

Reform of income tax in Australia: A long-term agenda

Peter McDonald, Australian National University

Rebecca Kippen, Australian National University

ABSTRACT

Income tax reform has been at the centre of the policy agenda in recent years. In particular, there is concern about whether tax rates are dampening work incentives at all levels of the income distribution. In this paper, we examine the potential for reform of the Australian income tax system. We explore three scenarios: one which maximises the tax-free income threshold while keeping existing marginal tax rates constant, a second which adjusts the relationship between the average tax rate and the company tax rate, and a third which maximises the tax-free threshold subject to a flat marginal tax rate of 35 per cent. We demonstrate that it would be possible over a decade to increase the tax-free threshold above the single adult rate of Newstart Allowance (the main unemployment benefit) and to reduce the gap between the company tax rate and average income tax rates to less than five percentage points over a wide range of incomes. Our modelling is contingent upon a continuation of increases in real earnings. The models demonstrate how benefits from continued increases in productivity can be distributed between the government and taxpayers in a way that promotes work incentives, achieves a gain in vertical equity, and allows the government's revenue to continue to grow in real terms.

Peter McDonald <peter.mcdonald@anu.edu.au> is Professor of Demography and Head of the Demography and Sociology Program in the Research School of Social Sciences at the Australian National University. Rebecca Kippen <rebecca.kippen@anu.edu.au> is a Research Fellow in the Demography and Sociology Program in the Research School of Social Sciences at the Australian National University. The authors thank two anonymous referees for their useful comments.

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Income tax reform has been at the centre of the policy agenda in recent years. In our view, this has been driven by the fact that, as we demonstrate below, the reductions in income tax that accompanied the introduction of the Goods and Services Tax had been completely eroded by the tax year, 2004–05. There has been a rising concern about whether tax rates were increasingly having a dampening effect upon work incentives at all levels of the income distribution. In response to this situation, since 2004–05, the Australian Government has pursued an agenda of tax reform that has focused upon increasing the income thresholds at which steps in the tax rates apply. The exception to this approach has been the tax-free threshold, which has remained unchanged. Instead of increasing the tax-free threshold, the Government has extended the low income tax rebate as a means of reducing the tax rates paid by low income people. This approach prevents the benefits arising from a cut in the tax-free threshold flowing through to higher income earners. We show the effects of the Government changes upon average tax rates paid by earners at different multiples of average weekly earnings. The Centre for Independent Studies (Chipman 2004) has been advocating a different approach, in which the tax-free threshold is increased considerably but above the threshold all income is taxed at a flat rate. Our contribution to the debate is to consider a third approach whereby the tax-free threshold is increased considerably but there are still variable (but lower) tax rates up the income distribution. Our purpose is to display the range of possibilities, not so much to argue the superiority of one approach over another. However, within the context of our own approach, we suggest a potential policy pathway.

In this paper, we examine the potential for reform of the Australian income tax system assuming that reform is applied not on an ad hoc basis but as part of a planned long-term strategy. Three scenarios are explored. The first is to maximise the tax-free income threshold while keeping existing marginal tax rates constant; the second, to maximise the income level at which the average tax rate exceeds the company tax rate by no more than 5 per cent¹ subject to a fixed increase in the tax-free threshold, and the third, to maximise the tax-free threshold subject to a flat marginal tax rate of 35 per cent. All scenarios are subject to the constraints that income tax revenue increases in real terms by 2.4 per cent per annum (in accordance with current budget estimates) and the implied welfare function of the current income tax system is not radically altered.

¹ In our view a gap of 5 percentage points between the average income tax rate and the company tax rate would be sufficient to eliminate the construction of elaborate systems to shift income from one system to the other.

Principles of an income tax system

An individual tax system should be based upon four principles.² The first is that taxes should not be expensive to collect. To achieve this, any proposed new system should be similar in form to the existing system; that is, it should have a small number of steps in marginal tax rates. The tax-free income threshold should be increased so that the number of low income workers who do not pay tax is increased. This would also enable the abolition of small, targeted rebates that complicate the existing system. Additionally, the difference between the company tax rate and the average income tax rate should be reduced so that the incentive to devise complex mechanisms to avoid income tax is diminished.

The second principle is that incentives for paid work should be maximised. This would involve raising the tax-free income threshold above the single adult rate of the Newstart Allowance, so that unemployed persons have a greater incentive to work. Lifting the tax-free income threshold would also increase the incentive to work for those not in the labour force or on low incomes (part-time workers and pensioners). There is also an argument that lowering the top marginal tax rate may provide greater work incentive.³

The third principle is that the tax burden should be spread equitably, reflecting the value placed by society upon the dispersion of incomes (vertical equity). To preserve vertical equity, changes in the existing tax scales should not result in any particular income group paying significantly more in tax than at present. In addition, gains through lower tax rates and thresholds should not be concentrated in any one section of the income distribution.

The final principle is that taxes should raise sufficient revenue to enable the government to fund its programs according to socially agreed preferences. To sustain government revenue, any proposed reform must maintain or increase the level of government revenue in real terms.

² Other principles not considered here include horizontal equity, proportionality to benefits received, and resource mobilisation.

³ Some commentators argue that work input at high income levels is not affected by the level of the top marginal tax rate (Gittins 2004; Quiggin 2005). Others argue the opposite (Saunders & Maley 2004; Chipman 2004). At the high end of the income distribution, a more tenuous argument is sometimes made that, if Australian tax rates are too high, some taxpayers will flee the country to seek greener tax pastures—and that Australia cannot afford to lose the talents of anyone who is clever enough to arrive at this decision.

The importance of the tax-free threshold

We give highest priority to a substantial increase in the tax-free threshold for the following reasons.

With benefits indexed to price changes and most pensions indexed to changes in earnings, the failure of successive Australian governments to increase the tax-free threshold in accordance with prices or earnings has meant that the tax-free threshold has fallen systematically relative to the levels of social security payments which are indexed to either prices (benefits and family payments) or wages (pensions). In 1983–84, the tax-free threshold was 20 per cent above the single adult rate of unemployment benefit. In 2006–07—even taking into account the introduction of the low income tax rebate—the tax-free threshold was almost 10 per cent below. This trend has reduced the incentive to work at low income levels. The failure to increase the tax-free threshold in line with wages has also meant that the average tax rate has increased very substantially for people on low incomes. In the past 25 years, the average tax rate on an income of one quarter of average weekly earnings has increased from 1 per cent to 5 per cent (Figure 1). Those on higher earnings have not experienced similar rises in taxation. To provide work incentives, it is important to maximise the gap between social security payments and after-tax earned incomes, especially given the relatively high costs of working (transport, clothing, additional household expenditure, child care). If the tax-free threshold had maintained its real value (CPI-adjusted) in 1978–79, it would have been approximately \$16,000 in 2006–07 rather than the actual level of \$6,000. If average weekly earnings had been used to index the tax-free threshold, it would have been higher again. Even the introduction of the low income tax rebate has increased the effective tax-free threshold to only \$10,000 for those earning less than \$25,000 in 2006–07.

