

# *New thinking for a new century*

## *Getting our priorities right in income tax reform*

**By Dr Craig Emerson**

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## **A chorus of parrots**

Paul Keating remarked in the early 1990s that every parrot in the pet shop was squawking micro-economic reform. Now, just five years after the Howard government gave Australia what it boasted to be ‘a new tax system for a new century’, every parrot in the pet shop is squawking tax reform. But unless the chorus of squawking is accompanied by verses about where spending should be cut, the call for tax reform will never be more than a cacophony of sound.

In my first *Progressive Essay* I argued that Labor should adopt a growth strategy for a more prosperous, fairer Australia. One part of a growth strategy, I suggested, was to recognise that middle Australia wants genuine tax relief and less government involvement in their lives and does not want governments deciding for them how to spend their money.

But I did not join the squawking about abolishing the top marginal income tax rate. Business groups failing to identify where the money should come from to finance the abolition of the top rate would be abrogating their responsibilities as advocates of sound fiscal policy.

Though the Australian Chamber of Commerce and Industry (ACCI) is astray in its advocacy of virtually total labour market deregulation, it has had the courage of its convictions in arguing for reductions in government benefits and tax breaks for the better off to pay for reductions in the higher rates of income tax. Liberal MPs are not so forthcoming, though Malcolm Turnbull did venture into a bit of base broadening advocacy, before he was hauled into line by the Treasurer. Mr Turnbull is scheduled to lay out his plan for abolishing the top marginal rate on 1 September 2005. To be credible, he must identify the method of financing the abolition of the higher marginal income tax rates – and not call on the less well off to foot the bill by making their work-related expenses non-deductible.

Before we engage in the battle of ideas on how to fund the abolition of the top marginal rate of income tax we should objectively assess the arguments that have been put in its favour. In the remainder of this *Progressive Essay* I review the evidence and arguments. That review puts me in the camp: ‘deep sceptic’. I then propose a much fairer and economically beneficial alternative: abolishing the 42 cent rate applying over the \$70,000-125,000 per annum income range.

## **Who would benefit from abolishing the top marginal tax rate?**

From mid-2006 just three per cent of taxpayers will face the top marginal rate of 48.5 cents in the dollar. It will cut in at a personal *taxable* income of \$125,000 a year. If we

conservatively add \$10,000 worth of deductions to reach that taxable income these taxpayers are earning about \$135,000 *each* a year. They are not struggling. Though I said in my previous *Progressive Essay* that *families* in Sydney earning \$100,000 a year are not wealthy, it would be hard to argue that individual taxpayers, *each* earning \$135,000 a year, are doing it tough.

Since it is difficult to sustain an argument based on fairness for abolishing the top marginal income tax rate we would need to look at some of the economic arguments that have been put forward. Maybe they are more compelling?

## **Would the talented three per cent work more?**

During the great tax reform debate of 1985 the Treasury argued that a consumption tax was needed, in part, to finance reductions in the top marginal rate of income tax since Australia's most productive people (including Treasury officials) were paying the top rate. Incredibly, this argument is still being put forward to this day. It says that Australians earning more than \$135,000 a year would work more if they got a cut in the 48.5 per cent marginal income tax rate.

The argument purportedly comes from orthodox economic theory. In this theoretical model labour faces a choice between work and leisure. Work is done only to produce income, the spending of which gives people satisfaction (known as utility in the economic lingo). Leisure is assumed to give people satisfaction too but work does not. So people maximise their utility by dividing their time between unsatisfying work and satisfying leisure.

If tax rates are high, reducing the monetary returns to work, people will want to substitute out of work and into leisure. But high tax rates reduce workers' disposable incomes so they will have to work more hours to earn the income to buy the satisfying things they want.

If the substitution effect dominates the income effect they will work less at high marginal tax rates, but if the income effect is greater than the substitution effect they will, in fact, work more. So even in this theoretical model, high marginal tax rates do not necessarily cause people to work less. But for the sake of argument, let's suppose, as most economists do, that the substitution effect is bigger than the income effect. Workers would do fewer hours of work.

This model implicitly assumes that people derive no satisfaction from work – they only work to earn income to enable them to buy satisfying goods and services.

