



Taming the Monster: Reforming personal income tax

Robert Carling

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Executive Summary

Without any change in personal income tax rates or thresholds, each of the following will occur within the next five years (and some of them much sooner):

- The average tax rate (net tax paid as a percentage of taxable income) will reach the previous recorded peak and then keep rising to an unprecedented 26.6%, which compares with the long-term average of 22.5% since the late 1970s.
- Full-time workers on the minimum wage will face a marginal rate of 34.5% (including Medicare levy) and an effective marginal rate of 36% (also including LITO phase-out).
- Adult full-time workers on average earnings will face a marginal rate of 39%.
- The proportion of taxpayers facing either the highest (47%) or second highest (39%) marginal rate will exceed 35%. More than seven out of ten taxpayers will see more than a third of any extra earnings going to income tax.
- The share of personal income tax in total Commonwealth taxation will return to the historically high levels of the 1980s and 1990s.

The adverse economic impact of personal income tax is already high and is set to rise further if these trends go unchecked.

Increasing the thresholds for some or all marginal tax rates to match past growth in average earnings would alleviate the effects of bracket creep. While this has been the typical policy response in the past, it is a band-aid rather than a reform.

Genuine reform would include cuts in marginal rates — including the top rate — and automatic indexation of thresholds to prevent future bracket creep. This approach would provide a long-run supply-side boost to economic growth. The long-term goal should be a maximum marginal rate of 35%.

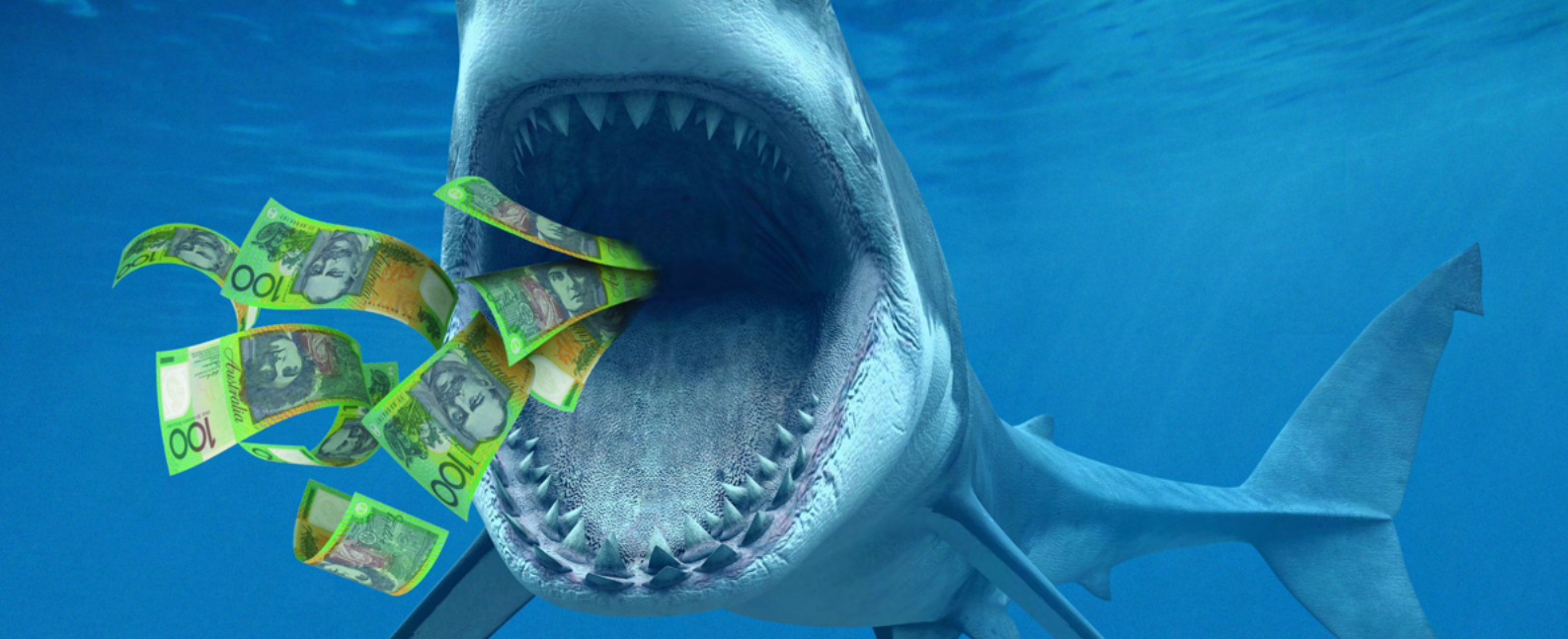
Concerns about the ‘fairness’ of such an approach are misplaced. Personal income tax (and the tax/transfer system more broadly) is already highly progressive and the trend has been for personal income tax to become more, not less, progressive — notwithstanding tax cuts since the 1990s. Much of the recent commentary on tax issues implies the system needs to be made more progressive, however there is no clear reason to introduce such a strategy. Indeed, reforms that make the system less progressive should be considered if there is a clear economic pay-off.

Cuts in marginal rates must be reconciled with budget repair. While cuts in marginal rates would help finance themselves in time by providing a boost to economic growth and revenue, the initial cost to revenue would be large. Even a medium size tax cut faces this dilemma. It is best resolved by more disciplined management of public expenditure.

Within the tax system, revenue to help finance cuts in marginal rates could be generated by broadening the tax base, but in each case (such as negative gearing, superannuation concessions, capital gains tax and deductions for work-related expenses) there are tight limits to how far the government should sensibly go.

A more radical way of accommodating lower and flatter marginal rates within the budget constraint would be to abolish the tax-free threshold, which is very costly to revenue, and replace it with tax credits or offsets that phase out at middle incomes.

An example of such a reform would be a marginal rate of 20% applied to all income from the first dollar to \$85,000 and 35% above \$85,000. A low income offset of up to \$4,400 would provide an effective tax-free threshold of \$22,000, but would be phased out at rate of 10% from \$41,000 to \$85,000, thereby creating an effective marginal rate of 30% over that range. All thresholds should be automatically indexed annually to average weekly earnings to preserve the new scale in real terms.



Introduction

The tax system reviews by the Labor government in 2010 (Australia's Future Tax System, or the 'Henry review') and the present government have highlighted deficiencies in the personal income tax system. Meanwhile, the personal tax burden is rising as a result of bracket creep, which is lifting average tax rates as thresholds are left unadjusted for the growth of average earnings. In the absence of policy change, average tax

rates are set to reach and surpass historic peaks within a few years.

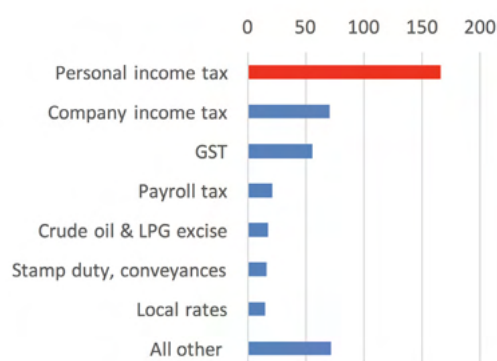
This report reviews the case for personal income tax reform. It assesses the current level of personal income tax, thresholds and rates in historical context. It then goes on to consider both traditional and more radical policy options.

How Much Income Tax Do We Really Pay — Past, Present and Future?

