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Taming the Monster: Reforming personal income tax

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Without any change in personal income tax rates or thresholds, 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% within five years, well above the long-term average. In addition:

- 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%.

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.

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. Reforms that make the system less progressive should be considered if there is a clear economic pay-off.

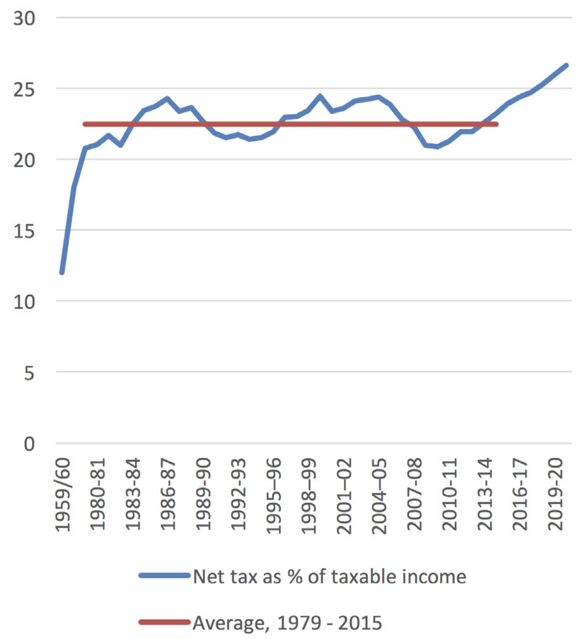
Cuts in marginal rates must be reconciled with budget repair. Even a medium size tax cut faces this dilemma. It is best resolved by more disciplined management of public expenditure.

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.

Another way to help accommodate lower 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.

The personal income tax burden is increasing

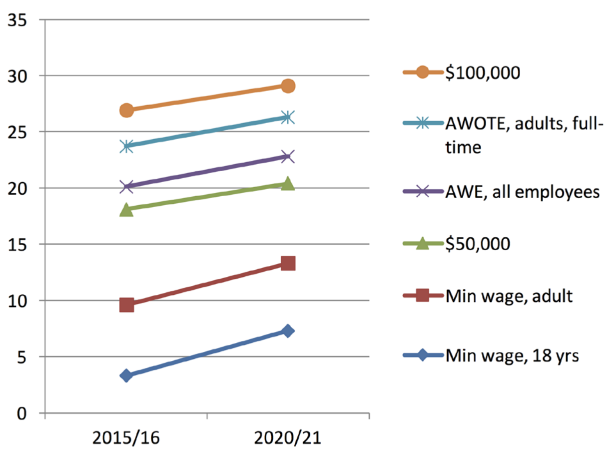
Figure 4: Personal Income Tax as % of Taxable Income



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

The aggregate average tax rate (personal income tax paid as a proportion of taxable income) has averaged 22.5% since the late 1970s. The Treasury estimates it is currently around 24% and projects it to rise to 26.6% within five years – by far the highest on record (Figure 4).

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



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

Figure 7 shows the projected increase in the average tax rate at selected income levels on the assumption that incomes grow by 4% a year. The increase is largest at lower incomes. For an adult full-time worker on the minimum wage (currently $34,160 a year), for example, the average tax rate increases from 9.6% to 13.3%. At average weekly ordinary time earnings (currently $78,000), the increase is from 23.7% to 26.3%.

Calibrating tax cuts

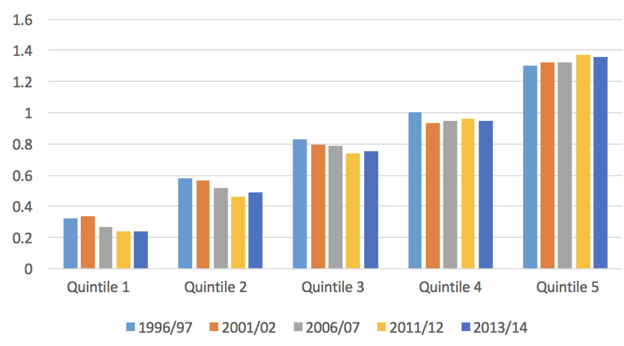
There have been tax cuts of all sizes since the 1970s, ranging from the 'sandwich and milkshake' cut of 2003 up to the large cut of 14% associated with the introduction of the GST in 2000.

- 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.
- 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. However, 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 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 that accompanied introduction of the GST. 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.

There is nothing 'fair' about making the rich pay more tax

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



Source: ATO Taxation Statistics.

The personal income tax system is highly progressive (or 'redistributive') and has become more so since the 1990s. The share of income tax paid by the top 20% of taxpayers is over 60% and has been increasing at a faster rate than their share of taxable income (Figure 15). The top 20% pay income tax at a rate of 1.35 times their share of income. The bottom 20% pay tax at less than 0.3 times their share of income. It is hard to sustain an argument that the rich are not paying their 'fair share'.

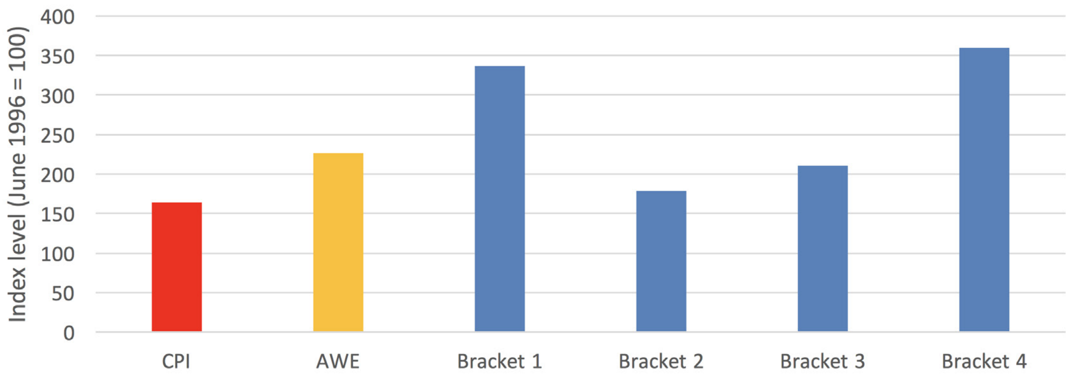
Don't fiddle with thresholds. Index thresholds and cut marginal rates

Income tax relief can be provided by increasing marginal rate thresholds or by cutting the marginal rates. Over the last 20 years there have been large increases in thresholds (Figure 12) but not much reduction in marginal rates. Increases in thresholds tend to be overtaken by growth in average incomes over time and are a band-aid rather than a reform. The benefit to taxpayers is temporary. The best solution is automatic indexation of thresholds to average weekly earnings every year. Cutting marginal rates is preferable because the effect is more enduring and marginal rates are a strong influence on peoples' decisions regarding work, saving and investment.

Key long-term targets for reform

- The long-term goal should be to reduce marginal rates, with a top marginal rate of no more than 35%.
- Thresholds should be automatically indexed to average weekly earnings every year to prevent future bracket creep.
- Consideration should be given to abolishing the tax-free threshold and replacing it with a low income tax offset to help fund cuts in marginal rates.

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



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

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