If the tax-free threshold were increased considerably, many deductions and rebates that presently complicate the tax system could be abolished. Indeed, the situation might be reached where many PAYE taxpayers are not required to submit a tax return as in some other industrialised countries such as the United Kingdom. A greater gap between social security payments and earned incomes is also likely to simplify administrative arrangements.

Increased work incentives become more significant when labour supply tightens with an ageing population. There are now reports that labour shortages are emerging at the lower skilled end of the labour market (Macken 2004). In a society like Australia with a broad-based social safety net, it is important that the tax system does not financially hinder people moving off social security and into employment. It is also important not to discourage second earners in couple families from entering the labour force should they wish to. Many second earners re-entering the work force want to work part-time and so will have relatively low incomes. An efficient way of providing work

incentives to low income earners is to have a large tax-free income threshold, ideally a threshold that is set at a higher level than the social security payment.

Over the past twenty years, as an alternative to increases in the tax-free threshold, numerous inefficient and complex rebates and means-tested payments that vary according to the characteristics of the person have been introduced, extended, abolished, modified and indexed according to the political whim of the day (Warren 2004). Successive and frequent modifications of these rebates and payments have been aimed at reducing the high effective marginal tax rates that are associated with this approach.⁴ However, as time progresses, the high effective marginal tax rates return as the indexing of the income thresholds for the receipt of these payments and rebates fails to keep pace with increases in earnings and as the real value of the tax-free threshold continues to fall. Then, like the dog chasing its tail, the process of modification starts again.

Successive governments have been reluctant to increase the tax-free threshold because of the revenue implications. We address this problem by spreading the increases over a long period of time in a planned way.

Tax changes in Australia from 1983–84 to 2006–07

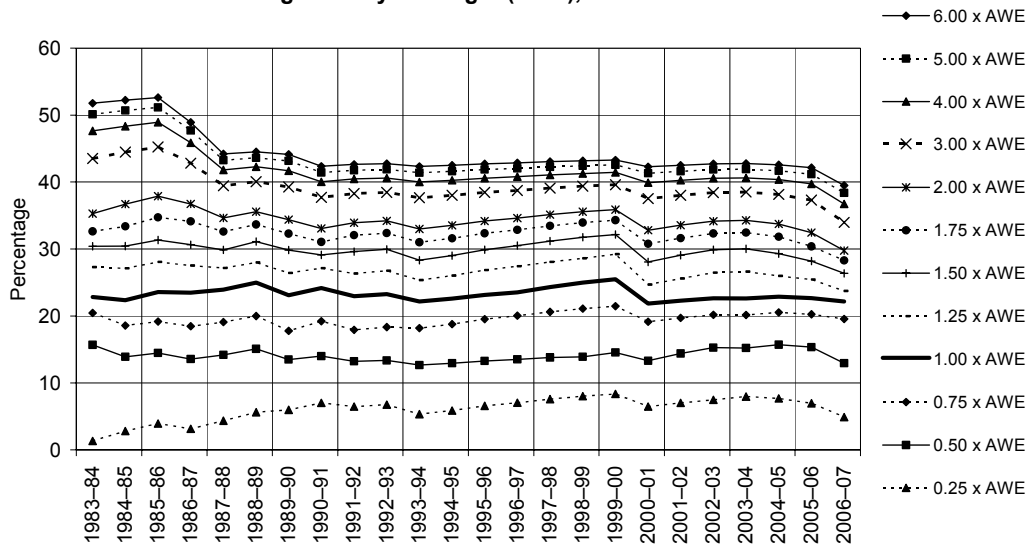
Changes to the system of income tax in Australia since the late 1970s have been characterised most often by ad hoc shifts in the tax thresholds at which different marginal tax rates apply or less often by changes in the marginal tax rates themselves. These changes have returned some of the government's cash gain through bracket creep to the taxpayers and the rewards have been spread in varying ways across people at different income levels in an apparently unsystematic way. The changes rarely seem to have been driven by long-term, fundamental principles or objectives. Figure 1 shows the changes in average tax rates applying at various multiples of average weekly earnings⁵ (AWE) from 1983–84 to 2006–07.

The chart has the following features. First, the large falls in average tax rates at high incomes (three times AWE and above) between 1985–86 and 1987–88 reflect the substantial lowering of the top marginal tax rate by the Hawke Government.

⁴ The effective marginal tax rate is the sum of the marginal income tax rate at a given level of income and the rate(s) of withdrawal of rebates and payments that apply at the same level of income. Effective marginal tax rates have been very high at low levels of income for most of the past twenty years (Ingles 1997).

⁵ All references to average weekly earnings refer to average full-time adult male ordinary time earnings.

Figure 1. Average tax rates^a by selected multiples of average weekly earnings^b (AWE), 1983–84 to 2006–07



^a Takes into account the low income rebate, introduced in 1993–94. From 1993–94 to 2003–04 the rebate was a maximum of \$150, with a taper rate of 4 per cent for those with taxable incomes above \$20 700. From 2004–05 the rebate was a maximum of \$235, with a taper rate of 4 per cent for those with taxable incomes above \$21 600. In 2006–07 the rebate was a maximum of \$600, with a taper rate of 4 per cent for those with taxable incomes above \$25 000.

^b Average full-time adult male ordinary time earnings.

Second, the average tax rate of those on one quarter of AWE has risen substantially from 1 per cent in 1983–84, peaking at 8 per cent in 1999–2000, then falling to 5 per cent in 2006–07. Over the entire period, this is equivalent to an increase in taxation of just under \$600 for a person earning only \$16,000.

Third, over the full period, the range of average tax rates has narrowed. The range from 0.25 x AWE to 6.00 x AWE was 50 percentage points in 1983–84 and 34 percentage points in 2006–07. Fourth, average tax rates for all multiples of AWE increased steadily from 1993–94 to 1999–2000, a period in which no changes were made to the tax scales despite rising incomes. These increased rates of taxation provided the launching pad for the broadening of the tax base through the Goods and Services Tax.

