Reform 30/30: Rebuilding Australia's Tax and Welfare Systems

John Humphreys

Perspectives on Tax Reform (10)

THE CENTRE FOR INDEPENDENT STUDIES

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Foreword

There is a very old and corny joke about a holidaymaker in Ireland who gets lost and stops a local to ask directions. 'Well, I wouldn't start from here,' is the reply. In this, the tenth in the series of CIS papers on tax reform, John Humphreys offers the same advice to those looking to reform Australia's creaking income tax and welfare systems. He suggests we should tear them up and start afresh.

Other papers in this series have looked at the case for reducing marginal tax rates, raising the tax-free threshold, moving to a flat tax, simplifying the tax code, aligning personal and corporate tax, modifying the taxation of families or disentangling the tax and welfare systems, but Humphreys sets out a proposal for doing all of this, and more. This is, therefore, the most radical paper in the series, and some readers will inevitably have misgivings about various aspects of what Humphreys is saying. But a paper like this serves an important purpose, for in setting out an ideal, it challenges us to think about what we are trying to achieve and how we might move closer to realising our aims.

The Centre for Independent Studies routinely notes of all of its publications that the views expressed are those of the author and do not necessarily reflect those of the Centre's staff, advisors, directors or officers. It is worth emphasising this in the present case, for Humphreys directly challenges a number of policies and principles advanced by other CIS writers. It should also be emphasised that CIS is non-aligned politically, and in publishing this paper we do not endorse or imply any support for the Liberal Democratic Party or the Australian Libertarian Society, both of which Humphreys founded and runs. We have published this paper, not because we necessarily agree with everything that Humphreys is arguing, but because we think what he has written is valuable in stimulating and focusing the ongoing debate on tax reform in this country.

Although it is undeniably radical, there is actually little that is new in Humphreys's basic approach. He wants a flat tax of 30% on any income earned from any source in excess of $30,000 per year, together with a Negative Income Tax (NIT) of 30% paid to anybody earning below that annual threshold (the NIT would replace all existing welfare and family payments). The argument for a flat tax has been around since Robert Hall and Alvin Rabushka first suggested it in the 1980s, and the idea has taken off in recent years as a number of former Soviet countries, including Russia, have opted for it in an attempt to simplify and modernise their tax systems while giving their economies a vibrant kick-start.[1] As for NIT, this idea was first advanced by Milton Friedman as long ago as 1962,[2] and a diluted version of it has been advocated in Australia by leading economists who have called for an 'Earned Income Tax Credit' to top-up the wages of low-income families.[3]

What is exciting about Humphreys' paper is the way he puts these ideas together. His combined flat tax and NIT (together with the increased tax-free threshold of $30,000, as compared with the current $6,000) offers the prospect of a simultaneous reform of both the tax and welfare systems that goes to the heart of the problems in both. It has been clear for a long time that our over-complex and burdensome tax system is eroding work incentives, and that this is compounded at the lower end of the income distribution by a tightly means-tested welfare system which sharply withdraws benefits as soon as people begin to take responsibility for earning their own money. The combined effect is that people can lose three-quarters or more of every additional dollar they earn as they attempt to move from welfare dependency into self-reliance. The only real solution to this is to disentangle the tax and welfare systems so that no worker receives welfare at the same time as he or she is paying tax, and no claimant pays tax at the same time as he or she is receiving welfare. Humphreys's so-called '30/30' reform achieves this, for above the $30,000 threshold one pays tax at 30%, and below one receives NIT top-ups of 30%. Nobody pays tax at the same time as they get top-ups, and nobody loses more than 30% of the next dollar they earn.

A reform like this would undoubtedly strengthen work incentives by reducing tax-welfare churning and slashing 'effective marginal tax rates' (EMTRs). But this is not the only advantage of this proposed reform. It would also make for a much simpler, more transparent and less dishonest tax system; it offers potentially huge efficiency gains by stimulating economic activity while cutting back on administration and compliance costs; and it allows the minimum wage to be scrapped (for NIT would top-up low wages), thereby stimulating the creation of up to half a million new jobs.

Humphreys anticipates that critics will attack him on two main grounds: cost and equity.

As regards costs, raising the tax-free threshold to $30,000 while lowering the tax rate to 30% represents a big bite out of the Federal Government's current revenue. Moreover, a 30% NIT will increase spending on top-ups to many working families, even though it would reduce the basic level of welfare benefits.

Estimates of likely revenue gains and losses from tax and welfare reforms are notoriously unreliable, especially when analysts try to factor in possible behavioural changes (for example, more people working and paying tax as a result of a tax cut). When change on the scale outlined here is proposed, figures inevitably become highly speculative, for there are bound to be knock-on effects that no model can reliably predict. Humphreys does, nevertheless, attempt to gauge the likely fiscal impact of his reforms, and he concludes that, over the medium term, they could well pay for themselves. But even if they do not, his point is that these changes should still be implemented because of the other benefits they promise to bring, and he expresses impatience with those who insist that any reform must be revenue-neutral, as if current levels of taxation and government spending are somehow set in stone.

The second major target for Humphreys' critics is likely to be the impact of his proposals on income inequality. Humphreys is quite clear that his NIT proposal would reduce the value of benefits for those with no other income (although he is open to the idea of top-ups for the disabled and others who cannot work). He also recognises that his flat tax proposal would increase the take-home pay of high income earners. Inevitably, therefore, these changes would stretch the gap between the top and bottom of the income distribution—something that already concerns many political commentators and activists who see any increase in income inequality as inherently reprehensible.[4]

Humphreys develops a number of telling points which should help rebut such concerns. For a start, he shows that the biggest proportional gainers from the changes he proposes would be working people on low wages (the disposable income of a minimum wage earner, for example, would rise by 31%, as compared with a 14% increase for those on average wages and an average 19% increase for higher earners). He also points out that a flat tax with a high tax-free threshold is still strongly 'progressive' (for example, those earning $50,000 per year would lose 12% of their income in tax while those on $100,000 would lose 21%), and he reminds us that, by reducing unemployment, a change like this would increase the average incomes of those who are currently jobless (because many of them will find work), even though unemployment benefits would be lower.

There are, therefore, strong counter-arguments to those who will claim that Humphreys's ideas are 'too costly' or are 'unfair' and therefore 'un-Australian'. Nevertheless, there are still aspects of his proposals that demand careful and critical evaluation.

There is, for example, an important issue of principle regarding the tax and welfare treatment of families. At the moment, the tax system assesses people's incomes individually (couples are taxed separately) while the welfare system assesses their needs on a family basis (for example, benefits accruing to an unemployed person are adjusted according to his or her partner's income). In an earlier paper in this series, Terry Dwyer argued that the two systems should be brought into line by recognising family obligations in the tax system as well as in the welfare system. His argument was that a single person with no dependents enjoys a much higher 'equivalent income' than a worker on the same wage who has a dependent partner at home looking after small children, for the latter has to share part of his/her income with other family members. To take account of this, Dwyer suggested that everyone, including non-employed adults and children, should have their own tax-free earnings allowances which could then be pooled and used by the principal earners. For example, children might have an allowance worth half that of a single adult, while a dependent partner might qualify for an allowance of two-thirds the full rate. A worker supporting a dependent partner and children could then aggregate these allowances in order to claim a higher tax-free earnings threshold than an equivalent worker supporting nobody but him/herself.[5]

Humphreys adopts a different solution to the same problem. Rather than explicitly recognising family liabilities in the tax system, he prefers to individualise the welfare system. Although he concedes in the Appendix that parents could be given a higher tax-free threshold to take account of the costs they incur in raising their children, he prefers to stick to the principle that people should be taxed without regard to their family circumstances. This means every individual would continue to have his or her own tax-free income allowance, just as they do at the moment.

A non-working adult would therefore receive a basic Negative Income Tax payment irrespective of whether or not he or she had a partner, and each partner in a jobless couple would receive his or her own full NIT allowance. This contrasts with the current welfare system which offers a couple living together less than it gives two single people living alone because their needs are less (two can live cheaper than one). Humphreys rejects this approach, arguing instead that a couple should be allowed to reap the economies of scale that arise from living under one roof. Against this, however, it could be argued that welfare is intended to meet households' basic needs, and that taxpayers should not be required to give couples more than they need in order to cover their shared living costs.

This issue of individual versus family tax and benefits will clearly attract argument and debate. So too will Humphreys's recommendations regarding taxation of superannuation.

Humphreys wants to wipe out all 'tax expenditures' (although he recognises that expenses necessarily incurred in generating an income will still have to be allowable against tax), and one of the principal tax expenditures in his sights is the concession on super contributions. Currently, super contributions are taxed at a concessionary rate of 15%, but under his proposals, contributions would be made out of post-tax income (that is, after the 30% flat tax has been deducted on earnings over $30,000). Fund earnings would also be taxed at the full 30% rate (again contrasting with today's concessionary rate), although superannuation would not be taxed when it was finally withdrawn, for this would represent double taxation of the same money.

