opportunities for simplification because final tax can be withheld at source, eliminating or simplifying tax returns. There are additional advantages if the flat tax on personal capital income is aligned with the corporate income tax rate.

The concept of a dual tax system has its attractions and should be seriously considered, but not as a substitute for a reduction in tax on labour income as well. While it is true that economic costs are higher for a given rate of tax on capital income than on labour income, this does not negate the reality that current marginal tax rates on labour income also result in excessive deadweight economic costs. If the suggested scale above were to be adopted within the context of a dual system, then the graduated rates of 0, 15, 27, 35% should apply to labour income and a flat rate of, say, 25% to capital income. It would also be desirable for corporate profits to be subject to the same tax rate as personal capital income.

The concept of a dual tax system has its attractions and should be seriously considered, but not as a substitute for a reduction in tax on labour income as well.

A dual system would need to include robust safeguards against opportunities to disguise what is truly labour income as capital income in order to take advantage of the lower marginal tax on capital income.

(c) The Medicare levy

The Medicare levy has existed since 1984, starting at 1%, then being raised twice to its current level of 1.5%. In more recent years, a 1% surcharge was added to the basic levy for those above specified income thresholds who do not take out private health insurance. The levy raises around $7 billion per year but covers only a fraction of the true cost of Medicare. As such, it is misleading in that it neither determines nor constrains public spending on Medicare, but this does not stop it from encouraging a strong sense of entitlement to 'free' medical care. Spending on Medicare is determined independently of the levy. The levy is really just a second income tax and is more accepted by the public because of its link to a popular spending program.

There are arguments for and against such 'earmarked' or 'hypothecated' taxes and although they can serve a legitimate purpose in limited situations as 'user pays' taxes, levies such as the Medicare levy are an abuse of the concept and should not be part of the tax system.[30] Since then, other similar levies have been proposed for dental care and disability support, and the same arguments apply.

Both the basic Medicare levy and the surcharge add to complexity in the tax system, with 11 pages of Tax Pack being devoted to them. On top of that, the phase-in of the levy between $17,794 and $20,934 distorts the marginal tax rate, effectively adding 10 percentage points over that range, bringing it to 25%.

There is a strong case on transparency grounds for abolishing the levy as part of tax reform, and accommodating the cost of abolition within the setting of new marginal rates. Other levies of a similar kind should not be adopted. Abolition of the Medicare levy surcharge means that an alternative 'stick' would be needed to encourage take-up of private medical insurance, but the existing lifetime cover arrangement may be sufficient in itself.

(d) Thresholds

As discussed above, there have been large increases in thresholds in recent years. The priority now should be lowering marginal rates rather than further increases in thresholds. The one exception to this would be higher tax-free thresholds to recognise family circumstances of taxpayers, rather than spouse offsets and family payments. For example, the basic tax-free threshold of $16,000 could be boosted by, say, $8,000 if the taxpayer has a dependent spouse and by a certain amount for each dependent child. This idea is not explored further here because it would take the paper too far from its core proposition.

It is a matter for consideration whether the new top rate should cut in at the existing top threshold ($180,000), the second top threshold ($80,000), or somewhere in between.

(e) Indexation of thresholds

The final issue in the reform of the personal income tax scale is indexation of the thresholds. Australia briefly experimented with indexation in 1976, but it was quickly watered down and then completely abandoned because the government preferred to make adjustments to thresholds

as well as marginal rates at its discretion. The experience of other countries has been different, and full, automatic indexation is still practised in countries such as the United States, the United Kingdom, and Canada.

There is a very powerful argument for full, automatic indexation. In its absence, average tax rates tend to increase as income inflation results in a larger proportion of incomes being subjected to higher marginal rates. In other words, average tax rates increase even if real incomes do not. This is convenient for governments because it super-charges revenue growth by stealth without legislative effort or transparency. The revenue dividend from this 'bracket creep' can be allowed to build up for a number of years, and then committed—at least in part—to tax 'cuts.' The discretionary threshold increases of recent years (as discussed above) went beyond compensation for bracket creep, but that does not alter the fact that in part they merely handed back the proceeds of bracket creep to taxpayers, even though they were presented as tax 'cuts.'

