Personal income tax cuts

Discussion paper

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Introduction

This paper examines the government's 2018 personal income tax proposals by presenting a distributional analysis of the tax cuts and then looking at some general tax principles and considerations that we can use to assess the present proposals.

We begin in the next section by outlining exactly how the government intends the tax cuts to operate.

The Government's tax plan

This section is taken from Budget Paper No 1 and has not been edited in any way. Any non-neutral sentiments are in the original text.

Step 1 – Tax relief to low and middle-income earners

This first step targets personal income tax cuts to low and middle-income taxpayers, helping to relieve cost of living pressures. A new, non-refundable tax offset, in addition to the Low Income Tax Offset (LITO), will provide tax relief of up to $530 to low and middle-income earners for the 2018–19, 2019–20, 2020–21 and 2021–22 income years. The offset will be received as a lump sum on assessment after individuals lodge their tax returns.

This low and middle-income tax offset will assist over 10 million Australians, with about 4.4 million taxpayers with incomes between $48,000 and $90,000 receiving the full $530 benefit for 2018–19.

Step 2 – Protecting middle-income Australians from bracket creep

The second step will ensure Australians take home more of their wages, rather than being penalised through a higher marginal tax rate as their wages grow (bracket creep). As part of the second step of the plan, the following changes will be made to the personal income tax system:

- from 1 July 2018, the top threshold of the 32.5 per cent tax bracket will be increased from $87,000 to $90,000. This will provide a tax cut of up to $135 per year to about 3 million taxpayers and will prevent about 200,000 people from facing a marginal tax rate of 37 per cent in 2018–19. This is expected to prevent average full-time wage earners from facing a higher marginal tax rate of 37 per cent in 2019–20;
- the top threshold of the 32.5 per cent bracket will then be further increased from $90,000 to $120,000 from 1 July 2022, providing tax relief of up to $1,350 each year. This change is projected to prevent about 1.8 million taxpayers from facing a higher marginal tax rate of 37 per cent in 2022–23; and
- the benefits provided by the low and middle-income tax offset will be locked in by increasing the top threshold of the 19 per cent bracket from $37,000 to $41,000 and increasing the LITO from $445 to $645.

Increasing the top threshold of the 32.5 per cent bracket builds on the change in the 2016–17 Budget which increased it from $80,000 to $87,000.

Step 3 – Making personal taxes simpler and flatter

The Government is simplifying and flattening the tax system from 1 July 2024 by reducing the number of income tax brackets from five to four. By increasing the top threshold of the 32.5 per cent bracket, thereby removing the current 37 per cent bracket, working Australians will face the same marginal tax rate for incomes between $41,000 and $200,000. The top marginal tax rate of 45 per cent will remain for incomes above $200,000.

This change is projected to prevent about 1.8 million taxpayers from paying a marginal tax rate of 37 per cent or more in 2024–25.

Australia has a progressive tax system which ensures that those with the greatest ability to pay contribute a larger share of all personal income tax revenue. In 2015–16 the top 20 per cent of taxpayers paid about 61 per cent of all personal income tax. Under the plan, this cohort is projected to continue to contribute a broadly similar share.

When completed, the plan ensures that about 94 per cent of taxpayers are projected to face a marginal tax rate of 32.5 per cent or less in 2024–25. This compares with a projected 63 per cent of taxpayers in 2024–25 under current settings if there were no changes. The plan provides certainty to the majority of taxpayers that they will face the same marginal tax rate into the future, encouraging Australians to take on additional work, seek advancement and improve their skills.

Table 1: New personal tax rates and thresholds 2018–19, 2022–23 and 2024–25

Rate (%)	Current tax thresholds Income range ($)	New tax thresholds From 1 July 2018 Income range ($)	New tax thresholds From 1 July 2022 Income range ($)	New tax thresholds From 1 July 2024 Income range ($)
Tax free	0 - 18,200	0 - 18,200	0 - 18,200	0 - 18,200
19	18,201 - 37,000	18,201 - 37,000	18,201 - 41,000	18,201 - 41,000
32.5	37,001 - 87,000	37,001 - 90,000	41,001 - 120,000	41,001 - 200,000
37	87,001 - 180,000	90,001 - 180,000	120,001 - 180,000	-
45	>180,000	>180,000	>180,000	>200,000
Low and middle income tax offset	-	Up to 530	-	-
LITO	Up to 445	Up to 445	Up to 645	Up to 645

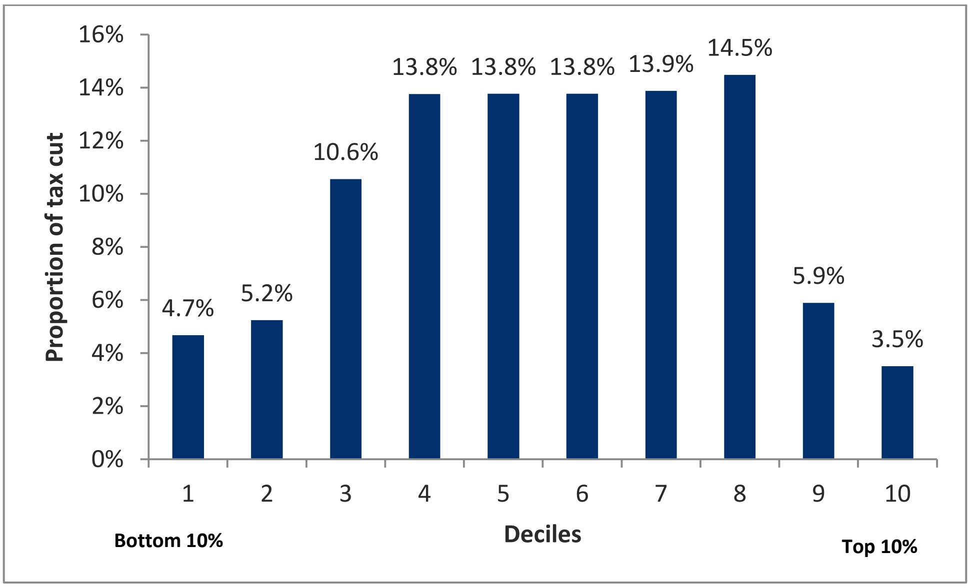
The income distribution of the proposed income tax cuts

In the 2018 Budget, the government announced a radical plan to reshape the income tax system over the next seven years. While the first stage of the plan largely involves tax refunds for low and middle income earners, stage two and three would remove the 37 per cent tax bracket – and, as a consequence, flatten Australia's tax system.

Part of stage two and all of stage three would increase the 32.5 per cent tax threshold from $90,000 to $200,000 and remove the 37 per cent tax bracket. When the plan is fully implemented in 2024-25, it would mean that someone on $41,001 would face the same marginal tax rate as someone on $200,000 and 83 per cent of all taxpayers would be in the same tax bracket.

Stage one of the tax cuts are targeted largely to low and middle income earners. In 2018-19 when stage one is in place the income distribution of the tax cut is shown in Figure 1.

Figure 1 – Benefit of Benefit of proposed tax cut by income decile in 2018-19



Source: ATO (2018) *Taxation Statistics 2015-16* and Australia Institute calculations

When fully implemented in 2024-25 the benefit of the proposed tax cuts will go overwhelmingly to high income earners. The Australia Institute did a distributional analysis of the tax cuts for 2024-25, the first year when the tax cuts are fully implemented. We split taxpayers into three groups; high income, middle income and low income. High income earners were classified as the top 20 per cent of taxpayers. Low income earners were classified as the bottom 30 per cent of taxpayers and middle income earners were classified as the remaining 50 per cent of taxpayers.

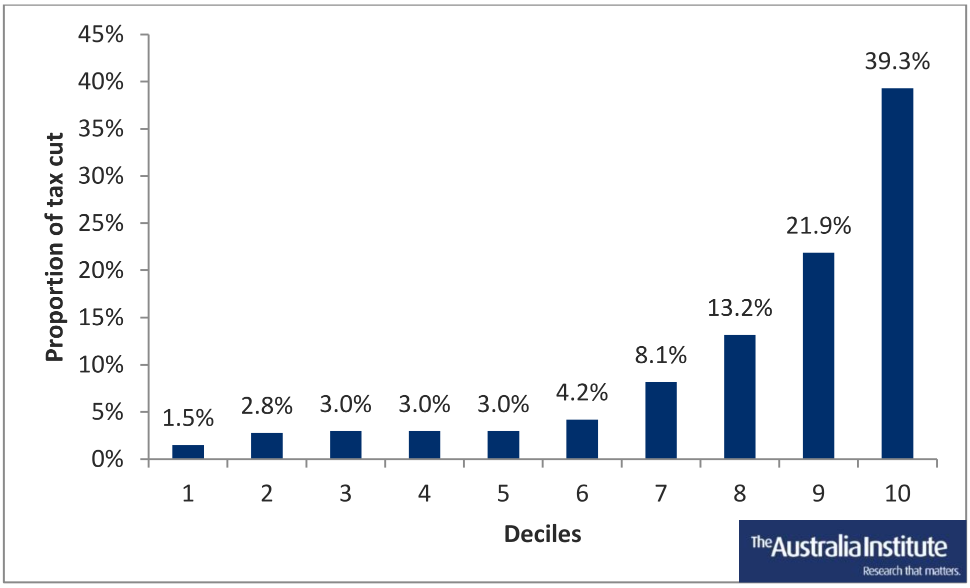
This shows that high income earners get the majority of the benefit (62 per cent). Middle income earners get about half this (despite making up two and half times as many taxpayers). Low income earners get very little benefit, only seven per cent.