Personal income tax is the monster of Australia's tax system, currently raising over \$170 billion (Figure 1). As a share of total Commonwealth taxation it is around 50% and rising towards the historic peak of more than 55% recorded in the 1980s and 1990s (Figure 2). By international standards, Australia depends relatively heavily on personal income tax.

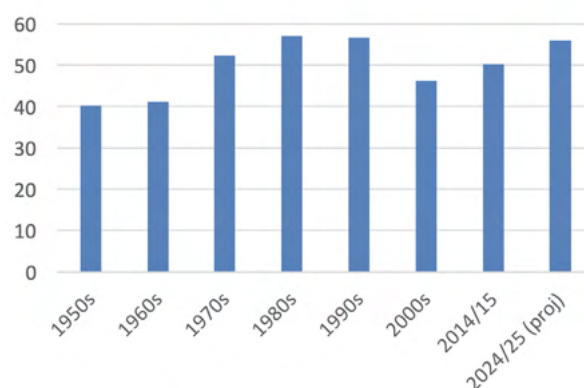
A deeper understanding of the burden of personal income tax can be gained by examining economy-wide measures and the marginal and average rates paid by individuals, all in an historical context.

Figure 1: Revenue, 2013-14 (\$b)



Source: ABS Taxation Revenue, 2013-14

Figure 2: Personal Income Tax as % of Total Commonwealth Taxation



Source: Commonwealth Budget Papers; ABS Yearbooks, various; Treasury, Re:think Tax Discussion Paper, March 2015.

Economy-wide measures

A commonly used measure of the economy-wide burden of personal income tax is revenue as a proportion of GDP. As Figure 3 illustrates, this proportion more than doubled from 1960 to as high as 13% in the 1980s, and again approached that peak in the late 1990s. Following both peaks, tax cuts (reductions in marginal rates and increases in bracket thresholds) were granted to ease the burden, and in addition the recession of the early 1990s and the financial crisis of the late 2000s led to some reduction in personal tax revenue relative to GDP. However the ratio is again increasing and within a few years will reach a level not seen since the late 1990s, and without policy change will continue rising.

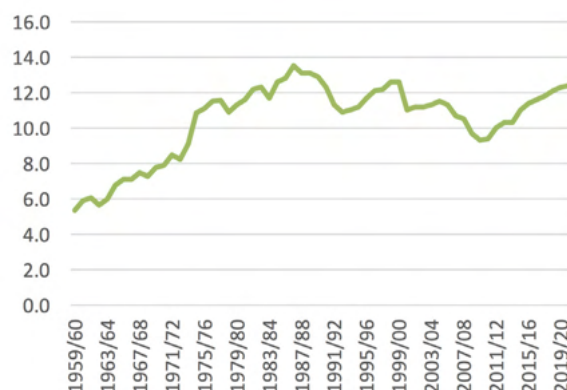
As a gauge of the personal tax burden, revenue as a percentage of GDP suffers the problem that GDP is not the base for personal income tax. Tax paid as a percentage of taxable income (the average tax rate) is in many respects a more meaningful measure. As shown in Figure 4, the average tax rate increased steadily from around 12% in 1960 to 18% in 1970, 21% in 1980 and peaks above 24% in the late 1980s and late 1990s. With tax cuts and the impact of the financial crisis it fell back to around 21% in 2009/10, but it is increasing again and had reached reached 22.4% in 2013/14, equal to the long-term average since the late 1970s.

Recently released Treasury projections show that the average rate will again exceed 24% by 2016-17 and then keep rising to levels never before seen unless policy action is taken to stop it.¹

These aggregate measures of the personal tax burden understate the effective level to the extent some of the income tax attributable to individuals is paid by other entities on their behalf in the form of fringe benefits tax (FBT) and superannuation fund taxes — both levied since the late 1980s. The government chose to impose FBT on employers but with the explicit expectation that the burden would be shifted to employees over time in the form of lower wages than would otherwise have prevailed. Superannuation fund taxes (on contributions and fund earnings) are a direct deduction from members' account balances. FBT and super fund taxes together, if paid by individuals, would add about 7% to the personal tax burden.

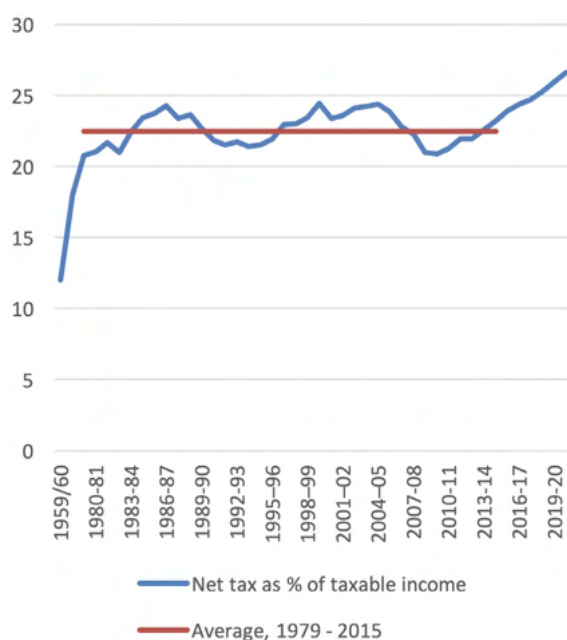
This brief history of the personal income tax burden brings out two remarkable features. One is the scale of the increase from the 1950s to the 1980s. This should not be surprising, given the massive increase in government spending as a share of the economy over the same period. Personal income tax bore a disproportionate share of the burden of financing the growth of government.

Figure 3: Personal Income Tax as % of GDP



Source: Commonwealth Budget Papers; ABS Yearbooks, various; Parliamentary Budget Office for projections.

Figure 4: Personal Income Tax as % of Taxable Income



Source: ATO Taxation Statistics; ABS Yearbooks, various; Treasury Ministerial Brief, 'Economic and Fiscal Effects of Rising Average Tax Rates', 1 February 2016.

Average tax rates rose massively through bracket creep, which went uncorrected from 1954 to 1972. Bracket creep is the process whereby, over time, average tax rates creep up for everyone and some are pushed into higher marginal rate brackets, if the thresholds for graduated marginal rates fail to be adjusted in line with the growth of average wages. The ease with which personal income tax expanded due to bracket creep no doubt facilitated the growth of government spending.

The other feature is the continued growth and resilience of personal income tax revenue despite many rounds of tax cuts in the 1970s, 1980s and 2000s. Once again in the current decade, we are witnessing a repeat of the past pattern; as the data above illustrate, following a brief retreat in the weight of personal income tax, it marches on inexorably towards past peaks and will eventually exceed them. How can it be that governments have so often cut the burden of personal income tax yet any relief proves only temporary? It is not that the cuts have not been real at the point of implementation, but that they have been overwhelmed by the dynamics of bracket creep.

At the individual level – marginal and average rates

The starting point for determining how much an individual pays is the scale of legislated tax rates and thresholds. Since the early 1990s, there has been a tax-free threshold and four rates above it. These are called marginal rates because they apply only to the tranches of income defined by the thresholds, not to a taxpayer's total income. Currently the marginal rates above the tax-free threshold of \$18,200 are 19%, 32.5%, 37% and 47%, excluding the Medicare levy.