There is a very powerful argument for full, automatic indexation. In its absence, average tax rates tend to increase as income inflation results in a larger proportion of incomes being subjected to higher marginal rates.

Indexation would come at a cost to revenue growth in the future but is not a substitute for cuts in marginal rates. It is essential that a combination of marginal rates and thresholds that minimise economic costs are put in place first, followed by the indexation of thresholds. Indexation would then cement (in real terms) a desirable rate scale rather than the current one.

(f) The new rate scale

Table 3 illustrates the new rate scale (which would be indexed) and compares it with the current, unindexed effective scale taken from Table 2.

Table 3: Current (effective) and proposed marginal rate scales

True Scale (current) (with Medicare levy and LITO)		**Proposed Scale**	
$		$	
0 – 16,000	0%	0 –16,000	0%
16,001 – 17,794	15%	16,001 – 37,000	15%
17,795 – 20,934	25%	37,001– 80,000	27%
20,935 – 30,000	16.5%	>80,000	35%
30,001 – 37,000	20.5%		
37,001 – 67,500	35.5%		
67,501 – 80,000	31.5%		
80,001 – 180,000	38.5%		
>180,000	46.50%		

Reducing complexity

(a) Removing tax relief (or 'broadening the base')

Certain reforms to the tax scale proposed above would simplify the personal income tax system—for example, converting LITO to a simple tax-free threshold. Simplification also, however, demands reform of the tax base, which requires a searching examination of tax deductions, offsets, rebates, exemptions, and concessional rates (here termed 'tax relief' for simplicity). Such an examination also provides part of the solution to financing the proposed reform of the tax scale, and helps to improve the horizontal equity of the system by promoting equal treatment of equals.

Simplification demands reform of the tax base, which requires a searching examination of tax deductions, offsets, rebates, exemptions, and concessional rates (here termed 'tax relief' for simplicity).

Different forms of tax relief affect tax paid in different ways and need to be defined. A *deduction* is an allowance for an expenditure incurred and is a reduction in income in the calculation of taxable income. The rationale for some deductions is that they recognise expenses directly incurred in earning taxable income, but some deductions are allowed for other reasons such as for donations to charities. Deductions are open-ended and provide a larger reduction in tax the higher the taxpayer's marginal rate.

Tax *offsets, credits and rebates* are reductions in tax payable after a person's taxable income has been calculated and the tax rate scale has been applied. They are usually capped in dollar terms and cannot reduce tax payable below zero unless they are classified as 'refundable,' the main instance of which is franking credits on dividends. In some cases such as the LITO, the full offset is effectively means-tested as it applies only up to a certain income level and is then phased out as income increases.

Tax *concessions* take the form of exemptions or lower tax rates for certain types of income, such as the 15% tax on superannuation contributions and earnings and the 50% capital gains concession.

In general, there has been a trend towards more tax relief in the personal income tax system over the years, which has added to complexity and made the incidence of personal income tax more variable in response to individual taxpayers' circumstances. This has reflected in part the use of the tax system to pursue social objectives, the incorporation of concessions for some forms of capital income, or simply governments playing politics by using the tax system to reward favoured groups or causes. The same sacrifice of revenue by governments could have been made to lower marginal tax rates across the board. Reform that reduces selective relief and cuts marginal rates across the board is often referred to as 'broadening the base and lowering the rates.' The last major reform of this kind was undertaken in the late 1980s, when capital gains and fringe benefits were brought into the tax net and marginal rates were cut. Since then, however, tax relief has crept back into the system.

