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REFORM OF THE PERSONAL INCOME TAX SYSTEM IN AUSTRALIA

by

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This paper examines the case for reform of Australia's Personal Income Tax (PIT), argues that it is outdated, and demonstrates a growing consensus for reform. The importance of tax avoidance, particularly the use of trusts, in the Australian PIT system, and arguably its abrogation of modern-day criteria of what constitutes a 'good tax', is emphasised. Three possible 'reform' options are identified: the 'tinkering and tokenism' approach of current Government policy; moderate reform and a proposed 'significant reform option' costing around \$22 billion. Essentially this comprises company and top PIT rate equalisation and a doubling of the tax-free threshold. But funding this is problematical. Two key arguments of the paper are that: (real) simplification i.e. lower compliance costs, is an important yet usually down-played objective in reform proposals; savings from reform denying PIT deductions such as work expenses are insufficient to achieve significant PIT reform. An increase in the rate of the Goods and Services Tax (GST) from 10% to 15% (with a compensation package) is therefore advocated in a revenue-neutral analysis ignoring current Government budget surpluses. The overall outcome would be a simplified, more equitable and incentive-driven PIT system that would move Australia closer to the PIT and GST policies of other OECD countries. But the political difficulties of reform mean that the Government's 'tinkering' approach is likely to continue.

Key Words: Personal Income Tax, Tax Reform, Tax Simplification

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1 Introduction

The Australian Personal Income Tax (PIT) system is an outdated relic of the post-war period up until the 1980s. Many other OECD countries have reformed their PIT by reducing the number of tax rates and reducing or eliminating high marginal tax rates (Sandford, 2000, pp. 51–52 and 158–160). Most OECD countries have higher income

* Tax Policy Research Unit, School of Economics and Finance, Curtin University. Thanks to Prafula Fernandez and Ian Kerr for their advice on an earlier draft of this paper, and particular thanks to an anonymous referee for insightful and helpful comments. Note that this paper cites the relevant published data in specific year dollars and source; data are not expressed on a common year price basis. This paper was written prior to the Commonwealth Government 2005-06 Budget (www.budget.gov.au/2005-06) that made a small step in the right direction.

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thresholds than Australia (Warren, 2004a, pp. 121–122). In short, Australia's PIT is outdated. There appears to be a growing consensus holding this view and favouring PIT reform.

From primarily an economic perspective, the equity of Australia's PIT is a myth. Whilst the Pay-As-You-Earn (PAYE), now known as and part of the wider Pay-As-You-Go (PAYG) withholding tax system, is progressive and reasonably equitable, the PIT as a whole is inequitable, and its equity is a myth that politicians and other sections of society perpetuate because of their vested interests. The (Australian) PIT is divided into two separate groups or 'nations',¹ basically those taxpayers that are part of PAYG i.e. individual wage and salary earners, and those taxpayers that use trusts, partnerships and/or companies in a complex web of tax returns by the whole family in order to minimise their overall tax liability (i.e. tax avoidance²). As is well known, the PIT is affected by bracket creep (inflation pushing taxpayers into a higher marginal rate tax bracket or increasing the average rate of PIT within a bracket³) that the Government (of whatever political persuasion) exploits to its advantage.

From a political perspective, PIT payers are unorganised and do not have an effective lobby group. Yet, at the 2001 election, 86% of voters considered tax policy as very important (Davidson, 2004, p. 3). The millions of unorganised PIT payers may be contrasted with the powerful lobby groups of business e.g. Business Council of Australia, Australian Chamber of Commerce and Industry, the professions e.g. Australian Medical Association, agriculture e.g. National Farmers' Federation, and social and welfare e.g. Australian Council of Social Service (ACOSS). Moreover, politicians, certainly over the past twenty years or so, gear their tax policies to the median voter and thus favour middle-income taxpayers, to the neglect of lower and upper income taxpayers. But most importantly PIT reform is politically 'just too hard'.

The complex Australian PIT system is characterised by a significant tax avoidance industry that may be estimated through tax compliance costs. The latter, when added to the ATO's administrative costs, gives the operating costs of the PIT system. The high marginal PIT rates give rise to three main negative economic effects: work disincentives; distortion effects within the economy, in terms of individual and business decision-making and also the interaction of the tax and welfare systems; and loss of productive Australian skilled and professional workers offshore.⁴

These major factors largely explain why Australia's PIT is outdated and in need of urgent and significant reform.

This paper has four main objectives regarding PIT reform: to analyse relevant key data and the rationale for reform; to review the magnitude of the Government's main options; to develop a significant proposal that builds upon a fundamental principle on which there is a growing consensus (30% top PIT rate) but that includes two possibly contentious propositions (increasing the tax-free threshold and abolishing Capital Gains

¹ As far as this author is aware, the term 'two nations' was first referred to in Covick (2004, explained in pp. 257–259). This provides an apt description of the situation, discussed briefly later in this paper.

² Tax avoidance can be costly and may have consequences under Part IVA of the *Income Tax Assessment Act*, 1936. Tax evasion is illegal.

³ Most of the revenue the government gains from bracket creep comes from the devaluation of the benefits of the infra-marginal rate taxed segments of taxpayers' incomes rather than change of marginal rate effects, although the latter do impact heavily on incentives for those affected.

⁴ Such issues are not the focus of the present paper.

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Tax concessions); and to outline the major benefits and revenue costs of this proposal. The paper is written from a 'first principles' tax policy approach that does not pander to the majority and (some may say) the political realities of the day. It recognises the important distributional issues involved in PIT reform but leaves that debate aside for further work.

2 Key Data and Analysis

The PIT rates⁵ for 2004–2005 and the Government's changes in income thresholds for 2005–2006 are shown in Table 1.