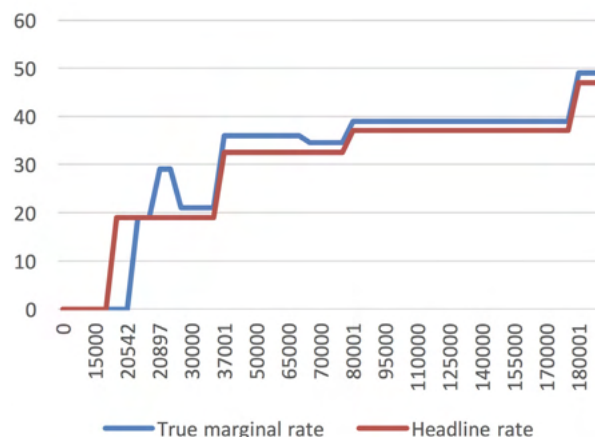
The first complication is the low income tax offset (LITO), which creates a higher effective tax-free threshold. The LITO is phased down above a certain income level by applying an incremental 1.5% marginal rate in the phase-out range. This mechanism ensures that higher income taxpayers receive only the tax-free threshold, not the higher effective threshold delivered by the LITO.

The second complication is the Medicare levy of 2%, which further adds to the marginal rates people actually pay. Moreover, the Medicare levy has its own tax-free threshold, which ensures people with incomes below the threshold pay no levy. The relief provided by this threshold is phased out in full by an incremental 10% marginal rate immediately above the threshold. The phase-out is completed at a relatively low income level (e.g. \$26,120 for a single taxpayer) above which taxpayers pay the 2% levy on their total income from the first dollar.

Thus, as illustrated in Figure 5, the true marginal rate schedule looks quite different from the headline marginal rate schedule described above. In effect there are seven marginal rates above the tax-free threshold, not four, and the effective rate applying to the largest number of taxpayers (income range \$37,000 to \$66,667) is 36%, not the headline rate of 32.5%. The picture is further complicated by tax offsets such as those for seniors and pensioners, and their own phase-down schedules.

Although the discussion here is limited to the income tax system, it should also be noted that means-tested social security benefits in effect create an additional layer of marginal rates, resulting in some cases in very high effective marginal rates above 50%.²

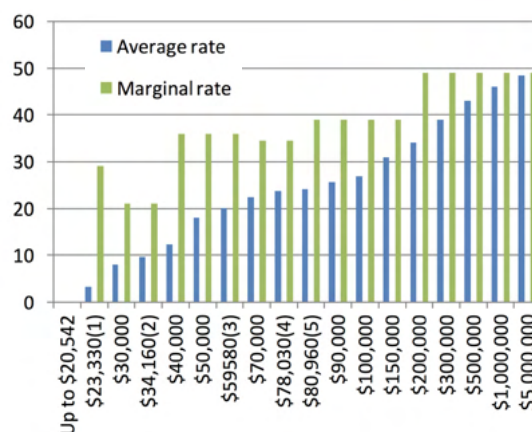
Figure 5: Marginal Rate Scale, 2015-16 (%)



Source: ATO

Another way of looking at how much the individual pays is to calculate average tax rates, which are total income tax paid as a percentage of taxable income. The average rate is always lower than the individual's highest marginal rate, because part of their income is untaxed and the rest is taxed at lower marginal rates. By way of illustration, Figure 6 compares the marginal and average tax rates at various income levels using the current tax schedule.

Figure 6: Average and Marginal Rates at Selected Incomes (%)



1. Minimum wage, 18 years old
2. Minimum wage, adult
3. Average total earnings, all employees
4. Average ordinary time earnings, adult, full-time
5. Average total earnings, adult, full-time

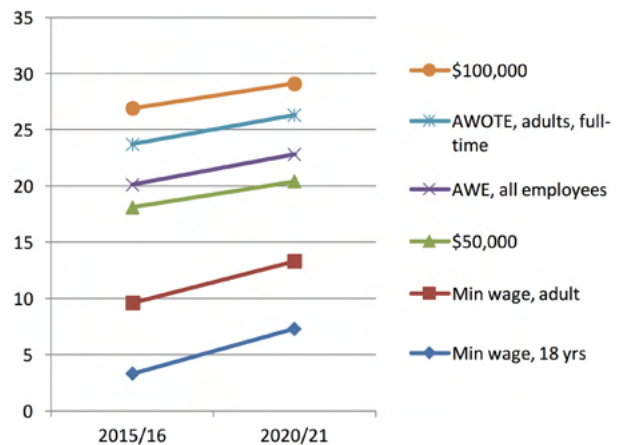
Source: ATO; Fair Work Australia; ABS Average Weekly Earnings, Nov 2015.

For example, the current adult minimum wage equates to \$34,160 a year, and the average tax rate at this income is 9.6%, compared with the marginal rate of 21%. At average weekly earnings of all employees (just below \$60,000) the average rate has risen to 20.1% and the marginal rate is 36%. At average ordinary time earnings of adult full-time workers (\$78,000) the average rate is 23.7% and the marginal rate 34.5%. The average rate then continues to increase to 26.9% at \$100,000 and 34% at \$200,000, by which level the marginal rate has reached the peak of 49%, including the Medicare levy. The average rate continues to rise towards the top marginal rate without ever actually reaching it — for example, at a taxable income of \$5 million the average rate is 48.4%. The bulk of taxpayers have average rates in the range 18-25% and marginal rates of 34.5 – 39%.

The average rates shown in Figure 6 refer to 2015-16. It is also relevant to look at what will happen to the average tax rates at selected income levels over the next five years if the income tax scale remains unchanged. Figure 7 shows the projected increase in average tax rates to 2020-21 at selected income levels on the assumption that nominal incomes increase by 4% a year. The tax increases are steepest at low to middle incomes.

Both average and marginal rates are meaningful for different purposes. The average rate is a measure of the burden the total income tax paid by an individual represents relative to their income. The amount left over after income tax is deducted is take-home pay or

Figure 7: Average Tax Rates at Selected Incomes (%), 2015/16 and 2020/21 (projected)



Source: as for Figure 6; author's projections.

disposable income — the amount available for private spending. The marginal rate, by contrast, is a better measure of the extra tax the individual will pay on any extra earnings above their current income. This is why economists emphasise marginal rates as a measure of the effect of income tax on individuals' economic behaviour, such as decisions on whether to work more hours, seek promotion, or invest in improving their marketable skills.

Trends in Marginal Rates and Thresholds

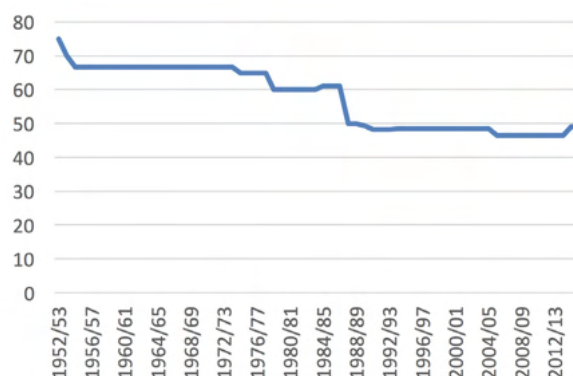
Marginal rates and thresholds have varied substantially over the decades. One point of focus is the top marginal rate, which has come down from a post-war peak of 75% to a low of 46.5% in 2006 and is currently 49% but legislated to drop back to 47% from July 2017. As shown in Figure 8, a top rate of 66.7% prevailed until the mid-1970s. It was then reduced to 61% and then again to 50% in 1987.