Now to the real world. As Gittins points out:

*'...we should look sceptically at the incessant calls for lower tax rates to encourage people to work harder ... higher income earners in particular have powerful non-*

*monetary motives for working long and hard: job satisfaction and the pursuit of power and status'.*

And as Treasurer Costello observes in defending the retention of the legislated top marginal rate and the income threshold at which it cuts in from mid-2006, Australia will be 'right in the centre of international practice'.

Are advocates of abolishing the top marginal income tax rate seriously arguing that a new round of productivity growth would be unleashed as the top three per cent of taxpayers decided to work longer hours and go for promotions that they are now shunning because they are paying 48.5 cents and not 43.5 cents in the dollar on that part of their earnings above \$135,000 a year? People earning more than \$135,000 a year would typically be on salary packages instead of hourly pay and overtime loadings for extra hours worked.

We are told that management works horrendous hours already. But are we supposed to believe that managers would work even more horrendous hours if only a federal government would abolish their top marginal rate? Even if this absurd proposition were accepted by gullible policy makers, would Australia truly be better off if its managers camped at work and never saw their families?

## **Aligning the top marginal rate with the company tax rate**

A second argument for cutting the top marginal rate is to deal with tax avoidance or more accurately, tax minimisation, through incorporation. By this argument, abolishing the top marginal rate would cause revenue to rise as wealthy taxpayers were no longer able to defer their tax obligations by setting themselves up as companies.

It is true in principle that more closely aligning the top marginal rate of personal income tax with the company tax rate would reduce incentives for individual taxpayers to set themselves up as companies. Incorporation allows them to pay only the company tax rate on current income and to defer personal income tax until they distribute company profits to themselves and to family members as dividends.

But now for a reality check. The gap between the top marginal personal income tax rate and the 30 per cent company tax rate is 18.5 cents in the dollar. Incorporation in Australia costs the small amount of around \$800. Removing incentives of individuals to incorporate would require dropping the top marginal rate to a level very close to the company tax rate – say 36 per cent. Cutting the top marginal rate and the second-highest marginal rate of 43.5 per cent to 36 per cent would cost a massive \$6.2 billion in 2006-07 and even more in 2007-08 – all to prevent a deferral of personal income tax payments.

## **Is the top marginal rate contributing to a brain drain?**

At least three-quarters of a million Australians are living overseas on a long-term or permanent basis. Over the five year period to 2003 Australia appears to have lost about five per cent of its total stock of employed professionals. Australia continues to lose

around 50,000 people a year in emigration. These are people who officially indicate that they are leaving Australia permanently, though a number of them do eventually return.

While Australia numerically has a net brain gain, with annual inflows of skilled migrants exceeding outflows of skilled Australians moving overseas by around 36,000, this is not an argument against attracting expatriates home and encouraging them not to leave in the first place.

Australia can benefit substantially from its best and brightest gaining experience overseas. But in the coming decades there will be fierce international competition for the world's pool of creative talent and it will not be good enough for Australia to accept up to 50,000 permanent departures a year so long as overall there is a net numerical brain gain:

*'If those people are the brightest and best – if they are that really top group of achievers; if they are people who, if they stayed here, could really make the difference in making the social and economic breakthroughs which improve the country – then one person does not equal one person ...'.*

Australia needs a better understanding of the causes of losing such large numbers of the creative class to overseas destinations before we can develop appropriate policy responses. The need for that better understanding is urgent if Australia is to maximise its share of the pool of creative talent that will be so fundamental to determining the prosperity of nations in the coming decades.

One possible contributor to the permanent departure of talented Australians might be Australia's top marginal tax rate. But Treasurer Costello's observation that Australia's top marginal rate and the income level at which it will cut in from mid-2006 puts us right in the middle of international practice tends to undermine the argument that Australia's income tax system is a major driver of emigration.

An analysis of the destinations of Australia's permanent departures raises some concerns. The major destinations are New Zealand (23 per cent), the UK and Ireland (almost 16 per cent), Singapore (5 per cent), China (almost 6 per cent), Hong Kong (8 per cent) and the United States (10 per cent). Each of these countries has a lower top marginal rate of income tax than Australia.