TABLE 1
CURRENT AND FORTHCOMING PIT RATES WITHOUT REFORM

Current		Government Forthcoming	
Taxable income range in \$	Tax rate in %	Taxable income range in \$	Tax rate in %
2004–2005	2004–2005	2005–2006	2005–2006
0–6,000	0	0–6,000	0
6,001–21,600	17	6,001–21,600	17
21,601–58,000	30	21,601–63,000	30
58,001–70,000	42	63,001–80,000	42
70,001 or more	47	80,001 or more	47

Source: ACCI (2004, p. 21).

Note: The Medicare Levy of 1.5% applies to most taxpayers with taxable incomes of \$15,717 or more in 2004–2005. Most taxpayers regard the Medicare Levy as a tax and therefore legitimately added to their marginal tax rate. For example, the top rate of tax becomes 48.5%.

Using earlier data for 2001–2002 (*Taxation Statistics, 2001–2002*, (2004, pp. 10 and 16–21), the latest year published ATO statistics are available) shows that:

- 10.3 million personal taxpayers lodged returns⁶
- personal taxpayers had total income of \$359 billion, taxable income of \$342 billion and paid \$80 billion in net tax
- 8.3 million personal taxpayers claimed \$19.7 billion in total deductions⁷, including \$9.6 billion in work-related expenses⁸ (and 800,000 taxpayers claimed \$42 billion in business expenses⁹)
- around 7 million personal taxpayers were entitled to tax offsets and credits¹⁰ worth nearly \$9 billion.¹¹

⁵ The Medicare Levy of 1.5% that applies to most taxpayers is disregarded in the rest of this paper for simplicity (other than appropriate Table notes).

⁶ It is worth emphasising that the ATO publication *Taxation Statistics* uses the term 'taxpayer' to mean different things in different tables, and care should be exercised when using this data source.

⁷ Personal taxpayer allowable deductions are deducted from assessable (or total) income for expenses deemed worthy by the Government, e.g. work-related (p. 17).

⁸ Work related expenses are 49% of total deductions. Other deductions included prior year losses (\$3.1 billion, or 16%), gifts \$868 million (4%) and, interestingly, cost of managing tax affairs \$933 million (4%) (Table 3.2, p. 17).

⁹ The issue of business expenses is not considered here.

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Overall, the average PIT rate is 23%,¹² a surprisingly relatively low figure, given the highest marginal rate of 47%.

Six important overall characteristics of the Australian Commonwealth tax system and PIT in particular are:

1. The over-dependency of overall Commonwealth tax revenue upon PIT. For example, in 2001–2002 49.2% of all Commonwealth Government tax revenue came from PIT; PIT accounted for 73% of Federal Government income tax revenue in 2001–2002 (Warren, 2004a, pp. 36–37).
2. The impact of the top marginal tax rate at just above average income levels. For example, in 2002 this was only 1.1 times greater than GDP per capita¹³ (Davidson, 2004, p. 2); it cuts in at 1.3 Average Weekly Ordinary Time Earnings (AWOTE)¹⁴ (CPA Australia, 2004, p. 18).
3. The better-off contribute a relatively high, and arguably an unduly high, proportion of PIT. The bottom 37% of taxpayers¹⁵ account for only 3% of tax revenue; the middle 45% of taxpayers account for 38% of tax revenue; the top 18% of taxpayers account for 59% of tax revenue (estimated from *Taxation Statistics, 2001/02*, Table 3.1, p. 16 and Table 3.10, p. 24).
4. Whilst all PIT threshold levels have been affected by bracket creep, the impact upon the tax-free threshold has been particularly significant, a point sometimes disregarded by some. If the 1978–1979 tax-free threshold had been raised in line with inflation i.e. in real terms, it would have been \$13,549 in July 2003 and not \$6,000 i.e. 126% higher¹⁶ (Warren, 2004a, p. 106).
5. Tax arbitrage is very significant. Whilst 20% of full-time wage and salary earners had gross incomes greater than the top marginal tax rate threshold, only 9% paid tax at this top rate in 2002 (CPA Australia, 2004, pp. 17–18¹⁷).
6. The (net) tax compliance costs of PIT are relatively high—around two-thirds higher than those of the UK¹⁸—and estimated at \$1.5 billion in 1994–1995,

¹⁰ Tax offsets (formerly known as rebates) “provide tax relief for certain personal taxpayers”: e.g. low income earners, pensioners, and reduce the amount of tax payable on taxable income. Essentially they are determined by the Government’s social security policy and are based on taxable income and other factors. Tax credits are for tax already paid by the taxpayer or a trustee on his or her behalf (p. 20).

¹¹ These include, for example, imputation credits (47% of total), termination payments (16%), senior Australians tax offset (12%) (Table 3.6, p. 21).

¹² \$80 billion divided by \$342 billion (*ibid.*). It would be interesting to investigate how many PIT taxpayers would accept a simple, no deduction and no offset flat rate of 23%!

¹³ For comparison, Canada was 2.19, Japan 5.32, Singapore 9.53, UK 1.69 and USA 8.46.

¹⁴ It cut in at three times AWOTE in 1980.

¹⁵ A taxpayer is defined as someone who submits a PIT return, thus including 1.9 million taxpayers (18%) who pay zero PIT out of a total of 10.3 million PIT payers.