Under Humphreys's proposed arrangements, anyone earning less than $60,000 per year would actually end up paying less tax on his or her super contributions than they do now, but those earning above this would pay more, so middle and high earners will end up with smaller savings than they do at the moment.[6] There is also the problem that, by taxing fund earnings at the full 30%, people's funds will grow more slowly than they do currently, for they will lose some of the beneficial effects of compounding over time. When they draw down their retirement savings, retirees will pay no further tax, but their capital will be smaller. The number of people saving enough to avoid any reliance on the government age pension may, therefore, remain higher than Humphreys would hope.[7]

Other readers will have other criticisms, worries and misgivings as they go through this paper. But this is precisely its strength—its radical challenge forces us to start thinking about basic principles and innovative policy solutions. John Humphreys has a vision of how the tax and welfare systems could be refashioned to break through the dispiriting problems that currently bedevil them. It is for those who reject this vision to put forward something better, for the present set-up cannot and should not be allowed to stagger on in its present form.

Peter Saunders
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The Centre for Independent Studies

Executive Summary

Reform is good. Sometimes, revolution is better.

Much has been said about the need for tax and welfare reform in Australia, but the tyranny of the status quo and self-imposed limitations such as 'budget neutrality' and 'no-person-worse-off' doom any radical reform proposal to failure. Consequently, this paper has given up on arguing for incremental reform and instead offers a new template from which to consider tax and welfare issues. A tax revolution: Reform 30/30.

Under Reform 30/30, all income taxes (company, Capital Gains Tax [CGT], Pay As You Go [PAYG], Fringe Benefits Tax [FBT]) would be equal at 30%, and the Medicare levy removed. The tax free threshold (TFT) would be increased to $30,000 per person and all tax expenditures (tax deductions, offsets, and so on) would be removed. The current welfare system would be replaced by a sliding scale of payments (called a Negative Income Tax or NIT) that phased out at 30% and finished at an income of $30,000.

The NIT would allow the removal of the minimum wage which would lead to the creation of 500,000 new jobs. The incentives for low-income earners will be improved as their effective marginal tax rate (EMTR) is reduced from over 60% to 30%—so that people have an incentive to take the new jobs. These two policies represent the best solution to unemployment and poverty available to Australia.

Reform 30/30 is unambiguously beneficial to the economy—with estimated benefits of $90 billion as well as higher ongoing economic growth. Reform 30/30 is unambiguously simpler than the current system—with no tax return, no tax avoidance opportunities and much lower administrative costs.

Issues of equity will always be contentious, but Reform 30/30 is more equitable than the status quo for several reasons. First, it massively reduces unemployment and poverty. Second, it ends the discrimination against couples. Third, it ends the discrimination against risky business and inconsistent income.

Finally, this reform will actually pay for itself. Rough estimates suggest a medium-term impact on the budget of +$15 billion per year, and more in the long run.

Reform 30/30 offers 500,000 new jobs, less poverty, a $90 billion bigger economy, higher growth rates, lower tax levels and a simpler, fairer tax/welfare system and more money in the budget. The price is that some sacred cows of politics ('progressive' tax, minimum wage, no-person-worse-off) will have to be sacrificed. It's worth it.

REFORM 30/30: REBUILDING AUSTRALIA'S TAX AND WELFARE SYSTEMS

It seems that everybody these days has a suggestion on how the current tax and welfare system in Australia can be reformed. Some ideas include cutting the top marginal income tax rate, increasing the tax-free threshold, cutting middle-class welfare, broadening the income tax base and flattening the rates, slowing the phase-out of welfare benefits and reducing the endless array of tax concessions.

This paper argues for fundamental (some would say radical) reform of our tax/welfare system including all of these elements, and a total re-think of the way in which we help the poor.

The problems

Broadly speaking, there are two pressing problems in Australian public policy today: our tax system and our welfare system.

Our income tax system is complex, arbitrary, inefficient, wasteful—and the level of taxation is simply too high. Our top marginal tax rate is higher than the rate in communist (sic) China, our income tax burden is one of the highest in the developed world[8] and Australians are currently suffering from the highest level of tax in our history. An estimated 80,000 people are employed to avoid or enforce taxes,[9] and those taxes result in about $30 billion of lost efficiency every year.[10]

The current system of welfare payments is complex, expensive, inefficient and ineffective. If we distributed the current federal welfare budget directly to the poorest 25% of Australians, each family of four would receive $72,000 per year.[11] And welfare spending continues to increase quickly. In three years, we will reach $100 billion federal spending on welfare ($80,000 for each of our poorest 25% of families). And yet, despite this massive level of expenditure, poverty remains and is even entrenched. One reason is that our current approach to poverty prevents people from getting jobs, and then fails to reward people who do work.

The idea: 30/30

In brief, the idea of Reform 30/30 includes a tax-free threshold of $30,000 and a flat income tax of 30%, with no deductions. In addition, the Fringe Benefits Tax (FBT) would be reduced to 30% and the Medicare levy would be abolished.[12] All welfare payments would be replaced by a sliding scale of payments made only to people with an income below $30,000.[13]

This welfare system, called a Negative Income Tax (NIT), would pay the recipient 30% of the difference between his or her income and the tax-free threshold ($30,000). Rates of welfare payments are outlined in Box 1. As the NIT is paid to low-income earners, it would also replace the minimum wage.

Box 1. Basic welfare payments under Reform 30/30

Wage	Tax Free Threshold	Shortfall	Negative Income Tax	Final income	NIT rate of withdrawal
$0	$30,000	$30,000	$9,000	$9,000	n/a
$5,000	$30,000	$25,000	$7,500	$12,500	30%
$10,000	$30,000	$20,000	$6,000	$16,000	30%
$15,000	$30,000	$15,000	$4,500	$19,500	30%
$20,000	$30,000	$10,000	$3,000	$23,000	30%
$25,000	$30,000	$5000	$1,500	$26,500	30%
$30,000	$30,000	$0	$0	$30,000	30%

No special treatment is given for parents, the disabled or the aged. This is not because these issues are unimportant, but because this paper did not want to link the Reform 30/30 to any particular agenda on child subsidies, disability support or retirement policies. Each of these issues deserves the attention of policy makers, but this does not have to be linked to the central elements of Reform 30/30. Additional welfare payments for these groups are considered in the Appendix.

This reform will decrease the welfare payment to the unemployed and increase the payment to the working poor. Note that for every additional dollar earned, the NIT payment is reduced by \$0.30—so that the work incentives are identical for all workers irrespective of whether they are above or below the tax-free threshold. For more details on the theory of the NIT see Friedman[14] or Humphreys.[15]

There are generally three criteria by which to measure tax/welfare policies—efficiency, equity and simplicity. However, before addressing each of these areas, it is worth specifically considering the two primary benefits of Reform 30/30: *Creating jobs by replacing the minimum wage* and *fixing incentives by reducing the effective marginal tax rate to 30%* on everybody.

Replacing the minimum wage

One of the primary advantages of the NIT is that by directly helping low-income earners through the welfare system, it removes the need for the minimum wage. Instead of legislating for higher wages, the NIT allows wages to stay at their market rate and instead supplements low incomes with an NIT payment.

This proposal is an extension of the so-called Five Economists' Plan first published in 1998. Their basic idea was to freeze minimum wage increases in nominal terms (allowing the minimum wage to decrease in real terms) and replace minimum wage increases with a tax credit.[16]

Both the Five Economists' Plan and the 30/30 NIT directly confront the fact that the minimum wage causes unemployment and recognise that the minimum wage is a uniquely bad instrument for helping poor workers.

The minimum wage does not target poor households. Dawkins[17] cites evidence that only 10% of minimum wage earners are from families in the bottom 10% of disposable incomes, and 25% of minimum wage earners come from families in the top 30% of disposable incomes. There is also some evidence that minimum wages are offset against lower quality of work (fewer fringe benefits, less on-the-job training). Further, if minimum wages affect industries that supply basic goods and services (such as food) then they will negatively affect low-income consumers.[18]

More importantly, the minimum wage results in unemployment and unemployment is the main cause of poverty in Australia.

The minimum wage results in unemployment and unemployment is the main cause of poverty in Australia.

In the labour market, people's wages will approximate their level of marginal productivity. If the minimum wage is set above a person's level of marginal productivity, then they will not be employed. For example, if I bring \$7/hour of value to a business, but the business is forced to pay me \$8/hour, it will simply not employ me or it will make a loss. In economic jargon, this is referred to as 'setting the wage rate higher than the market-clearing wage rate so that labour supply exceeds labour demand'. In common language, we just say 'unemployment'.

The consequences overwhelmingly fall on young, low-skilled and inexperienced workers. In groups with a high level of reliance on the minimum wage (youth, Aborigines, rural workers, low-skilled workers) their level of unemployment is higher than average. Lewis[19] shows how minimum wage legislation changes the nature of employment opportunities in a way that negatively impacts on the low-skilled and less educated. Not surprisingly then, the data show that unemployed people (especially the long-term unemployed) tend to have fewer skills and less education.