While the top marginal rate has been significantly reduced, three points are worth emphasising. First, the biggest reduction occurred in the late 1980s and the top rate has not changed much since then. Second, the threshold at which the top rate applies has also been substantially lowered relative to average weekly earnings. In 1950 the top rate did not apply until around 20 times male AWE. By 1999-2000 the top rate was lower, but the multiple had come down to merely 1.3 times. It is currently around 2.5 times and is likely to fall to around 2.2 times by 2020 (Figure 9). Looked at another way, the current top rate applies at 2.5 times, but the same marginal rate did not apply until 5 times AWE in the mid-1950s, which in today's dollars would be around \$360,000. Third, avoidance opportunities for high income earners were more abundant when very high top marginal rates applied, and those rates raised relatively little revenue. Very few PAYE taxpayers were affected by them because very few salaries were high enough. Anti-avoidance legislation was much weaker than it is now. Today, the top tax bracket accounts for almost 30% of all revenue.

Apart from the top rate, there have been many other changes in marginal rates over the decades — which make it difficult to summarise them — but there are some clear trends. One is a reduction in the number of marginal rates from 29 as recently as the early 1970s to just three (in 1977) or four (since 1991). Another is a reduction in the dispersion of marginal rates. Not only has the top rate come down but the lowest rate has risen, resulting in a narrower spread of marginal rates (Figure 10). However, most of the flattening occurred in the 1980s, with very little since then.

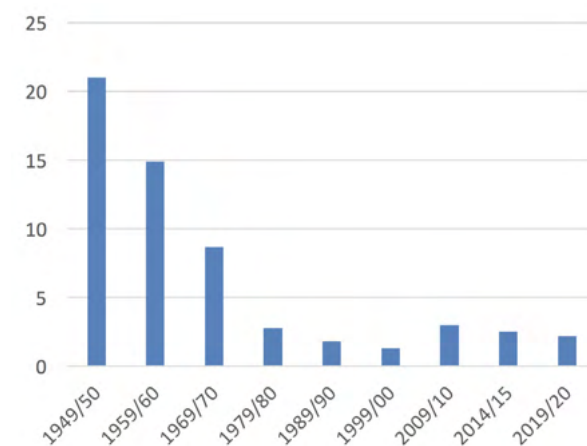
Until the 2000s, however, adjustments to thresholds generally lagged behind growth in average weekly earnings, so that at any given multiple of average earnings the marginal rate was increasing over time. This is illustrated in Figure 11, which shows the marginal rate in selected years at various multiples of average weekly earnings. In fact, marginal rates increased up to 1999/2000 at all income levels up to about 2.5 times AWE. The reduction in marginal rates above that multiple was due to the reduction in the top rate discussed above.

Figure 8: Top marginal rate since 1950, %



Source: ATO

Figure 9: Top rate threshold as multiple of male AWE since 1950



Source: ATO; ABS Average Weekly Earnings; author's projections.

Figure 10: Spread of Marginal Rates at Multiples of Male AWE

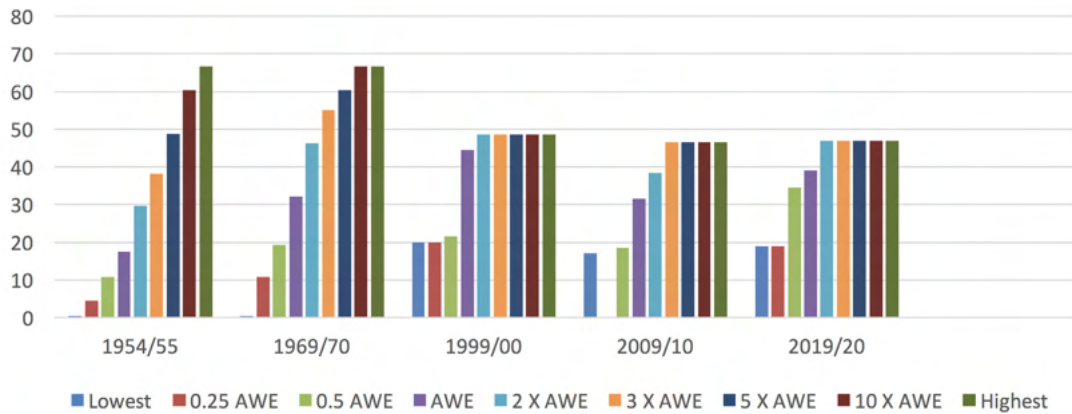
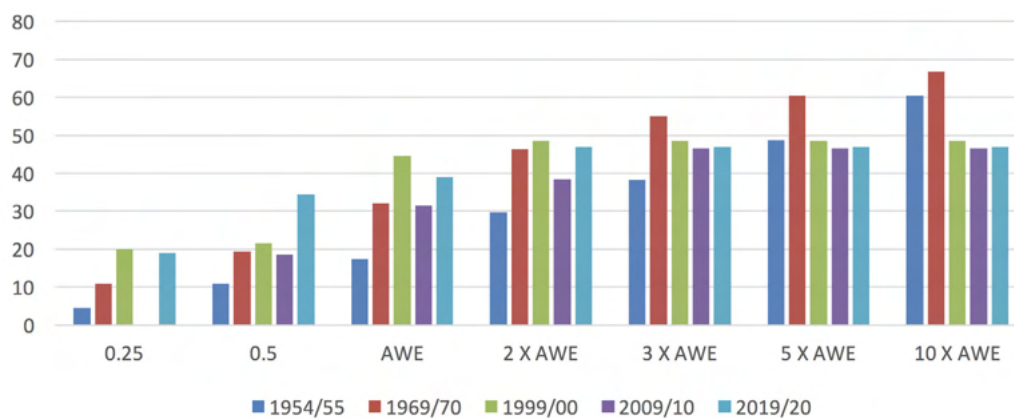
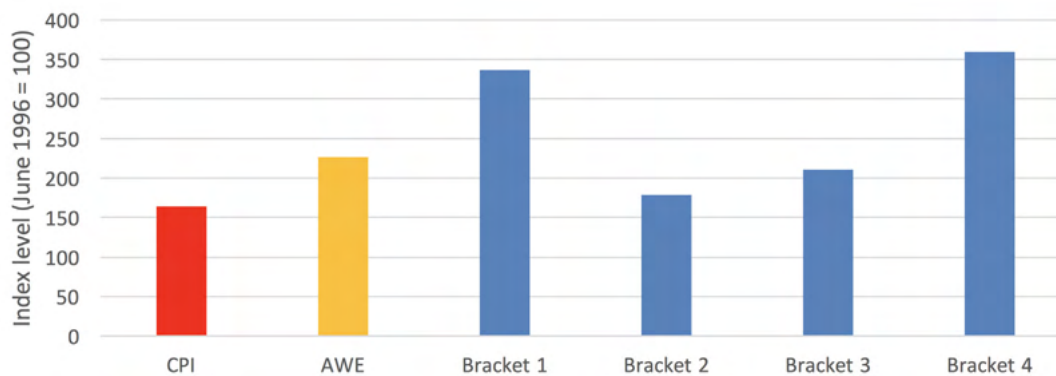


Figure 11: Marginal Rates at Multiples of Male AWE



Source: ATO; ABS Average Weekly Earnings; author's projections for 2019/20.