But an examination of the birthplaces of emigrants from Australia points to another influence. The main birthplaces of emigrants are New Zealand (12 per cent), the UK and Ireland (almost 8 per cent), China (more than 6 per cent), Hong Kong (more than 3 per cent) and the United States (less than 2 per cent). So to some extent, migrants are returning to their birthplaces.

But many Australian-born emigrants are leaving for destinations that happen to have lower top marginal tax rates. Maybe they are leaving for other reasons, such as career advancement, higher pre-tax remuneration, lifestyle preferences and the fact that most of these destinations are English-speaking countries. There is only one way to find out –

ask them. One study does exactly that and concludes that professional development, better job opportunities and higher remuneration are indeed important factors.

Until a comprehensive study is done on the reasons for Australia's elevated levels of skilled emigration the jury is out on the role of income tax rates. But even strong advocates of abolishing the top marginal rate of tax conclude that:

*'... in all likelihood taxation is not a primary driver in emigration for most Australians'.*

So although the jury is still out, the evidence gathered by the prosecution is not strong.

## **Outing the elephant**

A valid argument, grounded in both efficiency and equity considerations, can be made for broadening the income tax base and using the proceeds to pay for reductions in the higher marginal tax rates. Though this argument is conceptually sound and is advocated by economists, and some Coalition MPs, there is no agreement on the base broadening measures that should be adopted.

Everyone who benefits likes their 50 per cent capital gains tax discount. Everyone likes their negative gearing. Everyone likes their deductions for work-related expenses. Everyone likes their private health insurance rebate. And they like their child care rebate. Company executives like their tax-favoured executive share schemes. And the Coalition government likes giving these tax breaks not for reasons of economic efficiency but for political expediency. And they like nothing more than Labor politicians advocating their removal.

Everyone knows there is an elephant in the Coalition party room, charging at the income tax base, urged on by frontbenchers and backbenchers alike, daring Labor to out it so that they can re-run scare campaigns that Labor would impose capital gains tax on wedding rings and the family home, force up housing rents and abolish the Private Health Insurance Rebate.

But the onus is not on Labor to out the elephant. It is on those champions of cutting the higher marginal income tax rates. To be credible, these high income earners and their equally high income earning champions should identify the tax breaks they are willing to forego in exchange for reductions in the marginal rates they face. They put the elephant in the room; they can remove it.

To help them out the elephant, the Australian Chamber of Commerce and Industry (ACCI) has identified a broad range of savings including abolishing the child care rebate and means testing the Private Health Insurance Rebate. These are *not* Labor policies or my recommendations; just two of the many ways nominated by ACCI that higher income earners could self-finance reductions in their marginal income tax rate.

## **Kick the welfare habit if you want your top marginal rate abolished!**

The family payments system was originally designed to redistribute income to those families most in need (vertical equity) and also to recognise the extra costs of raising children (horizontal equity). It has been successful in its stated objectives, redistributing income from the better off to the less well off such that around three-quarters of the payments are received by the bottom 40 per cent of households.

But as the Howard government has extended the family payments system right through middle Australia and onto the wealthy, the system has become less progressive. Lower income earners received a diminishing share of family payments between the mid-1990s and the early 2000s. More than 38,000 families earning in excess of \$100,000 a year receive family payments for stay at home mothers - a consequence of John Howard's social engineering where the government pays wealthy mothers to stay at home while obliging poor single mothers to go out and work.

The Howard government has deliberately moved the family payments system away from its original redistributive role and is converting it into a giant recycling scheme. The government collects more than \$100 billion a year in personal income tax and immediately gives one quarter of it back as family payments.

Over the 10-year period from the mid-1990s, when real private incomes grew by 15 per cent and unemployment fell to its lowest rate since the 1970s - such that welfare dependency should have been declining - real Commonwealth social security spending increased by almost one half.

If spending on social security as a share of GDP were to return to the level of the last year of the Hawke government the savings would be \$16 billion. Yet now, almost half the taxes paid by the top 40 per cent of households are returned to them as government benefits and by 2008 real social security spending is budgeted to increase by 56 per cent over the levels of the mid-1990s.

A government that describes itself as a champion of private initiative and reward for effort has presided over the biggest expansion in the welfare state in the nation's history!

How else do we explain almost 90 per cent of families with dependent children receiving taxpayer-funded family payments? How do we justify giving family payments to millionaire couples so long as the mother agrees to stay at home? And why does the government provide family payments for working couples earning up to \$145,000 a year?