Dawkins shows that the effect of freezing nominal wage increases over four years could lead to a 1–1.5% reduction in the unemployment rate and he notes that this would specifically help unskilled workers and the long-term unemployed. This theme of wage changes especially impacting on low skilled workers is re-enforced by the international work done by Hamermesh.[20] Borland summarises the data on labour demand elasticities for Australian youth and finds evidence that wage changes have a big potential impact on youth employment.[21]

There is an ongoing debate about the exact size of the relationship between wage rates and employment. One recent Australia estimate by Lewis and MacDonald suggests a wage elasticity of labour demand of –0.9 (for hours worked) and –0.8 (for employment).[22] That is, if average wages were increased by 10% then employment would decrease by 8%. Some economists have suggested a lower estimate of around –0.4.[23] Either estimate is plausible and consistent with previous studies both in Australia and internationally.

In a (in) famous American study, Card and Krueger[24] purported to show no relationships between minimum wages and labour demand. While this study is often cited by defenders of the minimum wage, most studies in America disagree with the Card and Krueger results.

Several criticisms have been levelled at the Card and Krueger study. One of the most relevant is that they used a short-term period when it is generally accepted that the link between wages and labour demand takes one to two years to be fully appreciated. Another complaint is that Card and Krueger only considered one industry (fast-food restaurants) and therefore failed to notice that employment actually did fall following the increase in the minimum wage.[25] Also, natural experiments always suffer from the difficulty of isolating the experiment from external events. Robson[26] outlines some additional concerns about the study.

Further, even if Card & Krueger were correct for America, the American minimum wage is significantly different from the Australian minimum wage. Not only is it much lower, but fewer people are on the American minimum wage. Obviously, the more people on the minimum wage, the greater the impact of a change in the minimum wage. Even Card and Krueger do not deny the relationships between minimum wages and labour demand if the price is right. A better country comparison is France, where studies show a significant negative relationship between minimum wages and employment.[27]

Put simply, the minimum wage is bad policy and should be scrapped. It is a bad way to help poor people, while it is a very good way of creating unemployment—the primary cause of poverty.

How much employment would Reform 30/30 create? The original Five Economists' Plan suggested an increase of 2.5–3% (250,000–300,000). Dawkins later estimated an effect of 2–2.5% (200,000–250,000),[28] though he added that it could be higher. Borland[29] has estimated a 2.1–7.2% (210,000–720,000) increase in employment from the Five Economists' Plan. Richardson[30] suggests 169,000 after ten years and Dixon and Rimmer[31] estimated 2% (200,000) after five years and 4% (400,000) after ten years.

If the minimum wage had been kept constant in nominal terms over the last ten years, there would now be 650,000 more jobs.

Lewis cites recent evidence that shows that relatively slower wage growth for low income earners over the last ten years in Australia has coincided with a relatively higher rate of jobs growth, and he extrapolates from that to conclude that if the minimum wage had been kept constant in nominal terms over the last ten years, there would now be 650,000 more jobs.[32] This is consistent with the estimates of the more moderate Five Economists' Plan.

As discussed above, recent Australian estimates of the total wage elasticity of labour demand range from –0.4 to –0.8. Consequently, if real wage growth were slowed by 10% over the coming years then there would be 400,000–800,000 more jobs. It should be noted that the above elasticity measures the relationship between average wages (not the minimum wage) and employment.

Andrew Leigh recently looked at the Australian minimum wage elasticity for labour demand by comparing WA minimum wage changes with the rest of Australia. In six natural experiments, he found an elasticity of -0.03, -0.25, 0.01, –0.41, –0.22 and –0.2. In aggregate, Leigh determined the minimum wage elasticity of labour demand to be –0.15 (that is, a 10% increase in the minimum wage would lead to a 1.5% decrease in employment).[33] It is also interesting to note that the biggest effect is on young people, with 15–24 year olds suffering an elasticity of –0.49.[34] Leigh's results are lower than previous Productivity Commission estimates and are on the low-end of international estimates and ACCI gives reasons for believing the Australia-wide minimum wage elasticity may be higher.[35]

The impact of Reform 30/30 is more radical than the Dawkins option in abolishing the minimum wage, and so the employment benefits would be bigger. However, as the minimum wage is lowered, the marginal benefits from further reductions are smaller as fewer people are on the minimum wage. A rough estimate of 400,000–600,000 (with a midpoint of 500,000) new jobs leading to a 2–3% reduction in the unemployment rate seems reasonable.

Fixing Incentives: Reducing the effective marginal tax rate to 30%

The above section estimated that Reform 30/30 could lead to 500,000 new jobs. Fixing the income incentives might create an even bigger benefit in the long run. Combined, these two issues represent the best cure for unemployment and poverty in Australia.

The incentive to work is determined by the 'effective marginal tax rate' (EMTR). This measures how much of an additional dollar earned has to be given to the government (either in tax or reduced welfare payments). If the EMTR is 100%, then an extra dollar earned must be given straight to the government and the worker is no better off.

In Australia, the EMTR is highest on low-income families because of the quick withdrawal of welfare payments when people start to earn income combined with income tax. For example, the Parenting Payment (Single) is withdrawn at a rate of 40% once one has an income over $4,411 per year. The Newstart allowance is withdrawn at 50% or 70%. The Family Tax Benefit (A) is withdrawn at 20% once one has an income over $31,755. In addition, 17% tax (soon to be 15%) is paid on incomes earned over $6,000 and 30% tax on the income over $21,600. Also, the Medicare levy is phased in at $0.20 in the dollar for incomes between $26,834–29,010. Other welfare benefits are also removed as incomes increase, such as the low-income tax rebate and housing assistance.

The combination of these impacts can result in a low-income earner suffering from EMTRs approaching 100%. Almost one million people face EMTRs of 60% or more. The consequence of this is a significant incentive *not* to work, and the fact that this leads to a cycle of poverty is referred to as the *poverty trap*.

The biggest winners in this reform are the working poor who previously had the highest EMTRs and who now get to keep more of their welfare benefits and are exempt from income tax.

To reduce poverty, high EMTRs have to be addressed, and there are only three ways this can be done. First, welfare benefits for jobless people can be lowered in order to reduce the rate at which benefits get withdrawn when people start earning. Second, welfare top-ups for the working poor can be increased. Third, tax on the working poor can be decreased or removed.

Reform 30/30 does all three. Unemployment benefits are reduced from over $10,000 per year (for a single person) to $9000 per year. Welfare benefits for low-income earners are increased as the NIT payment is withdrawn at only 30%. Finally, no low-income person would pay income tax.

The key point to note here is that by increasing the tax-free threshold to $30,000 and only providing welfare to people with incomes below $30,000, there is no overlap between taxpayers and welfare recipients. Not only does this remove the problem of overlapping work disincentives, but also it removes the pointless churning of money from taxpayers to bureaucrats back to the same taxpayers. The size of this pointless churning has been estimated as high as $85 billion.[36]

The reform suggested in this paper would ensure a constant EMTR of 30% for everybody, in all situations, with the welfare withdrawal rate lining up perfectly with the 30% marginal tax rate. The biggest winners are clearly the working poor who previously had the highest EMTRs and who now get to keep more of their welfare benefits and are exempt from income tax.

This idea shares a number of characteristics with the idea of 'earning credits' paid to low-income earners to offset their tax burden. This was one of the suggestions in the Five Economists' Plan. The primary difference is that Reform 30/30 has more benefits and fewer costs.

Under a recent proposal for an earning credit in Australia, it was estimated that the EMTR for a jobless couple with two children would move from 69% to 65%. In contrast, under Reform 30/30 the EMTR for the same family would move from 69% to 30%.

One complaint against earning credits is that they do not remove the work disincentive, but simply shift it up the income scale (I note that shifting the work disincentive up the income scale could still be a good thing). A related complaint is that earning credits perpetuate the churning of money where a family is both taxpayer and welfare recipient. In Britain, 85% of families with children are now eligible for a tax credit.[37] The NIT suffers from neither of these complaints as no taxpayer receives welfare and no welfare recipient pays income tax, and the EMTR is a constant 30% for every level of income.

By abolishing the minimum wage, Reform 30/30 creates more jobs. By fixing the incentives, people are more likely to take up these new jobs.

The impact of this outcome should not be underestimated. Unemployment has been linked to crime, low self-esteem, loss of social capital, decreased responsibility and a loss of a sense of community. In contrast, employment leads to lower levels of poverty, higher self-esteem, greater social participation and further opportunities for advancement.

To reject the prospect of these benefits, there would have to be a strong efficiency, equity or simplicity reason. However, as shown below, Reform 30/30 is unambiguously more efficient and simpler and arguably more equitable.

Economic efficiency and growth

How would Reform 30/30 impact on the economy? In the medium term, the reforms will impact economic efficiency through (1) lower efficiency cost of taxation (2) reduced unemployment/poverty; and (3) less waste from a simpler system. These benefits are estimated at $20 billion, $60 billion and $10 billion respectively. The total estimate is about $90 billion, or $4,500 per person per year.