Table 2 – Benefit of proposed tax cut by income group in 2024-25

	Low income earners	Middle income earners	High income earners
Proportion of tax cut	7%	31%	62%
Approx number of tax payers	3 million	5 million	2 million

If we then look at the distribution of the tax cuts by decile we see that the top 10 per cent of taxpayers get about 40 per cent of the tax cut, while the bottom 10 per cent only get 1.5 per cent of the tax cut.

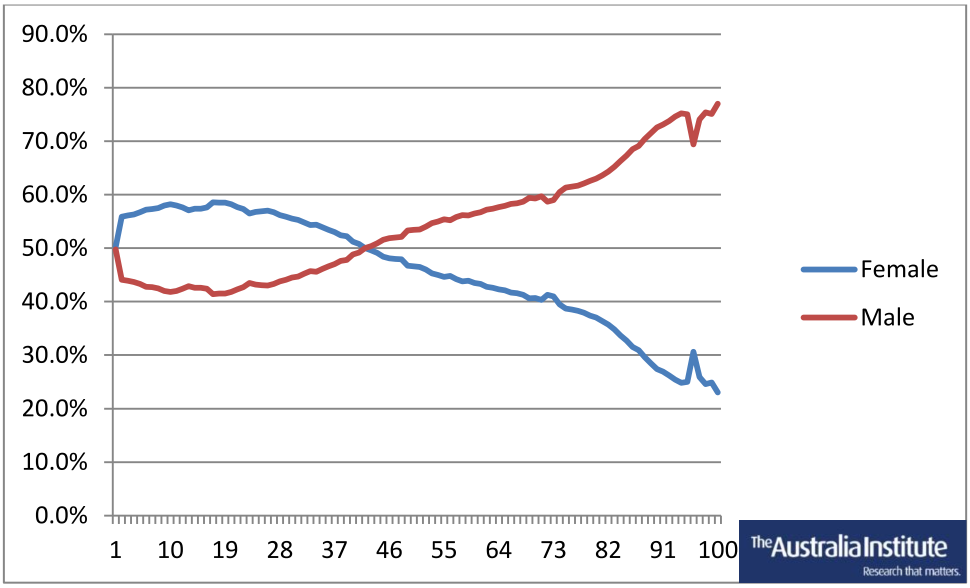
Figure 2 – Benefit of proposed tax cut by income decile in 2024-25



Source: ATO (2018) *Taxation Statistics 2015-16* and Australia Institute calculations

The Australia Institute has also looked at the gender split for the proposed income tax cuts. Men are more likely to be high income earners than women. This is shown in Figure 3.

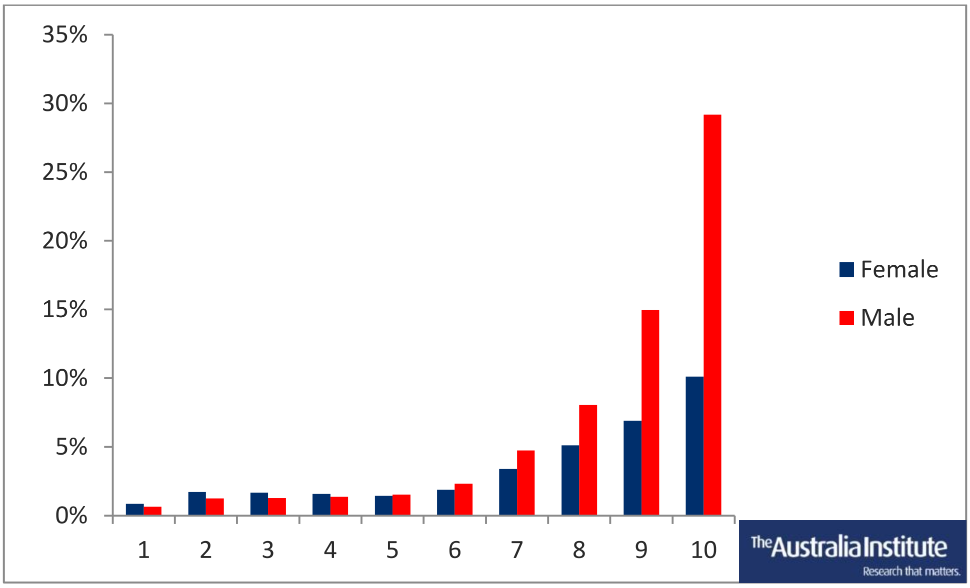
Figure 3 – Income percentiles by gender



Source: ATO (2018) Taxation Statistics 2015-16

The over representation of men at higher income levels coupled with the fact that the tax cuts favour high income earners means that men get a larger proportion of the tax cuts than women. Men get twice the tax cut compared to women. The split between men and women by income decile in 2024-25 is shown in Figure 4.

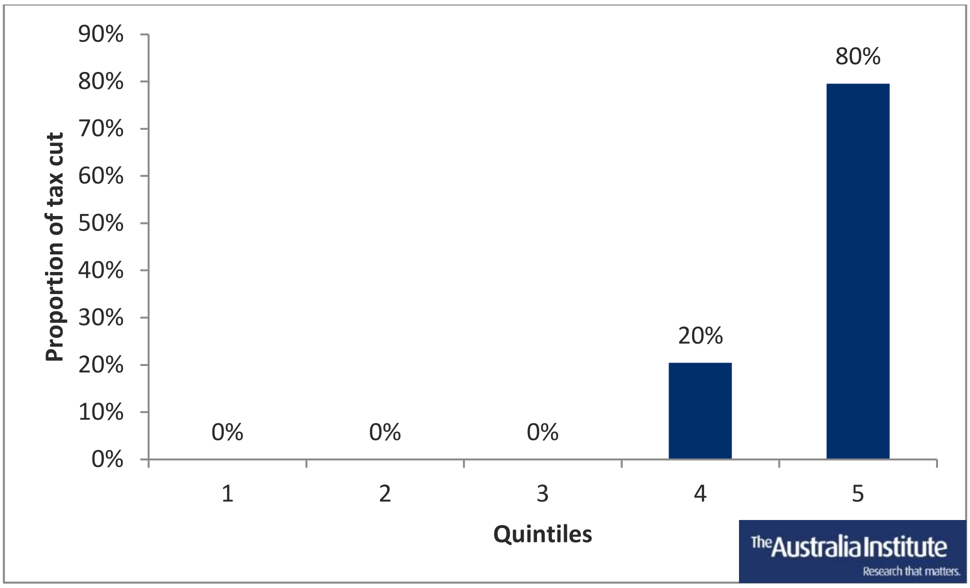
Figure 4 – Benefit of the income tax cut in 2024-25 by decile and gender



Source: ATO (2018) *Taxation Statistics 2015-16* and Australia Institute calculations

The previous analysis focused on the impact of all three stages of the tax cuts. The Australia Institute has also modelled just the income distributional impacts of increasing the 32.5 cent threshold from $90,000 to $200,000 and the removal of the 37 cent bracket. This represents part of stage two and all of stage three of the government's tax plan. The results are shown in Figure 5.

Figure 5 – Benefit of removing 37 per cent tax bracket by quintile in 2024-25

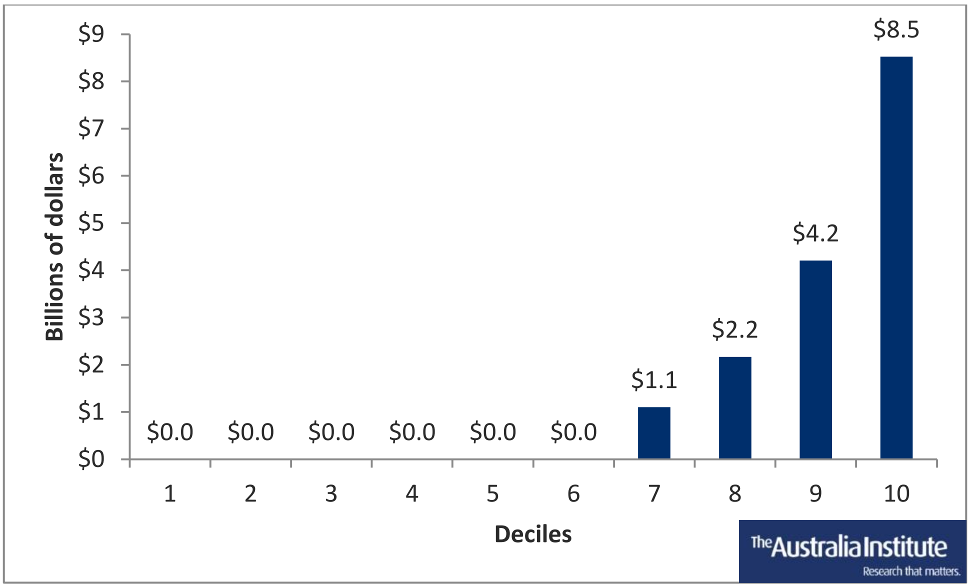


Source: ATO (2018) *Taxation Statistics 2015-16* and Australia Institute calculations

The part of the income tax cuts that removes the 37 per cent tax bracket is the most costly to the budget. In 2024-25 it is estimates to cost the budget $16 billion. While the first stage of the tax cut focused on middle and low income earners, the later more costly parts of the tax cut favoured high income earners. 80 per cent of the benefit of getting rid of the 37 per cent bracket flow to the top 20 per cent of taxpayers. The remaining benefit went to the next 20 per cent of taxpayers. 60 per cent of taxpayers will get no benefit from this tax cut.