Fifth, average tax rates fell at all income levels in 2000–01 when the government reduced income tax rates in association with the introduction of the GST, but, subsequently, the rates rose steadily at all income levels. By the tax year, 2004–05, average income tax rates were higher at all multiples of AWE than they had been ten years earlier in 1994–95, despite the fact that the GST and the Medicare levy surcharge had been added to the overall tax mix in the intervening years (Table 1).

Table 1. Average tax rates by selected multiples of average weekly earnings^a (AWE), 1984–85, 1994–95 and 2004–05

Multiples of AWE	Income in Nov. 2003 dollars	Average tax rate (% of total taxable income)		
		1984–85	1994–95	2004–05
6.00 x AWE	310,911	52.2	42.5	42.6
5.00 x AWE	259,093	50.7	41.6	41.7
4.00 x AWE	207,274	48.3	40.3	40.4
3.00 x AWE	155,456	44.5	38.0	38.2
2.00 x AWE	103,637	36.7	33.5	33.7
1.75 x AWE	90,682	33.4	31.6	31.8
1.50 x AWE	77,728	30.4	29.0	29.3
1.25 x AWE	64,773	27.1	26.0	26.0
1.00 x AWE	51,819	22.4	22.6	22.9
0.75 x AWE	38,864	18.6	18.8	20.5
0.50 x AWE	25,909	13.9	12.9	15.7
0.25 x AWE	12,955	2.8	5.9	7.7

^a Average full-time adult male ordinary time earnings.

Sixth, since 2004–05, the trend has been for tax thresholds to be increased and the low income tax rebate to be extended, with substantial changes in the tax year 2006–07. Unlike the changes that were made when the GST was introduced, the benefits of the recent changes have been negligible around the middle of the income distribution (average weekly earnings) but substantial at high and low income levels.

Assumptions and data input

Scenario modelling commences with the 2006–07 tax scales and from the 2006–07 financial year. Estimated taxable incomes for the year 2005–06 were obtained from the Department of the Parliamentary Library (see Appendix A), and adjusted to the 2006–07 financial year. The number of taxpayers is assumed to increase at the rate of 1.6 per cent per annum, consistent with the likely demography of the next decade. All taxable incomes are assumed to rise at the same annual rate across the decade.

Two rates of increase of taxable incomes (in nominal dollars) are used: the average annual rate of increase over the past five years of 4.75 per cent and a lower level of 3.5 per cent. We use two rates to illustrate the extent to which reform is contingent upon the actual rate of increase of taxable incomes relative to inflation; that is, the real rate of increase of incomes. The rate of inflation is set at 2.5 per cent per annum, in line with recent experience.

Existing tax rebates and relationships between fringe benefits taxes and taxable incomes are ignored because of the complexity involved. This could also be justified on the grounds that a new system should attempt as far as possible to eliminate these complex and potentially unfair aspects of the tax system. However, no increase or reduction in revenue is factored in for the abolition of any of these factors. The exception is the low income tax rebate, which we phase out by 2009–10 in each scenario. This phasing out, combined with consistent increases in the tax-free threshold, would eliminate the need for several hundred thousand low income Australians to submit tax returns.

We also do not consider the implications of the Medicare Levy or Family Benefits payments. The Medicare Levy is effectively a constant in the system and would not change the results. Family Benefits are received by only a minority of taxpayers and their purpose is to benefit families with children; they are not an income tax measure. To extend the analysis to include Family Benefits would imply that these are being assessed as well. Much can be said about the efficacy and fairness of the Family Benefits system, but this is not the purpose of this paper.

While the modelled changes to the tax system are made in order to increase work incentives particularly for those receiving government payments, no behavioural savings from reduced social security payments or increased numbers of taxpayers are factored into the calculations. However, behavioural savings are likely to be substantial. Vertical equity is evaluated through an examination of the average tax payable on multiples of average weekly earnings. The aim is to achieve a result in which average tax rates fall at all income levels.

Reform of income tax is facilitated through earnings rising faster than prices. Taking into account the future increases in nominal taxable incomes and the inflation rate assumed above, real incomes are assumed to rise by 2.25 per cent or 1 per cent per annum. Rises in real incomes are contingent upon future levels of labour productivity. The average growth rate of labour productivity has been 2.3 per cent per annum over the past 40 years (Australian Bureau of Statistics 2005), a level above both the increases in real wages we assume. In recent years, the increase in real earnings has been high and this has enabled governments to run surplus budgets, increase spending in real terms and provide ad hoc income tax reductions. In this circumstance, an essential issue for income tax reform is: what percentage of the benefit should be retained by government for its social redistribution programs and what percentage should be retained in income terms by the taxpayer? Consistent with the government's budget plans over the short term, we fix the government's revenue increase at a real value of 2.4 per cent per year over a decade and then distribute the remaining benefits to taxpayers through tax cuts in accordance with our scenarios.

We use two assumed levels of future productivity because there are those who argue that the high rate of productivity improvement in the past two decades is unlikely to be sustained. In the past four years, annual productivity growth has fallen to an average of 1.6 per cent, a level roughly half-way between our two assumptions. On the other hand, the potential for technological change to improve productivity in the future should not be dismissed. In our conclusion, we argue that, within a long-term framework, tax rates can be changed as the actual productivity levels are revealed.

Scenarios

We present the results of three scenarios for each of the two assumed levels of increase in wages. Under the first scenario, existing marginal tax rates are held constant, and we maximise the level of increase in the tax-free threshold that can be achieved with the two assumed levels of increase in wages. Under the second, subject to the constraint that the tax-free threshold rises to \$16,000 by 2016–17,⁶ we maximise the income level at which the average tax rate reaches 35 per cent—five percentage points above the company tax rate—with the two assumed levels of increase in wages. Under the third scenario the tax-free threshold is maximised subject to the achievement of a flat marginal tax rate of 35 per cent by 2016–17, again using the two assumed increases in wages.

The three scenarios reflect differing value positions in relation to the distribution of benefits across the income range. Scenario 1 directs benefits to the low end of the income range and Scenario 3 directs benefits to the high end. Scenario 2 occupies an intermediate position.

Results

Scenario 1: Maximising the tax-free threshold

Table 2 shows the outcomes in terms of tax scales. Scenario 1 shows that the tax-free threshold could be increased to \$36,000 in nominal terms over the ten-year period if earnings rise continually at 4.75 per cent per annum. The level reduces to \$21,000 if the increase in earnings is only 3.5 per cent per annum. These results indicate that, under either level of rise in earnings and given the assumed level of inflation, substantial increase in the tax-free threshold is possible over a ten-year period. Remember, all models are subject to the constraint that income tax revenue rises by 2.4 per cent per annum in real terms.