In the longer term, there will also likely be an impact on economic growth. This benefit is more difficult to estimate but even a small improvement in the growth rate will lead to substantial benefits.

1. The efficiency benefits of a low flat income tax on tax payers

There are two elements of Reform 30/30 that reduce the efficiency cost of taxation. The first is reduction in tax and the second is the switch from a multi-level income tax to a flat income tax, including the alignment of company tax, individual tax, CGT and FBT.

Taxes involve more than a transfer from citizens to government. They also involve a change in incentives and consequently a change in behaviour away from a person's first choice of actions. This often results in a loss of welfare, and this loss of welfare from tax is referred to as the deadweight loss DWL) of taxation. With regards to income tax, one possible consequence is that people shift out of formal work and instead increase work in the informal sector (including housework) or simply substitute into leisure. For some people, an income tax may induce them to work more to compensate for the lost income. These effects are called the 'substitution effect' and the 'income effect' respectively and both represent a net welfare loss. There is some evidence to suggest that the 'substitution effect' is more common, especially among high income earners and the self-employed.[38] Income tax also decreases the profitability of starting a new business and so leads to fewer businesses (and consequently less employment and competition). Estimates for the size of the DWL of Australian income tax vary from $0.19–0.60 per tax dollar raised.[39]

Raising the tax-free threshold rate to $30,000 is a tax cut of $26 billion.

Raising the tax-free threshold rate to $30,000 is a tax cut of $26 billion. Removing the 42% and 47% brackets is a further $8 billion tax cut.[40] Abolishing the Medicare levy and bringing FBT into line with other income taxes would cut revenue by about $6 billion and $1 billion respectively. The total tax cut is about $41 billion. Such a tax cut would reduce DWL by between $8 and $24 billion per year.

In addition to a reduction in tax, Reform 30/30 replaces the current multi-stage income tax with a more efficient flat tax. A multi-stage tax creates disincentives against risk, by taxing the proceeds of high-risk, high-return investments at a higher rate than low-risk, low-return investments, even though both may have the same expected return. A flat tax is also more efficient because it does not discriminate against volatile annual incomes or different levels of income. In addition, by taxing all incomes (fringe benefits, capital gains, wages, dividends, interest) at the same level, businesses and individuals have the incentive to structure their finances in the most efficient way. Consequently, the DWL of the remaining income tax would be lower under Reform 30/30.

A total efficiency gain of about $20 billion from the tax changes is a reasonable estimate.

2. The efficiency/growth benefits of more employment.

As discussed previously, the biggest benefits from Reform 30/30 relate to more jobs and better incentives for poor Australians leading to about 500,000 new jobs and a cut in unemployment of 2-3%.

Okun's law suggests that for every percent of unemployment, the national product is 2–4% lower than what it otherwise would be. Using this rule of thumb, a 2–3% reduction in unemployment would result in a 4–12% increase in GDP. Australian GDP for 2005–06 is estimated at $927.6 billion. Consequently, Okun's law predicts an economic benefit of $37.1–$111.3 billion. Given the uncertainty, a reasonable point estimate is $60 billion per year.

3. Lower costs: Compliance, administration, rent-seeking, evasion costs, churning

The issues of simplicity are discussed in more detail below. For the moment, it is enough to note that a simpler system will result in less wasted spending on compliance, administration, rent-seeking and tax evasion.

If we accept the Robson estimate of over 80,000 people currently employed in avoiding and enforcing tax and consider that most of these jobs would be unnecessary under Reform 30/30 then we can estimate a reduction in waste of perhaps $8 billion per year. In addition, Leigh estimates that on average the compliance cost to each taxpayer is about $300, for a total annual impact of around $3 billion.[41]

Another benefit from a lower and simpler tax system is the reduced incentive and ability to avoid tax—leading to more reported income and a smaller black market. The size of the black market is difficult to estimate. This paper estimates a total benefit from increased simplicity of around $10 billion.

4. Higher economic growth

While the exact estimates above may be disputed, the existence of the above three elements is not in question. More controversial, and much harder to measure, is the long-run impact of tax/welfare reform on economic growth. However, this element is also potentially the most important, as even a moderate increase in economic growth will lead to significant benefits in the long run.

A simpler system will result in less wasted spending on compliance, administration, rent-seeking and tax evasion.

There are good reasons for believing that a more efficient tax/welfare system will have a growth benefit. There is a growing body of evidence that suggests a link between competition and growth,[42] and tax and the minimum wage act as barriers to entry and therefore as restrictions on competition. By including an additional 500,000 minds to the workforce there are more opportunities for new ideas to be developed and tested. Some of the best minds of the country will switch their attentions from tax avoidance to innovation and wealth creation. Finally, income tax cuts increase the incentive to invest in income-generating activities like education and research—which are drivers of growth.[43]

Robson[44] points out that no country with a tax/GDP ratio over 40% has managed a 4% growth rate; he also shows that tax-cutting countries have had growth rates three times higher than non-tax cutting countries.

A conservative estimate of a 0.1% increase in the rate of growth would increase the size of the economy by nearly $1 billion every year. Note that while the medium-term benefits do not grow over time, the growth benefit does—so that the annual benefit is $10 billion after 10 years or $20 billion after 20 years. As can be seen, it does not take long for reforms that increase economic growth to pay for themselves.

Equity

There are a number of different equity issues that are raised by Reform 30/30: the treatment of the poor, the treatment of the rich, and the treatment of couples. For the moment, this discussion excludes the consideration of children, the disabled or the aged. These issues are considered in the Appendix (p. 23) as they need not be tied directly with Reform 30/30.

Static impact

There are two ways of looking at the winners and losers from this reform. The first way is to look only at the actual transfers—in which case welfare reform is largely a zero-sum game with some winners and some losers. The second, and by far the more useful way, is to consider the consequences of the reform. Unfortunately, while the latter approach is more appropriate, the former approach is more popular because it is easier.

The static consequences of Reform 30/30 on individual incomes for different wage categories are shown in Table 2. Such a table does not consider the primary benefits of reform: higher employment, better incentives, higher growth and less poverty. Still, the table provides some interesting starting information.

Box 2. Static impact of Reform 30/30 on an individual[45]

Income	Current Welfare	30/30 Welfare	Current Tax	30/30 Tax	Current Total	30/30 Total	Change
No income	$10,147	$9,000	$0	$0	$10,147	$9000	-11%
Half minimum ($11,658)	$3512	$5504	$962	$0	$14,209	$17,162	+21%
Minimum ($23,316)	$0	$2005	$3166	$0	$20,150	$26,482	+31%
Average ($48,993)	$0	$0	$10,869	$5698	$38,124	$43,295	+14%
Double Average ($97,986)	$0	$0	$32,859	$20,396	$65,127	$77,590	+19%

In static terms, the biggest winners are workers—especially low-income individuals. Those on half minimum wage see their disposable income increase by 21% while those on the minimum wage see their disposable income increase by 31%.

Note that the current system has people on half minimum wage both paying tax ($962) and receiving welfare ($3,512) while the Reform 30/30 option has no such churning. In the current system, people moving from no income to half-minimum wage see their welfare payment decrease by 57% while they also pay an average of 8% income tax, giving them an EMTR of 65%. People currently on half minimum face an EMTR of 49%, those on the minimum wage face an EMTR of 30% and those on an average wage face an EMTR of 45%. Under Reform 30/30 they all face a constant EMTR of 30%.

Average and above-average wage earners also benefit by 14% and 19% respectively. Note that the income tax paid by a worker on an average income almost halves from nearly $11,000 to $5,700.

In contrast, the unemployed see their disposable income reduced by 11%.

Punishing the poor?

As noted above, the unemployed are the losers in the static analysis as their welfare payments are cut from over $10,000 to $9,000 per year. Some will argue that it is inequitable to cut welfare payments. However, such an argument ignores the total impact on poor people and ignores the dynamic consequences of this policy. Indeed, the most important consequence from this policy is a reduction in unemployment and poverty. This highlights the problem in ignoring the dynamic element of reform.

The current system is generous to the degree that it offers the third-highest level of net transfers to poor people in the world (exceeded only by Norway and Finland)[46], but this generosity is undermined by the fact that our current system also offers some of the highest EMTRs in the world which ensure that our poor stay poor. In contrast, while Reform 30/30 continues to ensure that nobody need live in absolute poverty, it removes the poverty trap and allows the creation of hundreds of thousands of new jobs.

Further, while our current system is generous in financial terms, it is burdensome in terms of compliance and requirements on the job-seeker. When determining the real benefits of welfare to the recipient, it is appropriate to calculate the net benefit after removing costs of compliance. By some interpretations, the government has pursued a policy of decreasing the net benefit of welfare by increasing compliance costs (work for the dole, dole diary, and so on).[47] In contrast, Reform 30/30 removes the compliance costs for welfare recipients. Consequently, the net benefit to the welfare recipient may not actually decrease, while the cost to the taxpayer certainly will.

