RE: Senate inquiry into Australia's Taxation System

**Submission by The Australian Taxpayers' Alliance**
Dr John Humphreys, 18 October 2024

Please see below the Australian Taxpayers' Alliance (ATA) response to selected points from the inquiry terms of reference.

> (a) the social and economic impact of taxing people who earn less than the cost of living;

The issue of tax-welfare churn is a common problem across the developed world, where families are in the strange situation of both paying income tax to the government and simultaneously receiving welfare payments back from that same government. Besides being pointless and wasteful, this also leads to large work disincentives for low-income earners, catching them in a so-called "poverty trap".

People earning as little as $5,000 per year can end up facing effective marginal tax rates (EMTRs) of 70%, due to the double-hit of both losing their welfare payments at 60% and also paying income tax at an effective rate just over 10%[1]. This creates a significant work disincentive.

Removing all tax-welfare churn would require far-reaching and fundamental reform to both our tax and welfare systems, but the ATA suggests three incremental steps that would help address the problem:

1. Make welfare payments non-taxable.

The current tax system has an effective annual tax-free threshold of $21,884 (once we factor in the low-income tax offset). The single JobSeeker payment is $20,228 per year, and this counts as taxable income. That means a single person can only earn $1,656 of annual income before they start paying income tax.

The Australian Taxpayers' Alliance calls for welfare payments to be made non-taxable, so that workers would be able to earn up to $21,884 before they started paying income tax. The above-mentioned person earning $5,000 would see their EMTR drop from 70% down to 60%.

[1] A single person earning $5k and receiving JobSeeker would have a taxable income of roughly $25k. At that income they must pay 16% marginal tax rate and an effective 10% marginal Medicare Levy (during the Medicare Levy phase-in period), which sums to 26%. This rate is only applied to the 40% they receive after welfare is withdrawn at 60%, so the implied tax rate is 0.26 * 40% = 10.4%. Their effective marginal income tax is the that tax rate (10.4%) plus the welfare withdraw rate (60%), which is 70.4%.

2. Further reduce (and preferably abolish) the bottom tax rate

While the above proposal is a step forward, the 70% EMTR would still exist for people earning as little as $25,000, continuing to create needless tax-welfare churn and work disincentives for people on relatively low incomes.

The ATA believes that the government should set an aspirational goal of removing the bottom tax rate entirely. This would increase the annual tax-free threshold to $45,000[2], directly benefiting those workers as well as reducing the amount of tax-welfare churn and improving work incentives for low-income earners.

To achieve that aspirational goal, we propose a phased reduction in the bottom tax rate. This could either be achieved through a scheduled series of fixed future tax cuts (legislated early to give certainty), or as part of a broader policy commitment for annual tax cuts to offset bracket creep.

3. Remove the regressive element of the Medicare Levy

The Medicare Levy is commonly believed to be a fixed 2% levy on all income, but that is not how it operates in reality. The actual rates are 0% for income up to $26,000, then 10% for income between $26,000 and $32,500, and then 2% for income above $32,500.

The current version of the Medicare Levy is a regressive tax, with low-income earners paying a higher marginal tax rate than high-income earners. This regressive anomaly should be removed by simply removing the 10% Medicare Levy bracket, and charging a fixed 2% on income over $26,000.

If the tax-free threshold is eventually lifted to $45,000 (as suggested above) then the Medicare Levy threshold should be raised to at least the same level.

[2] The low-income tax offset should be removed, so that the official tax-free threshold is also the effective tax-free threshold.

(b) assumptions used by Treasury in modelling income tax cuts;

Treasury does not actually use a tax model in their "modelling" of tax cuts. A serious tax model would estimate the impact of tax cuts on behaviour, and draw implications about the change in economic output and the tax base. Amazingly, Treasury simply assumes that people never respond to taxes, despite the overwhelming evidence to the contrary.

This should be a scandal, but it is often dismissed because it's hard to believe that Treasury (and the Parliamentary Budget Office) would make such a big error, and because the underlying issue can get fairly complex. This is a mistake, because the non-modelling of tax changes has a significant impact on public debate.