One indicator of complexity is the number of pages of Tax Pack devoted to explain the various types of tax relief: 12 pages on deductions for work-related expenses; eight pages on the spouse or housekeeper offset; six pages on the education tax refund; three pages on the senior's offset; and so on. Another indicator is the volume of tax legislation—with the core *Income Tax Act* now weighing in at around 9,000 pages—and yet another is provided by estimates of tax expenditure, which reveal revenue foregone from personal income tax and retirement income tax relief of $63.8 billion in 2007–08.[31]

The following table illustrates the extent of personal income tax relief including, where possible, the revenue foregone. This table covers the types of income tax relief available up to 2006–07, but since then more have been added, such as the education tax rebate and the increased child care tax rebate.

Table 4: Personal income tax relief, 2006–07

Type of relief:	**Amount deducted $ billion**	**Revenue foregone $ billion (a)**
Deductions:		
• Rental deductions	27.3	9.7
• Work-related expenses	14.2	5.0
• Non-employer super contributions	8.1	1.4
• Interest and dividend deductions	3.6	1.3
• Undeducted purchase price of pensions	3.6	1.3
• Gifts and donations	1.9	0.7
• Cost of managing tax affairs	1.4	0.5
• Other	1.4	0.5
Total		20.4
Offsets and credits		
• Dividend franking credits		10.5
• Low income tax offset		2.3
• Termination payments		1.4
• Super contribution, annuity and pension offset		1.2
• Senior Australians		1.1
• Mature age workers		0.5
• Pension or pensioner		0.5
• Spouse, housekeeper		0.5
• Medical expenses		0.4
• Child care rebate		0.4
• Zone/overseas forces		0.2
• Entrepreneurs		0.2
• Baby bonus offset		0.2
• Other		0.3
Total		19.7
Selected concessions:		
• Superannuation:		
o Fund earnings		12.2
o Employer contributions		10.2
• Capital gains discount		8.6
• Exemption, various government cash benefits		4.2
• Statutory formula to value car benefits		1.8
Total		37

Sources: Tax Expenditures Statement 2008 (Australian Treasury, January 2009); Taxation Statistics 2006–07 (Australian Taxation Office, January 2009).

(a) Assuming marginal tax rate of 35.5%

These estimates are by no means beyond dispute. For example, the estimate for the capital gains concession simply applies full tax rates to the capital gains actually reported in a particular year; in reality, the volume of realised gains is highly sensitive to the tax rate and the abolition of the concession would certainly not produce an extra $8.6 billion in annual revenue. In general, estimates of revenue foregone make no allowance for what the behavioural response of taxpayers would be to the removal of the deduction or concession. Moreover, the costing of the various superannuation benefits is strongly contested, and with different methodologies from those used by the government, it is possible to come up with much lower costs.

It would be surprising if an amount of $10 billion –$20 billion per year could not be saved from the complete catalogue of tax relief—an amount that could go a long way towards funding the reductions in marginal rates proposed above.

It must also be recognised that there is a sound conceptual case for much of the tax relief built into the system. For example, there is a case for deductions for expenses incurred in deriving taxable income, for franking credits on dividends to avoid double taxation of dividends, for capital gains concessions, and for concessional taxation of superannuation and other forms of saving. Reflecting this reality, no income tax system in the world fails to allow for any tax relief at all.

The complete list, however, contains some that could be removed or the benefit of which could be delivered in another form without complicating the tax system. Even in the case of those for which there is a conceptual case, the simplification objective could justify their removal and replacement by lower marginal rates for all taxpayers. For example, the deduction for work-related expenses has a conceptual basis, but the principle is applied inconsistently and there is a lot of room for dispute at the margins as to what constitutes a valid work-related expense. Alternatives would be to allow a standard deduction from all wage and salary income, or to apply the revenue saved from abolishing the deduction to lower marginal rates for all.

Notwithstanding the above qualifications, it would be surprising if an amount of $10 billion –$20 billion per year could not be saved from the complete catalogue of tax relief—an amount that could go a long way towards funding the reductions in marginal rates proposed above.