There is also a strong equity argument for the increase of the tax-free threshold and moving all poor families out of the income tax system, and Reform 30/30 achieves this. Saunders and Maley argue that it is a point of principle that the government should not tax people who do not earn enough money to meet their basic needs.

Finally, if we look at the total consequence of Reform 30/30 on people who are currently unemployed, the impact is positive with the creation of 500,000 new jobs. The average disposable income for people who are currently unemployed will increase despite the decrease in welfare payments, because of the increase in employment. If cutting the welfare benefits for the unemployed is considered inequitable, then how much more inequitable is it to continue with a policy that keeps people unemployed?

Tax cuts for the rich?

A second consequence of this policy is a cut in income taxes for all earners, including high-income earners. Some will argue that this is inequitable.

First, it should be noted that the reform outlined in this paper ensures that high-income earners cannot access welfare (other than the tax-free threshold) and it removes the myriad tax concessions that tend to benefit high-income earners.

More to the point, there is no reason to think that forcing high-income earners to pay exorbitant levels of income tax is inherently moral. Lachlan Chipman provides a solid rationale for the equity of a flat tax.[48] A flat tax is sometimes called 'regressive' by its opponents, but this is simply wrong. A perfectly flat tax would be proportional, with each person paying the same percentage of his or her income and the rich paying more than the poor. It is little wonder that these misrepresentations are common in the tax debate with fewer than 50% of Australians actually understanding that we currently have a progressive income tax system.[49]

A flat tax is sometimes called 'regressive' by its opponents, but this is simply wrong.

However, the flat tax in Reform 30/30 is not proportional either, it is progressive. This is true for two reasons. First, a flat income tax is progressive because it double taxes savings and rich people have a higher marginal propensity to save.[50] Second, and more importantly, the $30,000 TFT makes the flat tax significantly progressive.

A person with an income of $30,000 pays an average tax of 0%, while a person with an income of $40,000 pays an average tax of 7.5%. A person with an income of $50,000 pays an average tax of 12%. A person with an income of $100,000 pays an average tax of 21%. As can be seen, the higher the income, the higher the average tax paid.

There is little evidence that Australians want high-income earners punished any more than the above tax scale would achieve.[51]

Taxing the family

Another equity consideration is the treatment of couples compared with singles. Under previous tax systems, couples are punished for being couples. There is no clear rationale for undermining family units and denying people the benefit from economies of scale. Indeed, not only is this inequitable, but it is also inefficient as it encourages people to make sub-optimal lifestyle choices.

As Saunders and Maley note, 'the welfare system assesses needs at a family or household level … the tax system currently treats individuals as distinct income units'.[52] Dwyer[53] argues that the tax system should be brought into line with the welfare system. The alternative, suggested here, is that the welfare system be brought into line with the tax system so as to avoid distortions in people's incentives over family structures.

Saunders and Maley echo the conventional view when they argue that families and household units have the benefit of economies of scale, and should therefore receive less welfare and pay more tax. However, the economies of scale are an appropriate reward for making economising decisions. Punishing people for making low-cost decisions makes no sense and offers a perverse set of anti-family, anti- shared house incentives.

Intertemporal equity

An important but often overlooked equity consideration is intertemporal equity—or equal treatment over time. One of the foundation principles of horizontal equity is that people in the same position be treated the same. For example, if we both earn the same income, we both pay the same tax. However, once we introduce time into our consideration then a multi-level income tax system will discriminate against people with volatile incomes.

For example, under the current tax system a person on $50,000 will pay a top marginal tax rate of 30%. However, a person whose income fluctuates between $10,000 and $90,000 each year will occasionally fall into a higher tax bracket and will end up paying a higher average tax rate—even though his total income over time is the same as the first person. Not only does this create an inefficient disincentive against pursuing risky jobs and businesses, but this violates the rules of horizontal equity.[54]

The dreaded 'Tax Pack' would become a thing of the past for most Australians, saving considerable time, money and headaches.

The role of civil society

According to the Australian Tax Office (ATO), $960 million was donated by Australian citizens to private charities and declared to the tax office in 2002–03. If we add charitable donations not reported to the government, this indicates that Australians donate over $1 billion per year to private charity. In addition to this philanthropy, a significant part of voluntary help for the disadvantaged is undertaken at the community level between families and friends.

Davidson[55] calculates a correlation between the top marginal tax rate in different countries and their rate of charitable giving of –0.23 (that is, the higher the tax rate, the lower the level of charitable donations). As Reform 30/30 decreases the top marginal tax rate by 18.5 percentage points, it should encourage more charitable giving. Also, there is ample evidence that rich people give more to charity, so as Reform 30/30 leads to a larger and stronger economy it will also lead to more philanthropy.

There are benefits from achieving welfare goals through civil society, including a more personal treatment of the poor and the virtues of voluntary redistribution (based on moral choices) compared with a compulsory system (that may foster resentment).

Simplicity

Another important benefit from Reform 30/30 is the simplicity of the system. Currently we have myriad programmes, tax law that runs to about 10,000 pages, various tax rates and tax offsets and tax deductions and tax minimisation schemes, as well as a broad range of welfare payments and welfare supplements and withdrawal rates and top up payments and penalties, and so on. Thousands of administrators are given the task of removing tax from workers, so that the same money can be paid back to the same workers. Taxpayers struggle with tax returns and wealthy Australians find tax loop-holes.

By having a flat tax at the same level as company tax, and removing all tax expenditures[56] (that is, removing all tax offsets and deductions except those necessary to retain the integrity of the income tax system), there would be no need for tax returns for the majority of taxpayers. Compliance cost is removed. The dreaded 'Tax Pack' would become a thing of the past for most Australians, saving considerable time, money and headaches. [57]

One problem of the current system is the churning of welfare—where the same person both pays income tax and receives welfare. Under the above proposal, this would be abolished. Reform 30/30 integrates the income tax and the welfare system because welfare is only paid to people with incomes below $30,000 and income tax is only charged to people with incomes over $30,000. An individual with an income of $30,000 would neither pay tax nor receive welfare. Administration costs would be reduced.

There would be no question of tax avoidance and no need for complex accounting procedures. People would have a choice between paying a 30% fringe benefits tax, a 30% company tax, a 30% individual tax, a 30% capital gains tax or having their welfare reduced by 30%. No need for trusts or shell companies. Tens of thousands of tax lawyers/accountants would be out of a job. The biggest losers from Reform 30/30 would be tax accountants—which is surely a sign of good tax reform.

Further, lower tax rates, lower compliance costs, a more simple system and a perfectly flat incentive structure will reduce tax evasion.[58] Some people will continue to be employed in the black market and some businessmen will claim personal expenses as business expenses. However, these problems are unavoidable in any income tax system and Reform 30/30 would decrease the incentive for, and ability to achieve, tax evasion.

Every avenue of government activity opens up the cost of rent-seeking. Differential tax rates, tax expenditure and a complex range of welfare payments open up significant scope for interested parties to lobby the government for special favours. This lobbying behaviour is itself an economic waste as rent-seeking behaviour is not directed at creating extra production.

As Robson notes, rent-seeking costs should be included as a part of the efficiency cost of tax. However, this is rarely the case. A low, simple and flat tax offers fewer possibilities for special favour and, therefore, less scope for rent-seeking activities.

Public finance

One potential criticism of Reform 30/30 is that it is not affordable. However, rough estimates indicate that it would more than pay for itself. The below estimates suggest a $15 billion per year improvement in the budget bottom line (excluding any potential benefits from higher economic growth).

Even if the reforms did cost the budget, the benefits of this plan more than justify eating into the surplus or removing a range of poor current spending policies.

There are eight ways that this reform impacts on the budget:

1) Tax cut of about $40 billion per year
2) Replace all welfare with an NIT, which saves about $15 billion per year
3) Additional spending on children, aged & disabled of about $25 billion per year
4) Abolish tax expenditures of about $30 billion per year
5) Higher tax from a bigger economy of about $25 billion per year
6) Administrative savings of about $5 billion per year
7) Decreased tax avoidance and evasion of about $5 billion per year
8) Potential future benefits of higher economic growth

Tax cuts

As mentioned earlier, raising the TFT to $30,000 is a tax cut of $26 billion. Removing the 42% and 47% brackets is a further $8 billion tax cut.[59] Abolishing the Medicare levy and bringing FBT into line with other income taxes would cut tax by about $6 billion and $1 billion respectively. The total tax cut is about $41 billion.

Replace welfare with NIT

Reform 30/30 includes two elements that will reduce welfare payments. First, the welfare payments to the unemployed are reduced to $9,000 per year. Second, more jobs and better incentives will result in fewer unemployed people claiming full benefits. These benefits are partially offset by increased welfare payments to the working poor. Initial estimates for the cost of the NIT payments are $70 billion per year.[60] As current welfare payments total to $85.3 billion (+$2.3 billion administration), this represents a cut in basic welfare payments of $15 billion.