Figure 12: Increases in marginal rate thresholds compared with CPI and AWE, 1996 - 2016



Source: ATO; ABS Average Weekly Earnings and Consumer Price Index

Three sets of changes have combined to lower the overall personal tax burden from a peak of more than 24% of taxable income reached in 1999/2000:

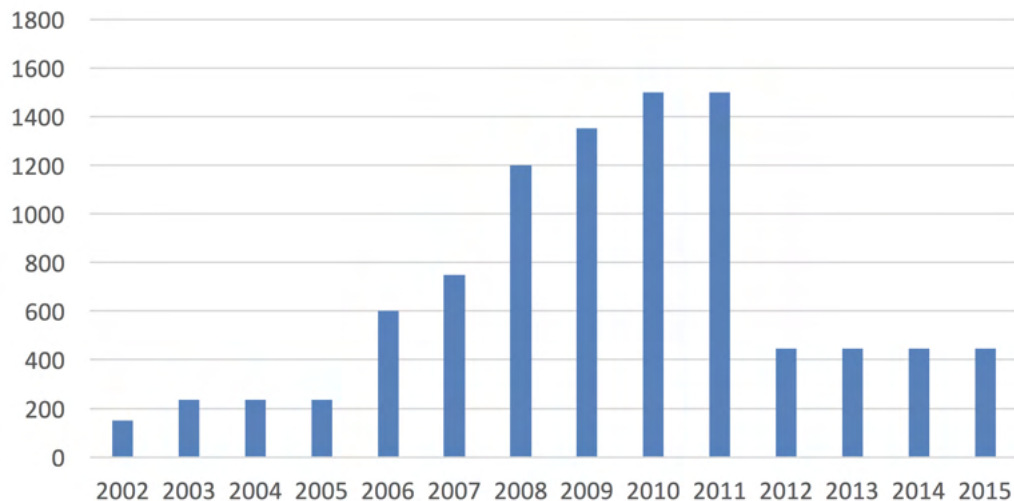
- Reductions in the upper two marginal rates (subject to the temporary reversal in the top marginal rate in

the 2014 budget). The lower two marginal rates were also cut in 2000 and later years, but these cuts were largely reversed in 2012 when the tax-free threshold was lifted, thereby negating one of the major income tax reforms associated with the introduction of the GST in 2000.

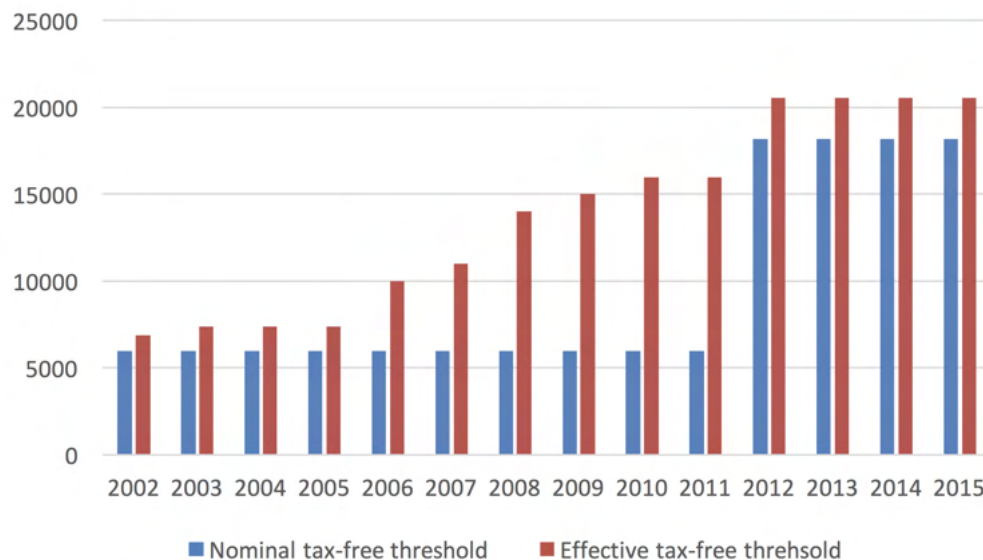
- Substantial increases in marginal rate thresholds (Figure 12). For the lowest and highest thresholds these increases were substantially in excess of inflation and growth in AWE, but for the middle thresholds the increases lagged the growth in AWE.
- A large increase in the effective tax-free threshold, initially via the low income tax offset from 2003 to 2010 and then an increase in the actual threshold from \$6,000 to its current level of \$18,200 in 2012 (Figure 13).

These changes have countered the automatic tendency for the average tax rate to increase as a result of bracket creep. However, as marginal rates and thresholds have stabilised in recent years, the effects of bracket creep have again dominated and the average tax rate has resumed its upward trend. As shown in Figure 4, in the absence of further relief through threshold and/or marginal rate changes, the average rate is set to reach and surpass historical peaks within a few years.

Figure 13: Low Income Tax Offset since 2002 (\$)



..... and the Nominal and Effective Tax-free Thresholds



Source: ATO; Budget Papers

The Fairness Question: How Is The Income Tax Burden Distributed?

'Fairness' has been the focus of much of the recent public and political discussion of desirable reforms of personal income tax. Fairness — or equity — has both horizontal (equal treatment of equal incomes) and vertical (relative treatment of different incomes) dimensions. Both are relevant to the recent debate, but more often than not it is vertical equity that people are alluding to when they observe, for example, that a disproportionately large share of the benefit of some tax concession or tax cut goes to the highest 20 per cent of income earners. Such claims are based on a presumption or value judgment — usually implicit rather than stated — that the current tax system is not sufficiently progressive or redistributive, or that the rich don't pay their 'fair share'. Likewise, it is often asserted that income tax cuts since the 1990s have favoured higher income earners and made the distribution of the tax burden less progressive.

There is a place for value judgments about distribution, and ultimately the political process will assess such judgments and balance them against other criteria. Even value judgments, however, should be based on an understanding of the facts, and the facts do not support claims that the income tax system is not progressive or has become less progressive.

Figure 14 shows the shares of total net tax paid by each 20% tranche (quintile) of the income tax paying population, from lowest to highest. Clearly, the share paid by the lowest three quintiles (60% of taxpayers) has been falling for many years, while that paid by the top quintile has been rising.

It is not just the shares of tax paid that are relevant, because they have to be compared with shares of taxable income. It is possible that the share of tax paid has become more concentrated at the top end only because the share of taxable income has become similarly concentrated (that is rising pre-tax inequality). To test whether that is the case, we need to compare the share of tax paid with the share of taxable income for each quintile. Figure 15 shows the share of net tax paid as a ratio to the share of taxable income for each quintile.³

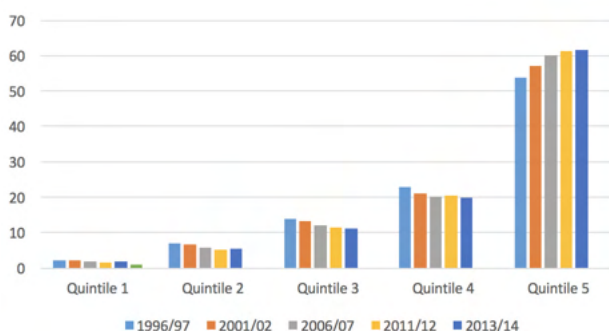
If income tax were proportional (neither 'progressive' nor 'regressive'), then each quintile would pay the same share of tax as its share of income, and the ratio would be unity. Of course this is not the case, and the ratio rises from below 0.3 for the lowest quintile consistently through the higher quintiles to above 1.3 for the highest. This is as would be expected for a progressive system. The striking feature, however, is that the ratio has been rising slightly for the fourth quintile and more noticeably for the top quintile, indicating that the income tax system has become more progressive, not less. This finding is relevant to claims often heard that the rich are not paying their 'fair share' and that the income tax scales should be re-jigged, or concessions restructured, to increase the burden on higher income taxpayers.

