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Too Little; Too Late: Personal Income Tax Reform in Australia

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REDUCING THE BURDEN FOR FUTURE GENERATIONS

THE CENTRE FOR INDEPENDENT STUDIES

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Preface

This Policy Paper is a slightly edited version of the authors' submission to the Senate Standing Committee on Economics Legislation for the Committee's Inquiry into the Treasury Laws Amendment (Personal Income Tax Plan) Bill 2018. The submission was lodged on 24 May, 2018.

Introduction

The federal government in its 2018–19 Budget is proposing to make the following changes to the Australian personal income tax system:

- introducing a low and middle income tax offset to reduce the tax payable by low and middle income earners who are Australian residents in the 2018-19, 2019-20, 2020-21 and 2021-22 financial years;
- merging the low and middle income offset and the current low income tax offset into a new low income tax offset from the 2022-23 financial year;
- increasing various income tax rate thresholds in the 2018-19, 2022-23 and 2024-25 financial years;
- abolishing the 37% rate of income tax in 2024-25; and
- amending the Income Tax Assessment (1936 Act) Regulation 2015 and five Acts to make consequential amendments.

These proposals are best assessed against standard tax design principles as formally outlined in the government's own 2015 tax discussion paper *Re:think*[1] and the 2009 'Henry' Tax Review.[2]

A well-designed tax system will raise revenue, while balancing the core principles of adequacy, efficiency, simplicity, equity and sustainability:

- **adequacy:** the tax system must be capable of raising sufficient revenue to fund the legitimate expenditures of future governments;
- **efficiency:** economy in tax collection so as to have the lowest possible cost over and above the revenue that is raised;
- **simplicity:** the tax system should be easy to understand and simple to comply with;
- **equity:** fairness in the distribution of the tax burden; and
- **sustainability:** where this is the ability to meet the changing revenue needs of governments, with consistency across tax laws and treatments and a reasonable degree of stability and predictability for taxpayers.

Adequacy

The most basic requirement for any tax system is to raise enough revenues to fund the legitimate expenditure requirements of governments. Since the Global Financial Crisis, tax adequacy has become an increasing concern because of ill disciplined government spending.

Between 2007-08 and 2017-18, federal government expenditures have grown from $271.8 billion to $459.9 billion. This expenditure growth has far outstripped inflation, illustrated by the fact that, as a percentage of Australia's GDP, the federal government's expenditures have risen from 23.1% in 2007-08 to 25.1% in 2017-18 and are expected to remain around that level.[3]

Increases in tax revenues over the same period have lagged expenditure growth, resulting in a decade of budget deficits. However, recent expenditure discipline by the government and surging tax revenues, as bracket creep and an improving economy fill the government's coffers, mean that the budget is on track to be in balance in 2019-20 and then record small surpluses.

If the Treasury's current revenue projections are realised, and in the absence of the proposed tax cuts, the federal government's total revenues as a percentage of GDP will soon rise above 26.1%, which was the 40-year high for government revenues recorded during the final boom year of 1986-87, before the 1987 stock market crash.

The recent profligacy by governments of all political persuasions has led to the amassing of $350 billion in net debt that must ultimately be repaid. Sustained expenditure restraint, rather than an increased tax burden, should be the mechanism ensuring the government builds regular surpluses to repay this debt.

Many of the cost drivers pushing government expenditures ever higher are a simple repackaging of the average taxpayer's own income, repaid as a government service less wasteful government administration costs. In a host of situations — from child care to health care to education — it is more cost effective, fair and efficient for taxes to be lower and allow citizens to pay for these services from their own pockets rather than to use government command and control to confiscate citizens' incomes.

In this light, the proposed changes to the personal income system are not excessive and are not even a true tax cut. Even with the proposed 'tax cuts' for next year, personal income tax receipts are expected to increase by 6% in 2018-19, another 5% in 2019-20 and then 7% in both 2020-21 and 2021-22, which are growth rates well above the expected inflation rate of around 2.5% or even the average increase in nominal GDP (4.4%).