Children, the aged and disabled

The basic NIT does not give special treatment to parents, the aged or disabled. Additional payments to these groups could cost an additional $25 billion per year. This is discussed further in the Appendix (p.23).

This paper has not suggested a specific range of additional welfare policies. This is not to suggest that these areas are unimportant or should be removed, but because there are several different approaches that could be taken for these groups and there is no need to tie Reform 30/30 to specific policies on child subsidies, disability support or retirement assistance.

Removing tax concessions

The Tax Expenditure Statement shows that current tax concessions sum to about $35 billion in 2005–06 and are increasing rapidly. While tax expenditures are nominally reductions in tax, for all intents and purposes they are spending proposals. For efficiency purposes, tax concessions do not reduce the DWL of tax (and may actually increase it by further changing incentives). For equity purposes they have the same impact as spending proposals, except that the primary beneficiaries of many tax expenditures are high-income earners. For simplicity purposes, tax expenditures distort our tax system, create tax avoidance opportunities, create considerable administration and compliance costs, and decrease public policy transparency.

Undoubtedly, there will be calls to retain some tax concessions. The best response to this is that allowing any tax concessions will open the door to another round of perverse modifications of the tax system, destroying the benefits of simplicity and undermining the efficiency of the system. While some tax concessions may have merit, they can be achieved through other means. And anyway, do their benefits really compare with the benefits from Reform 30/30?

A low and flat income tax with no deductions removes both the incentive and ability to pursue tax minimisation schemes.

It is necessary to retain some tax deductions for companies and the self-employed to ensure that they are taxed only for their profit and not for their entire revenue.

The reduction in income tax will mean that the effective size of the tax expenditures is reduced. The total savings from abolishing tax expenditures is estimated at $30 billion.

More tax from a bigger economy

The Laffer curve suggests that tax cuts can increase tax revenues because lower tax rates encourage greater work effort and a larger economy. While the strict interpretation of this for Australia's current position is controversial, the broad point that tax cuts are partially offsetting should not be in question.

Using the earlier estimates of this paper that showed a DWL from tax of about $20 billion, and a government/GDP ratio of 30%, then the Laffer offset is estimated at only $6 billion per year.[61]

In addition to tax cuts, the other factor contributing to a larger economy was the higher employment from welfare reform. Given the estimated benefit of about $60 billion to the economy the government should gain an additional $18 billion.

The total benefit to the government is about $24 billion. Of this, perhaps $8 billion will go to state and local governments (mostly through the GST).

Administrative savings

The simplicity of the tax system will lead to a number of budgetary savings. The ATO currently spends $2.6 billion per year and The Department of Family and Community Services currently spends $2.3 billion, which could be severely cut under Reform 30/30. Other areas of the government that also have to deal with the complex tax and welfare systems could be cut back—including Treasury and Finance. A total administrative saving of about $5 billion could be expected.

Decreased avoidance and evasion

Finally, a low and flat income tax with no deductions removes both the incentive and ability to pursue tax minimisation schemes, which will result in more tax revenue.

Davidson notes that income reported by high-income earners is likely to be more sensitive to changes in marginal tax rates because 'this group of taxpayers can afford the best tax planning advice, they may receive a large proportion of their total income in a form other than wages and salary, and they have the ability to shift assets and income into tax-advantaged (or at least, less tax-disadvantaged) forms, or to alter the timing of taxable income.'[62]

The evidence includes Feldstein's study that linked a cut in top marginal income tax from 50% to 28% in the US with a large positive impact on taxable income from high income earners.[63] After Reagan's tax cuts, the share of income tax paid by the richest 5% grew from 35.3% to 38.9%. In the UK, the top marginal tax rate was cut from 83% to 40% by Thatcher and the top 10% of income earners saw their share of the total tax bill increase from 35% to 42%. The increased tax from high-income earners that follow tax cuts can be partly explained by increased work effort, but some of it also likely comes from less tax avoidance.[64]

The above discussion only considers legal tax avoidance. In addition there is the issue of illegal tax evasion. High-income earners have access to tax schemes that approach or pass the fine legal line, but average taxpayers also have plenty of opportunities for (and incentive to commit) tax evasion under the current system. This would be reduced under Reform 30/30.

It is difficult to put a value on this benefit, but an increase of several billion would not be unexpected.

Other budgetary issues

While the above estimates indicate that Reform 30/30 will be good for the budget, a few caveats are important. First, these are rough costings and further investigation of the impacts of the reform is needed.

In addition, the above estimates consider the impact of Reform 30/30 in the medium term. It may take several years for the full impact of the tax and welfare reforms to be felt in the economy and by the government. In the short term, the impact on the budget will be less positive.

Finally, the above estimates include the medium-term impacts only and do not consider the potential long-term growth benefits, which could be $3 billion after ten years even on conservative estimates. In the long term, the impact on the budget will be more positive.

However, if the benefits of Reform 30/30 are real, then this policy deserves to be pursued *even if* it costs the budget. There are plenty of government programs in need of removal, most specifically including corporate welfare. The possibility of short-term deficits is a poor excuse to deny people the benefits of Reform 30/30.

It would be easy for a conservative mind to dismiss these ideas as too bold or too controversial.

Conclusion

The reforms suggested in this paper are more radical than most other suggestions being considered today. This paper calls for implementing a flat tax, cutting taxes significantly, aligning all income tax rates, removing all tax expenditure, abolishing the minimum wage and introducing a new and unique welfare system. It would be easy for a conservative mind to dismiss these ideas as too bold or too controversial.

Even strong supporters of tax/welfare reform and tax cuts shy away from proposing such fundamental reforms. Tax reform advocates such as the CIS's Peter Saunders and Liberal backbencher Malcolm Turnbull call for more moderate reform in the belief that fundamental reform is not possible.

Others refuse to consider any proposal that is not strictly budget neutral in the short term, or that could potentially lead to any loss in the static analysis. There is no reason to apply these parameters as they unreasonably assume the status quo has merit, and they ignore the far more important medium-term and dynamic effects.

The potential benefits from Reform 30/30 are difficult to ignore. In a perfect world, we may well combine high welfare payments with good incentives, or a range of tax expenditures with a simple and efficient tax system—but we do not live in such a world. In reality we must choose among competing priorities.

This paper has outlined how a negative income tax can replace the minimum wage as an effective means of helping the working poor and how this will lead to 500,000 new jobs. The constant effective marginal tax rate of 30% is a significant improvement on the current poverty trap that sees some people face an EMTR of around 100%. Combined, these two effects would help combat poverty and allow greater upward mobility for all Australians.

The impact on economic efficiency is unambiguously positive, with a benefit of perhaps $90 billion in the medium term and larger still in the longer term. Likewise, the impact on simplicity is unambiguously positive and leads to significant benefits through lower compliance costs, administration costs, and tax avoidance costs.

The impact on equity is more complex because the criteria for equity are so often subjective. However, as the biggest benefit of Reform 30/30 is the reduction in unemployment and poverty, it is hard to see how it could be called inequitable. Given the only consistent objective criteria of equity, a flat tax (and flat incentive structure) seems more equitable than any alternative. Further, Reform 30/30 ends the current inequitable discrimination against couples.

Reform 30/30 offers a choice between a high, distorting, complex and costly tax system, a failed and counter-productive minimum wage and a welfare system that creates poverty—or a simple system that keeps people out of poverty, creates new jobs, fixes the incentives, creates a larger economy, decreases avoidance, as well as administration and compliance costs.

Reform is needed. Reform 30/30 is a good template for serious reform. It is efficient, equitable, simple and affordable. The only ingredient missing is political courage.

Appendix: Children, disabled and aged

The body of this paper has considered the basic Reform 30/30 without considering the additional complicating factors of parents of children, the disabled and the aged. This is not because these areas are unimportant, but because they are not central to the functioning of the Reform 30/30 system. The basic ideas of Reform 30/30 hold whether you want to abolish, change, cut or increase child subsidies, disability payments or the aged pension.

Based on current welfare policies towards the aged, disability and children, an additional $20–30 billion (with a midpoint of $25 billion) could be spent on welfare supplements.

For each of these categories there are broadly five approaches that can be considered:

1) Increase the TFT for these groups, with the associated increase in the NIT payment. This is the same as introducing an additional non-means tested welfare payment.
2) Introduce an additional means-tested welfare payment. This approach would undermine many of the benefits of Reform 30/30.
3) Decentralise responsibility for these groups to State and/or local governments (note that Reform 30/30 would lead to more revenue to State and local governments).
4) Decentralise responsibility for these groups to civil society, potentially with government subsidies (note that Reform 30/30 would lead to more philanthropy)
5) Consider non-traditional government support, such as supporting disability-related services or adjusting other taxes.

The important thing to note with additional welfare payments is that they should seek not to undermine the efficiency and simplicity of the tax/welfare system by introducing tax expenditures or withdrawal rates. This can be done by adjusting the TFT if necessary, by decentralising responsibility to a more individual level (States and civil society), or by using non-traditional methods to help those in need.