¹⁶ In the UK for 2003–2004 the tax-free threshold was 4,615 pounds (www.inlandrevenue.gov.uk/rates), or A\$11,538 at a typical exchange rate of one pound = 2.5 Australian dollars. Note that the UK figure for 30 June 2001 given by Warren (2004, p. 121) has omitted the tax-free threshold or zero rate. For further comparison, in countries where tax-free thresholds exist, the rates converted to A\$ as at 30 June 2001 were: France A\$6,759; Canada (Federal) A\$9,647; Singapore A\$8,117 (selected examples only; Warren, 2004a, pp. 121–122).

¹⁷ Citing data from Reserve Bank of Australia (2003), Productivity Commission Inquiry on First Home Ownership (2003) and Hansard (2003), Question No. 1638, p. 18169, 12 August. This statistic (that 55% of ‘top rate’ tax-payers use tax avoidance) is one of the most compelling reasons in favour of PIT reform.

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accounting for 4% of PIT net revenue in 1994–1995, and for 0.34% of GDP in 1994–1995 (ATO, 1997,¹⁹ pp. 27–28). High income earners accounted for \$255 million (16%), medium income earners for \$802 million (52%) and low-income earners for \$477 million (31%) (*ibid.* p. 26). Personal income taxpayers in 1994–1995 spent \$310 million on fees to professional advisers *after tax deductions* (20%) and \$873 million in time costs (57%) (*ibid.*)

In 2004–2005 PIT is forecast to raise around \$102 billion (Warren, 2004a, p. 127).

Any reform of PIT needs to be viewed in the context of other relevant rates, for 2004–2005 as follows:

- Company tax 30%
- Capital Gains Tax (CGT)²⁰ for highest rate income taxpayer:
 - 47% if assets held for less than one year
 - 23.5% if assets held for one year or more
- GST 10%

Personal income tax in the OECD countries in 2001 accounted for 26.5% of *all* Government tax revenue in 2001–2002 (Warren, 2004a, p. 53), significantly lower than the Australian figure of just over 40% (Davidson, 2004,²¹ p. 1). By comparison, the rate of GST in OECD countries in 2001 averaged 18.5% compared with Australia's rate of 10% (Warren, 2004a, p. 53). Australian GST is growing strongly: it raised net revenue of \$30.7 billion in 2002–2003 (*Taxation Statistics, 2001–2002*, p. 153), \$33.2 billion in 2003–2004 (AFR, 2004, p. 4), and is likely to raise over \$34 billion in 2004–2005.

Before proceeding further it is important to recognise and emphasise the myth of Australian PIT, namely that PIT *overall* is progressive and equitable. It is progressive and reasonably equitable for PAYG taxpayers but not overall once other entities are included. Trusts²² and partnerships pay no tax, but are entities that distribute income to other entities i.e. individuals and companies, to which normal rates apply. Further, the unit of taxation for trust income is the *family* rather than that of the *individual*, the current basis for all PAYG taxpayers²³ (see Covick, 2004; Sandford, 2000, pp. 54–61; Head and Kreyer, 1996; and Dwyer, 2004, for discussion of this critical issue).

Arguments against Australia's PIT being equitable and progressive include:

- Use of trusts for business and investment income and ensuing tax avoidance is inequitable (both vertically and particularly horizontally)

¹⁸ 65% higher than UK expressed on a social compliance cost of GDP basis when sole traders are included (Australia: 0.63%; UK: 0.38%) (ATO, 1997, p. 65). The breakdown of the Australian figure is: 0.34% for personal taxpayers (*ibid.*, p. 28) and thus 0.29% for sole traders.

¹⁹ This major study has yet to be updated.

²⁰ CGT is the tax payable on any 'net capital gain' included with any other assessable income on an entity's (individual, company, trust or fund) tax return. In 1999 the Government introduced a 50% CGT concession for personal income taxpayers holding assets for one year or more.

²¹ Citing ABS (2002) *Taxation Revenue* Cat.5506.0 data. Davidson's figure thus includes Federal, State, and Local taxation. As noted earlier, PIT accounts for 49.2% of Commonwealth tax revenue.

²² The main type of trust in Australia is the *discretionary trust*. Trusts may be non-testamentary or testamentary, the latter, arising as part of a will, generally being more beneficial from a tax avoidance perspective (Covick, 2004, pp. 259–263).

²³ Ironically, some parts of the PIT system and especially the welfare system require family income not just an individual's income, thereby increasing administrative and particularly compliance costs.

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- Average business income of trusts is relatively very low, at \$380,921 in 2001–2002 (derived from *Taxation Statistics, 2001–2002*, p. 90)
- 58% of trusts have a loss or nil business income in 2001–2002, and a further 39% ('micro trusts') have business income of up to \$2 million in 2001–2002 (*Taxation Statistics, 2001–2002*, p. 94)
- Only 4% have business income of \$2 million *per annum* or greater
- Trusts reported \$174 billion in business income in 2001–2002, with \$160 billion in expenses (or 91% of income) (*Taxation Statistics, 2001–2002*, p. 90)
- Gross tax compliance costs of small trusts were roughly double that of other business entities (\$65.44 per \$1,000 of turnover compared with an average of \$34.13²⁴) in 1994–1995 (ATO, 1997, p. 79)
- Net tax compliance costs of small trusts (i.e. after tax deductions) were roughly double that of other business entities (\$55.34 per \$1,000 of turnover compared with an average of \$26.96²⁵) in 1994–1995 (ATO, 1997, p. 80)

Taxpayers that are part of the PAYG system (or 'nation') have lower tax compliance costs on average than taxpayers using trusts (the 'other nation').²⁶ Business net compliance costs (estimated at \$4.6 billion in 1994–1995) accounted for 9.4% of net business tax revenue in 1994–1995 and 1.02% of GDP in 1994–1995 (ATO, 1997, p. 53), compared with PIT (net) tax compliance costs of 4% of net revenue and for 0.34% of GDP in 1994–1995, as noted earlier.