The situation becomes worse when taking into account the expected rise in total federal government revenues from $445 billion in 2017/18 to $554 billion in 2021/22. This $109 billion tax increase represents an increase in taxes and fees of around 5.6% a year, resulting in an increase in revenue as a proportion of GDP from 24.3% to 25.5%.

Much has been made of the claim that the proposed personal income tax cuts will 'cost' $140 billion in revenue over 10 years. Leaving aside the questionable accuracy of this figure, this 10-year aggregate (and other figures cited in tax policy debates) is being used as a rhetorical device to dramatise a relatively modest policy proposal. To put $140 billion into perspective, federal revenue over the next 10 years can be expected to total some $6,000 billion.

The government's proposal to cap total taxation receipts at 23.9% of GDP is welcomed, but the cap is higher than the current total tax take (22.7%), so represents only a very loose restriction on revenue raising. Taking an historical perspective, the tax take has exceeded the proposed 23.9% cap only on five occasions during the boom conditions for federal revenue in the first decade of the 2000s, and then only slightly. It is also doubtful that this legislated cap would have any meaningful effect on the revenue raising ability of future governments, as it is very difficult to credibly restrict the actions of future parliaments.

The proposed tax cuts do not undermine the ability of the government to meet its legitimate future expenditure needs and will do no more than ensure the federal tax take remains within historical peaks.

Efficiency

Tax revenues should be raised in a way that is least detrimental to economic growth and that supports a diverse economic structure. The more a particular tax has the unintended effect of altering people's behaviours, the more economically destructive it tends to be.

The imposition of personal income tax has many unintended, harmful economic consequences, including:

- **Reduced incentives to work**. The higher the income tax rate, the less benefit individuals receive from an additional hour of work.
- **A reallocation of resources between different economic activities.** Differences in tax rates, tax payment timing and ability to hide taxable incomes means that the relative benefits of investing in different economic activities changes as tax rates change.
- **Reduced incentive to save.** High rates of tax on interest income and capital gains discourage productive investment, reducing the potential for future economic growth and overall prosperity.
- **Increased resources used to avoid taxation.** The higher the income tax rate, the more incentive a taxpayer has to hire accountants and lawyers to find ways of reducing the total amount of income tax paid. Higher tax rates also encourage the development of black markets where income taxes are almost completely evaded. These activities move resources away from more socially beneficial economic activities.
- **Increased administration and compliance costs.** The more complex and onerous a personal income tax system is, the more economic resources are wastefully used to administer and comply with the tax system.

If fully implemented, the government's proposed personal income tax changes will unambiguously improve the efficiency of the Australian tax system. The proposed changes will reduce both the average and marginal tax rates of many (though by no means all) taxpayers, thereby increasing incentive to work, save and invest and reducing the incentive to undertake tax avoidance activities.

The best indicator of how personal income tax affects peoples' decisions is the marginal rate of tax — as this is the rate that determines how much extra tax an individual pays as a result of earning an extra dollar of income. For that reason, ***the government's proposed elimination of the 37% bracket and decision not to raise the Medicare levy (which represents an addition to all marginal rates) are welcome initiatives***.

According to many economic studies on the impacts of personal income taxes, including a recent OECD paper[4] surveying recent income tax reforms in the developed world, lowering marginal tax rates on low and high income earners provides the greatest gains in economic growth. The government's commitment to lower the tax rates of low income earners by raising the 19% and 32.5% tax rate thresholds is therefore particularly economically beneficial.

