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# REFORM OF INCOME TAX IN AUSTRALIA: A LONG-TERM AGENDA

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# REFORM OF INCOME TAX IN AUSTRALIA: A LONG-TERM AGENDA

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## Objective

In this paper, we examine the potential for reform of the Australian income tax system assuming that reform is applied not on an ad hoc basis but as part of a planned long-term strategy. Three scenarios are examined:

1. To maximise the tax-free income threshold while keeping existing marginal tax rates constant.
2. To maximise the income level at which the average tax rate exceeds the company tax rate by no more than five per cent[1] subject to a fixed increase in the tax-free threshold.
3. To maximise the tax-free threshold subject to a flat marginal tax rate of 35 per cent.

All scenarios are subject to the constraints that income tax revenue increases in real terms by 2.4 per cent per annum (in accordance with current budget estimates) and the implied welfare function of the current income tax system is not radically altered.

## Principles of an income tax system

An individual tax system should be based upon the following four principles:

1. Taxes should not be expensive to collect (administrative efficiency).
2. Incentives for economic activity should be maximised (labour market efficiency).
3. The tax burden should be spread equitably reflecting the value placed by society upon the dispersion of incomes (vertical equity); and
4. Taxes should raise sufficient revenue to enable the government to fund its programmes according to socially agreed preferences (revenue raising).

To achieve administrative efficiency:

- Any proposed new system should be similar in form to the existing system (a small number of steps in marginal tax rates).
- The tax-free income threshold should be increased so that the number of low-income workers who do not pay tax is increased.
- A higher tax-free threshold would enable the abolition of small, targeted rebates that complicate the existing system.
- The difference between the company tax rate and the average income tax rate should be minimised so that the incentive to devise complex mechanisms to avoid income tax is reduced.

To achieve labour market efficiency:

- The tax-free income threshold should be above the single adult rate of the Newstart Allowance so that unemployed persons have a greater incentive to work.

[1] It is argued that a gap of five percentage points between the average income tax rate and the company tax rate would be sufficient to eliminate the construction of elaborate systems to shift income from one system to the other.

- The tax-free income threshold should be increased so that the incentive to work is increased for those not in the labour force or on low incomes (part-time workers and pensioners).
- There is an argument that lowering the top marginal tax rate may provide greater work incentive[2].

To achieve vertical equity:

- Changes in the existing tax scales should not result in any particular income groups paying significantly more in tax than at present. In addition, gains through lower tax rates and thresholds should not be concentrated in any one section of the income distribution.

To sustain government revenue:

- Any proposed reform must maintain or increase the level of government revenue in real terms.

**The importance of the tax-free threshold**

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

With benefits indexed to price changes and pensions indexed to changes in earnings, the failure of successive Australian governments to increase the tax-free threshold in accordance with prices or earnings has meant that the tax-free threshold has fallen systematically relative to the levels of social security payments which are indexed to either prices (benefits and family payments) or wages (pensions). In 1983/84, the tax-free threshold was 20 per cent above the single adult rate of unemployment benefit. Now, it is 40 per cent below, effectively halving its value relative to the unemployment benefit. This trend has reduced the incentive to work at low-income levels. The failure to increase the tax-free threshold in line with wages has also meant that the average tax rate has increased very substantially for people on low incomes. In the past 20 years, the average tax rate on an income of one quarter of average weekly earnings has increased from around one per cent to around nine per cent (Figure 1). No higher multiple of average weekly earnings has experienced a rise in taxation anything like this much. To provide work incentives, it is important to maximise the gap between social security payments and after-tax earned incomes, especially given the relatively high costs of working (transport, clothing, additional household expenditure, child care). If the tax-free threshold had maintained its real value (CPI-adjusted) in 1978/79, it would be approximately $15,000 in 2004/05 rather than the actual level of $6,000. If average weekly earnings had been used to index the tax-free threshold, it would have been higher than $15,000 in 2004/05. If the tax-free threshold were increased considerably, many deductions and rebates that presently complicate the tax system could be abolished. Indeed, the situation might be reached where many PAYE taxpayers were not required to submit a tax return as is the case in some other industrialised countries such as the United Kingdom. A greater gap between social security payments and earned incomes is also likely to simplify administrative arrangements.