In 2001–2002 the composition of the 12.1 million entities submitting returns, in rounded figures, was:

- 10.3 million individuals (85.3%)
- 650,000 companies (5.3%)
- 456,000 trusts (3.8%)
- 463,129 partnerships (3.8%)
- 211,000 funds²⁷ (1.7%) (*Taxation Statistics, 2001–2002*, p. 7)

For the way in which trusts and related entity structures provide such an effective way of tax avoidance see the excellent paper by Covick (2004, especially pp. 259–267). This analysis clearly shows why PIT reform is long overdue.

A final theoretical point relevant to later reform arguments is that "an income tax with a tax free allowance [or zero rate] and just one positive rate is progressive and may be more or less progressive than a multiple rate system" (Sandford, 2000, p. 52; see the worked example on pp. 52–53).

²⁴ Sole traders were lowest at \$27.72, followed by partnerships (\$31.74), superannuation funds (\$32.08), and companies (\$36.68).

²⁵ Sole traders were lowest at \$21.10, followed by partnerships (\$24.81), superannuation funds (\$27.51), and companies (\$28.56). The report explains these relatively high compliance costs in terms of: the nature of the personnel (internal and external, and "primarily more expensive lawyers") and trusts relatively low turnover (that increases the ratio of compliance costs to turnover). Both of these reasons support the proposition that trusts are a vehicle for tax avoidance, particularly by relatively small business entities.

²⁶ As well as other business entities such as partnerships and companies—an issue not pursued further here.

²⁷ Superannuation and life insurance funds.

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3 The Rationale for PIT Reform

Taxpayers deriving business and investment income and who use trusts, and in comparison with PAYG taxpayers, are part of a PIT system that is:

- Inequitable
- Complex, with high compliance costs

Thus at least two (i.e. equity and simplicity) of the four main criteria for a good tax system²⁸ are breached by the Australian PIT. Further, Covick (2004, p. 264) argues that allocative efficiency is also likely to be breached by the use of trusts and the 'two nations' PIT system.

Overall, arguably, the tolerance and importance of trusts in the Australian PIT system abrogates all four of modern-day criteria of what constitutes a 'good tax', namely equity, efficiency, simplicity and revenue-raising ability.

The critical question, in the context of the relatively recent failure of reform of entity taxation²⁹ and other pressures,³⁰ thus becomes 'how might the PIT be reformed "in one hit" in order to reduce as many of the current deficiencies of the present PIT system as possible?'

4 Government Options for Personal Income Tax Reform

Whilst there are any number of possible reforms to PIT depending upon economic, political, and social affiliations and preferences, arguably the government has three main reform choices.

Personal income tax reform is ultimately about the cost and risks to the Treasury, points often ignored or downplayed by commentators. Realistically, revenue neutrality (no major change in the real level of government tax revenue and ensuing expenditure) means that foregone PIT revenue has to be recouped from elsewhere in the tax system. But where?

The first 'reform' option may be termed the 'tinkering and tokenism' approach e.g. small increases in upper-income thresholds in July 2004 and July 2005. Much lip-service was paid to 'reform' but there was no real long-term change. Such 'reforms' are likely to cost less than \$5 billion in the year introduced, and do little more than keep up with bracket creep over the previous few years. This would be the worst-case 'reform' scenario.

²⁸ Originally deriving from the days of Adam Smith, three criteria for a 'good tax' always cited in the literature are: equity, divided into horizontal and vertical; efficiency, often referred to as neutrality; simplicity. Most Governments and many academics and commentators now add a fourth: revenue-raising ability. See CPA Australia (2004, p. 11) for a useful summary in the context of Australian tax policies since 1974.

²⁹ The Government's proposed entity tax reform, first mooted in 1998 (under ANTS, 1998, and at the time of the major 'push' for the GST) and developed under Ralph (Ralph Report, 1999), was effectively abandoned in 2001, mainly due to strong lobbying by vested interests, particularly small business, and, to a lesser extent, technical difficulties in the proposed legislation. (See Pope and Fernandez, 2001, pp. 146–147 for a summary of recommendations and ensuing criticisms.) The Board of Taxation had advised the Government that there were not compelling reasons to tax discretionary trusts like companies.

³⁰ For example, tentative moves by business lobby groups to lower the company tax rate still further, Government investment and financial objectives to maintain a buoyant economy and the role of CGT in this, the interaction of tax and welfare, an ageing population, superannuation issues, and so on.

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A second option is the 'moderate approach'. The major feature could be a top PIT rate of 40%—what a leading analyst saw as 'the most realistic possibility' in his recent article on this subject (Warren, 2004b). A moderate reform package might cost between \$5 billion in the year first introduced and \$20 billion, given reasonable rate reductions and/or higher thresholds at the lower and middle parts of the PIT scale.

A third approach may be termed the 'significant reform option', costing over \$20 billion in its first year (i.e. a cut of at least 20% in current net PIT revenues). This may lower the importance of PIT to around 37% of all Commonwealth Government tax revenue (down from 49% in 2001–2002).³¹ Such reform would be ambitious, requiring statesmanship and political 'champions' (a pre-requisite of nearly all major tax reform throughout the world) to drive it through (Sandford, 2000, pp. 184–186).

5 Significant PIT Reform

Significant PIT reform involves mitigating as many of the faults and difficulties of the present PIT system as possible. These include the disincentive to paid work (at around both the current tax-free threshold of \$6,000 and the \$58,001³² threshold), the loss of Australian professional workers overseas,³³ the large size of the tax avoidance industry, high administrative and particularly compliance costs of PIT, and inequities (especially between the two 'nations'). It should include effective reform of the significant current differences in the level of taxation upon so-called higher income salary persons and business persons, labour and capital gains income, and the unit of assessment (individual or family, as with trust income).