⁶ At this level in 2016–17, the tax-free threshold would be around 20 per cent above the single adult rate of Newstart Allowance.

Table 2. Projected tax scales, Australia, 2006–07 to 2016–17

2006–07		2007–08		2008–09		2009–10		2010–11		2011–12	
Income	MTR ^a	Income	MTR	Income	MTR	Income	MTR	Income	MTR	Income	MTR
Scenario 1: Maximising the tax free threshold, 4.75% per annum increase in average weekly earnings											
0	0.00	0	0.00	0	0.00	0	0.00	0	0.00	0	0.00
6,000	0.15	8,400	0.15	10,800	0.15	13,000	0.15	15,500	0.15	18,300	0.15
25,000	0.30	27,000	0.30	29,000	0.30	31,000	0.30	33,000	0.30	35,000	0.30
75,000	0.40	75,000	0.40	75,000	0.40	75,000	0.40	75,000	0.40	75,000	0.40
150,000	0.45	150,000	0.45	150,000	0.45	150,000	0.45	150,000	0.45	150,000	0.45
Scenario 1: Maximising the tax free threshold, 3.5% per annum increase in average weekly earnings											
0	0.00	0	0.00	0	0.00	0	0.00	0	0.00	0	0.00
6,000	0.15	8,000	0.15	10,000	0.15	12,000	0.15	13,300	0.15	14,600	0.15
25,000	0.30	25,000	0.30	25,000	0.30	25,500	0.30	26,000	0.30	27,000	0.30
75,000	0.40	75,000	0.40	75,000	0.40	75,000	0.40	75,000	0.40	75,000	0.40
150,000	0.45	150,000	0.45	150,000	0.45	150,000	0.45	150,000	0.45	150,000	0.45
Scenario 2: Maximising the income level at which the average tax rate reaches 35%, 4.75% per annum increase in average weekly earnings											
0	0.00	0	0.00	0	0.00	0	0.00	0	0.00	0	0.00
6,000	0.15	8,000	0.15	10,000	0.15	12,000	0.15	12,600	0.15	13,200	0.15
25,000	0.30	26,000	0.30	28,000	0.30	30,000	0.30	33,000	0.30	37,000	0.30
75,000	0.40	76,000	0.40	77,000	0.39	78,000	0.39	79,000	0.38	80,000	0.38
150,000	0.45	153,000	0.44	156,000	0.43	159,000	0.42	162,000	0.41	165,000	0.40
Scenario 2: Maximising the income level at which the average tax rate reaches 35%, 3.5% per annum increase in average weekly earnings											
0	0.00	0	0.00	0	0.00	0	0.00	0	0.00	0	0.00
6,000	0.15	8,000	0.15	10,000	0.15	12,000	0.15	12,600	0.15	13,200	0.15
25,000	0.30	25,000	0.30	25,000	0.30	25,000	0.30	25,000	0.30	25,000	0.30
75,000	0.40	76,000	0.40	77,000	0.39	78,000	0.39	79,000	0.38	80,000	0.38
150,000	0.45	153,000	0.45	156,000	0.44	159,000	0.44	162,000	0.43	165,000	0.43
Scenario 3: A flat marginal tax rate of 35%, 4.75% per annum increase in average weekly earnings											
0	0.00	0	0.00	0	0.00	0	0.00	0	0.00	0	0.00
6,000	0.15	10,000	0.17	14,500	0.19	17,900	0.21	21,400	0.23	24,500	0.25
25,000	0.30	27,000	0.30	29,000	0.31	31,000	0.31	33,000	0.32	35,000	0.32
75,000	0.40	75,000	0.40	75,000	0.39	75,000	0.39	75,000	0.38	75,000	0.38
150,000	0.45	150,000	0.44	150,000	0.43	150,000	0.42	150,000	0.41	150,000	0.40
Scenario 3: A flat marginal tax rate of 35%, 3.5% per annum increase in average weekly earnings											
0	0.00	0	0.00	0	0.00	0	0.00	0	0.00	0	0.00
6,000	0.15	8,800	0.17	12,000	0.19	14,000	0.21	16,500	0.23	18,400	0.25
25,000	0.30	27,000	0.30	29,000	0.31	31,000	0.31	33,000	0.32	35,000	0.32
75,000	0.40	75,000	0.40	75,000	0.39	75,000	0.39	75,000	0.38	75,000	0.38
150,000	0.45	150,000	0.44	150,000	0.43	150,000	0.42	150,000	0.41	150,000	0.40

^a Marginal tax rate.

Table 2. Projected tax scales, Australia, 2006–07 to 2016–17 (continued)

2012–13		2013–14		2014–15		2015–16		2016–17	
Income	MTR	Income	MTR	Income	MTR	Income	MTR	Income	MTR
Scenario 1: Maximising the tax free threshold, 4.75% per annum increase in average weekly earnings									
0	0.00	0	0.00	0	0.00	0	0.00	0	0
21,000	0.15	24,000	0.15	27,500	0.15	31,500	0.15	36,000	0.15
38,000	0.30	41,000	0.30	44,000	0.30	47,000	0.30	50,000	0.30
75,000	0.40	75,000	0.40	75,000	0.40	75,000	0.40	75,000	0.40
150,000	0.45	150,000	0.45	150,000	0.45	150,000	0.45	150,000	0.45
Scenario 1: Maximising the tax free threshold, 3.5% per annum increase in average weekly earnings									
0	0.00	0	0.00	0	0.00	0	0.00	0	0
15,900	0.15	17,200	0.15	18,500	0.15	19,800	0.15	21,000	0.15
28,500	0.30	30,000	0.30	31,500	0.30	33,000	0.30	35,000	0.30
75,000	0.40	75,000	0.40	75,000	0.40	75,000	0.40	75,000	0.40
150,000	0.45	150,000	0.45	150,000	0.45	150,000	0.45	150,000	0.45
Scenario 2: Maximising the income level at which the average tax rate reaches 35%, 4.75% per annum increase in average weekly earnings									
0	0.00	0	0.00	0	0.00	0	0.00	0	0.00
13,800	0.15	14,400	0.15	15,000	0.15	15,500	0.15	16,000	0.15
41,000	0.30	45,000	0.30	49,000	0.30	55,000	0.30	59,000	0.30
81,000	0.37	82,000	0.37	83,000	0.36	84,000	0.36	85,000	0.35
168,000	0.39	171,000	0.38	174,000	0.37	177,000	0.36	180,000	0.35
Scenario 2: Maximising the income level at which the average tax rate reaches 35%, 3.5% per annum increase in average weekly earnings									
0	0.00	0	0.00	0	0.00	0	0.00	0	0
13,800	0.15	14,400	0.15	15,000	0.15	15,500	0.15	16,000	0.15
26,000	0.30	27,000	0.30	28,000	0.30	29,000	0.30	30,000	0.30
81,000	0.37	82,000	0.37	83,000	0.36	84,000	0.36	85,000	0.35
168,000	0.42	171,000	0.42	174,000	0.41	177,000	0.41	180,000	0.40
Scenario 3: A flat marginal tax rate of 35%, 4.75% per annum increase in average weekly earnings									
0	0.00	0	0.00	0	0.00	0	0.00	0	0
27,700	0.27	30,600	0.29	33,700	0.31	36,800	0.33	39,700	0.35
38,000	0.33	41,000	0.33	44,000	0.34	47,000	0.34	50,000	0.35
75,000	0.37	75,000	0.37	75,000	0.36	75,000	0.36	75,000	0.35
150,000	0.39	150,000	0.38	150,000	0.37	150,000	0.36	150,000	0.35
Scenario 3: A flat marginal tax rate of 35%, 3.5% per annum increase in average weekly earnings									
0	0.00	0	0.00	0	0.00	0	0.00	0	0
20,500	0.27	22,300	0.29	24,300	0.31	26,300	0.33	28,200	0.35
38,000	0.33	41,000	0.33	44,000	0.34	47,000	0.34	50,000	0.35
75,000	0.37	75,000	0.37	75,000	0.36	75,000	0.36	75,000	0.35
150,000	0.39	150,000	0.38	150,000	0.37	150,000	0.36	150,000	0.35