However, while the government's proposal enhances economic efficiency relative to the status quo, it does not address the long term problem of bracket creep. Progressivity in the personal income tax system is delivered by applying higher marginal rates of tax at different income thresholds. These thresholds do not automatically keep pace with inflation or wages growth. Bracket creep (also called fiscal drag) refers to the fact that taxpayers will face higher average, and sometimes marginal, tax rates over time even if their income has only increased by inflation.[5]

The failure to solve for bracket creep means that every year workers' average and marginal tax rates tend to increase, reducing the incentives to work and thereby reducing economic growth. Bracket creep also allows governments to raise revenues largely unbeknown to taxpayers and is one of the major reasons that tax revenues as a percentage of GDP continues to rise each year. The process by which governments increase total tax revenues should require transparency and parliamentary approval.

The problem of bracket creep is easily solved: index tax rate thresholds in line with the inflation rate or (preferably) the growth in average weekly earnings. Automatic indexation of tax thresholds would eliminate bracket creep, take the discretion away from government and prevent the tax burden from increasing automatically just because of inflation.

At current and projected rates of inflation, the revenue cost of indexation would be $2-3 billion per year cumulating. The annual saving to taxpayers compared to an unindexed tax scale would be small but cumulatively substantial after several years of indexation.

The government's current tax proposal should be enhanced by formally indexing income tax thresholds once the proposed discretionary

increases in thresholds are fully implemented. As proposed by the government, this would be 2024-25, but an earlier implementation would be highly desirable and more credible.

Another issue not addressed by the government's current tax reform proposal is the deleterious impact of the top marginal tax rate of 45% and the fact that an increasing proportion of taxpayers is subject to this punitive tax rate.

Over the last decade, the failure to increase the top tax threshold caused the 45% tax threshold to fall from being 3 times average weekly earnings (AWE) to around 2.2 times AWE. Even after the government's proposed income tax changes in 2024-25, the top tax rate threshold of $200,000 will only be around 1.9 times AWE (assuming moderate wage growth) and the proposed new threshold represents an increase of only 10% since the last increase in 2008, well below the rate of inflation or the increase in average incomes.

Greater global economic integration means that investment and highly skilled workers have become more mobile. Australia's top personal income tax rates are significantly higher than regional competitors such as Singapore and Hong Kong. Failure to address this competitive disadvantage will increase the already significant number of highly skilled Australians working overseas, undermining the government's ability to raise tax revenues.

Consistent with studies on the economic impact of high personal income taxes, ***the government's tax reform proposal would be improved by either increasing the 45% tax rate threshold by significantly more than the government is proposing and/or reducing the top marginal rate from 45%.*** Past CIS research has advocated a top marginal rate of 35%, comparable with the current company tax rate and with top marginal rates in the less heavily taxed countries.[6] As an initial step in this direction, the top marginal rate should be cut to no higher than 40%.

Funding this change would require more expenditure cuts which could be focused on government services or tax expenditures growing significantly faster than inflation.

Simplicity and Transparency

The income tax system should be coherent and reflect a greater emphasis on simplicity and transparency than is presently evident.

Once fully implemented, the government's reform proposal does not materially improve the simplicity or transparency of the income tax system. However, changes to the Low Income Tax Offset (LITO) and the introduction of the Low and Middle Income Tax Offset will increase the complexity of the income tax system in the short run.

While these measures enable the government to more accurately target tax cuts to low and middle income workers, they also increase the effective marginal tax rates faced by workers as the benefits of these offsets are reduced as a worker's income increases. Higher effective marginal tax rates flowing from these offsets reduces the incentives for middle and low income taxpayers to work.

Currently the LITO is withdrawn at taxable incomes above $37,000 at a rate of 1.5%. This represents an addition to the effective marginal rate up to $66,667. Under the government's proposal, there will be a new withdrawal range of $90,000-$125,333 subject to a 1.5% addition to the effective marginal rate until 2021-22 and then a new withdrawal range of $37,000-$41,000 subject to a 6.5% addition to the effective marginal rate. The latter will effectively negate half the marginal rate reduction from lifting the $37,000 threshold to $41,000 on 1 July 2022. Too little attention is paid to these implications of targeted tax offsets for effective marginal rates.