Removal of the 37 per cent tax bracket will cost the budget $16 billion in 2024-25. $12.7 billion of that will go to taxpayers in the top 20 per cent. The top 10 per cent will get $8.5 billion.

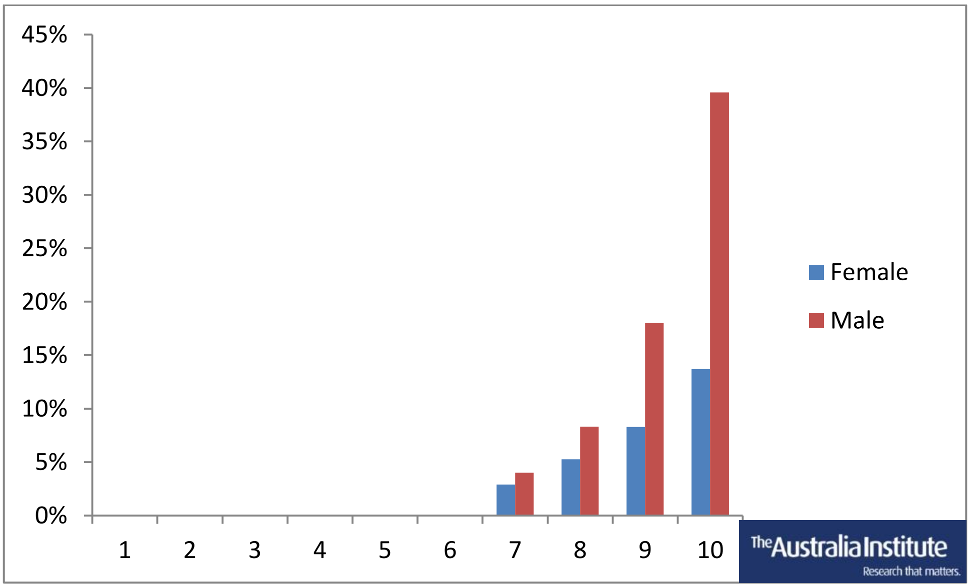
Figure 6 – Benefit of removing 37 per cent tax bracket by decile in 2024-25



Source: ATO (2018) *Taxation Statistics 2015-16* and Australia Institute calculations

The gender distribution of removing the 37 per cent tax bracket also heavily favours high income earning men. 70 per cent of the tax cut will go to men, with 30 per cent going to women. The distribution by decile is shown in Figure 7.

Figure 7 – benefit of removing 37 per cent tax bracket by decile in 2024-25



Source: ATO (2018) *Taxation Statistics 2015-16* and Australia Institute calculations

CONCLUSION

While some have suggested that these income tax cuts are primarily aimed at middle income earners, the distributional analysis tells a different story. While stage one of the tax cuts will benefit low and middle income earners, the far larger part of removing the 37 per cent tax bracket (that makes up most of stage 2 and all of stage 3) will overwhelmingly benefit high income earners.

METHOD

We have calculated the benefit of the tax cut by income and by gender using the latest taxation statistics. Using the taxation statistics, we have constructed a model of Australia's income tax system. We then broke down all taxpayers into 100 groups from the lowest income earners to the highest and identified the proportion of females and males in each group. By inflating income by nominal GDP and population growth we calculated how much each group pays as the income tax cut is introduced. We then calculated how much went to each income decile and quintile and how much of the tax cut went to women and men.

Inequality

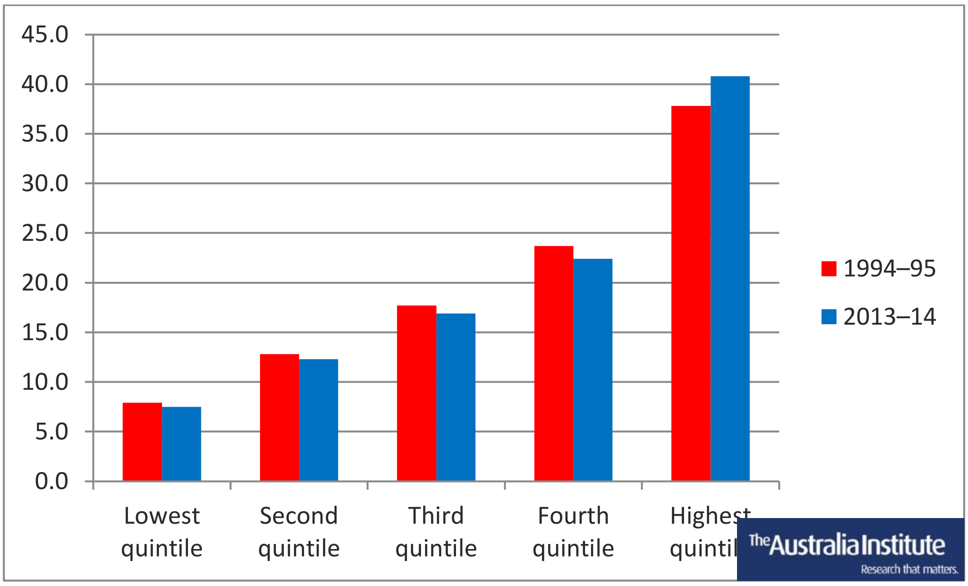
The Treasurer Scott Morrison has claimed that;

> Around 2 per cent of individuals collectively pay around 22 per cent of total personal income tax.[1]

As shown above the proportion of tax paid by high income earners is not particularly large when looking at Australia's recent history. The larger amount of tax paid by high income earners is in part a consequence of growing rates of inequality. According to all the evidence inequality in Australia is getting worse. This includes both income inequality and wealth inequality.

The latest household income survey[2] shows that between 1994-95 and 2013-14 the top 20 per cent of income earners share of income rose from 37.8 per cent to 40.8 per cent. Meanwhile every other quintile saw their income share fall. This is shown in figure 8.

Figure 8 – Equivalised disposable income shares by quintiles

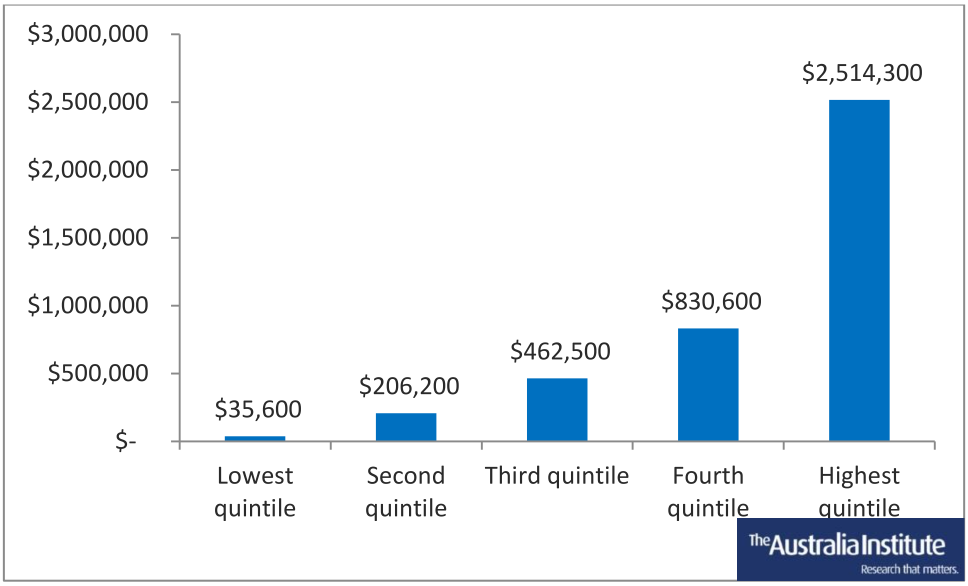


Source: Australian Bureau of Statistics (2015) *6523.0 – Household Income and Wealth, Australia, 2013–14*

[1] Morrison (2015) *A National Platform for Economic Growth and Jobs*
[2] ABS (2013) *Household income and income distribution, Australia, 2011-12*

Wealth is more unevenly distributed than income. Figure 9 shows household net worth by decile in 2013-14.