Figures 2.1–2.10 show the average tax rates that would be payable at different multiples of average weekly earnings. Under Scenario 1, with both levels of increase in earnings, the average tax rate at 0.25 x AWE drops to zero across the decade. At 0.50 x AWE, the average tax rate would drop from 13 per cent to 4 per cent (4.75 per cent wage rise) or to 10 per cent (3.5 per cent wage rise). Those on AWE experience a decrease of 4 per cent (4.75 per cent wage rise) or 1 per cent (3.5 per cent wage rise) in average tax rates. At higher multiples of AWE, average tax rates remain constant or increase slightly.

Reflecting its design, this is a scenario that, in relative terms, provides all of the benefit to income levels at or below average weekly earnings.

Scenario 2: Maximising the income level at which the average tax rate reaches 35 per cent

Under this scenario, the tax-free threshold is constrained to rise to \$16,000 in nominal terms over the decade. The top marginal tax rate would fall from 45 per cent to 35 per cent if earnings rose at 4.75 per cent per annum and to 40 per cent if earnings rose by 3.5 per cent. This difference shows clearly how much greater the reform can be if real earnings continue to rise at the higher level. At the higher assumed level of earnings rise, all taxpayers would have an average tax rate below 35 per cent by 2016–17. At the lower assumed level of earnings rise, all those with earnings under \$403,000 (around 4.80 x AWE) would have an average tax rate below 35 per cent.

As expected, under this scenario, there is little change in the average tax rate payable for those on AWE and below (Figures 2.1–2.6). Above average weekly earnings, the falls in average tax rates rise as income rises, especially where real earnings increase at the higher level. At 6.00 x AWE, for example, the average tax rate would fall from 39 per cent to 32 per cent if incomes rose at the higher rate, equivalent to a cut in tax of about \$24,000 per annum in 2006 dollars.

Scenario 3: A flat tax of 35 per cent

Under this scenario, the tax-free threshold would rise to \$39,700 in nominal terms in 2016–17 if the higher increase in earnings were to apply and to \$28,200 if the lower rate were to apply. In some ways, this could be described as a more extreme example of Scenario 2 in that those on low incomes would gain, but the benefits to those on high incomes would be even higher again. The gains at low and high incomes would be paid for by those on middle incomes for whom average tax rates would increase if earnings were to rise more slowly than in recent years.

Figure 2.1. Average tax rate on quarter average weekly earnings, 4.75% per annum increase in average weekly earnings

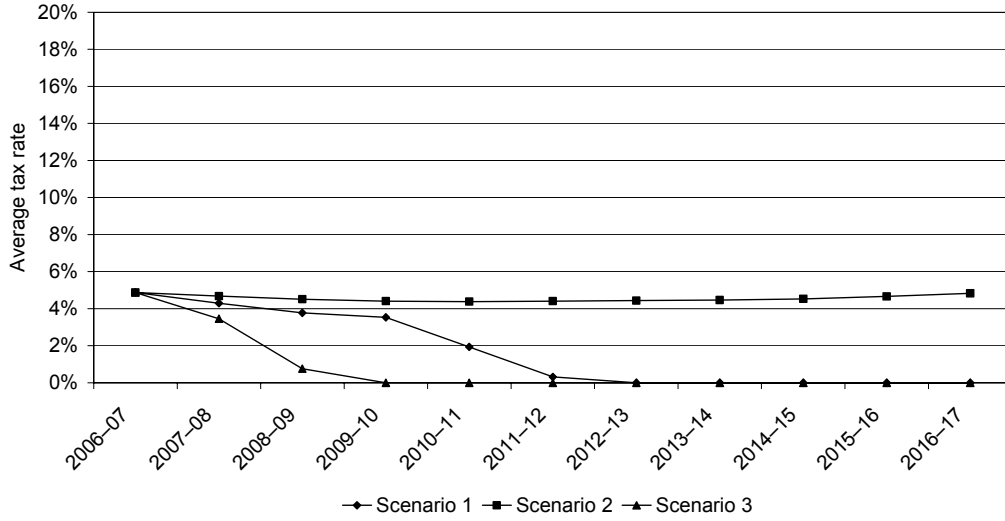


Figure 2.2. Average tax rate on quarter average weekly earnings, 3.5% per annum increase in average weekly earnings