(b) Other ways to reduce complexity

One route to simplification that is often suggested is to do away with the need for annual tax returns for many taxpayers. This will only be possible, however, if the tax system itself is simplified, such as by eliminating or standardising deductions as discussed above.

Greater resort to withholding taxes would also help. The PAYE system for wage and salary earners is a withholding system, but often tax is over-withheld because taxpayers have deductions or other circumstances that prevent the employer from withholding the correct amount.

The concept of withholding at source could be extended to investment income such as interest and dividends, and this is already done (at the top marginal rate) where a taxpayer does not quote a tax file number. Again, however, under the current system withholding agents cannot withhold correct amounts as taxpayers' actual marginal rates are unknown to them. This would be less of a problem if investment income were to be taxed at a single, flat rate as under the dual tax system discussed above, but even then taxpayers' marginal rates would vary depending on the investment income deductions they are allowed and use.

Doing away with annual tax returns is not as easy as it sounds.

Conclusion

Australia's personal income tax system has undergone sporadic change and reform over many years, but there is still much unfinished business. Tax reform more broadly defined is once again squarely on the policy agenda, although it is not clear what the government has in mind for personal income tax. What is clear is that tax reform will be seriously lacking if it fails to address the unfinished business of personal income tax reform.

In the view of this paper, the main issues are high marginal rates of tax (both 'headline' and 'effective'); an excess of selective tax relief in the form of deductions, offsets, credits and concessions;

and complexity. These are all closely inter-related. The main reason for tackling them is to reduce the high economic costs of the current system and to make it simpler and more transparent. The goal of reducing economic costs is very much in harmony with the Rudd government's objective of lifting productivity growth.

Cutting marginal rates of tax as proposed here would come at a substantial cost to government revenue, but this can be managed by phasing in the changes over a long period, curbing the growth of government spending, and reducing selective tax relief (broadening the tax base). Australia last saw the base broadening/rate cutting approach to personal income tax reform in the 1980s. It is time to cut rates and broaden the base again.