Increased work incentives become more significant when labour supply tightens with an ageing population. There are now reports that labour shortages are emerging at the lower skilled end of

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

the labour market (Macken 2004). In a society like Australia with a broad-based social safety net, it is important that the tax system provides a strong incentive for people to move off social security and into employment. It is also important that the system does not discourage second earners in couple families from entering the labour force when they wish to do so. Many second earners re-entering the work force want to work part-time and so will have relatively low incomes. The most efficient way to provide work incentives to low income earners is to have a large tax-free income threshold, ideally a threshold that is set at a higher level than the social security payment.

Over the past 20 years, as an alternative to increases in the tax-free threshold, numerous inefficient and complex rebates and means-tested payments that vary according to the characteristics of the person have been introduced, extended, abolished, modified and indexed according to the political whim of the day (Warren 2004). Successive and frequent modifications of these rebates and payments have been aimed at reducing the high effective marginal tax rates that are associated with this approach[3]. However, as time progresses, the high effective marginal tax rates return as the indexing of the income thresholds for the receipt of these payments and rebates fails to keep pace with increases in earnings and as the real value of the tax-free threshold continues to fall. Then, like the dog chasing its tail, the process of modification starts again.

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

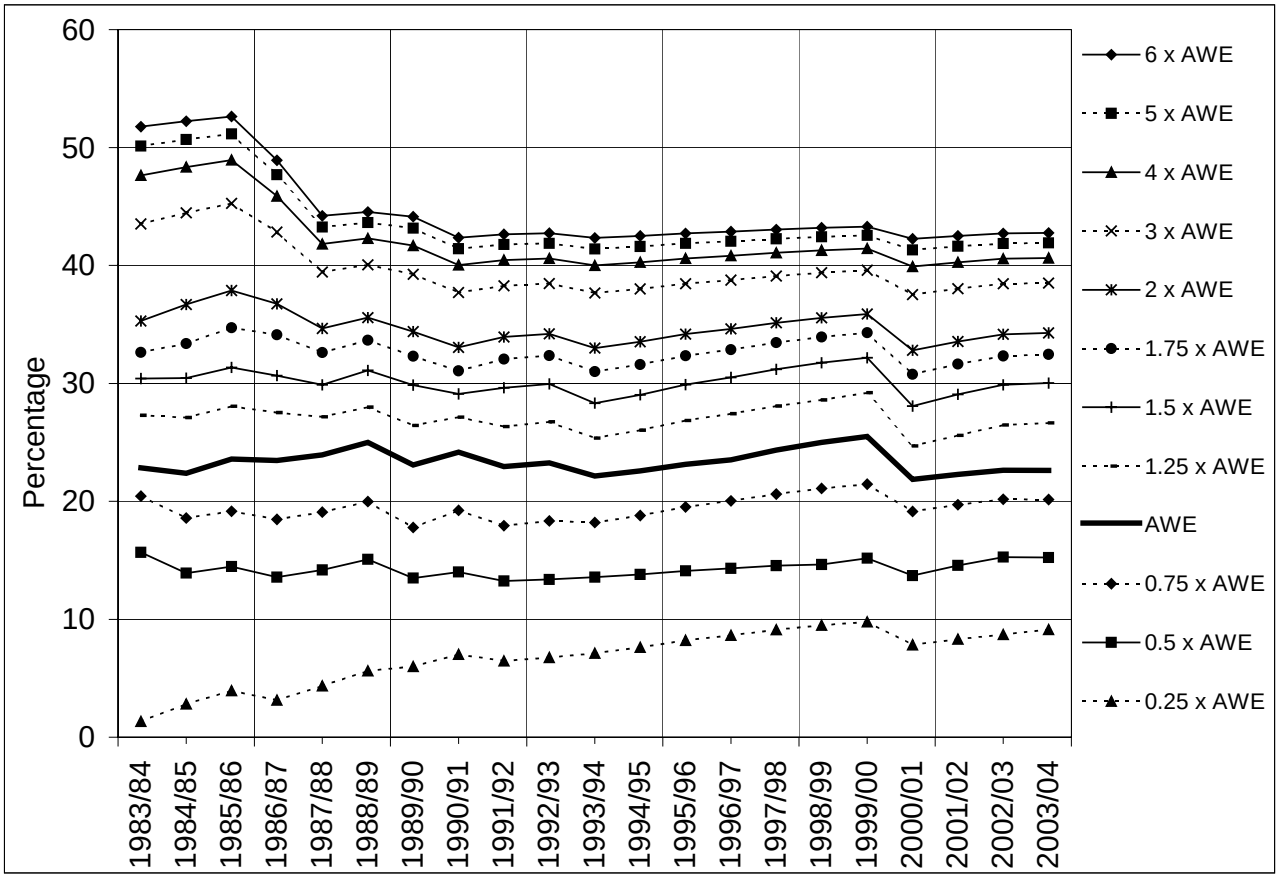
**Tax changes in Australia from 1983 to 2004**