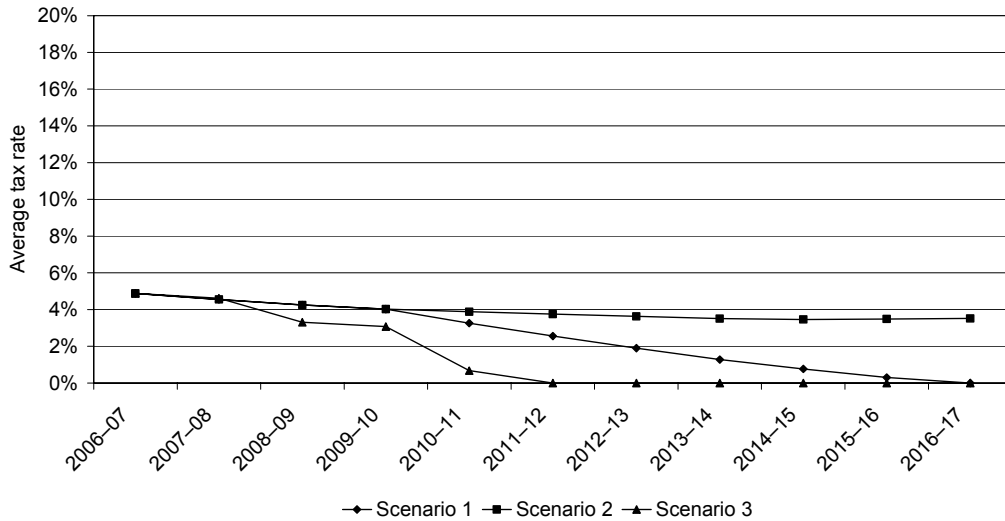


Figure 2.3. Average tax rate on half average weekly earnings, 4.75% per annum increase in average weekly earnings

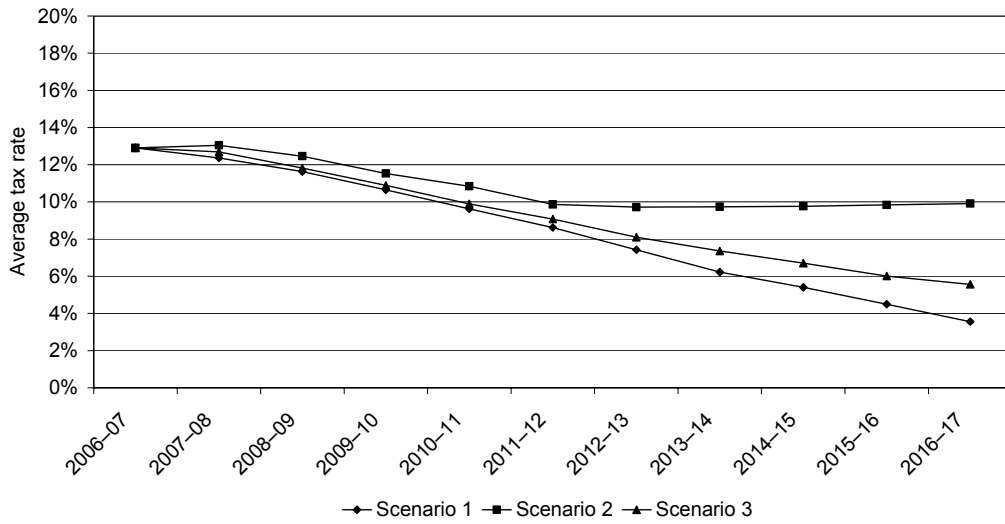


Figure 2.4. Average tax rate on half average weekly earnings, 3.5% per annum increase in average weekly earnings

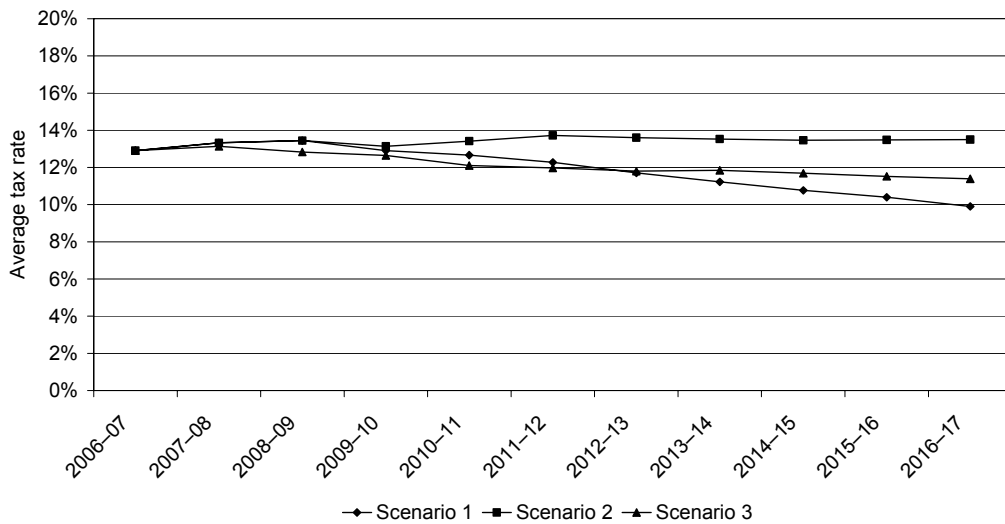


Figure 2.5. Average tax rate on average weekly earnings, 4.75% per annum increase in average weekly earnings

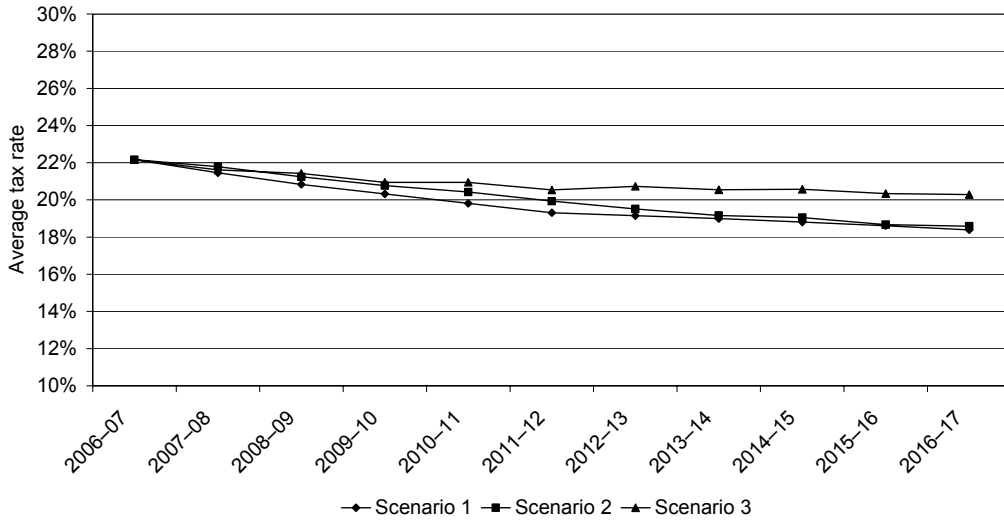


Figure 2.6. Average tax rate on average weekly earnings, 3.5% per annum increase in average weekly earnings