Parents

While the decision to have children is made by parents and not the taxpayers, arguments that suggest parents be solely responsible for their children are unlikely to find political support.[65] Perhaps the best response to the demand that families be helped to meet the costs of raising children would be to adjust the tax-free threshold for parents, and consequently the size of the NIT payment.

If the tax-free threshold was raised by $6,000 per child this would cost an additional $7.2 billion in higher welfare payments and lost tax revenue. If the tax-free threshold were raised by $10,000 per child, this would cost an additional $12 billion. This second option is identical to the Maley suggestion of a $3,000 non-means tested child subsidy.[66] For comparison, the current approach of Family Tax Benefit (A and B), Child Care Benefit and Maternity Allowance cost about $13.2 billion per year.[67]

With a child TFT supplement of $6,000, a couple with two children would now have a combined TFT of $72,000 ($30,000 + $30,000 + $6,000 + $6,000). An unemployed couple with two children would receive $21,600 through the NIT.

Such a policy would not impact on the incentives or consequences of the basic reform plan except to increase its budgetary cost. One important point to note is that such a policy does not differentiate between working parents and stay-at-home parents and so does not discriminate for or against any particular lifestyle choice.

With even the lower child-TFT supplement, nearly all couples with children will still gain from the reforms, both in a static sense and more especially in a dynamic sense. In a static sense there are significant benefits to most workers, especially those on an average income, but also those on double the average wage and those on the minimum wage.

More importantly, in a dynamic sense the EMTR for families is dramatically reduced under Reform 30/30. Under the current system, people on no income have an EMTR of 65%, the EMTR for people on half minimum wage is 89%, the EMTR for people on the minimum wage is 66% and

Box 3. Static impact of Reform 30/30 on a single-income family (2+2).
The first 30/30 figure represents a child TFT supplement of $10,000 and the bracketed figure represents a child TFT supplement of $6000 per child. [68]

Income	Current Welfare	30/30 Welfare	Current Tax	30/30 Tax	Current Total (EMTR)	30/30 Total	Change
No income	$27,148	$24,000 ($21,600)	$0	$0	$27,148	$24,000 ($21,600)	-12% (-20%)
Half minimum ($11,658)	$20,536	$20,503 ($18,103)	$962	$0	$31,232	$32,161 ($29,761)	+3% (-5%)
Minimum ($23,316)	$12,385	$17,005 ($14,605)	$3,166	$0	$32,535	$40,321 ($37,921)	+24% (+17%)
Average ($48,993)	$3,132	$9,302 ($6902)	$10,869	$0	$41,256	$58,295 ($55,895)	+41% (+35%)
Double Average ($97,986)	$2,037	$0 ($0)	$32,859	$5396 ($7796)	$67,164	$92,590 ($90,190)	+38% (+34%)

the EMTR for people on an average wage is 47%. In contrast, the Reform 30/30 system has a constant EMTR of 30%. The biggest winners in a dynamic sense are clearly the low-income workers.

In addition, note that the current system takes tax off all earnings categories and churns that money back in welfare to all earnings categories. In contrast, under the 30/30 system, people either receive welfare or pay tax; they don't do both.

However, with a low child subsidy, fewer unemployed single parents will gain as (1) they do not get the economies of scale of living with another adult; (2) the current system is particularly generous to this group; and (3) single parents are less able to take advantage of workplace opportunities because of domestic responsibilities. There are several options for dealing with unemployed single parents. One option is simply to pay a higher child subsidy. Perhaps a better option is to decentralise responsibility to State and local governments and civil society groups who are better able to deal with the day-to-day realities of single parents living in poverty. The situation of single parents is not something easily fixed by throwing money at it and is best addressed at a more personal level.

Irrespective of which approach is taken, it is unlikely that a budget for child subsidies would exceed $10–15 billion.

The disabled and aged

Another important issue for welfare is the protection of people who are particularly disadvantaged such as the disabled, and policies for retirement income. This paper does not aim to deal with these complex issues and Reform 30/30 is consistent with various approaches to disability and retirement policies.

Both disability payments and the aged pension could be paid as TFT supplements (as suggested for parents of children). However, there are potentially better alternatives.

With disability services there is an argument for decentralising responsibility to the State level and civil society. The needs of the disabled vary considerably and it makes little sense to bundle in the seriously disabled with those who are suffering in the recent epidemic of convenient bad backs and depression. These issues are best addressed at a more personal level.

With regards to the aged pension, there is an argument that the compulsory superannuation system removes the need for any additional welfare payments beyond the NIT. One approach would be to introduce a TFT supplement for current aged pension recipients and phase this out as the generation of compulsory superannuation savers reach retirement. Civil society would be more than strong enough to offer any additional help that would be necessary.

Using current disability pension and aged pension payments, the cost of additional disability and aged welfare supplements is likely to be about $10–15 billion.

Endnotes

1 Lauchlan Chipman, *The Very Idea of a Flat Tax*, Policy Monograph 66 (Sydney: The Centre for Independent Studies, 2004).

2 Milton Friedman, *Capitalism and Freedom* (Chicago: University of Chicago Press, 1962).

3 For example: Peter Dawkins, Alan Duncan and John Freebairn, 'Modifying Income Support in the Australian Tax and Transfer System', Paper to the *Pursuing Opportunity and Prosperity Conference, 13-14 November 2003* (Melbourne: University of Melbourne, 2003).

4 A recent example was the St Vincent de Paul Society which warned (absurdly) of 'a headlong dash into the chasm of inequality'. For a critique of this scaremongering, see Peter Saunders, 'A Headlong Dash into the Chasm of Hyperbole' (Sydney: The Centre for Independent Studies, 2005).

5 Terry Dwyer, *The Taxation of Shared Family Incomes,* Policy Monograph 61 (Sydney: The Centre for Independent Studies, 2004). If we assume the rationale for a tax-free threshold of earnings is that people should be able to earn enough to ensure their own subsistence before they are taxed, then Dwyer's proposal for pooling family thresholds makes perfect sense. The bigger the family, the greater its subsistence income needs to be, therefore the higher should be its total tax-free earnings allowance.

6 Today, on a salary of $60,000, they pay 15% on the 9% of their income contributed to super; under the Humphreys scheme, someone earning $60,000 pays $9,000 income tax on the whole $30,000 of taxable income, which works out at a rate of 15%, and they pay their super contribution out of this taxed income. Below $60,000, the average tax rate is lower than 15%; above it, it is higher.

7 Under existing arrangements it is projected that in 2050, three-quarters of retirees will still qualify for the age pension, two-thirds of them receiving a reduced rate. See Hazel Lim-Applegate, Peter McLean, Phil Lindenmayer and Ben Wallace, 'New Age Pensioners: Trends in wealth', Paper to the *SPRC Conference, 20–22 July 2005* (Sydney: SPRC, 2005).

8 Peter Burn, *How Highly Taxed Are We? The Level and Composition of Taxation in Australia and the OECD*, Policy Monograph 67 (Sydney: The Centre for Independent Studies, 2004).

9 Alex Robson, *The Costs of Taxation,* Policy Monograph 68 (Sydney: The Centre for Independent Studies, 2005).

10 As above.

11 Information regarding federal government spending and tax rates are taken from www.budget.gov.au.

12 It is suggested that HECS repayments are also taken out of the tax system and instead administered separately as a government loan.

13 The exact details of how the NIT and TFT would be coordinated need not be finalised at this stage. One suggestion would be to tax all income at 30% initially with no TFT and then pay back the excess tax every fortnight along with the NIT payment. Such a payment would always sum to $9000. For example, with an income of $10,000 the worker would receive $3000 tax back and $6000 NIT. With an income of $25,000 the worker would receive $7500 tax back and $1500 NIT. The unemployed would receive $9000 NIT and those with incomes over $30,000 would receive $9000 tax back.

14 Milton and Rose Friedman, *Free to Choose* (Chicago: Harcourt, 1980).

15 John Humphreys, 'Reforming Wages and Welfare Policy: Six Advantages of a Negative Income Tax', *Policy* (Autumn 2001).

16 A recent expansion on the Five Economists' Plan was given by one of the five economists in Peter Dawkins, 'The 'Five Economists' Plan: The Original Idea and Further Developments', ANU Discussion Paper No. 450 (Canberra: Centre for Economic Policy Research, 2002).

17 As above.

18 Marc T. Law, *The Economics of Minimum Wage Laws*, Public Policy Sources No. 14 (Vancouver: The Fraser Institute) accessed at http://oldfraser.lexi.net/publications/pps/14/

19 Philip Lewis, 'Low Pay or No Pay? The Economics of the Minimum Wage', *Policy* (Spring 2005).

20 Daniel Hamermesh, *Labor Demand* (Princeton: Princeton University Press, 1993).

21 Jeff Borland, 'Disaggregated models of unemployment in Australia', Melbourne Institute Working Paper 16/00, 2000, accessed at http://www.melbourneinstitute.com/wp/wp2000n16.pdf, 14.