Changes to the system of income tax in Australia since the late 1970s have been characterised most often by ad hoc shifts in the tax thresholds at which different marginal tax rates apply or less often by changes in the marginal tax rates themselves. These changes have served to return some of the government's cash gain through bracket creep to the taxpayers and the rewards have been spread in varying ways across people at different income levels in an apparently unsystematic way. The changes rarely seem to have been driven by long-term, fundamental principles or objectives. Figure 1 shows the changes in average tax rates applying at various multiples of average weekly earnings[4] (AWE) from 1983/84 to 2003/04. The features of this chart are:

[3] The effective marginal tax rate is the sum of the marginal income tax rate at a given level of income and the rate(s) of withdrawal of rebates and payments that apply at the same level of income. Effective marginal tax rates have been very high at low levels of income for most of the past 20 years (Ingles 1997).

[4] All references to average weekly earnings refer to average full-time adult male ordinary time earnings.

**Figure 1. Average tax rates by selected multiples of average weekly earnings* (AWE), 1983/84–2003/04**




*Average full-time adult male ordinary time earnings.

- The large falls in average tax rates at high incomes (three times AWE and above) between 1985/86 and 1987/88, a reflection of the substantial lowering of the top marginal tax rate by the Hawke Government.
- The substantial rise in the average tax rate of those on one quarter of AWE from one per cent in 1983/84 to around nine per cent in recent years. This is equivalent to an increase in taxation of about $1,000 for a person earning only $13,000.
- Over the full period, the range of average tax rates has narrowed. The range from 0.25AWE to 6AWE was 50 percentage points in 1983/84 and 34 percentage points in 2003/04.
- The sustained rise in average tax rates for all multiples of AWE from 1993/94 to 1999/2000, a period in which no changes were made to the tax scales despite rising incomes. These increased rates of taxation provided the launching pad for the broadening of the tax base through the Goods and Services Tax.
- The falls in average tax rates at all income levels in 2000/01 in association with the introduction of the GST.
- The sustained rises in average tax rates at all income levels from 2000/01 to 2003/04.

In the most recent tax year, 2003/04, average tax rates were higher at all multiples of AWE than they had been ten years earlier in 1993/94, even though the GST had been added in the intervening years (Table 1).

**Table 1. Average tax rates by selected multiples of average weekly earnings* (AWE), 1983/84, 1993/94 and 2003/04**

| Multiples of AWE | Income in Nov. 2003$ | Average tax rate (% of total taxable income) | | |
|---|---|---|---|---|
| | | 1983/84 | 1993/94 | 2003/04 |
| 6 x AWE | 310,911 | 52 | 42 | 43 |
| 5 x AWE | 259,093 | 50 | 41 | 42 |
| 4 x AWE | 207,274 | 48 | 40 | 41 |
| 3 x AWE | 155,456 | 43 | 38 | 39 |
| 2 x AWE | 103,637 | 35 | 33 | 34 |
| 1.75 x AWE | 90,682 | 33 | 31 | 32 |
| 1.5 x AWE | 77,728 | 30 | 28 | 30 |
| 1.25 x AWE | 64,773 | 27 | 25 | 27 |
| AWE | 51,819 | 23 | 22 | 23 |
| 0.75 x AWE | 38,864 | 20 | 18 | 20 |
| 0.5 x AWE | 25,909 | 16 | 14 | 15 |
| 0.25 x AWE | 12,955 | 1 | 7 | 9 |

*Average full-time adult male ordinary time earnings.