Equity

If a government wishes to address income inequality, the most effective and efficient means available are via progressive personal income taxation and a means tested transfer system. The majority of the redistribution measures undertaken by the federal government are facilitated by the income tax and transfer system.

According to the Henry Tax Review, the tax and transfer system should treat individuals with similar economic capacity in the same way, while those with greater capacity should bear a greater net burden, or benefit less in the case of net transfers. This burden should change more than in proportion to the change in capacity. That is, the overall system should be progressive.

The government's proposed income tax changes largely maintain the current level of progressivity in the Australian tax system in the short run. A number of think tanks and media commentators have argued that the proposed income tax cuts are 'unfair' as up to 60% of the tax cuts flow through to the top 20% of income earners.

In fact, the proposed income tax changes will actually slightly increase the proportion of total income tax paid by the top 20% of adult income earners as, according to Deloitte Access Economics, this group currently pays over 79% of total income taxes and by 2024-25 this group will pay 81.3% of total income taxes. Simply put, the Australian income tax system is already highly progressive and high income earners pay the vast majority of income tax. [7]

Also, eliminating the 37% tax threshold and the failure to index the income tax thresholds means that in the years after 2024-25, Australia's income tax system is actually going to become even more progressive; and an even higher proportion of the total tax take will fall on the top 20% of adult income earners. The increasing progressivity of the system is driven by the fact that for every extra dollar high-income earners make, they will face the top marginal rate of 45% while income earners in lower brackets will have their taxes increased by lower rates. The failure to index thresholds results in an ever-increasing proportion of the taxpayer population facing the top marginal rate. In 2008-09 that proportion was 2%. Currently it is 5%, and according to the budget papers will rise further to 6% even after the proposed modest increase in the top rate threshold to $200,000.

Sustainability

The design and governance of the tax system should ensure that the benefits of reform are enduring.

Achieving sustainability may be the most difficult outcome for the Government's proposed personal income tax package. The most significant part of the proposed tax cuts, the abolition of the 37% tax threshold, will not come into effect until 1 July 2024, which is at least two election cycles away.

Without bipartisan support from Australia's major political parties, it is difficult for taxpayers to believe the proposed abolition of the 37% tax threshold is a credible tax cut. If taxpayers do not believe that the tax cuts are credible, they will be unlikely to make new investment plans today taking into account the benefits of a future with lower taxes. This lack of credibility reduces the potential economic benefits of the tax package in the medium term.

Credibility would be enhanced by an earlier introduction, such as full implementation within the life of the next parliament and within the four-year forward estimates horizon for the 2018-19 Budget. This would imply full implementation by 1 July 2021 rather than 2024.

Secondly, the increasing progressivity of Australia's tax system is having perverse outcomes; encouraging expansive, unsustainable expenditure. The more that a small minority of citizens pay the vast majority of taxes, the greater the incentives for politicians to introduce redistributive expenditure programs that benefit an increasing number of net welfare recipients.

To highlight this issue, analysis by economists across the political divide from Deloitte Access Economics, the Grattan Institute and the Australian National University, all using different data sets, show that at least the bottom 40% and some of the middle quintile of households, tax filers and/or adults pay virtually no net income tax.[8]

While, in the short run, this redistribution from the high income earners benefits the majority of voters, over the long run, extractive democratic regimes lead to reductions in economic growth and capital flight. If a small minority begin to believe they are being unfairly overtaxed, these highly mobile, in demand workers will act. Consequently, Australia could lose valuable highly skilled workers, face a declining tax face a declining tax base and permanently lower economic growth.

Conclusion

The main thrust of the Government's proposed personal income tax changes is welcome, but they could be improved to better promote economic efficiency. Also, implementation should be brought forward, with the earlier revenue losses offset by tighter expenditure management.