Another way of looking at changes in progressivity over time is to calculate the percentage tax reduction at all income levels from the stream of tax cuts implemented since the 1990s. The Treasury made these calculations in the 2007-08 budget and demonstrated that the largest percentage reductions in tax were at low incomes — an outcome that would have been reinforced by further changes since then, particularly the further increase in the effective tax-free threshold.⁴

What is relevant to judgments about redistribution is the redistributive impact of the tax and transfer payments system as a whole. This has been shown to be highly redistributive — in fact one of the most redistributive in the world. Peter Whiteford, for example, found that "Using the preferred measure of redistribution, it can be argued that Australia reduces income inequality by about as much as countries like Denmark and Sweden, usually seen as the epitome of redistributive welfare states."⁵

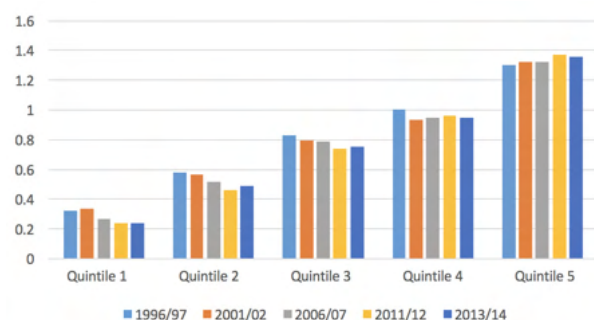
Notwithstanding these facts, people may still hold to the value judgment that income tax needs to be more progressive. The more compelling case, however, is that there is no need for changes in personal income tax to increase progressivity. Going further than that, if there are personal income tax reforms that will deliver substantial economic benefits but with the side effect of a reduction in progressivity, then distributional considerations should not stand in the way of adopting them.

Figure 14: Net Tax Paid by quintile as % of Aggregate Taxable Income



Source: ATO Taxation Statistics.

Figure 15: Ratio, Tax Paid Share to Income Share, by quintile





The Economic Case For Reform

The case for reforming personal income tax rests mainly on its harmful economic effects, the damage to incentives and the excessive dependence on it relative to other sources of tax revenue. Personal income tax reform is often viewed only as income tax cuts to boost take-home pay, but there is more to it than that. Reform provides the opportunity to increase economic growth — at least for a period if not indefinitely — through improvements to economic efficiency and productivity.

All taxes do some economic harm, but personal income tax is among the more harmful, particularly a progressive income tax. Part of the economic impact comes from the waste of resources devoted to complying with complex taxes and finding ways to avoid high taxation. The larger impact comes from the effects on people's choices with respect to work, saving and investing (including investment in unincorporated small businesses that are taxed through the personal income tax system).

The economic damage comes, for example, when income tax leads people to stay out of the work force; reduce their hours of work or reduce the intensity of work in other ways; decide not to strive for promotion; or switch to activities or occupations with significant non-pecuniary benefits. It can result when people forego opportunities to upgrade their marketable skills, devote more of their income to consumption and less to saving, or change the pattern of saving and investment purely for tax reasons. It can also occur when the nation's best and brightest choose to work abroad for pecuniary reasons or skilled immigrants are discouraged by high tax rates. Finally, it can occur when tax considerations discourage people from investing in a small business or expanding an existing one.

Not all these opportunities are available to all people, but it is sufficient that some individuals respond in some of these ways for there to be an economic cost. It is sometimes argued that the adverse economic impact of marginal rates at high incomes is less than the impact at low to middle incomes, because labour force attachment is weaker at low to middle incomes and non-work (including welfare) alternatives more relevant.⁶ However, this view overlooks the many ways in which

high marginal rates can influence economic decisions of high income earners. Also, the higher marginal rates become on high incomes, the more is the unproductive effort that goes into avoiding them, and the less revenue they actually generate. This effect comes about in part due to the gap between the top personal income tax rate and the lower company tax rate.

Attempts have been made to quantify the economic cost of personal income tax through estimation of the 'excess burden' or 'deadweight economic cost', which is the reduction in economic welfare for each dollar of revenue raised. For example, the Treasury estimates the deadweight economic cost of a flat rate labour income tax at 21%.⁷ However, as Treasury researchers themselves have pointed out, this is a substantial understatement because the actual personal income tax is not a flat rate labour income tax but a progressive tax on comprehensive income, and a progressive income tax comes with a much higher economic cost.⁸

Alex Robson reviewed deadweight cost estimates for personal income tax in the United States and found estimates of 20% to 40%. Marginal deadweight costs were higher, with some exceeding 100%.⁹ Other research links the tax burden to the level or growth rate of GDP. The Treasury recently estimated that the increase in income tax due to bracket creep from 2016-17 to 2020-21 will reduce real GDP by 0.55%.¹⁰ Other research has found dynamic links between higher tax rates and ongoing economic growth, not just a one-off hit to the level of GDP.¹¹

Another aspect of the economic cost of taxation is the complexity of the system. However, complexity is related to high marginal rates, which create pressure for selective relief, which in turn makes the system more complex. A move to lower marginal rates would facilitate simplification. Complexity also makes taxation less transparent and comprehensible to citizens and undermines democratic accountability.

Economic considerations point to the need for tax reform to focus on lowering marginal rates and, through that, preventing the projected rise in average tax rates.

Policy Options

While there is a strong case for personal income tax relief, the extent of it will depend on overall budget conditions. The source of funding for income tax cuts is beyond the scope of this paper, but clearly as a matter of arithmetic the more budget expenditure is constrained and the more revenue comes from other taxes, the greater the scope to cut personal income tax.

When policymakers assess what is achievable, they should take into account the potential dynamic revenue gain from stronger economic growth and reduced tax avoidance resulting from lower personal income tax. This gain is dynamic in the sense that it grows over time and offsets the initial (static) revenue loss from tax cuts. Unfortunately budget methodologies focus only on the static loss from tax cuts and therefore tend to overstate the negative effect on revenue in the medium to longer term.

What scale and form might personal income tax relief take? There has been much discussion of 'returning the proceeds of bracketing creep' but this merely states an objective, not how it is to be achieved. Moreover, that objective on its own should not be taken as a limit on the options to be considered.

Options For the Size Of Tax Cuts

If we assume 2017-18 to be the year tax reform is implemented, collections are currently estimated at \$214 billion and the average tax rate at 24.7%.

There have been tax cuts of all sizes since the 1970s, ranging from the 'sandwich and milkshake' cut of 2003 up to the large cut of 14% associated with the introduction of the GST in 2000.¹²

- A 'sandwich and milkshake' cut would be about \$10 per week per taxpayer on average. The cost to revenue would be about \$5 billion a year, or just 2.3% of estimated 2017-18 collections.
- Moving up the scale, a medium size cut by past standards would be about \$25 a week on average. For example, this would be the benefit of correcting for bracket creep since 2012-13 (the last year there was any change), which the CIS estimates would cut revenue by \$12.5 billion in 2017/18, or 6% of revenue, and lower the average tax rate to 23.2%.¹³ At that level, the average tax rate would still be above the long-term average.
- Reducing the average tax rate to the long-term average would cut revenue by about \$19 billion, or 9%, in 2017-18. This would be an average cut of \$36 per week per taxpayer.
- A large reduction by past standards would, for example, match the 2000 cut, at 14% of revenue. This would initially cost \$30 billion a year and lower the average tax rate below the long-term average to 21.2%. This would be an average cut per taxpayer of \$57 per week.