Figure 9 – Household net worth by quintiles 2013-14



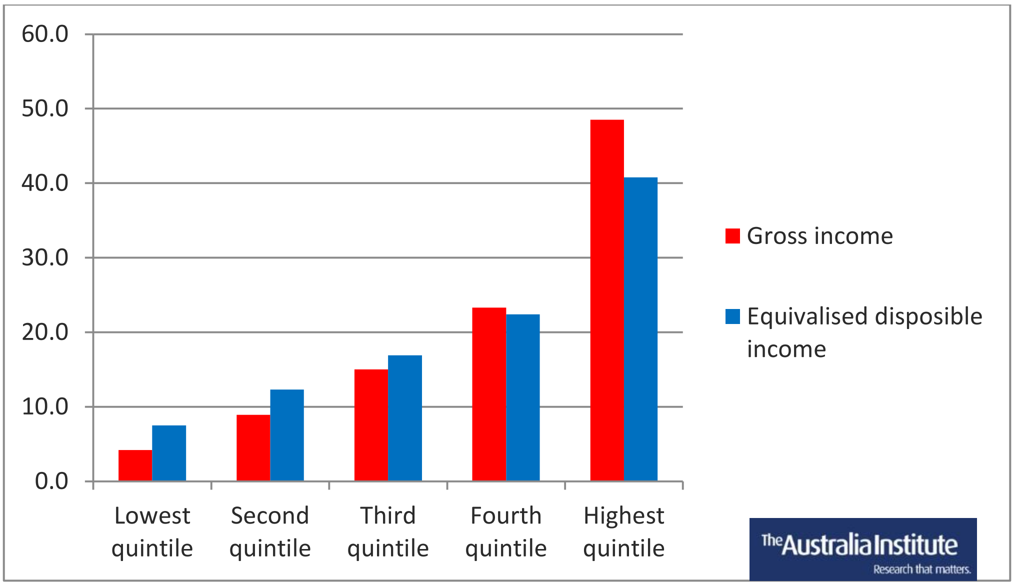
Source: Australian Bureau of Statistics (2015) *6523.0 – Household Income and Wealth, Australia, 2013–14*

Inequality data tends to be complicated but one of the most common measures of inequality is the Gini Coefficient. The Gini Coefficient for wealth and gross income shows that inequality is getting worse. Basically the rich are getting richer and the poor are getting poorer, especially in relative terms. Note in that context many low income earners have their payments indexed to the consumer price index (CPI) and over time they will slip behind as the rest of the population enjoys gradually rising living standards.

The government's tax and transfer (income support) system is one of the most effective ways of reducing inequality. Figure 10 shows how effective it is by looking at income distribution before tax and transfer payments (Gross income) and income distribution after tax and transfer payments (equivalised disposable income).[3]

[3] Equivalised disposable income does not only account for taxation. It also accounts for family type. This is not strictly comparing apples with apples since gross income is not equivalised, but the difference is likely to be small.

Figure 10 – Gross income and equivalised disposable income by quintile in 2013-14



Source: Australian Bureau of Statistics (2015) *6523.0 – Household Income and Wealth, Australia, 2013–14*

As Figure 10 shows the tax and transfer system increases the income shares of the bottom 60 per cent of households and decreases the income shares of the top 20 per cent. The fourth quartile is marginally affected. However, it is of course important to note that figure 10 does not include the government provision of income in kind, such as health, education and other services. Taking account these and similar expenditures is difficult to do but we can appreciate that there would be an even more apparent redistribution if we could make such adjustments.

Australia has tended to have a government sector that was one of the best in the developed world in terms of redistributing income towards the lower income groups and so producing a more equal society.[4] While the Australian tax-transfer system may be best in the sense of being well targeted it should of course by severely criticised for the level of adequacy insofar as the support for the poor are concerned. Given concerns about returning budgets to balance if not reaching surpluses then tax cuts higher up the income distribution are likely to mean less is available for assistance to the poor.

Worsening inequality has a negative impact on economic growth. The International Monetary Fund has studied the link between inequality and economic growth.[5] It found that higher rates of inequality lead to lower rates of economic growth. It further

[4] OECD (2008) *Growing unequal? Income distribution and poverty in OECD countries.*
[5] Dabla-Norris E et al. (2015) 'Causes and Consequences of Income Inequality : A Global Perspective', *IMF Staff Discussion Note 15/13*, June.

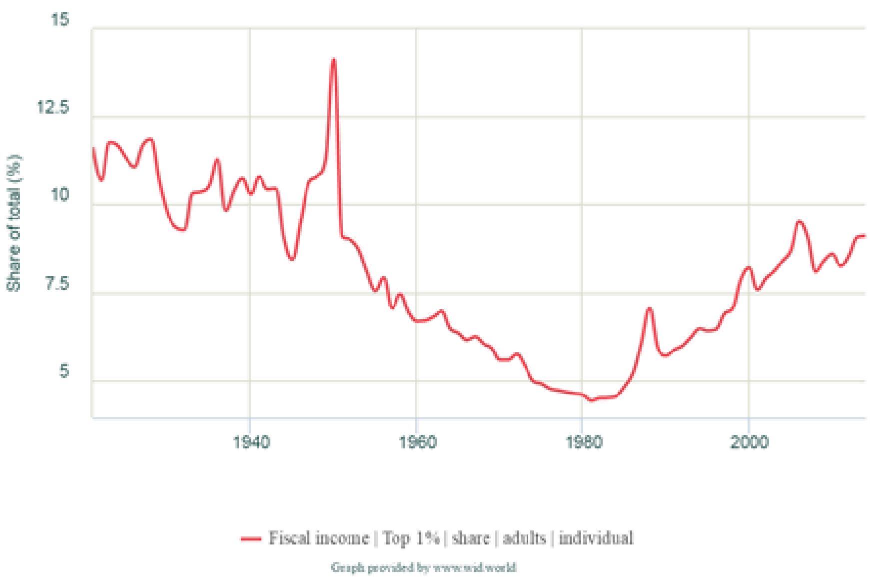
found that decreasing inequality improved economic growth. As Christine Lagarde, the head of the International Monetary Fund said;

> Our research shows that, if you lift the income share of the poor and middle class by 1 percentage point, then GDP growth increases by as much as 0.38 percentage points in a country over five years. By contrast, if you lift the income share of the rich by 1 percentage point, then GDP growth decreases by 0.08 percentage points. One possible explanation is that the rich spend a lower fraction of their incomes, which could reduce aggregate demand and undermine growth.[6]

Increasing the top marginal rate is likely to slow the rising rate of inequality and hence improve economic growth. Likewise, preserving the top rates and the thresholds at which they begin will do a small part to prevent any further deterioration in income inequality.

A longer historic view of the top one per cent of income earners can be obtained by using the World Wealth and Income Database developed by Thomas Piketty and his colleagues.

Figure 11 – Top 1% fiscal income share in Australia from 1921 – 2014



Source: World Wealth & Income Database. Note: Fiscal income is defined as the sum of all income items reported on income tax returns, before any deduction. It includes labour income, capital income and mixed income.

[6] Lagarde (2015) 'Lifting the small boats', *Address* at Grandes Conferences Catholiques Brussels, June 17

The graph shows a remarkable change in the share of the top over almost a century of data. Increasing post-war egalitarianism until around 1980 drove the share of the top one per cent down to 4.41 per cent in 1981. Since then the trend in the most recent figures shows the top one per cent back towards where they were at the beginning of the period covered in the graph, around the end of WW1. On the latest figures the top one per cent reached 9.1 per cent of income, just down from a peak of 9.5 per cent on the eve of the global financial crisis.

Table 4 shows the difference between 1981 and the last year in the on-line database (2013). The figures show the share of income received by the top 10 per cent of income earners in 1981 and 2013 in the first line of data together with the shares received by the top 5, one and 0.1 per cent of the population respectively.

Table 4: Top income shares compared; 1981 and 2013

Income shares %	1981	2013	Increase %
Top 10	24.4	31.6	29.5
Top 5	14.6	21.4	46.6
Top 1	4.5	9.0	102.2
Top 0.1	0.9	3.1	244.4

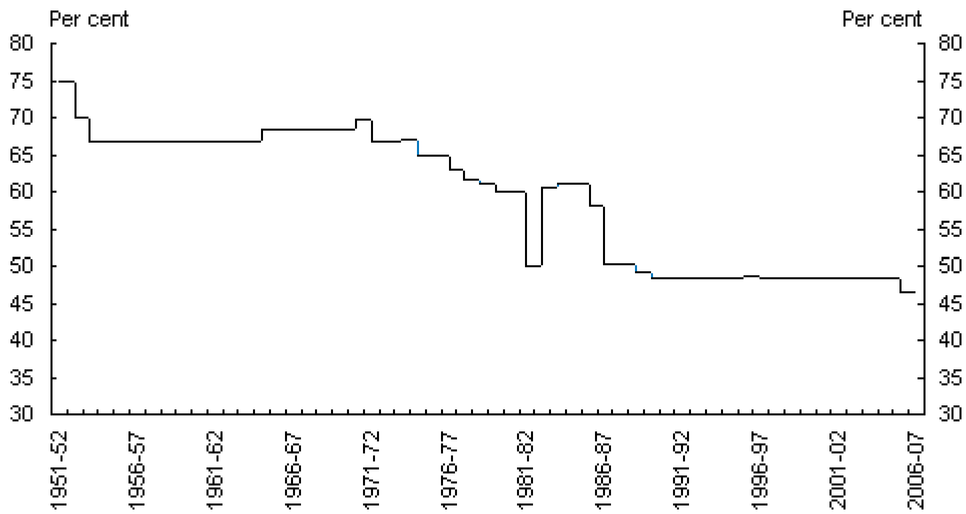
Source: World Wealth & Income Database

Inequality has been steadily getting worse in Australia since the early 1980s and the most effective tool the government has for fighting inequality is the tax and transfer system.

Australia's experience

The top marginal tax rate at 45 cents in the dollar (from July 2017 excluding the Medicare levy) is very modest now compared with the historical rates as shown in the following graph.