Abolishing the top marginal income tax rate would cost around \$1.5 billion a year. The family payments system costs around \$27 billion a year. A tightening in means testing of family payments of just 5.5 per cent would finance the abolition of the top marginal income tax rate.

If high-income earners want their top marginal tax rate abolished they should not expect the poor to foot the bill; they should pay for it themselves by giving up their welfare and some of the many other taxpayer-funded benefits the Howard government happily dishes out to them.

## **Aren't there other tax reform priorities?**

A combination of phasing out income support payments as earned income increases, together with the application of higher marginal rates of income tax, can produce high effective marginal tax rates (EMTRs). An EMTR is the proportion of a one dollar increase in private income that is lost to income tax and income tests on social security and family assistance payments.

Who faces the high EMTRs associated with the interaction of the income tax, social security and family payments systems? As a reference point, an EMTR greater than 60 per cent can be considered high. Since the EMTR calculations do not include the cost of travel, work clothing and child care, it is reasonable to conclude that the loss of more than 60 cents for each extra dollar earned is a genuine disincentive to work.

In 2004, the government reduced tapers on Family Tax Benefit (Part A) and (Part B) from 30 per cent to 20 per cent and increased the income level at which Family Tax Benefit (Part B) was fully payable. Although these measures reduced EMTRs for most of these households, they took the family payments system even further up the income scale. And for some households the changes actually increased EMTRs over particular income ranges.

Before the 2004 changes, only eight per cent of the working age population faced EMTRs greater than 60 per cent, almost all of these being in the 60-80 per cent range. But among households with private earnings, around one-fifth of couples with children and more than half of sole parents faced high EMTRs. Contrary to the popular belief that high EMTRs are mainly confined to low-income earners, they are very prevalent in the middle income ranges as a consequence of the extension of the family payments system to better-off Australians.

Hunting down and squashing any and every high EMTR is not good policy. EMTRs are not a very practical guide to examining decisions to engage in paid work or to increase the amount of paid work since people do not typically increase their private incomes by a dollar at a time. A more relevant measure takes account of the income range over which the EMTR operates.

Work propositions typically confronting a person on income support payments are whether or not to take a job, whether to seek a higher-paying job and, in the case of mothers of young children, whether to return to work, either on a full-time or on a part-time basis. These are decisions that involve earning extra thousands of dollars a year. For these decisions an EMTR of say, 50 per cent, extending over an income range of \$15,000, could be a greater deterrent than a higher EMTR extending over a much

narrower income range. That is, relatively moderate EMTRs over an extended income range can be a greater disincentive to work than higher EMTRs over a narrow range. A person confronted with a steeper EMTR over a narrow income range might peer through it into the clear blue horizons where EMTRs are low.

High EMTRs extending over broad income ranges are generally a bigger deterrent to workforce participation by low income families than they are for those on middle and high incomes. Before the 2004 Budget changes the EMTR for a low wage family did not drop below 60 per cent when working between three and 48 hours a week and often the EMTR was above 70 per cent. Similarly, low income couples with children often gain little or no extra family income when the mother increases her hours of work, and for some increases in hours worked they can actually be worse off after counting child care costs.

An analysis of EMTRs in the Australian tax and welfare systems and the income ranges over which they apply leads to the conclusion that:

*'As a general principle, the highest effective marginal tax rates are faced by low-income families. In particular, jobless families with only a few hours work a week gain remarkably little, financially, from one or even two family members obtaining jobs'.*

The withdrawal of benefits as the unemployed seek to move from welfare to work and the withdrawal of family payments as mothers seek to return to work after having a baby can impinge heavily on work decisions. But there is no magical way of further reducing EMTRs for the unemployed, sole parents and couples with children without other undesirable consequences. High EMTRs can be lowered only by reducing marginal income tax rates or slowing the tapers on income support payments. In a progressive income tax system and a needs-based income support system this is like squashing a hose – the EMTRs will not disappear but will pop up somewhere else along the income scale.