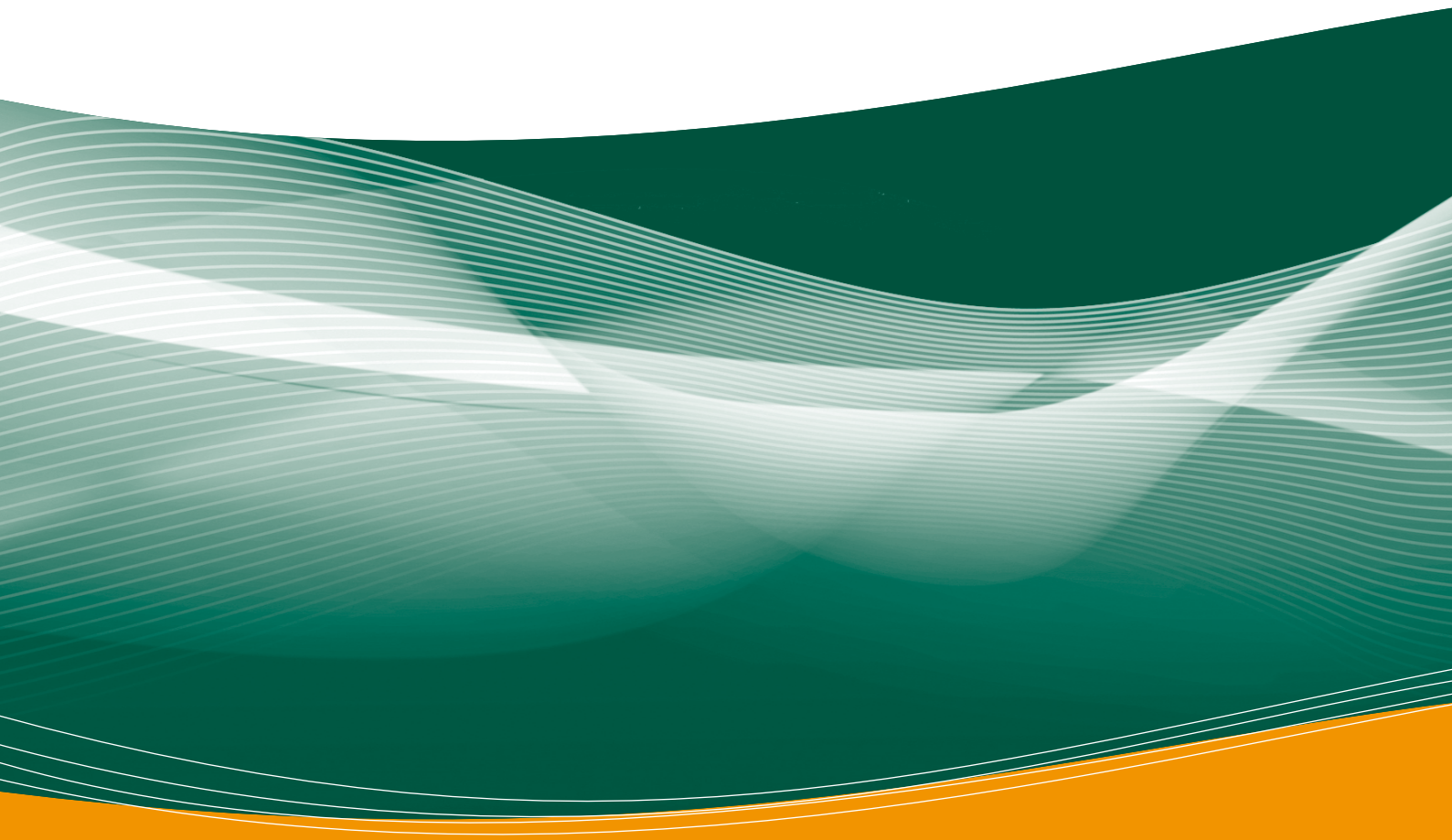
Endnotes

1 The Labor opposition adopted the Howard government's personal income tax proposals in the 2007 election with the sole exception of the proposal to cut the top marginal rate from 46.5% to 43.5%.
2 Peter Saunders (ed), *Taxploitation—The Case for Income Tax Reform*, CIS Readings 11 (Sydney: The Centre for Independent Studies, 2006).
3 See, for example, Sinclair Davidson, *The Faulty Arguments Behind Australia's Corporate Income Tax,* CIS Policy Monograph No. 87 (Sydney: The Centre for Independent Studies, 2008); and Robert Carling, *State Taxation and Fiscal Federalism— A Blueprint for Further Reform*, CIS Policy Monograph No. 73 (Sydney: The Centre for Independent Studies, 2006).
4 Robert Carling, 'Ten Principles for Tax Reform,' *Policy* 25:3 (Sydney: The Centre for Independent Studies, 2009).
5 Productivity Commission, *Australia's Productivity Performance*, Submission to the House of Representatives Standing Committee on Economics (Commonwealth of Australia, 2009).
6 Glenn Stevens, 'The Road to Prosperity,' address to the *2009 Economic and Social Outlook Conference* (Melbourne: 5 November 2009).
7 Kevin Rudd, 'Pain on the Road to Recovery,' *The Sydney Morning Herald* (25–26 July 2009).
8 Peter Whiteford, *Transfer Issues and Directions for Reform: Australian Transfer Policy in Comparative Perspective*, presented to Conference on Australia's Future Tax System (Melbourne: 18–19 June 2009).
9 See *Mid-Year Economic and Fiscal Outlook, 2007–08*, page 8, chart 3 (Commonwealth of Australia, November 2007).
10 Australian Taxation Office, *Taxation Statistics 2006–07* (Commonwealth of Australia, 2009).
11 The assumed 5.5% trend growth comprises 3% real growth and 2.5% inflation.
12 Full indexation to a discounted CPI was applied in 1976 and 1977 before being cut to half indexation in 1978 and then being eliminated completely in 1979.
13 John Humphreys, 'Revealing Australia's Real Income Tax Rates,' *Policy* 25:2 (Sydney: The Centre for Independent Studies, 2009).
14 Anne Harding, et al., 'Trends in Effective Marginal Tax Rates in Australia from 1996–97 to 2006–07,' *Economic Record* 85:271 (December 2009).
15 Peter Saunders, *The Government Giveth and the Government Taketh Away*, CIS Policy Monograph No. 74 (Sydney: The Centre for Independent Studies, 2007).
16 Peter Saunders and Barry Maley, 'Tax Reform to Make Work Pay,' in *Taxploitation*, as above.
17 Alex Robson, 'How High Taxation Makes Us Poorer,' in *Taxploitation*, as above.