A longer-term perspective would downplay the 'winners' and 'losers' mentality so beloved by the Australian media and others. Reform should focus upon the long-term benefits to the whole country (as in the case of the introduction of Singapore's GST in 1994; Pope and Poh, 2001), and must include an adequate short-term compensation package to those disadvantaged.

The objectives of PIT reform in Australia³⁴ should be:

- To equate the top marginal rate of personal income tax (under PAYG) with the company tax rate and also the top rate of capital gains tax (CGT) rate ('rate equalisation'), specifically at a rate of 30%

³¹ Ignoring any Laffer effects, discussed briefly later (footnote 57).

³² The \$58,001 threshold (in 2004–2005) triggers a 42% marginal rate.

³³ It has been estimated that around a million Australians work overseas, 90% of who are professionals with most living in countries with lower PIT, such as UK, USA, Hong Kong and Singapore (private communication).

³⁴ The fundamental proposals presented here are not new, as a number of authors, e.g. Walker (2004), lobby groups and professional organisations, e.g. ACCI (2004, p. 30), CPA Australia (2004, p. 7), and political and economic commentators, e.g. Russell (2004), support the basic proposal of a 30% top PIT rate aligned with the company rate. Indeed, Walker (2004, p. 10) cites a 2002 IMF report (*Staff Report for the 2002 Article IV Consultation*, p. 15) which argued that Australia would become more competitive in trying to attract "internationally mobile capital and skilled labour". Other researchers support a significantly higher tax-free threshold. For example, tax-free thresholds of \$14,000 and \$12,500 (the latter indexed annually) have been proposed by Walker (2004, p. 13) and Saunders and Maley (2004, pp. 6–12) respectively. The latter argue that the tax-free threshold should be based on a 'subsistence income' for a single person, being "the only practical way to overcome the problem of high effective marginal tax rates (EMTRs) arising from the interaction of the tax and welfare systems". Pope supports this view that strengthens the tax compliance cost argument.

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- To raise the tax-free threshold to \$12,000 i.e. double its current level ('increased tax-free threshold'), and near restoration to its real 1978–1979 level³⁵

A significant PIT rate and threshold reform proposal is shown in Table 2.

TABLE 2
PROPOSED SIGNIFICANT PIT REFORM

Government Forthcoming		Proposed (Pope)	
Taxable income range in \$	Tax rate in %	Taxable income range in \$	Tax rate in %
2005–2006	2005–2006		
0–6,000	0	0–12,000	0
6,001–21,600	17	12,001–21,600	17
21,601–58,000	30	21,601 or more	30
58,001– 80,000	42		
80,001 or more	47		

Note: An additional Medicare Levy of 1.5% applies to most taxpayers (refer footnote, Table 1).

Rate equalisation would lead to:

- Lower tax compliance costs, particularly lower lawyers' and accountants' fees to personal high-income and business taxpayers, plus lower opportunity costs (especially time) in dealing with tax compliance issues by taxpayers themselves, leading to improved economic productivity
- A significant reduction in the tax avoidance industry, with lawyers and accountants switching to more productive activities³⁶
- Greater equity in PIT overall, significantly reducing the effect of the 'two nations'³⁷ PIT system
- Greater neutrality regarding the taxation of earned and unearned income
- A combined basic and top rate of 30% would, over time, reduce bracket creep for over a majority of PIT payers³⁸
- Possibly, lower ATO administrative costs
- Possibly, a relatively smaller hidden or cash economy

An increased tax-free threshold would lead to:

- Lower compliance costs of PIT
- Lower ATO administrative costs
- Near restoration of the real tax-free threshold rate to its 1978–1979 level

³⁵ The ACCI (2004, pp. 27–28) does not support a higher tax-free threshold as this "could inadvertently reduce the participation rate of those workers on higher incomes . . .". Suffice it to say that I reject such arguments. The main arguments in favour (reducing tax compliance costs and helping overcome high EMTRs) far outweigh any participation rate concerns.

³⁶ Research estimating the economic benefits of this aspect of PIT reform is urgently needed. It is likely that any estimate would be non-trivial given (net) tax compliance costs of PIT of \$1.5 billion in 1994–1995 (ATO, 1997, pp. 27–28)—possibly hundreds of millions of dollars, and up to around \$1 billion if the value of PIT payers' time costs are included.

³⁷ Covick (2004, pp. 257–259).

³⁸ Refer footnote 3.

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- Greater incentive to work for part-time workers, including students and house-persons
- Greater incentive to make use of students and house-persons in income-splitting arrangements³⁹

Overall benefits would need to be fully researched and costed, but are likely to be large.

TABLE 3
THE GROWING CONSENSUS FOR SIGNIFICANT PIT REFORM

Author/ Year	30% Top Rate	\$12,000– \$14,000 Tax-Free Threshold	CGT 30% Top Rate*	Approx. Gross Cost of Package \$ billion	Timing/ Comments
Walker, G. (2004)	Yes	Yes	–	Not stated Emphasises the Laffer effect	IMF supports 30% top rate
Saunders, P. and B. Maley (2004)	Flat-rate (unspecif- ied; 40% top rate to begin with)	Yes	–	PIT 16.3 (plus 12 other)	Phased. Overall funding shortfall of \$15 billion
Warren (2004b)	40% 'most realistic'	–	–	na	Justification for PIT reform in media; 'in one package' implied
CPA Australia (2004)	Yes	No	No	Option costs outlined	Phased. Eighteen scales modelled: rates of 16/29/42 preferred in short-term
ACCI (2004)	Yes	No	–	PIT 10 (plus four others)	Phased. Six PIT options considered
Deutsch (2004)	Yes	No	–	Not costed	"Real, robust and fundamental simplification" needed
Pope (2005)	Yes	Yes	Yes	22 (approximately)	Revenue neutral; funding by PIT simplification and GST rate increase; 'in one package'
BCTR					Report likely in 2005

BCTR: Business Coalition for Tax Reform.