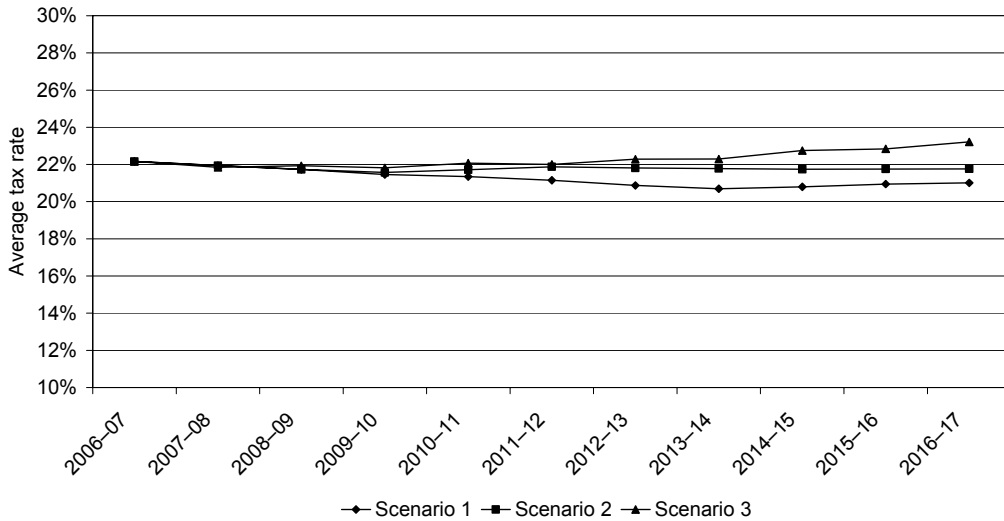


Figure 2.7. Average tax rate on twice average weekly earnings, 4.75% per annum increase in average weekly earnings

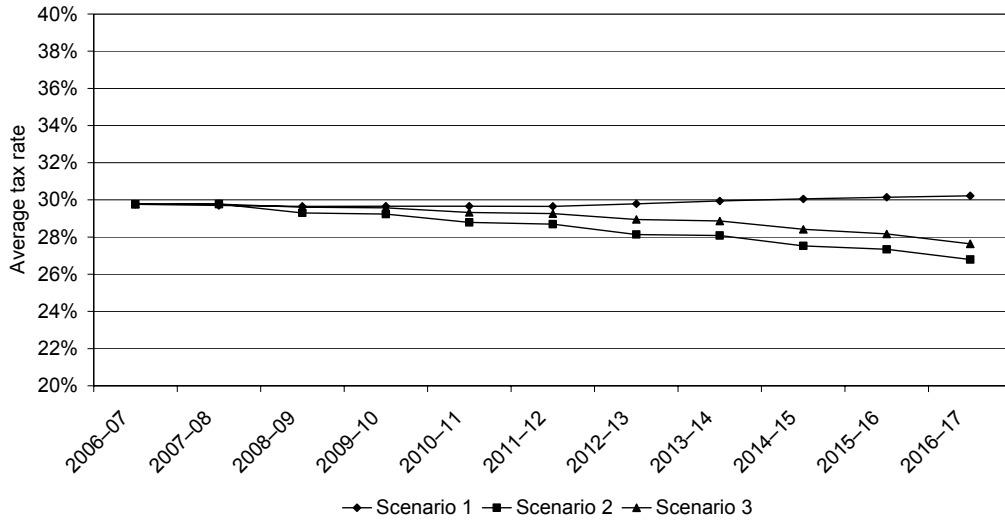


Figure 2.8. Average tax rate on twice average weekly earnings, 3.5% per annum increase in average weekly earnings

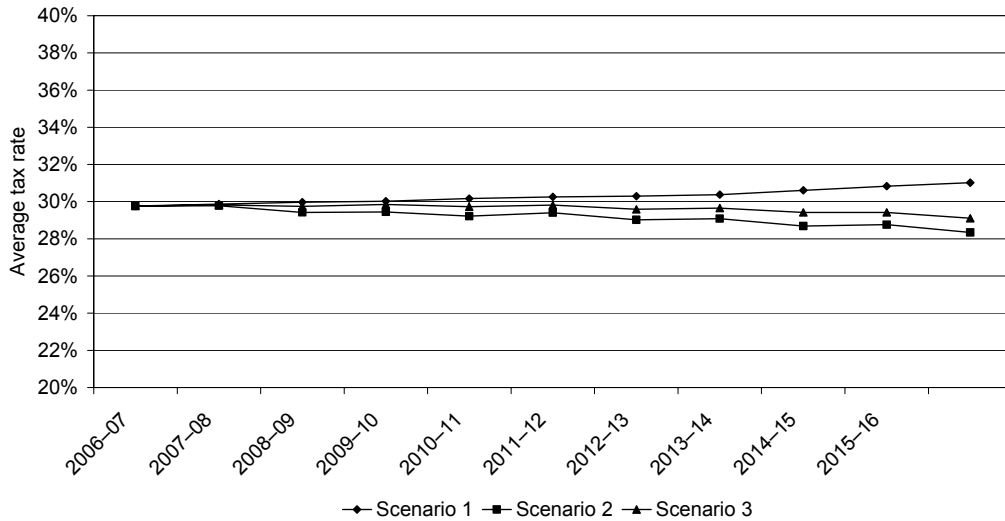


Figure 2.9. Average tax rate on six times average weekly earnings, 4.75% per annum increase in average weekly earnings