22 Cited in Dawkins. Incidentally, the lower elasticity for employment compared with hours worked indicates that a higher income has a positive impact on hours worked for people already employed. This is consistent with the substitution theory of wages and the idea that tax decreases the incentive to work.

23 Robert Dixon, John Freebairn and G.C. Lim, 'An Employment Equation for Australia 1966–2001', Research Paper 892 (Melbourne: University of Melbourne, 2004).

24 David Card and Alan Krueger, 'Minimum Wages and Employment: A case study of the fast-food industry in New Jersey and Pennsylvania', *American Economic Review*, 84, (1994), 772–93. Also Card

and Krueger, *Myth and Measurement: The New Economics of the Minimum Wage* (Princeton: Princeton University Press, 1995).

25 Law, *The Economics of Minimum Wage Laws.*

26 Alex Robson, 'A Labour Market Fable', *Policy* (Summer 2004-05).

27 Dawkins, 'The 'Five Economists' Plan'.

28 As above.

29 Borland, 'Will Lowering Wages Reduce Unemployment?', *CEDA Bulletin* (July 1999), 16–18.

30 C. Richardson, 'Reducing Unemployment', in *Rebuilding the Safety Net*, *Proceedings of a Conference*, *29 April 1999*, (Melbourne: Business Council of Australia. 1999).

31 P. Dixon and M. Rimmer, 'A Wage/Tax Policy to Increase Employment' (Melbourne: Business Council of Australia, 2000).

32 To put this in context, the number of people officially recorded as unemployed as of September 2005 was 531,000.

33 It should be noted that Leigh estimated the relationship between the minimum wage and employment, which is different to the wage elasticity of demand (which is the relationships between the average wage and employment).

34 Andrew Leigh, 'Employment Effects of Minimum Wages: Evidence from a Quasi-Experiment', *Australian Economic Review* (December 2003). Accessed at http://www.acci.asn.au/text_files/submissions/(2004-Feb)%20ACCI%20SN%20Subn%20(Attach%209C)%20-%20Leigh%20Erratum.pdf

35 Australian Chamber of Commerce and Industry, *Submission—2004 Safety Net Review* (2004). See 'Chapter 9: Impact of increasing the minimum wage', Accessed at http://www.acci.asn.au/SubmissionsMain.htm. One reason is that the WA economy grew faster than the Australian economy (the control group), which would have led to stronger jobs growth in WA, which would hide some of the negative employment impact of minimum wage changes.

36 Peter Saunders, 'The $85 Billion Tax-Welfare Churn' (Sydney: The Centre for Independent Studies, 2005).

37 Peter Saunders and Barry Maley, *Tax Reform to Make Work Pay,* Policy Monograph 62 (Sydney: The Centre for Independent Studies, 2004).

38 Sinclair Davidson, *Are There Any Good Arguments Against Cutting Income Tax?,* Policy Monograph 69 (Sydney: The Centre for Independent Studies, 2004).

39 Robson, *The Costs of Taxation*.

40 These costings are taken from Malcolm Turnbull, *Taxation Reform in Australia: Some Alternatives and Indicative Costings* (Sydney:2005), available at http://www.turnbullforwentworth.org.au/. Some costings had to be extrapolated.

41 Andrew Leigh, 'Simple Tax Means Many Happy Returns', *Canberra Times*, 27 October 2005.

42 Some of this evidence is summarised in Chapter 2 of Humphreys and Stoeckel, *Free Trade Areas* (Canberra: RIRDC, forthcoming).

43 Further discussion of the links between tax and growth can be found at Alex Robson, *Taxation, Individual Incentives and Growth* (Brussels: Institute for Research in Economics and Fiscality, 2004), accessed at http://www.iref-europe.org/fra/irefdocs/irefdocs_RobsonEssay.pdf. Also see Daniel Mitchell, *The Impact of Government Spending on Economic Growth* (Washington, DC: The Heritage Foundation, 2002).

44 Robson, *The Costs of Taxation*.

45 Statistics for the current system taken from Saunders and Maley. Does not take account of rent assistance or the Medicare Levy/Surcharge.

46 Saunders and Maley, *Tax Reform to Make Work Pay,* 6.

47 See Turnbull: 'The other approach [to addressing high EMTRs] … is to impose a more stringent work obligation so that the optionality (receive benefit vs work) is removed or at least heavily qualified. The Government's recent welfare to work reforms are moving, albeit cautiously, in that direction', 29.

48 Chipman, *The Very Idea of a Flat Tax.*

49 Taken from Davidson, *Are There Any Good Arguments Against Cutting Income Tax?*.

50 Only a flat consumption tax is truly proportional. A flat income tax double taxes savings because (1) interest on savings partly represents a payment in lieu of the time value of money (not an increase in wealth) and so taxing that interest is a tax on delaying consumption (that is, savings); and (2) capital return is double taxed because it is taxed itself and it is also lower due to expected future taxes (for example, future company tax liability decreases the share prices).

51 Andrew Norton, *Will You Still Vote For Me in the Morning?,* Policy Monograph 65 (Sydney: The Centre for Independent Studies, 2004).

52 Saunders and Maley, *Tax Reform to Make Work Pay.*

53 Dwyer, *The Taxation of Shared Family Incomes*.

[54] This problem was highlighted in my mind by an anonymous comment on the internet: 'In my case, I have sweated for every dollar, building a business from the ground up working 80 hour weeks for several years on a subsistence wage and taking huge financial risk in the process (I have almost lost everything several times). Now that my business is better established and I can afford to increase my salary, that 48.5c marginal rate seems grossly unfair'.

[55] Davidson, *Are There Any Good Arguments Against Cutting Income Tax?*, 20.

[56] Definition of tax expenditure according to the federal government: 'Tax expenditures provide a benefit to a specified activity or class of taxpayer. They can be delivered as a tax exemption, tax deduction, tax offset, reduced tax rate or deferral of a tax liability. The Government can use tax expenditures to allocate resources to different activities or taxpayers in much the same way that it can use direct expenditure programmes. For this reason, and noting their direct impact on the fiscal balance, these concessions are generally called tax expenditures.' http://www.budget.gov.au/2005-06/bp1/html/bst5-10.htm

[57] It should be noted that there is an additional cost of tax returns for over-paying individuals in that they are effectively giving the government an interest-free loan from the time they pay tax until they receive their tax return.

[58] Note the difference between tax avoidance and tax evasion is that tax avoidance is legal.

[59] Turnbull, *Taxation Reform in Australia.*

[60] This estimate was derived in two ways. There are approximately 15.5 million adults in Australia of whom about 5 million are not in the labour market, 0.5 million are unemployed and 10 million are employed. If the NIT is paid to all non-working adults and the half NIT is paid to 4 million workers then the total cost would be about **$67.5 billion** ((5.5 million * $9000) + (4 million * $4500)). An alternative way to estimate the cost is to consider Reform 30/30 as a flat $9000 payment to all adults with no TFT. Under this estimate the total NIT payment would be about $140 billion (15.5 million * $9000) which is artificially inflated by treating the TFT as welfare. The value of a 30% tax on income under $30,000 is estimated at about $70 billion (extrapolated from Turnbull, 2005) and so the real cost of the NIT is **$70 billion**. This may be an overestimate of the cost of the NIT because it does not take into consideration the benefits from a larger economy or more employment.

[61] It is worth noting the arguments of Davidson that Australia is on the 'wrong' side of the Laffer curve and therefore we would expect to see government revenue increase from the Laffer effect alone. However, evidence to suggest we are on the wrong side of the Laffer curve is not strong. Davidson points to the fact that Australia has high income tax rates but is a low tax country compared with others in the OECD and suggests that this is evidence that we are on the wrong side of the curve. However, Australia's relatively high level of *income taxes* does result in relatively higher taxes *from income*. Whether Davidson's comparison is a good proxy is a matter for debate. The estimates in this paper do not support the proposition that Australia is on the wrong side of the Laffer curve.

[62] Davison, *Are There Any Good Arguments Against Cutting Income Tax?*, 13.

[63] As above.

[64] Examples from Turnbull, *Taxation Reform in Australia.*

[65] I find it very hard to accept the argument that children are 'public goods' that need subsidising. Children are humans, and like all humans they bring benefits to people they interact with. If this is sufficient grounds for a subsidy, then there is nothing that would not be subsidised. Further, it is not true that we all benefit from child subsidies because we were all children - it is the parents that pay for their children, the parents that benefit from child subsidies, and not everybody is a parent. The strongest argument for child subsidies is simply that we do not want any child to live in abject poverty.

[66] Saunders and Maley, *Tax Reform to Make Work Pay*.

[67] As above.

[68] Statistics for the current system are taken from Saunders and Maley, *Tax Reform to Make Work Pay*. Does not take account of rent assistance, childcare or the Medicare Levy/Surcharge.

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