Figure 12: Australia's top marginal tax rates

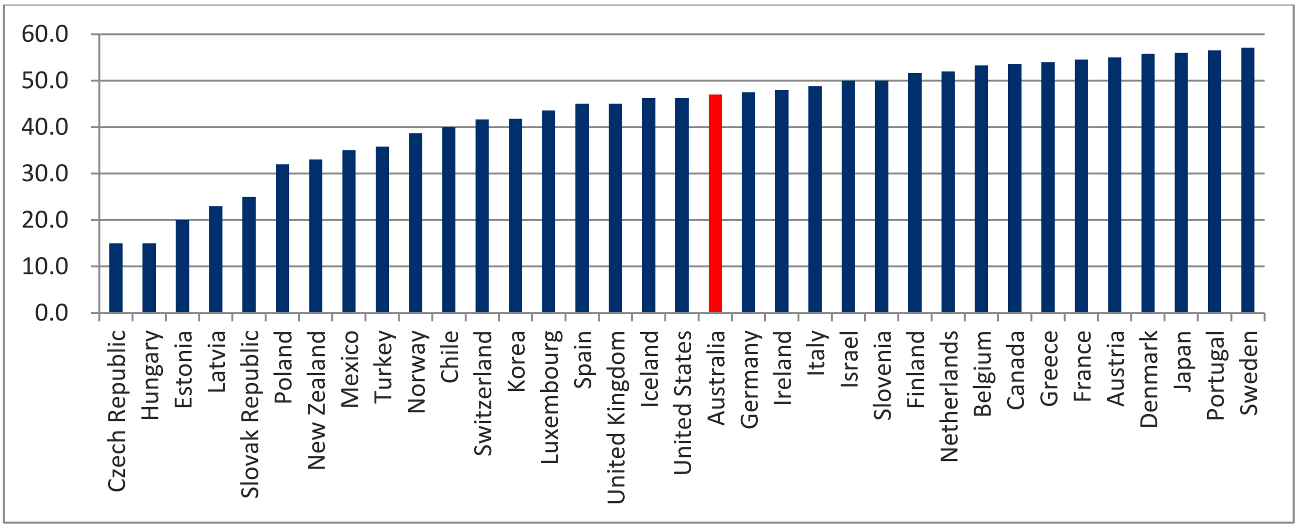


Source: Reinhardt S and Steel L (2006) 'A brief history of Australia's tax system' Paper presented to the 22nd APEC Finance Ministers' Technical Working Group Meeting in Khanh Hoa, Vietnam, on 15June2006. https://treasury.gov.au/publication/economic-roundup-winter-2006/a-brief-history-of-australias-tax-system/

The graph in Figure 12 shows that after world war two and throughout the Menzies era the top marginal tax rate never fell below 67 per cent. That period was perhaps the golden age of economic growth in Australia when the unemployment rate was consistently at two per cent or less. Since then governments have been persuaded by the fallacious arguments in favour of increasing incentives for high income earners.

At the moment Australia's top marginal tax rate ranks towards the middle when compared to other developed countries. Australia ranks 19th out of 35 OECD nations. Figure 13 shows where Australia ranks compared to other developed countries assuming that our top marginal tax rate is 47 per cent.

Figure 13 – Top statutory rates for 35 OECD nations assuming Australia's rate is 47%

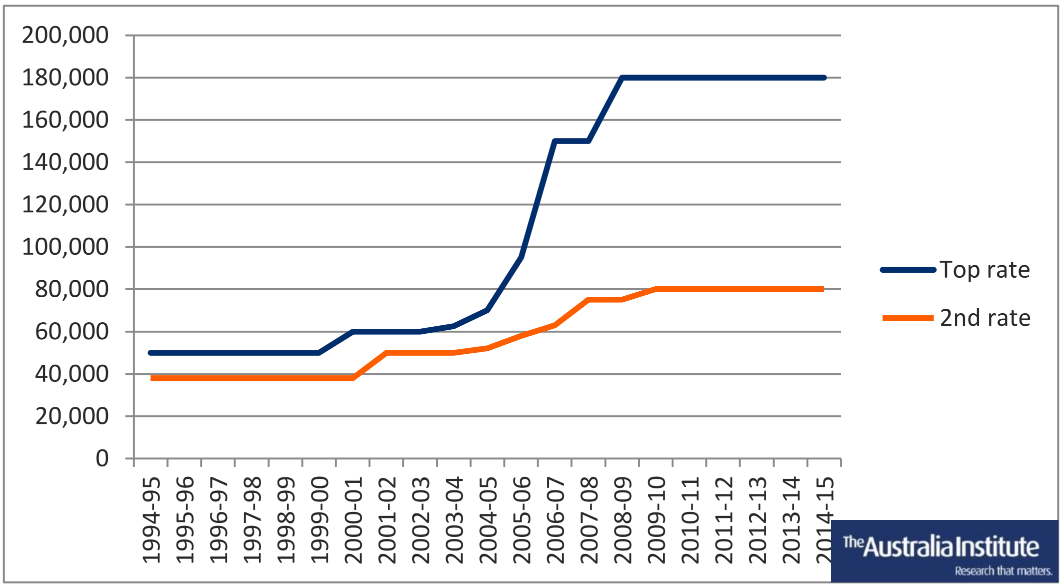


Source: Organisation for Economic Co-operation and Development (2017) Table I.7. Top statutory personal income tax rate and top marginal tax rates for employees

Proportion paying the top rates

As shown above the top marginal tax rate has fallen substantially over the last 50 years. The income threshold that the top rate begins has increased dramatically in recent years. This means that the proportion of tax payers who pay the top marginal tax rate has also changed dramatically. Figure 14 shows how the income threshold for the top two income rates has changed.

Figure 14 – Change in income thresholds for top two tax brackets 1995 to 2015

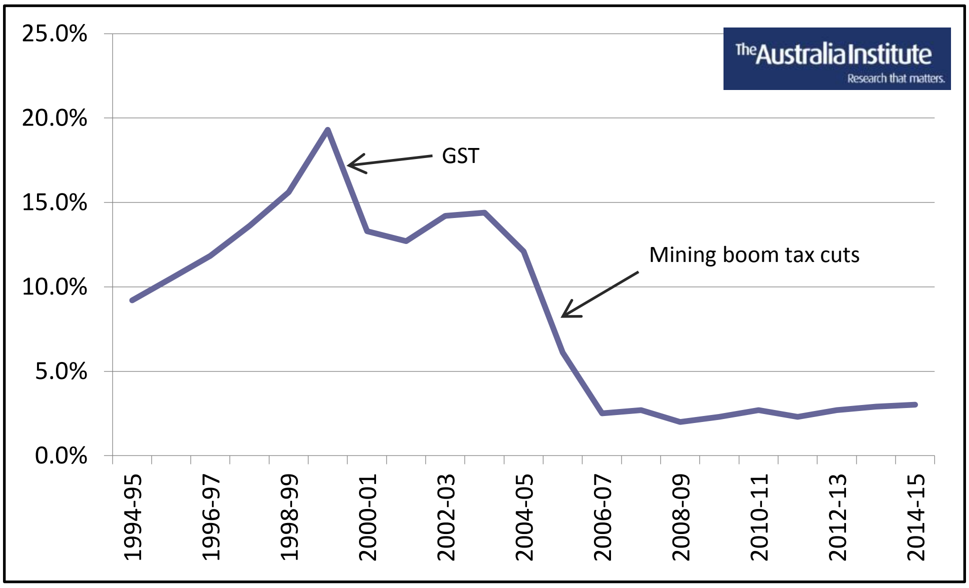


Source: Australian Tax Office (2017) Individual income tax rates for prior years

Figure 14 shows that the threshold for the top bracket has more than tripled. This occurred mainly during the mining boom tax cuts. The effect of such a large change in the threshold is to reduce the proportion of tax payers paying the top marginal rate. Over the last 20 years the rate has fallen from a peak of almost 20 per cent in year 2000 to a relatively low proportion of three per cent today.

Figure 15 shows the proportion of tax payers paying the top marginal tax rate. The introduction of the GST saw income tax revenue fall, and hence the proportion of people paying the top rate also fall, as part of the compensation for the GST. The proportion recovered modestly but then fell dramatically to historically low rates when the Howard government cut income tax using the mining boom's temporary windfall gains. Since then the proportion has stayed relatively flat.

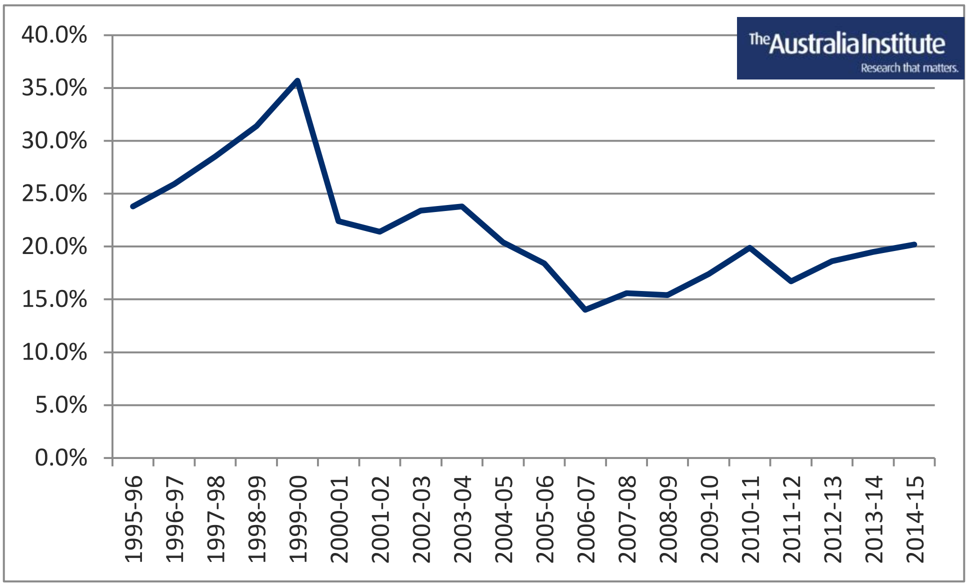
Figure 15 – Proportion of tax payers paying the top marginal rate from 1995 to 2015



Source: Australian Taxation Office (2017) Taxation Statistics: Individuals: Selected items, by taxable income range and total income or loss range: years from 1994-95 to 2014-15

The proportion of taxpayers who are paying either the second top or top rates of tax is a similar story. But because the increase in the second top threshold was not as dramatic as the top threshold the fall in the proportion paying into either of the top two rates is not as large.