* i.e., the 50% concession for holding an asset for over one year is abolished.

n.a.: not applicable.

– indicates not discussed.

Raising the tax-free threshold to \$12,000 would take an estimated 800,000 low income taxpayers out of the 'tax net': i.e. they would not need to submit a PIT annual

³⁹ Later costing figures do not take this factor into account.

return.⁴⁰ This represents a reduction of around 42% of the approximately 1.9 million taxpayers currently earning between \$6,000 and \$20,000. The compliance cost savings are estimated to be at least \$118 million *per annum*.⁴¹ Reducing the number of PIT returns from around 8.4 million to 7.6 million,⁴² or by nine per cent, would reduce the ATO's administrative costs of the PIT system.

Taxpayers (with part-time employment) earning \$12,000 *per annum* would save around \$785 *per annum* in annual tax, or 6.5% of their income,⁴³ plus time or agent costs of not having to submit an annual tax return. A higher tax-free threshold would give an incentive for some to work longer hours or enter the workforce. Of course all PIT payers would gain from this measure, to varying relative amounts.

The growing consensus in favour of significant or radical PIT reform is summarised in Table 3. However, an increased tax-free threshold is clearly not as well supported as rate equalisation. This author places emphasis on the simplification benefits (and also offset benefits to a proposed GST rate increase, discussed later). By contrast, other commentators and bodies seem particularly concerned with various issues including preventing certain PIT payers gaining an even greater advantage from their tax avoidance practices, lower participation rates for workers on higher incomes and its cost.

6 Cost of the Proposed Significant Reform of Personal Income Tax

The cost of the proposed reform to Australia's PIT would be roughly around \$22 billion, comprising:

- \$9.2 billion for increased tax-free threshold⁴⁴
- \$12.5 billion for reduced top rate to 30%⁴⁵

It must be emphasised that these estimates are approximate and indicate orders of magnitude. More precise estimates would need to be made by the ATO and Treasury if ever the proposal became realistically contemplated.

⁴⁰ This estimate assumes an even distribution of PIT payers in the \$6,001 to \$20,000 taxable income bracket for the income year 2001–2002, as derived from *Taxation Statistics, 2001–2002*, Table 3.10, p. 24.

⁴¹ The ATO (1997, p. 27) estimated the personal taxpayer compliance costs of low income earners to be \$148 in 1994–1995. Disregarding inflation since then gives a conservative estimate of \$118 million.

⁴² *Taxation Statistics, 2001–2002*, Table 3.10, p. 24.

⁴³ \$6,000 times 0.17 rate equals \$1,020, minus the \$235 maximum low income tax offset (that should be abolished in any PIT reform), gives a saving of \$785 p. a. (ATO 2003–2004 figures).

⁴⁴ Warren has estimated the cost of adding \$1,000 to the tax-free threshold at \$1.527 billion in 2004–2005. The cost of increasing it to \$12,000 is thus 6 times \$1.527 billion, or \$9.16 billion (Warren, 2004a, Table 8.8, p. 128). Saunders and Maley (2004, p. 14) estimated the cost of increasing the tax-free threshold to \$12,500 at \$10.3 billion.

⁴⁵ Warren (2004a, p. 128) has estimated the cost of reducing the marginal tax rate (MTR) by 1% for taxpayers earning \$62,501 and above for 2004–2005 at \$603 million. The cost of reducing MTR from 47% to 30% is thus 17 times \$603 million, or \$10.3 billion. Warren has estimated the cost of reducing the marginal tax rate (MTR) by 1% for taxpayers earning between \$52,001 and \$62,500 at \$184 million. The cost of reducing MTR from 42% to 30% is thus 12 times \$184 million, or \$2.2 billion. Adding the two together gives a total cost of a 30% top rate of \$12.5 billion. CPA Australia (2004, p. 14) cite a somewhat lower figure than Warren, and state that "preliminary modelling indicates that each 1% cut in the top personal tax rate would cost about \$459 million at anticipated 2003–2004 income levels", or \$7.8 billion overall. The ACCI (2004, p. xv) estimated reducing the top PIT rate to 30% plus some other PIT reforms at around \$10 billion. The variability of estimates shows that some caution is therefore necessary. This author prefers a conservative approach, i.e. an estimate on the higher side.

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Nearly all tax reform these days is based upon a revenue neutral requirement from Treasury and the Government. It would require a very radical Government to significantly reduce the *overall* level of Government expenditure and hence taxation revenue within the Australian economy. Some PIT reform papers, e.g. ACCI (2004), advocating moderate, phased-in reform consider current Government revenue surpluses largely sufficient to fund changes, whilst others (e.g. Warren 2004b) emphasise the role of reducing PIT concessions and offsets to fund reform.

The key issue thus becomes the most appropriate means of raising around \$22 billion in order to fund significant PIT rate reform.

7 Raising Tax Revenue to Fund Significant PIT Reform

The following analysis ignores any current projected Government revenue surplus that has arisen through bracket creep. This is forecast to be \$6.2 billion in 2004–2005⁴⁶ and, if used as an offset, would affect the following estimates (beneficially).