18 Michael Keane, *The Tax-Transfer System and Labour Supply,* presented to Conference on Australia's Future Tax System (Melbourne: 18–19 June 2009).
19 Alex Robson, as above.
20 This proposition is developed by the tax review panel in *Australia's Future Tax System—Consultation Paper* (Commonwealth of Australia, December 2008), 63–64.
21 Asa Johansson, et al., *Tax and Economic Growth*, OECD Economics Department Working Paper ECO/WKP 28 (Paris: OECD, 2008).
22 Christina Romer and David Romer, *The Macroeconomic Effects of Tax Changes: Estimates Based on a New Measure of Fiscal Shocks*, NBER Working Paper 13264 (National Bureau of Economic Research, 2007).
23 Fabio Padovano and Emma Galli, 'Tax Rates and Economic Growth in OECD Countries (1950–1990),' *Economic Inquiry* 39:1 (2001); and Fabio Padovano and Emma Galli, 'Comparing the Growth Effects of Marginal vs Average Tax Rates and Progressivity,' *European Journal of Political Economy* 18 (2002).
24 Eric Engen and Jonathan Skinner, 'Taxation and Economic Growth,' *National Tax Journal* 49:4 (1996).

25 Reinhard B. Koester and Roger Kormendi, 'Taxation, Aggregate Activity and Economic Growth: Cross-Country Evidence on Some Supply-Side Hypotheses,' *Economic Inquiry* 27:3 (1989).
26 Sinclair Davidson, 'Who's Not Paying Their Fair Share of Income Tax?' in *Taxploitation*, as above.
27 Lachlan Chipman, 'The Moral Case for a Flat Tax,' in *Taxploitation*, as above.
28 As above.
29 *Australia's Future Tax System*, as above, 67.
30 Robert Carling, *Tax Earmarking—Is It Good Practice?* CIS Policy Monograph No. 75 (Sydney: The Centre for Independent Studies, 2007).
31 Treasury, *Tax Expenditures Statement 2008* (Commonwealth of Australia, 2009).

About the Authors

Robert Carling is a Senior Fellow at The Centre for Independent Studies. He was Executive Director, Economic and Fiscal at the NSW Treasury from 1998 to 2006, and a Commonwealth Treasury official before that. He holds academic qualifications in economics and finance from the London School of Economics and Political Science, Georgetown University, and the University of Queensland.



THE CENTRE FOR INDEPENDENT STUDIES

CIS Policy Monograph • PM108 • ISSN: 0158 1260 • ISBN: 978 1 86432 217 0 • AU$9.95
Published March 2010 by The Centre for Independent Studies Limited. Views expressed are those of the authors and do not necessarily reflect the views of the Centre's staff, advisors, directors or officers.

This publication is available from the Centre for Independent Studies.
PO Box 92, St Leonards, NSW 1590 Australia • **p:** +61 2 9438 4377 **f:** +61 2 9439 7310 **e:** cis@cis.org.au