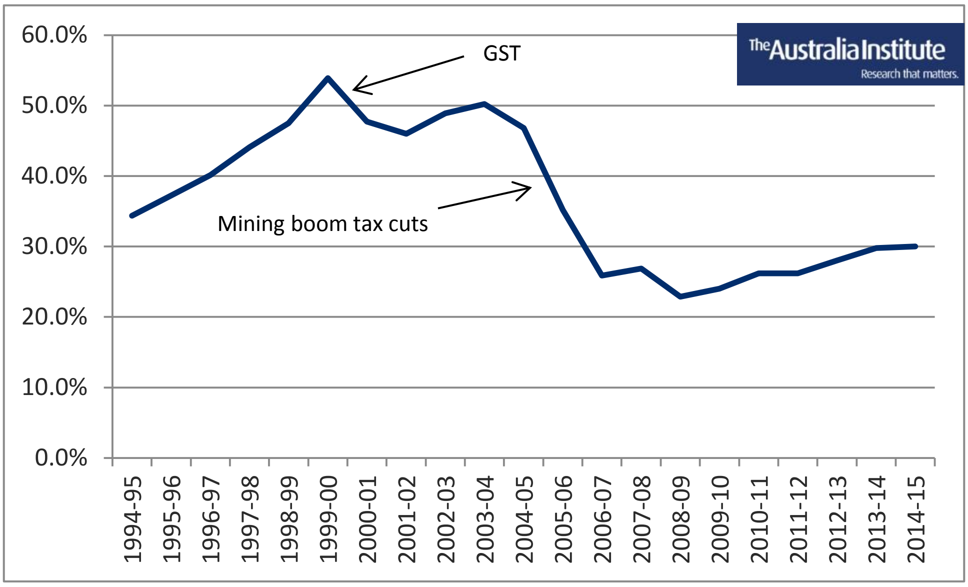
Figure 16 - Proportion of tax payers paying either the top or second top marginal rate from 1996 to 2015



Source: Australian Taxation Office (2017) Taxation Statistics: Individuals: Selected items, by taxable income range and total income or loss range: years from 1994-95 to 2014-15

The government has also claimed that a considerable proportion of tax is paid by those on high incomes. Figure 17 shows the proportion of net tax paid by those on the top marginal rate. Net tax is gross tax minus deductions. It shows that those on the top marginal rate are paying a historically low proportion of tax when compared to earlier years. The proportion of tax paid by this group peaked in the year 2000 at 50 per cent just before the introduction of the GST. It has since fallen to a historically low rate of 30 per cent.

Figure 17 – Proportion of net tax paid by those paying the top marginal rate from 1995 to 2015



Source: Australian Taxation Office (2017) Taxation Statistics: Individuals: Selected items, by taxable income range and total income or loss range: years from 1994-95 to 2014-15

The evidence shows that the proportion of taxpayers paying the top marginal tax rate is at historically low levels in large part because of the increase in the top tax threshold during the mining boom. The proportion of tax paid by those on the top marginal tax rate is also at historically low levels.

Then Treasurer Joe Hockey in an interview with the *AFRWeekend* says the 'personal income tax revenue is subject to unsustainable risk' because 'the top 10 per cent … pay nearly half' which he says 'is an over-reliance and dependence on a narrow base that is increasingly mobile'.[7] As it happens these people also receive 30.3 per cent of all the personal income. Progressive tax implies they pay a higher proportion of their income than lower income people.

[7] Walker T (2015) '"Not a cigarette paper between" Joe Hockey and Tony Abbott', *The Australian Financial Review*, 14 August.

Discussion

PROGRESSIVITY

A progressive tax system is an essential part of an income distribution policy since it determines who gets what in Australia today along with the social security and other mechanisms. A progressive tax raises revenue from those most able to pay and distributes it to those least able to support themselves or their families.

Equity implies that taxation should reflect income. In particular an equitable and fair tax system should impose proportionately higher burdens on people with higher incomes. Putting that differently, people on lower incomes should have a lower tax burden both in absolute and relative terms.

In the Wealth of Nations written in 1776 Adam Smith put the case for progressive income tax very eloquently when he said:

The necessaries of life occasion the great expense of the poor. They find it difficult to get food, and the greater part of their little revenue is spent in getting it. The luxuries and vanities of life occasion the principal expense of the rich, and a magnificent house embellishes and sets off to the best advantage all the other luxuries and vanities which they possess….It is not very unreasonable that the rich should contribute to the public expense, not only in proportion to their revenue, but something more than in that proportion.[8]

It is concerning that in some quarters a weakening of the commitment to a progressive personal income tax and that has been reflected in public policy. For example, in the present tax scale there are five different tax rates compared with 29 in 1965. The government's income tax proposal will go further and cut those five rates to four.

The present tax scales mean that the average paid tax for very high incomes goes towards 47 per cent (with the Medicare levy). In previous years the asymptotic value of the Australian tax system was much higher than that. For example, during the Menzies years of 1954-55 and 1964-65 the top tax rate was 66.67 per cent.[9]

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[8] Smith A (1776) *The Wealth of Nations.* Electronic edition sourced at History of Economic Thought Website at http://cepa.newschool.edu/het

[9] ABS (1965) *Australia Yearbook*. The top rate was 75 per cent through to 1951-52.

The late AB (Sir Tony) Atkinson advocated a top marginal tax rate for the UK of 65 per cent compared with 45 per cent.[10] Other influential researchers[11] suggest the top US top marginal rates should be around 73 per cent. These sorts of figures are around the top rate that applied through most of the Menzies Government.

VESTED INTERESTS?

For years those with vested interests in low taxation for the rich have used notions such as 'incentives-to-work' as a reason for taxing the rich lightly but arguing that the state should not support lower income earners because they needed incentives to work.

In his 2014 budget speech then Treasurer Joe Hockey talked about the incentive and opportunity given to the unemployed (by making Newstart harder to get and waiting longer) and has talked about the injustice of the rich paying too much in tax when he said 'Higher-income households pay half their income in tax'[12] (which is untrue). JK Galbraith once criticised this type of thinking as amounting to asserting that the poor have no incentive because they get too much while the rich have no incentive because they do not get enough.[13]

[10] AB Atkinson (2015) 'Book launch "Inequality"', *YouTube* 23 April at https://www.youtube.com/watch?v=ZBzj8UQeKDY

[11] Diamond P and Saez E (2011) 'The case for a progressive tax: From basic research to policy recommendations', *Journal of Economic Perspectives*, Vol 25(4), pp. 165-90.

[12] Martin (2014) 'Sorry, Treasurer, but your tax figures are a long way wide of the mark', *Sydney Morning Herald*, 6 August.

[13] Galbraith (1958) *The Affluent Society,* Harmondsworth: Penguin.

Tax and prosperity

Gale and Samwick make the point that in the US there was no income tax between 1870 and 1913, just prior to World War 1. On the other hand after World War 2, from 1947 to 2000 top marginal tax rate averaged 66 per cent. They comment 'However, the growth rate of real GDP per capita was identical - 2.2 per cent – in the 1870-1912 period and between 1947 and 1999'.[14]

A more common throwaway line that was particularly popular with former Prime Minister Tony Abbott is that no country has ever taxed its way to prosperity.[15] This has been regularly used as an argument against any increases in taxation.

This argument is essentially that taxation is a burden on the economy and the greater the rates of taxation then the greater the burden. If this argument is true then countries with lower tax rates would be expected to have higher incomes.

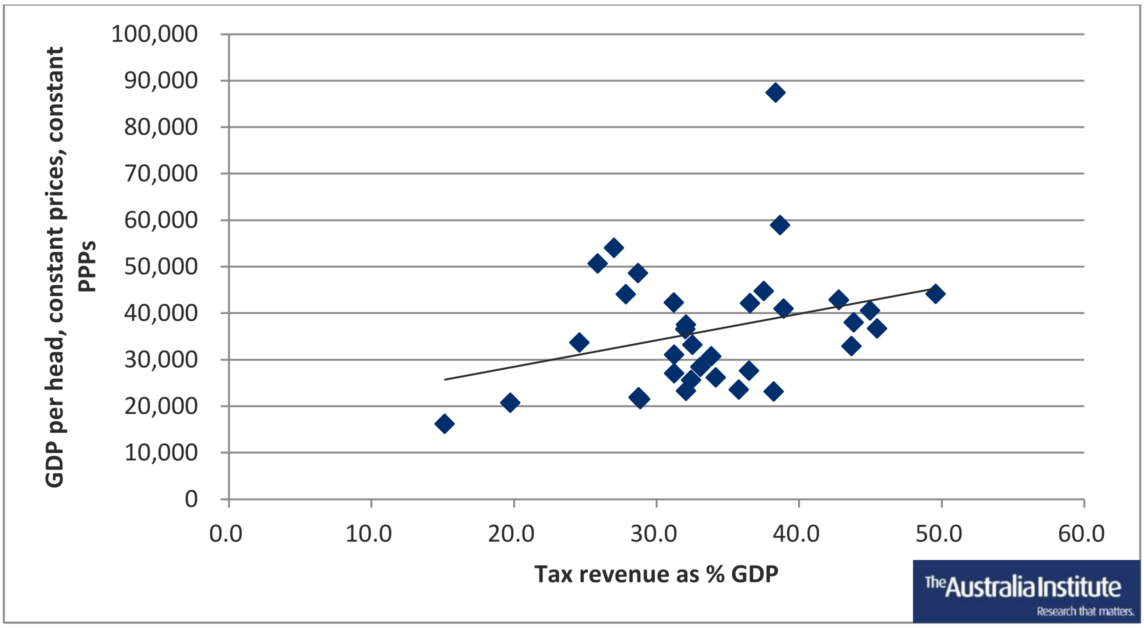
The most common measure of a countries tax burden is to use their tax to GDP ratio. This is effectively the amount of tax they collect compared to the size of their economy. A country's average income is measured as Gross Domestic Product (GDP) per capita. That is a countries GDP divided by its population.