This can be a problem with so-called earned income tax credits. If they are simply bolted on to the existing system they put a patch on high EMTRs over a particular range of earned income but have to be phased out over a higher income range to prevent them becoming prohibitively expensive. In effect, earned income tax credits do not remove high EMTRs, they just shift them further up the income scale where it is hoped they will do less damage to work incentives. However, earned income tax credits, as part of a comprehensive reform that includes reductions in relevant marginal income tax rates, can play an effective role in improving work incentives.

It is in the areas of moving from welfare to work and mothers returning to work after having children that reducing high effective marginal tax rates is likely to have the greatest beneficial effects on work incentives. And the related area of reducing child care costs for lower income families is also likely to be highly productive. These should be the policy priorities, not abolishing the top marginal income tax rate.

## **So should the top marginal income tax rate be abolished?**

Any objective assessment of the case for abolishing the top marginal income tax rate should conclude that the case is dubious. Certainly lower income earners should not pay for a policy that would benefit only the top three per cent of taxpayers each earning more than \$125,000 a year.

Meanwhile there are much higher policy priorities – reducing disincentives to move from welfare to work and disincentives for mothers to return to work after having children. If an effective marginal tax rate of 48.5 cents in the dollar is considered too high by those earning above \$125,000 a year, an effective marginal rate of more than 60 cents in the dollar is surely too high for low income earners.

## **A better plan – abolish the 42 cent rate**

From mid-2006, taxpayers earning between \$70,000 and \$125,000 a year will face the 42 cent marginal rate (43.5 cents counting the Medicare levy). Around 10 per cent of taxpayers will be in this bracket, compared with just three per cent paying the top marginal rate. Many of these taxpayers who happen to be parents of dependent children also face the phasing out of the base rate of Family Tax Benefit (Part A) at 30 cents in the dollar. Their EMTR is therefore 73.5 cents in the dollar – much higher than the EMTR of 48.5 cents facing taxpayers earning more than \$125,000 a year.

More generally, the one million working Australians earning between \$70,000 and \$125,000 a year who pay a 43.5 cent marginal tax rate would respond much more strongly to a 12 percentage point reduction in their marginal income tax rate than those earning above \$125,000 a year - who would get a much lesser five percentage point reduction in their marginal rate from the abolition of the top rate.

These one million upwardly mobile Australians on the 43.5 cent marginal rate have not 'made it' financially, especially in high-cost capital cities like Sydney, Melbourne and Brisbane. Many would choose to work longer hours from such a big drop in their marginal rate.

The Centre for Independent Studies (CIS) estimates that 20-30 cents of every dollar collected in income tax is lost through damaged work incentives. And that does not include the cost of the army of bureaucrats needed to collect the taxes and dole out the benefits, or of the opposing army of accountants and lawyers paid to resist the relentless encroachment of the welfare state.

Abolishing the 42 cent rate is a vastly superior economic alternative to continually feeding the Howard government's giant tax and spend recycling machine for the better off. And abolishing the 42 cent rate faced by one million taxpayers is a much higher priority than abolishing the 47 cent rate faced by 330,000 taxpayers. Bracket creep will

take more and more taxpayers beyond the 30 cent rate onto the 42 cent rate in the coming three years, each of them facing a big, incentive-sapping 12 cent leap in their marginal rate.

It would cost around \$5 billion to abolish the 42 cent rate in 2007-08, compared with a cost of \$1.8 billion to abolish the top marginal rate – a difference of \$3.2 billion. In a personal income tax system that will reap around \$115 billion in that year, \$5 billion is not a lot of money. The abolition of the 42 cent rate could be readily achieved in stages over say three years. The Australian Chamber of Commerce and Industry has identified any number of ways of paying for it, all of them involving cutting welfare and other government payments to the better off.

If the efficiency arguments for abolishing the 42 cent rate instead of the 47 cent rate weren't compelling enough, consider the equity arguments. A millionaire would get a tax cut of \$840 a week from abolishing the 47 cent rate while everyone earning less than \$125,000 a year – 97 per cent of taxpayers - would get nothing. But a taxpayer earning \$100,000 a year would get a tax cut of \$69 a week from abolishing the 42 cent rate while a millionaire would get a tax cut of \$127 a week.

In economic and equity terms a much stronger case can be made for abolishing the 42 cent rate than for abolishing the top marginal rate. And an even stronger case can be made for improving the incentive to move from welfare to work.

Let's get our priorities right.

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