Large reductions would be desirable, and the economic benefits in the form of faster growth would lower the revenue cost over time. However, managing large losses of revenue in the short-term within overall budget constraints would be a challenge to government, requiring significant additional revenue from other sources and/or stronger expenditure restraint than has been evident in recent years. In this context, the CIS advocates a long-term reduction in the relative size of government (defined as total government spending at all levels of government as a proportion of GDP) to 30%, which would provide scope for overall tax reduction in addition to balancing the budget.¹⁴

Traditional Policy Options

(i) Increasing bracket thresholds

Bracket creep is a focus of recent tax policy discussion, as it has been periodically for many years. One of the most common ways for income tax cuts to be delivered in the past was through one-off increases in the thresholds at which marginal rates apply. This can correct for bracket creep over a number of years. For example, if all thresholds were increased for the growth in average earnings since the last adjustment in 2012, the increase would be about 15%. As discussed above, this would initially cost about \$12.5 billion a year if implemented from 2017-18. The government could skew the adjustment in favour of one group or another by increasing some thresholds more than others or leaving some unchanged. In current circumstances they may pay particular attention to the third (\$80,000) threshold, as adult full-time average ordinary time earnings are approaching that level and adult full-time total earnings already exceed it.

Another approach to correcting bracket creep that takes the discretion and timing away from governments is to legislate for automatic annual indexation of thresholds, similar to the automatic indexation of excise duties (although in that case the adjustments are made at six-monthly intervals). The case for automatic indexation is put more fully in Carling and Potter (2015).¹⁵

The advantage of indexation is that, once instituted, it would stop future bracket creep. It would cease to be the recurring issue it has been in Australian public policy for decades. However, prospective indexation on its own would do nothing to correct for past bracket creep or address other existing deficiencies in the personal income tax scale. It is better thought of as a reform to accompany other measures to improve the existing personal income tax structure. Indexation then preserves the improved structure in real terms until such time as there may be further discretionary changes.

Threshold adjustments, whether discretionary or automatic, are the least satisfactory form of tax cuts and would not deserve to be labelled as a 'reform', which should focus on lowering marginal rates. While increases

in thresholds reduce marginal rates for a limited number of taxpayers (those whose incomes lie between the old and increased thresholds), the schedule of marginal rates itself is not reduced. For many there is no reduction in marginal rates. Discretionary adjustments have an additional drawback in that the relief provided is only temporary as bracket creep will recur. Threshold adjustments are not a substitute for cuts in marginal rates.

(ii) Cutting marginal rates

If a choice has to be made between increases in thresholds and cuts in marginal rates, the latter are preferable because their effect is more enduring and marginal rates are a strong influence on decisions relating to work, saving and investment. Cutting marginal rates in itself does not eliminate future bracket creep, but it reduces its potency, particularly if the marginal rate scale is made flatter.

The level and degree of graduation of marginal rates depends on revenue, economic efficiency and equity considerations. The notion of a progressive scale is deeply imbedded in public policy thinking. However, the option of a single tax rate should not be dismissed. If this is applied from the first dollar of income it is a truly flat (proportional) income tax. If combined with a tax-free threshold or LITO, it remains a progressive tax, albeit less so than with a graduated scale.

Although a single rate system is hardly mentioned these days in Australia — and has not been adopted in other countries outside Russia and a few Baltic countries — it has been advocated in the past. For example, a flat rate of 30% has been discussed.¹⁶ While it would offend some notions of 'fairness', others have argued that it is objectively the fairest system.¹⁷ It would also substantially reduce the deadweight economic cost of high marginal rates. The tax/transfer system as a whole would remain redistributive because transfer payments are highly targeted to the neediest.

If the system of multiple, graduated marginal rates is to be retained, there is still scope for argument about the appropriate degree of progression. As discussed above, the existing personal income tax structure is highly progressive. There are strong economic arguments for lowering the top rate. Cutting only the top rate or even the top two rates in isolation would be politically difficult, but it is important to include the top rate in any cuts to marginal rates. In the past there has been much discussion of reducing it below 40% and this would certainly be desirable.¹⁸ In another research report I have advocated a top rate of 35%, with two lower rates of 15% and 27%.¹⁹

Marginal rates cannot be set independently of thresholds, and for revenue reasons it may be appropriate, for example, for a top marginal rate of 35% to apply from a lower level than the current top rate threshold of \$180,000.

Other Policy Options

Other reform options are too numerous to list and discuss here, but a few are worth considering, particularly in light of the current and foreseeable budgetary constraints on the scope for marginal rate reductions.

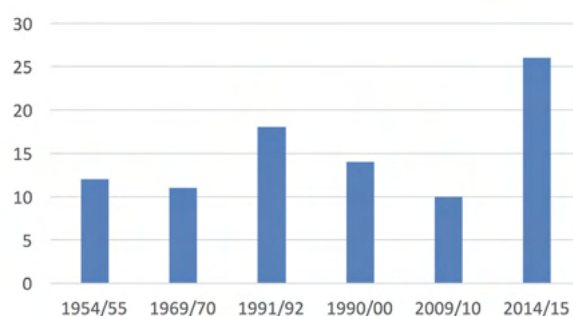
(i) Abolish the tax-free threshold and cut marginal rates

One of the focal points of tax policy in recent years has been to increase the tax-free threshold. As shown in Figure 16, by 2010 the threshold, then set at \$6,000, had declined to 10% of average male earnings, having increased little in dollar terms since the 1980s. The Henry tax review recommended a much higher tax-free threshold of \$25,000.²⁰ In the event, the government increased it to \$18,200 in 2012 as part of its compensation package for the then carbon tax. As a result, the tax-free threshold now stands at a historically high level relative to average earnings.

The thinking behind setting the tax-free threshold at a relatively high level is that it frees many welfare beneficiaries from income tax and prevents the interaction of benefit withdrawal rates (under means tests) with non-zero marginal income tax rates, which can produce very high effective marginal tax rates when the two are combined. In addition, setting the tax on low incomes at zero reduces 'churning', whereby the same people both pay income tax and receive income support payments from the government.

Another view of the tax-free threshold, however, is that it is very costly to revenue because the benefit (in lowering the average tax rate) flows to all taxpayers, not just those on low incomes whose purchasing power is most in need of the protection provided by the threshold. The loss of revenue results in marginal rates further up the income scale being higher than they otherwise would be, resulting in high deadweight economic costs. Moreover, some individuals on incomes below the tax-free threshold belong to relatively high income households or have sources of tax-exempt income, and therefore the threshold is in a sense poorly targeted. Another argument against the tax-free threshold is that it creates a section of the population with an interest in preserving and increasing benefits from government but none in minimising the income tax burden of financing such benefits.

Figure 16: Single taxpayer, tax-free threshold as % of male average earnings



Source: ATO; ABS Average Weekly Earnings

Imposing tax from the first dollar of income would generate much more revenue and enable large cuts in marginal rates. However, it would also impose much higher income tax bills on genuinely low income households that presently pay none or very little. It would require a large increase in income support payments by government, thereby exacerbating churn. For these reasons, although there are countries that tax from the first dollar, they also provide a low income tax credit that is withdrawn above a certain income level.²¹ Such a scheme has recently been proposed in Australia by KPMG.²²

Indeed, this was done in Australia during the decade from 2000. Although the tax free threshold remained at \$6,000, a low income tax offset (LITO) was also provided, and grew from \$150 in 2002 to \$1,500 in 2010, creating an effective tax-free threshold of \$16,000 (Figure 13). The LITO was withdrawn at a rate of 4% over the income range \$30,000 to \$67,500, above which the effective and actual tax-free threshold was \$6,000. When the actual tax-free threshold was increased to \$18,200 in 2012, the LITO was reduced to \$445

There are more targeted alternatives to LITO, such as a credit confined to earned (wage) income and excluding passive income. This is less costly to revenue and encourages labour force participation.