7.1 Non-allowance of PIT deductions

PIT deductions account for a very significant amount, namely \$19.7 billion in 2001–2002, although this figure does include more problematical items such as prior year losses and gifts as well as items more easily abolished, particularly work-related expenses of \$9.6 million and managing tax affairs of \$0.9 billion.⁴⁷ This represents around 24% of PIT net revenue. In line with a policy of simplifying the PIT system (outlined above), such deductions should be critically reviewed and significantly reduced.

Further, negative gearing of residential property costs the Government around \$1.2 billion⁴⁸—an issue worthy of policy change from a simplification and equity perspective. This is recognised but not considered further here.⁴⁹

Deductions of \$19.7 billion have been identified for possible abolition, thereby generating additional revenue of around \$4.5 billion, based on the average PIT rate of

⁴⁶ *Australian Financial Review* (2005), "Howard hints at possibility of further tax cuts", 16 March, p. 4, citing Treasury's mid-year review.

⁴⁷ ATO *Taxation Statistics, 2001–2002* Table 3.2, p. 17. Denying deductions for some items such as managing tax affairs and gifts for PIT returns yet allowing them for company, partnership and trust returns may counteract somewhat reductions in the inequity between PIT payers and other entities (the 'two nations' problem) arising from 30% rate equalisation. This is arguably a small price to pay for PIT simplification.

⁴⁸ For the year 2000–2001. Estimated by Warren, 2004a, Table 9.8, p. 150 (based on original data from ATO *Taxation Statistics 2000–2001*). Note that abolishing negative-gearing is a quarantining measure that would deny the deductibility of certain items until they can be deducted against the gross income stream with which they are associated. As such, tax revenue benefits would be short-term and 'transitory' providing that property owners eventually move into net profit, i.e. accumulated losses are then written off against net profits, a point recognised by Warren, 2004a, pp. 154–155. However, its abolition would reduce somewhat the need to remove some of the more problematical PIT deductions.

⁴⁹ See Warren, 2004a, pp. 149–158 for a full discussion. The Productivity Commission's *Inquiry on First Home Ownership* (2004) also addressed the issue (see www.pc.gov.au), but key findings were rejected by Government. The latter stated that: "the Government considers that it would be inappropriate to change existing arrangements relating to capital gains or negative gearing. The Government has improved incentives to save and invest by introducing an internationally competitive capital gains tax regime. The Government will therefore not be conducting a review of the tax system with respect to housing or changing the capital gains tax provisions" (Treasurer, Press Release No. 051, 23 June 2004).

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23%. This figure may be higher to the extent that claims for deductions are higher the higher the income and marginal tax rate. For example, top rate taxpayers (with \$60,001 or more taxable income pa in 2001–2002) accounted for 24% of all deductions (totalling \$19.7 billion) claimed.⁵⁰ Warren (2004a, p. 159) has made similar estimates i.e. \$5.1 billion in extra tax revenue from non-allowance of \$18.4 billion in deductions using 2000–2001 figures. CPA Australia (2004, p. 56) estimated savings of \$4.7 billion *per annum* from abolishing work-related expenses (WRE) alone.

Abolition of personal work expenses would lower compliance costs as less time would be spent completing the annual tax return by many taxpayers. Abolishing the tax-deductibility of tax agents (placing the 28% of PIT payers who complete their own returns with no tax deduction available for their opportunity costs on the same basis as the 72% currently using a tax-deductible tax agent for their PIT return) should reduce compliance costs but may increase ATO administrative costs if more errors arise in annual tax returns if taxpayers currently using tax agents switch to self-completion.

Thus even a radical reduction in PIT deductions only raises around \$5 billion, i.e. less than a quarter of the cost of significant PIT rate reform. Revenue is therefore needed from other sources. Whilst a vast array of options could be used by Government, an obvious and realistic option is to increase the GST rate from its relatively low current rate to, say, 15%⁵¹, much closer to the OECD country average of 18.5% (in 2001). This would lead to the usual equity arguments and effects on income distribution, recognised but beyond the scope of this paper other than recognising the necessity of compensatory arrangements. Increasing other Commonwealth taxes such as excise duties rather than GST is not considered a viable option because of equity and efficiency concerns.

7.2 *Increasing the GST rate to 15%*⁵²

Net GST revenue in 2002–2003 was \$30.7 billion, an increase of 14% on the previous year,⁵³ and is likely to be at least \$34 billion in 2004–2005.⁵⁴ Thus a 50% increase in its rate would lead to probably at least \$17 billion in 2004–2005 figures.

7.3 *Overall*

Abolition of PIT tax deductions (around \$5 billion) plus an increase in the GST rate from 10% to 15% (\$17 billion) would raise a total of \$22 billion in tax revenue, roughly equalling the cost of the PIT rate reform presented earlier.

⁵⁰ ATO *Taxation Statistics, 2001–2002*, p. 15.

⁵¹ Currently, all net GST revenue flows through to the States and Territories. There would be undoubted, but not insurmountable, difficulties in increasing the GST rate and using the revenue at a Commonwealth level in order to fund PIT reform. This issue is recognised but not pursued further here.

⁵² Other revenue-raising possibilities are recognised but not pursued here. For example, payroll tax is less regressive than GST and generally raises relatively higher revenue in EC countries than Australia, where it could arguably be increased to 10%–15%. Payroll tax is, however, a State tax and is much disliked by business, which generally would like to see its abolition!

⁵³ *Taxation Statistics, 2001–2002*, p. 153.

⁵⁴ Net GST revenue was \$33.2 billion in 2003–2004 (Treasury, *Fiscal Budget Outcome 2003–2004*, September 2004), 8.6% higher than earlier forecasts, namely \$31.7 billion in 2003–2004 and \$33.5 billion in 2004–2005 (Treasury, *Budget Paper No. 3*).