The main reason for tax cuts is that it will encourage people to earn and report more income. The size of that benefit is a crucial part of the story, and yet Treasury assumes that it's not possible for tax changes to impact the economy and so they simply assume that the benefit is automatically and always zero.

The other key statistic is the impact on government revenue. This is determined by the tax rate and the tax base. Treasury assumes that it's not possible for the tax base to change, so their "modelling" simply amounts to applying a different tax rate to the same tax base. In reality, tax changes do impact the tax base, and that can dramatically change the revenue estimates.

As an example, the Treasury and PBO "modelling" for the original stage 3 tax cuts assumed an economic benefit of zero (since nobody will change behaviour) and calculated a $20 billion revenue drop in the first year based on the assumption of a fixed tax base. In contrast, using midpoint elasticity estimates from the extensive academic literature, the more likely outcome was a $30 billion increase in GDP (instead of zero) and a $10 billion drop in revenue (instead of $20 billion).

The misleading estimates of Treasury and the PBO have warped the public debate.

The standard excuse for assuming that taxes are irrelevant to economic activity is to note that the labour supply elasticity is close to zero. This is true, but irrelevant. The direct labour supply response captured by that elasticity is just one small part of the behavioural response.

A more robust parameter is the "elasticity of taxable income" (ETI), which captures not just labour supply changes but also work effort, tax minimisation, tax evasion, and jurisdiction hoping[3]. Research into the ETI has boomed over the last 30 years with hundreds of global studies suggesting a mid-point elasticity of roughly 0.3 on average and significantly higher for high-income earners. The UK and USA governments have taken the obvious step of incorporating the ETI into their tax model, and provide public detail about the assumptions of their tax model. Australia should do likewise.

[3] Even the ETI fails to capture many of the most important behavioural responses to tax changes, such as switching careers, educational choices, willingness to take risks, and willingness to invest. It should be remembered that Australia's income tax rates also apply to capital income.

(f) the actual net company tax rate after franking credits have been refunded;

Australia's system of dividend imputation credits is an efficient method for ensuring that capital income is not triple-taxed.

Capital income is already double taxed to the degree that the domestic savings used for the investment was already taxed before it was invested. This is an inherent problem with income taxes, and will be addressed in the final proposal in this submission.

Some less sophisticated systems in other countries add a triple penalty by taxing capital income both when it is earned and when it is distributed, without fully integrating those two tax systems (as we do in Australia). That leads to cascading taxes, and distortions in the tax treatment of different types of income. We should not be tempted to emulate those systems.

Having said that, there are some improvements that should be made to our company tax system that would specifically support small business:

1. Clarify the Small and Medium Enterprise (SME) threshold at $50m turnover, and index that threshold to nominal GDP. Continue SME treatment for companies that exceed the threshold through natural business growth (excluding mergers).
2. Give SMEs the option to either keep the current 5% company tax discount, or switch to cash-flow company tax treatment, which effectively includes a tax deduction on all capital assets, inventory, prepayments, and also a limited deduction for "working capital" (see next point).
3. Introduce a tax deduction for up to $100k working capital per year, up to a maximum of $1 million[4], indexed to nominal GDP.
4. Provide a 12-month extension on GST and PAYG(w) payments for new start-ups with <$5 million turnover. This could be done as an income-contingent loan, with companies only required to pay that tax liability when they have a positive taxable income[5].
5. Introduce a $10k refundable tax offset for any business that has staff, both as an incentive to hire, and as compensation for the PAYG(w) compliance costs. Give micro-businesses with <$100k payroll the option of either accepting this tax offset or else being exempt from the PAYG(w) system entirely.

[4] For unincorporated businesses there should be no limit on the working capital tax deduction, coordinated through the Savings Trust Accounts discussed in the final proposal of this submission.
[5] For unincorporated businesses the repayments should only start at >$100k taxable income.