While the LITO and similar but more targeted provisions may appear to balance the advantages and disadvantages of a high tax-free threshold, the problem is that the effective marginal rate of income tax has to be higher in the income range over which the benefit of the threshold is withdrawn. The higher the tax credit to be withdrawn, the higher the incremental marginal rate needs to be to withdraw the credit over a reasonably compressed range of income. For example, withdrawing an effective tax-free threshold of \$20,000 over an income range of \$30,000–68,000 would require an incremental marginal rate of 10% over that range, which would detract from the benefit (to marginal rates) of limiting the tax-free threshold in the first place. A lower withdrawal rate would relieve the problem, but at a higher cost to revenue, which would return the pressure to marginal rates in another way.

However, the idea of a low income tax credit as an alternative to a tax-free threshold available to all is worth exploring if it can be designed in such a way as to meet revenue objectives and reduce actual and effective marginal rates.

(ii) Uniform treatment of savings income

Discussion of personal income tax generally assumes a comprehensive income tax system which, 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 then allows many departures through various forms of tax relief, which for example 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. If the suggested scale above were to be adopted within the context of a dual system, then the graduated rates of zero, 15%, 27%, 35% should apply to labour income and a flat rate of, say, 20% to capital income. It would also be desirable for corporate profits to be subject to the same tax rate as personal capital income.

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 and higher effective rates due to inflation and double taxation. Applying the same rate to all personal capital income would overcome distortions in the current treatment, which taxes different types of capital income at markedly different rates. 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 Henry tax review recommended something similar in the form of a uniform discount for personal capital income. This would create a lower but still progressive tax scale for capital income, not a flat rate.

These concepts of taxing capital income uniformly but differentiating from labour income should be seriously considered, but not as a substitute for a reduction in tax on labour income. While it is plausible that economic costs are higher for a given rate of tax on capital income than on labour income, current marginal tax rates on labour income also result in excessive deadweight economic costs.

(iii) Broaden the base and lower marginal rates

Broadening the tax base means cutting back on income tax exemptions, deductions, offsets and concessional rates. There has been much discussion recently of negative gearing, the capital gains tax discount, superannuation tax concessions and work-related expense deductions. While some people advocate curbing these provisions to raise more revenue for budget repair, the revenue could also be used to finance lower marginal tax rates. Base-broadening could also simplify the tax system and improve horizontal equity (equal treatment of people on the same incomes).

Some tax offsets have been removed in recent years, such as those for mature age workers, medical expenses and dependent spouses. However, many deductions, offsets and concessions remain. These appear to be very costly to the revenue, although the quantification of revenue effects is often very rubbery and contentious.²³ Table 1 illustrates some of the major items.

While they are often targeted for potential revenue gains, there is a sound conceptual case for many of these deductions, offsets and concessions.²⁴ 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 not taxing capital gains at full marginal rates, and for concessional taxation of superannuation and other forms of saving. Reflecting this reality, no income tax system is completely free of deductions, offsets and concessions.

A more radical approach would be to disregard the conceptual justifications, abolish all of them (except for

business deductions within unincorporated businesses) and use the additional revenue to slash marginal tax rates. This would allow a very large reduction in marginal rates or a flat tax rate of, say, 20%. The economic and simplification benefits would need to be weighed against the economic costs of doing away with the deductions and concessions, but with much lower marginal rates there would be less need for concessions.

Table 1: Personal Income Tax Deductions, Credits and Concessions, 2013–14

	Amount deducted \$ billion	Revenue foregone \$ billion (a)
Deductions:		
Rental deductions	42.5	15.3
Work-related expenses	20.8	7.5
Personal concessional super contributions	3.7	1.3
Interest and dividend deductions	2.0	0.7
Gifts and donations	2.6	0.9
Cost of managing tax affairs	2.3	0.8
Other	2.0	0.7
Offsets and credits:		
Dividend franking credits		9.8
Low income tax offset		2.1
Termination payments		1.3
Super contribution, annuity and pension offset		0.6
Senior Australians and pensioners		0.6
Selected concessions:		
Superannuation fund earnings		11.1
Employer contributions to superannuation		14.4
Capital gains discount		4.3

Sources: Tax Expenditures Statement 2015 (Australian Treasury, January 2016); Taxation Statistics 2013–14 (Australian Taxation Office, March 2016).

(a) Assuming effective marginal tax rate of 36%



Conclusion

Personal income tax is by far the largest tax and its relative size is set to increase much further and indefinitely in the absence of policy action. The overall average tax rate and average rates at many levels of taxable income will reach unprecedented levels within a few years as a result of bracket creep. The benefits of income tax cuts since 2000 will be largely reversed. The marginal rates at various multiples of average earnings will increase if thresholds are left unchanged. The top marginal rate is scheduled to come down slightly in 2017, but this will merely reverse the temporary budget repair levy imposed in 2014.

There is a strong case for reform based on the economic harm of marginal tax rates through their effects on individuals' decisions relating to work, saving, investment and small business activity. Tax reform would generate not only a one-off lift in the level of GDP but also a lift in the on-going economic growth rate through benefits to innovation and productivity growth. The case for a reduction in marginal rates applies at all income levels, but particularly above \$80,000, where the highest marginal rates apply.

Claims that high income earners are not paying their 'fair share' do not hold up under analysis. The distribution of the income tax burden is heavily skewed towards the top 20% of taxpayers, and has become more skewed since the 1990s even though there have been some cuts in high-end income tax. Distributional considerations should not be an obstacle to cuts in the upper marginal rates.

There is a range of possible policy responses, from traditional to radical. It is clear that one of the traditional responses — one-off increases in thresholds — would provide only temporary relief and would not constitute reform. Reform requires reductions in marginal rates and automatic indexation of thresholds to preserve the benefits in real terms.

The problem for the government is that any significant reform will be very costly to revenue at a time of chronic budget deficits. Even a modest reform package would reduce revenue by more than \$10 billion initially, while a package more in line with the size of the problem being addressed would cost \$20 – 30 billion, although these revenue losses would diminish once the benefits to economic growth and reduced avoidance activity have had time to build up.

Detailed identification of ways of accommodating a large reform package within responsible fiscal policy settings is beyond the scope of this report. Some offset could be found in base-broadening measures, but the scope for these is often overstated by those favouring this strategy. An option that holds more promise is to replace the entire tax-free threshold with a low income tax offset phased out over the range of middle incomes and use the additional revenue to lower and flatten the marginal rate scale. Beyond that, government expenditure curbs are an obvious option, particularly as federal spending is running at historically high levels as a proportion of GDP.

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About the Author



Robert Carling

Robert Carling is a Senior Fellow at The Centre for Independent Studies. He undertakes research into a wide range of public finance issues, writes papers for publication, and regularly comments in the media on taxation and other budget issues. He previously worked as an economist in the Australian Treasury, New South Wales Treasury and the International Monetary Fund.

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