The proposal can be assessed against standard tax design principles, with the following conclusions:

- **Tax adequacy:** the proposal does not undermine the ability of the government to meet its legitimate future expenditure needs and will ensure that the federal tax take remains below previous peaks.
- **Efficiency:** if fully implemented, the government's proposed personal income tax changes will unambiguously improve the efficiency of the Australian tax system and should lead to improved economic growth outcomes. However, much more could — and should — be done through personal income tax reform to advance economic efficiency.
- **Simplicity and Transparency:** if fully implemented, the government's reform proposal does not materially change the simplicity or transparency of the income tax system. Rather, the greater use of low and middle income tax offsets will complicate the system and add to effective marginal rates up the scale.
- **Equity:** the government's proposal largely maintains the current level of progressivity in the Australian tax system in the short run. However, over the longer term, the proportion of taxes paid by the top 20% of adult income earners will continue to rise.

achieving sustainability may be the most difficult outcome for the government's proposed personal income tax package. Without bipartisan support from Australia's major political parties, it is difficult for taxpayers to believe the proposed abolition of the 37% tax threshold is a credible tax cut, given it will not be implemented until 1 July 2024. Also, failure to address the increasing progressivity of Australia's income tax system erodes our democratic institutions and increases the threat of skilled labour flight to regional competitors such as Singapore and Hong Kong.

Due, in part, to concerns about the long-term sustainability of Australia's tax and transfer system, the government's proposal should be enhanced by implementing the following measures:

- Formally indexing income tax thresholds once the planned discretionary increases in thresholds are implemented.
- Significantly increasing the 45% tax rate threshold beyond the level proposed by the government and/or reducing the top marginal rate from 45%.
- Bringing forward the planned elimination of the 37% rate to a more credible date — say, within the life of the next parliament and within the current forward estimates period.

These enhancements of the government's plan should be at least partially funded by expenditure cuts, particularly to open ended expenditure programs which are indexed to grow faster than inflation.

Indexing the income tax thresholds would reduce the impact of bracket creep, a phenomenon that allows government revenues to grow at a rate faster than inflation without the advent of new tax laws. The process for governments to increase total tax revenues should be made transparent and require parliamentary approval. Bracket creep allows governments to raise revenues largely unbeknown to taxpayers, and undermines the democratic process.

The increasing progressivity of Australia's tax system is having perverse outcomes; encouraging expansive, unsustainable expenditure programs. The more that a small minority of citizens pay the vast majority of taxes, the greater the incentives for politicians to introduce redistributive expenditure programs that benefit an increasing number of net welfare recipients.

While, in the short run, this redistribution from the high income earners benefits the majority of voters; over the long run, extractive democratic regimes lead to reductions in economic growth and capital flight. If a small minority begin to believe they are being unfairly overtaxed, these highly mobile, in-demand workers will respond. Under these circumstances, Australia could lose valuable highly skilled workers, face a declining tax base and permanently lower economic growth.

Endnotes

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Robert Carling is a Senior Fellow at The Centre for Independent Studies, an independent public policy research and educational institute based in Sydney. 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. His most recent publication under the CIS banner was Cutting Income Tax: Can we add the bacon to 'hamburger and milkshake' cuts? published in April 2018. Before joining the CIS, he was a senior official with the New South Wales Treasury, and prior to that, with the Commonwealth Treasury.

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Matthew has worked in numerous parts of the finance industry with a particular emphasis on infrastructure investment. He has sourced, undertaken commercial due-diligence and managed an array of infrastructure assets in a diverse number of industries including the aviation, transport and the utilities sectors. He has managed various investment teams in Australia and overseas and also has extensive experience in managing fixed income and listed equity portfolios and managing exotic financial instruments such as Collateralized Debt Obligations and financial derivatives.

He has also worked for the Commonwealth Treasury and the Commonwealth Department of Finance and Administration and has researched and provided advice to governments on tax, fiscal, investment and regulation policy.

Related works

Robert Carling, Cutting Income Tax: Can we add the bacon to 'hamburger and milkshake' cuts? CIS Policy Paper No 1, April 2018.

Robert Carling, Taming the Monster: Reforming the personal income tax, CIS Research Report 12, April 2016.

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