(h) whether capital gains tax concessions for passive investment cause a misallocation of capital into the non-productive economy which has to be offset by higher taxes on active income which drives down productivity and the velocity of money; and

A basic principle of income tax policy is that all types of income should generally be taxed at the same rate, to avoid a bias towards less productive activities and unwanted arbitrage between income types.

The complicating factor with capital gains is that the real income from capital investment is not the same as the nominal return on capital invested. This is because of the time delay, which creates additional costs for the investor that need to be factored in when trying to determine the real net income from that investment.

The 50% capital gains tax (CGT) discount was intended as a simple way to adjust for these time costs. This is an appropriate goal, but it is also appropriate to consider whether there are alternative approaches that might give a more accurate adjustment.

The most obvious alternative is to return to a system of cost base indexation, as existed in Australia before the 1999 reforms. Under that system the cost of the capital was indexed to inflation, so that the CGT only applied to the real (inflation adjusted) return on capital. If the return on capital was 6% but there had been 2% inflation, then the tax only applied to a capital gain of 4%[6].

We argue that the old cost-base indexation approach was insufficient, because it doesn't adjust for all of the costs associated with time delay. The missing factor is the time value of money, which describes the fact that people put a higher value on money today than they put on money in the future. The reality of time value is fundamental to the functioning of our financial markets, and ignoring time value would mean that we are taxing money that does not represent a net benefit for the investor.

The ATA propose that the government considers the option of returning to cost-base indexation, but instead of indexing to inflation the government should index capital cost to inflation +3% to compensate for the time value of money.

The consequence of this change would be to increase CGT on some investments while decreasing CGT on others. Specifically, the ATA proposal would lead to lower tax in situations where there are low or normal returns on investment, and it would increase tax in situations where there are windfall gains[7]. This proposal would also remove the current anomaly where a person can be liable for CGT despite making a real net loss on their investment.

(i) related matters.

[6] Note that under this hypothetical example, the cost-base indexation approach is equivalent to a 33% CGT discount, though the effective discount would be different in other situations. If the return on capital was 4% with inflation 2%, that is equivalent to a 50% CGT discount. If the return on capital was 3% with inflation 2%, that is equivalent to a 67% CGT discount.

[7] This is particularly relevant in the case of highly leveraged assets, such as investment properties and speculative derivatives, which may become less profitable under this proposal. There may need to be an exemption made for venture capital and other desirable high-risk investments.

By international standards, Australia has relatively high levels of income tax and relatively low levels of consumption tax. The main difference between the two types of tax is how they impact on savings and investment, since income tax applies to all taxable income while consumption tax only applies to the income that is spent. Our heavy reliance on income tax creates a bias against savings, leading to artificially low levels of savings and domestic investment.

A common response is to suggest a tax swap between income taxes and consumption taxes. The ATA opposes such a move, and regardless of the merits of the proposal, it has proven politically infeasible. Nonetheless, the problem of the anti-saving bias remains.

Instead of a tax swap, the same economic benefit can be achieved by making savings tax deductible.

An unlimited savings tax deduction would convert our income tax system into a Kaldor tax, which is effectively a progressive consumption tax. While this idea has merit, our proposal is for a relatively more modest introduction of Savings Trust Accounts (STAs) where workers can make tax-deductible contributions of up to $30,000 per year[8].

People should be free to make additional contributions above the $30,000 threshold, but those contributions would not be tax-free. Earnings on the STAs should also be tax free, and withdrawals from the STAs should be taxed at the taxpayers' marginal tax rate[9]. This would boost domestic investment (one of the main drivers of productivity) and improve financial security for households (making it easier for families to save for large expenses and consumption smoothing).

In addition, the government could allow for tax-free withdrawal of up to $100,000 for people to use towards a deposit on their first house, helping to make the dream of home-ownership more achievable.

[8] There should be no limit on contributions that come from unincorporated business profits, to ensure that small business owners only pay tax on the profits that they take as income.
[9] After retirement age, withdrawals should be taxed at half the marginal rate, so that STAs would double as an additional form of retirement savings.