Figure 18 looks at developed countries tax burden and its average income. It shows that economic prosperity rises with taxation. This is the opposite of what Mr Abbott has suggested.

[14] Gale WG and Samwick AA (2014) 'Effects of income tax changes on economic growth', *Economic Studies at Brookings*, September

[15] Abbott (2016) 'In defence of my economic narrative and tough decisions', *The Australian*, 27 February.

Figure 18 – OECD nation's tax to GDP and GDP per capita from 2014



Source: Organisation for Economic Co-operation and Development (2017) *Gross Domestic Product (GDP)* and *Revenue Statistics*

The evidence suggests that tax rates and average incomes are positively correlated, that is they rise and fall together. The idea that no country has ever taxed its way to prosperity is not based on the evidence.

Theory

A lot of the public discussion revolves around the incentive effects of taxation; the question of whether higher taxes discourage work and other participation in the domestic economy. The following passage is a good example of how economists approach the topic:

> An across-the-board cut in income tax rates… raises the marginal return to work—increasing labor [sic] supply through the substitution effect. It reduces the value of existing tax subsidies and thus would likely alter the composition of economic activity. It also raises a household's after-tax income at every level of labor supply, which in turn, reduces labor supply through the income effect. The net effect on labor supply is ambiguous. Similar effects also apply to the impact of tax rate cuts on saving and other activities.[16]

So the pure substitution effect does indeed imply that people will want to participate less in the workforce because the marginal benefit of doing so is reduced. On the other hand the income effect works in the opposite direction. If taxes are increased then in order to maintain living standards people will want to put in additional hours of work. There is no logical reason to suppose the substitution effect will dominate and so in the absence of further information we have to be agnostic on the question of whether or not an increase/decrease in tax rates will reduce/increase people's participation in the workforce.

HIGHER TAX RATES AS A DISINCENTIVE TO WORK

One of the main arguments against high marginal income tax rates is that it discourages people from working. The argument is that the higher the marginal tax rate the less benefit a worker gets if they decide to work additional hours. It follows that lower marginal tax rates could encourage additional work which could potentially raise income, increase output and consumption. This of course depends on the substitution effect dominating the income effect which may of not be the case. However, we are going to follow this argument to see where it leads.

Encouraging people to give up leisure time for more work time increases what economist call participation. This along with the population and productivity are what

[16] Gale WG and Samwick AA (2014) 'Effects of income tax changes on economic growth', *Economic Studies at Brookings*, September, p2

many economists believe are the three most important factors in increasing long term economic growth rates. This theory is used to argue that income tax rates should be cut to encourage more people to seek out work and raise living standards.

While there is an incentive to do less of something the more it is taxed, care must be used when applying this to the incentive to work and the top marginal tax rate. There are groups where a higher marginal tax rate is likely to act as a bigger disincentive to work, but there are also groups where the disincentive is likely to be very small.

Women are the group where the largest gains can be made from improvements in workforce participation. Women's participation rates are lower than men's and those women who are not in the labour force are on average more highly educated than men who are not in the labour force. The economy has the most to gain from encouraging women back into the workforce.

The biggest barrier to female participation in the workforce is the not the top rate of marginal tax. Rather it is the cost of childcare and the way in which the welfare system interacts with women returning to work after having children.

The group where changes in marginal tax rates are likely to have less impact is with full time workers on high income salaries. Consider a manager who works full time. A change in their marginal tax rate is unlikely to induce a change in the number of hours worked. Their job requires a certain number of hours and they are unlikely to have the flexibility to change those hours.

The empirical evidence shows that changes in the top marginal tax rates have little effect on participation while subsidies to childcare and paid parental leave had a big impact.[17] If the government is concerned with participation rates then it would be more effective to lift high income tax rates and use the money to subsidise initiatives to encourage women to re-enter the workforce after having children.

THE OPTIMUM TOP MARGINAL TAX RATE

Economic theory suggests that the top marginal tax rates should be much higher than present rates. For example Diamond and Saez[18] suggest that the optimal US top marginal rates should be around 73 per cent. The argument is technical but the intuition is clear; on average a dollar received by a low income earner is valued much

[17] Jaumotte F (2003) 'Labour force participation of Women: Empirical evidence on the role of policy and other determinants in OECD countries', *OECD Working Paper No. 37*, 25 October.

[18] Diamond P and Saez E (2011) 'The case for a progressive tax: From basic research to policy recommendations', *Journal of Economic Perspectives*, Vol 25(4), pp. 165-90.

more than a dollar earned by those in the top income groups and high income earners are unlikely to change their behaviour so as to cause us to be concerned about, for example, a hypothetical welfare loss if corporate executives slacken off. High earners are less responsive to changing tax rates than a family's second income earner for example.

Piketty notes that the evidence suggests that an 80 per cent rate on incomes of half a million or so in the US 'would not reduce the growth of the US economy but would in fact distribute the fruits of growth more widely while imposing reasonable limits on economically useless (or even harmful) behaviour'.[19]

As mentioned Australian evidence points to the relative unresponsiveness of labour supply among high income earners. Gruen points out that any tax change leads to most response in the bottom of the income distribution so that a tax change for lower income earners is likely to generate a much larger response than a tax change for higher income earners.[20] All the evidence is that the second family earner is sensitive to incentives especially those households that include children. The marginal tax rate is an important component of that incentive structure.

These considerations reinforce the argument that tax rates should be kept low in the income ranges affecting a household's second adult earner. However, higher tax rates further up the income scale are unlikely to affect behaviour. This seems to be a rather helpful conclusion in that it implies that we do best for both inequality and economic performance with a strongly progressive tax system.

[19] Piketty T (2014) *Capital in the twenty-first century*, Cambridge MA: Harvard UP, p 513.

[20] See Gruen N (2006) 'Tax cuts for growth', CEDA Information Paper 84 at http://apo.org.au/research/tax-cuts-growth, Freebairn J (1998) 'Microeconomics of the Australian labour market', Unemployment and the Australian Labour Market, Reserve Bank of Australia Conference 9-10 June at http://www.rba.gov.au/publications/confs/1998/freebairn.html and Keane's survey at Keane M (2010) 'Labor supply and taxes: A survey', *University of Techhnology Sydney, Working Paper Series, No 160* at http://www.finance.uts.edu.au/research/wpapers/wp160.pdf

Surcharges on unearned or property income.

An exception to the equal treatment of the same income principle used to occur when the tax system imposed a surcharge on unearned income. In some countries unearned income has been treated differently for tax purposes in order to redistribute income or to recognise its qualitative difference from income derived from productive work. The prime example is the United Kingdom, where income taxes on the highest brackets reached 98 per cent in 1979.[21] If there are two people otherwise equal except that one works for a living and the other earns the same without working then there was a case for taxing the latter more heavily. Australia retains a surcharge on unearned income for minors who pay tax on 'unearned income' at the top marginal tax rate of 45 cents in the dollar.[22] The main reason for the present differential is to counter tax avoidance which may take place through the splitting of income to appear in a child's name.

An argument for a surcharge on unearned income is that those two people with the same income are not otherwise the same in that one has to work a full week in order to make the same income as the other does with no effort. The one with unearned income in a sense has more resources available in that he/she may at any time convert the additional leisure into income. On a capacity to pay argument the one on unearned income might be addressed with an unearned income tax surcharge.

Current position

At the moment Australia only taxes unearned income differently when it is earned by a minor who attracts a marginal tax of up to 45 per cent on incomes above $1,307. An ordinary taxpayer would only pay that marginal rate on incomes above $180,000. This treatment of minors is explicitly designed to counter income splitting, a class of tax avoidance strategies involving children.

[21] Atkinson, A.B., "Income Tax and Top Incomes over the Twentieth Century", December, 2003, p. 132.
[22] ATO (2018) *Rates of Income Tax – Minors,* 7 February.

1950s surcharge on property income

Until the year 1953-54 Australia imposed a tax surcharge on property incomes. The maximum rate was 16 pence in the pound or a marginal rate of 6.67 per cent. The full details are in an appendix.

1970s

In 1974-75 the Whitlam Government introduced a surcharge on property income where the property owner's income exceeded $5,000. The rate was then phased in until it reached 10 per cent at $5,500. In today's prices those values are $36,000 and $39,600 respectively. The surcharge operated as an increase of 10 per cent on the tax that would have otherwise been paid.