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The outstanding issue, which can only be considered briefly here, is a Government compensation package to retirees, pensioners, welfare and family support recipients. Rather than consider this on a needs basis, this is approached from a funding i.e. available tax revenue, basis.

A compensation package to transfer payment recipients (to offset a one-off inflationary impact of perhaps 3% or so,⁵⁵ and higher living expenses thereafter) could be funded from:

- Additional gross revenue from increasing the Capital Gains Tax (CGT) rate paid by top-rate PIT payers from 23.5% to 30% for assets held over a year less losses from other taxpayers/assets: Relatively low and difficult to estimate⁵⁶
- Laffer curve effect:⁵⁷ difficult to estimate and nearly always disregarded by Government in any tax reform proposals as the outcome is high risk, but possibly high

Thus figures for any compensation package are somewhat problematical, but funding of at least \$2 billion would need to be factored in to any PIT reform package involving an increase in GST.

8 Concluding Comments

This paper has focused only on the arguments and supporting data in favour of a PIT rate and tax-free threshold change. It has disregarded any distributional impact and wider economic impacts e.g. inflation; such issues would require much further work and econometric modelling.

The paper has, however, demonstrated that a PIT reform package of around \$22 billion is worthwhile. On a revenue-neutral basis, it has been shown that tax simplification alone would not generate sufficient revenue to achieve this. Additional

⁵⁵ Based on previous experience of 3% to 4%, after the 10% GST was introduced in July 2000 (although there were offsetting inflation effects from the abolition of the Wholesale Sales Tax and some State taxes).

⁵⁶ In 2000–2001 around \$2.3 billion was raised by CGT (Warren, 2004a, p. 149). A figure of \$2.4 billion, paid by some 880,000 individuals, is cited by the ATO for the 2001–2002 income year (Taxation Statistics, 2001–2002, Table 9.4, p. 127). Increasing the CGT rate from 23.5% to 30% represents a 27% increase. Thus the additional CGT revenue might be of the order of \$0.6 billion, less lost CGT revenue arising from capital gains (on any assets held for less than one year) taxed at the full rate (which for taxpayers on the 47% and 42% marginal rate would fall to 30%). The net CGT outcome is likely to be a comparatively low amount in terms of tax reform measures.

⁵⁷ This states that a reduction in tax rates leads to an increase in tax revenue because of enhanced economic performance i.e. higher real incomes, and parts of the hidden or cash economy now entering the official, measured, and (most importantly) taxable economy. Whilst there would be positive effects from lowering the top PIT rate to 30% (from 47%), there may be negative effects from increasing the GST rate to 15% (from 10%). Arguably, the former effect is likely to be greater. Evidence on the Laffer effect is very limited, but the Reagan PIT cuts in the USA in 1981 (from 70% to 50% for the top rate) are often cited. For example, Walker (2004, p. 10) states that “The Inland Revenue Service predicted a US\$1 billion drop in collections from higher earners in 1982. The reverse happened . . . There was a US\$9 billion rise [in 1982 that continued in 1983]”. The ACCI (2004, p. 22) cites a US Congress review of research (Saxton, 2001) that suggests that, on average, a 10% increase in the after-tax share of marginal income leads to a 4% increase in taxable income. The latter is much larger at higher incomes. Walker claims that a 28% cut in the top tax rate led to an 11% increase in tax revenue from the rich. More recently in Australia, cuts in the company tax rate from 36% (in 1999–2000) to its current 30% have coincided with significant revenue increases (also recognised by Walker, 2004, p. 10), although separating the Laffer effect from cyclical and other economic factors is extremely difficult.

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funding would be needed. Increasing the GST rate from 10% to 15% (thereby raising at least an additional \$17 billion pa in tax revenue) seems the best option.

In the longer term, further meaningful PIT reform could concentrate on one or more of the following:

- Increasing the threshold at which the standard rate of 30% commences (\$21,601 taxable income pa)
- Further increases in the tax-free threshold of \$12,000
- Introduction of a new low rate, of between 10% and 15%, to replace the 17% rate

For the shorter-term, whilst all PIT payers would pay less tax under this proposed package, lower and middle income taxpayers (with taxable incomes of between \$12,000 and \$58,000 pa) would gain the least, expressed as a percentage of taxable income. This analysis clearly demonstrates the difficulty of major PIT reform and helps to explain why both the Australian Government and Opposition tax policies continue to 'tinker at the edges', with little if any real impact on PIT, as shown, for example, by proposed tax policies during the election campaign in September–October 2004.

An alternative to the proposal presented here is that by, for example, Covick (2004, pp. 268–269), that income tax for all PIT payers should be based on the *family unit* (the basis for taxation of trust income discussed earlier) rather than that of the *individual* (the current basis for all PAYE/PAYG taxpayers). Covick anticipates the extremely high tax revenue cost of such a proposal. Indeed, this high cost to the Treasury merely reflects the significant current benefits of tax avoidance per family for those using the trust system.

By contrast, the significant PIT reform proposal outlined here focuses on PIT rate and threshold reform (a very easy *technical* legislative reform) in preference to either unit reform and, or, trust reform (both extremely complex from a legal perspective).

To conclude, the case for significant PIT reform is overwhelming. Australia has a golden opportunity in the next few years to become one of the leading OECD countries in terms of having an efficient, equitable, incentive-driven and internationally competitive PIT system, rather than continually lagging behind other countries. But the likely political difficulties of reform mean that the odds are on the Government merely continuing to 'tinker' with our antiquated PIT system.

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