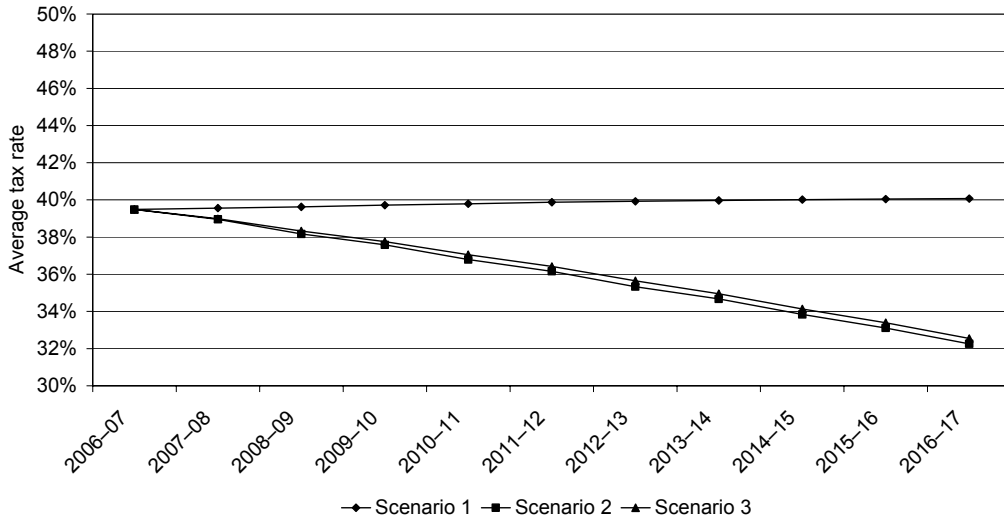
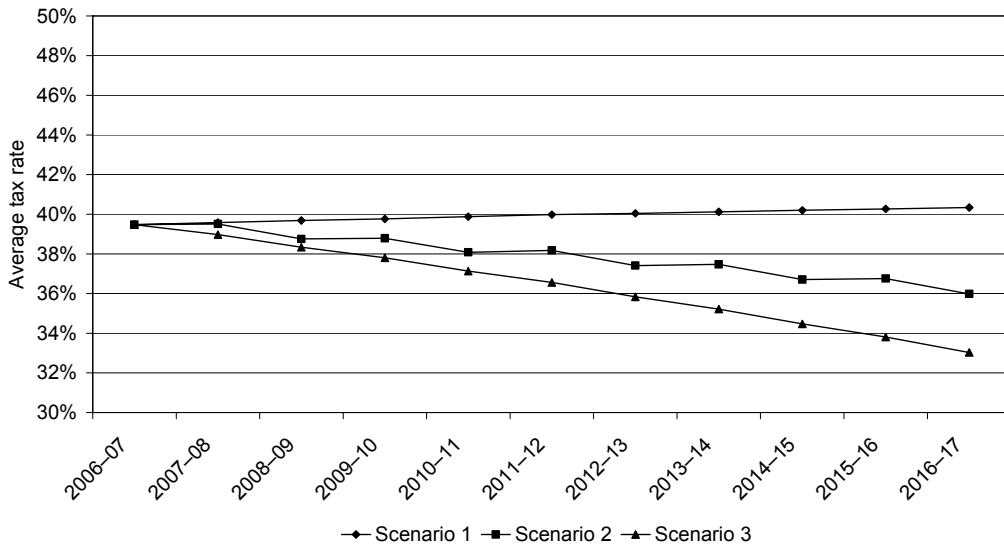


Figure 2.10. Average tax rate on six times average weekly earnings, 3.5% per annum increase in average weekly earnings



A best-case scenario

The specification of a best-case scenario is a value judgment. Our value judgment is that average tax rates should not rise at any income level and that the tax-free threshold should rise to a level at least 20 per cent above the single adult rate of Newstart Allowance. A best-case scenario should also be robust to changes in the real rate of increase of earnings; that is, the strategy should not need to be revised drastically if this rate changes. Based on these criteria, we consider Scenario 2 is the best of the three. Scenarios 1 and 3 both produce rises in average tax rates at certain income levels and those rises are highly contingent upon the level of rise in earnings.

With Scenario 2, average tax rates would not rise at any income level so long as earnings rose by at least the lower rate assumed here. Gains at income levels under average weekly earnings are largely independent of the rate of increase in earnings because an increase in the tax-free threshold to \$16,000 is locked in. At average weekly earnings, the average tax rate would fall from 22 per cent to 19 per cent if earnings rose at the higher rate and would remain unchanged if earnings rose at the lower rate. Thus, the variation is small when earnings change. At income levels above average weekly earnings, under Scenario 2, the fall in average tax rates is contingent upon the rate of increase of earnings. Substantial falls are feasible if earnings increase at the higher rate and more moderate if earnings increase at the lower rate. Thus, the more that high income earners are successful in raising the earnings of all, the higher are the tax cuts that they themselves receive. This would be an interesting way to structure incentives for high income earners.

The proposal in simple terms

We propose that the tax-free threshold be increased by an average of \$1,000 per annum in nominal terms for the next ten years and that this reform is locked in. In addition, we propose that the top marginal tax rate be reduced contingent upon the real rate of increase in earnings. If the real increase of earnings is above 2 per cent, the top marginal tax rate would be reduced by 1 percentage point per annum. If the real increase of earnings is half this level, then the top marginal tax rate would be reduced by 0.5 percentage point per annum. If real earnings do not rise at all, then the top marginal tax rate would remain fixed. Other tax rates and thresholds would be adjusted to be consistent with these changes, as indicated in Table 2.

Conclusion

We have demonstrated that it would be possible over a decade to increase the tax-free threshold to a level well above the single adult rate of Newstart Allowance and to reduce the gap between the company tax rate and average income tax rates to less than 5 percentage points over a wide range of incomes. The modelling is contingent upon the continuation of a positive gap between rises in incomes and rises in prices

as has been the case over the past decade (an increase in real earnings). The models demonstrate how the fruits of such an advantageous economic situation can be distributed between the government and taxpayers in a way that promotes work incentives, maintains vertical equity, and allows the government's revenue to continue to grow in real terms.

If a long-term reform agenda were to be set in place from the May 2007 budget, annual adjustments to the direction of the reform could be made at each successive budget in the light of actual economic outcomes (inflation and earnings growth).

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Appendix A. Estimating population by level of taxable income

The 2005–06 population submitting tax returns by estimated weekly taxable income was provided by the Department of the Parliamentary Library and used to calculate annual taxable incomes. These data were split to give annual income ranges of approximately \$1,500. The range midpoints were used to estimate future income levels.

Table A.1 Estimated weekly and annual taxable income by population of those submitting tax returns, 2005–06

Weekly taxable income (\$)	Annual taxable income (\$)	Population
< 150	< 7,827	1,284,131
150–299	7,827–15,654	2,086,055
300–449	15,654–23,480	1,251,127
450–599	23,480–31,307	944,651
600–749	31,307–39,134	989,791
750–899	39,134–46,961	716,656
900–1,049	46,961–54,788	559,154
1,050–1,199	54,788–62,614	495,204
1,200–1,349	62,614–70,441	487,829
1,350–1,499	70,441–78,268	380,927
> 1,500	> 78,268	1,679,702
Total		10,875,227

Source: Department of the Parliamentary Library, 2004.