At the time the Whitlam Government introduced the surcharge the UK and US also taxed property income but in different ways. In the US the tax scale went right up to a top rate of 70 per cent but the maximum rate on personal exertion was 50 per cent. You effectively received a discount for income from personal exertion rather than a surcharge for unearned income.

Until 1973 the UK allowed a deduction of an earned income allowance of two-ninths of personal exertion income to ₤4,005 and 15 per cent thereafter. However after 1973 that was swapped for a surcharge on investment income.

The Henry Report wanted to tax income from personal exertion much more heavily than 'unearned income'. Unearned income is income from investments as opposed to personal exertion. The Henry Report wants investment income to be discounted by 40 per cent compared with someone who works for a living.

The ideological justification for lower taxes on unearned income is clear in the way the Henry Report refers to the 'taxation of income from saving'. The Review shows how by taxing the income on savings, someone who puts away some savings has it greatly reduced after 45 years as a result of taxation of the interest compared with the hypothetical alternative of zero tax and compounding the interest savings.

Henry can dazzle us with compound arithmetic. He portrays the process of investment and the acquisition of wealth in Australia as the result of hardworking individuals salting away their hard-earned, delaying consumption today for consumption on a rainy day later in their lives. Tax on that investment income is frustrating that process.

But the facts are that household savings over the last decade has averaged less than $10 billion per annum and some of that will be savings on the part of unincorporated business. The total capital stock in Australia is worth around $3,400 billion. The latter figure does not come about as a result of a bunch of workers saving part of their income for use in retirement.

In fact total savings in Australia was $62 billion over the last decade. Evidently the story told by the Henry Report refers to a small part of the real economy when it uses the analogy of workers' savings as the basis for taxing the income on wealth.

Imagine an economy in which workers' savings out of their wages is the only form of creating wealth and we get the Henry Report's vision and its justification for discounting the taxation on unearned income. That story, whereby wealth is merely workers' savings, cannot really handle the real world of inherited wealth and where savings and investment decisions made in board rooms, not around the kitchen table.

Polling

A lot of the discussion about personal income tax takes it for granted that people know their own tax position and how it would change if they changed their working arrangements. If marginal tax rates have a major effect on people's behaviour then we would expect that people have a fair degree of knowledge about them.

In 2009 The Australia Institute conducted an online survey of 1,000 people using a nationally representative sample by age, gender and state/territory. Respondents who said they were in paid work (619 of 1,000) were asked a number of questions designed to see how much they knew.

The results for the first question indicated

- only 16.4 per cent of respondents could correctly nominate their correct tax rate;
- 35.9 per cent nominated an incorrect tax rates and
- 47.6 per cent said they did not know their tax rate.

When asked if they knew what the marginal tax rate would be in the next tax bracket

- Only 5.6 per cent of respondents could correctly nominate the correct tax rate;
- 15.1 per cent nominated an incorrect tax rates and
- 78.2 per cent said they did not know their tax rate and
- 1.1 per cent were already in the top tax bracket.

These results have very interesting and important implications for public policy. If people are not sufficiently motivated to work out their marginal tax rates then it is hard to believe they can be a major determinant of their behaviour.

Conclusion

Recommendation: That the Senate Committee take note of the distributional analysis in this submission. In particular the finding that when fully implemented in 2024-25 the benefit of the proposed tax cuts will go overwhelmingly to high income earners. Hence the top 10 per cent of taxpayers get about 40 per cent of the tax cut, while the bottom 10 per cent only get 1.5 per cent of the tax cut. When broken down by gender men get twice the tax cut compared to women.

The changes higher up the income scale involve large disproportionate benefits for the rich. Hence the benefit of the removal of the 37 per cent tax bracket gives 80 per cent of the benefit to the top 20 per cent of taxpayers.

Recommendation: The Senate Committee note that removal of the 37 per cent tax bracket disproportionately benefits the rich and men at a cost of $16 billion in 2024-25.

Given the present economic circumstances any tax cuts should be targeted at those lower down the income distribution who have not had the benefit of rapidly growing non-labour incomes and who have not the luxury of high wage incomes that puts them beyond the need for any tax 'relief'.

Recommendation: That the Senate reject, or send a message to reject, those parts of the Treasury Laws Amendment (Personal Income Tax Plan) Bill 2018 that would disproportionately benefit high income earners.

If the arguments here are accepted then we should always be looking for opportunities to market the tax system more progressive and not less.

Polling by The Australia Institute found that almost no-one knew their marginal tax rate. The implications of that are first that policy makers should not be concerned about the impact of the marginal tax rates themselves and further that tax scales can be designed without worrying about whether there are too many or too few brackets and marginal tax rates.

Recommendation: The Senate Committee take note of TAI polling that shows most people do not know either their own marginal tax rate or the one just above their own.

This submission has addressed Australia's worsening inequality and discussed how a more progressive tax scale has the effect of cushioning the inequality due to market outcomes.

Recommendation: That the Senate Committee endorse the need for redistributive policies towards a more progressive outcome using the personal income tax system as one of the major tools in that exercise.

Recommendation: That the Senate Committee note that the higher tax rates under the Menzies Government was consistent with higher economic growth. More recent international data show tax revenue per capita is associated with higher living standards.

Recommendation: That the Senate Committee note that concern about individuals in the top bracket/s is misplaced especially given that the proportions were much greater in recent decades and did not present a problem.

Recommendation: That the Senate Committee note that throughout history those with vested interests in lower taxes on the rich have put self-serving arguments in favour of themselves and today is no different.

Recommendation: That the Senate Committee note that the economic theory is silent on the effect of tax incentives on the labour market but the evidence suggests second adult earners contemplating work may be adversely affected. Theory also suggests the optimum top tax rate is much higher than the present rate. These and a concern for inequality all point in the direction of increasing the progressivity of the tax system; not reducing it.

We note that the share of income in Australia has moved significantly against labour and in favour of non-labour income. **Recommendation: That the Senate Committee consider a surcharge on unearned income.**

Recommendation: the Senate Committee restate a commitment to a progressive tax scale for Australia's personal income tax system.

In the words of Nicholas Kaldor (later Lord Kaldor): "the choice of the principle on which the burden of taxation can most fairly be allocated between persons is ultimately a moral and not an economic one".[23]

Recommendation: The Senate Committee be very sceptical of any claims or modelling that suggests that lower and flatter tax scales have economic benefits.

[23] Kaldor N (1955) *An Expenditure Tax*, London: Allen & Unwin, p 25.

Appendix: How the property income tax surcharge worked

The surcharge on property income was imposed according to the following table. The tax scale in the years before 1953-54 included 28 separate rates. Rather than show how the surcharge affected them all we concentrate on the income ranges shown in the following table.

Table 5: Further tax and contribution on property income; 1950-51 to 1952-53

1 Taxable income	2 Further tax payable	3 Ordinary marginal tax rate	4 Ordinary marginal rate	5 Combined marginal rate
£			%	%
0-100	Nil	1d.	0.42	0.42
100 to 1,000	8d. on each £1 in excess of 100	6d. to 56d.	2.50 to 23.33	5.83 to 26.67
1000 to 4,000	£30 + 16d. on each £1 in excess of 1,000	64d. to 136d.	26.67 to 56.67	33.33 to 63.33
4,000 to 6,000	£230 + 8d. on each £1 in excess of 4,000	144d. to 160d.	60.00 to 66.67	63.33 to 73.33
6,000 to 10,000	£296/13/4 + 4d. on each £1 in excess of 6,000	168d. to 176d.	70.00 to 73.33	71.67 to 75.00
10,000 and above	£363/6/8 + no rate on excess over £10,000.	180d.	75.00	75.00

Source: ABS (1954) *Yearbook 1954*

Reading down this table we can see for example that for someone in the income range £4,000 to £6,000 as shown in column 1, the tax surcharge payable was £230 plus 8 pence in every additional pound of income which is given in column 2. That surcharge applies in addition to the ordinary marginal tax rate shown in column 3. For this income the ordinary marginal tax rate varied from 144 pence to 160 pence in the pound. It is difficult for us to now think in pounds, shillings and pence so Column 4 expresses those marginal rates as percentages and we can see that for this income range, the marginal tax rate ranged from 60 to 66.67 per cent. When the surcharge for property income is included those marginal rates increase to 63.33 through to 73.33 per cent as shown in Column 5.

Note average male weekly earnings gave an annual income of ₤567 in 1950-51 and ₤757 in 1952-53 (ABS *Yearbook 1954*). So what this tax scale is saying is that well before average weekly earnings there was a surcharge on unearned income of 8 pence in the pound or 3.33 per cent of income above ₤100. However, at ₤1,000, almost two times average earnings (or one and a half in 1952-53), the surcharge increases to 16 pence in the pound or 6.67 percentage points. That penalty was a flat rate until income reached ₤4,000 or around seven times average earnings. At that point the ordinary marginal tax rate increased to 60.00 per cent and there would have in any case been very few people relying on income from personal exertion at those incomes. Hence the surcharge is faded out so that by the time one was on ₤10,000, or some 17 times the average the full marginal tax rate of 75 per cent was applicable and the at that point the surcharged was fully phased out.

Note too that a male with a spouse and two children under 16, a male earner would be entitled to deductions of ₤234 and so would pay no tax until his income reached ₤1,352 pa or around twice average earnings.