## Assumptions and data input

1. Scenario modelling necessarily commences with the current tax scales and from the 2005/06 financial year.
2. The initial distribution of estimated taxable incomes for the year 2005/06 was obtained from the Department of the Parliamentary Library (see Appendix A).
3. The number of taxpayers is assumed to increase at the rate of 1.6 per cent per annum consistent with the likely demography of the next decade.
4. All taxable incomes are assumed to rise at the same annual rate across the decade.
5. Two rates of increase of taxable incomes (in money terms) are used: the average annual rate of increase over the past five years of 4.75 per cent and a lower level of 3.5 per cent. We use two rates to illustrate the extent to which reform is contingent upon the actual rate of increase.
6. The rate of inflation is set at 2.4 per cent per annum, in line with recent experience.
7. Existing tax rebates and relationships between fringe benefits taxes and taxable incomes are ignored because of the complexity involved. However, this could also be justified on the grounds that a new system should attempt as far as possible to eliminate these complex and potentially unfair aspects of the tax system. However, no reduction in revenue is factored in for the abolition of any of these aspects.
8. While the modelled changes to the tax system are made in order to increase work incentives particularly for those receiving government payments, no behavioural savings from reduced social security payments or increased numbers of taxpayers are factored into the calculations. However, behavioural savings are likely to be substantial.
9. Vertical equity is evaluated through an examination of the average tax payable on multiples of average weekly earnings.
10. Reform of income tax is facilitated through earnings rising faster than prices. In recent years, the gap between the rise in earnings and the rise in prices (the increase in real earnings) has been high and this has enabled governments to run surplus budgets, increase spending in real terms and provide ad hoc income tax reductions. In this circumstance, the essential issue for

income tax reform is what percentage of the benefit should be retained by government for its social redistribution programmes and what percentage should be retained in income terms by the taxpayer? In agreement with the government's budget plans for the next three years, we fix the government's revenue increase at a real value of 2.4 per cent per annum over a decade and then distribute the remaining benefits to taxpayers through tax cuts in accordance with our scenarios.

## Scenarios

We present the results of three scenarios for each of the two assumed levels of increase in wages:

1. Holding the existing marginal tax rates constant, we maximise the level of increase in the tax-free threshold that can be achieved with the two assumed levels of increase in wages. Income thresholds at which the successive marginal tax rates apply are adjusted upwards somewhat reflecting the higher tax-free threshold.
2. Subject to the constraint that the tax-free threshold rises to $16,000 by 2015/16[5], we maximise the income level at which the average tax rate reaches 35 per cent with the two assumed levels of increase in wages.
3. The tax-free threshold is maximised subject to the achievement of a flat marginal tax rate of 35 per cent by 2015/16, again using the two assumed increases in wages.

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

## Results

### *Scenario 1: Maximising the tax-free threshold*

Table 2 shows the outcomes in terms of tax scales. Scenario 1 shows that the tax-free threshold could be increased to $30,000 over the ten-year period if earnings rise continually at 4.75 per cent per annum. The level reduces to $19,000 if the increase in earnings is only 3.5 per cent per annum. These results indicate that, under either level of rise in earnings and given the assumed level of inflation, substantial increase in the tax-free threshold is possible over a ten-year period. Remember, all models are subject to the constraint that income tax revenue rises by 2.4 per cent per annum in real terms.

[5] At this level in 2015/16, the tax-free threshold would be a little over 20 per cent above the single adult rate of Newstart Allowance.

**Table 2. Projected tax scales, Australia, 2005/06–2015/16**

| 2005/06 | | 2006/07 | | 2007/08 | | 2008/09 | | 2009/10 | | 2010/11 | | 2011/12 | | 2012/13 | | 2013/14 | | 2014/15 | | 2015/16 | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Income | MTR[1] | Income | MTR | Income | MTR | Income | MTR | Income | MTR | Income | MTR | Income | MTR | Income | MTR | Income | MTR | Income | MTR | Income | MTR |
| Scenario 1: Maximising the taxfree threshold, 4.75% per annum increase in average weekly earnings | | | | | | | | | | | | | | | | | | | | | |
| 0 | 0.00 | 0 | 0.00 | 0 | 0.00 | 0 | 0.00 | 0 | 0.00 | 0 | 0.00 | 0 | 0.00 | 0 | 0.00 | 0 | 0.00 | 0 | 0.00 | 0 | 0.00 |
| 6,000 | 0.17 | 8,000 | 0.17 | 10,000 | 0.17 | 12,000 | 0.17 | 14,000 | 0.17 | 17,000 | 0.17 | 20,000 | 0.17 | 22,000 | 0.17 | 24,000 | 0.17 | 27,000 | 0.17 | 30,000 | 0.17 |
| 22,000 | 0.30 | 23,000 | 0.30 | 24,000 | 0.30 | 26,000 | 0.30 | 29,000 | 0.30 | 31,000 | 0.30 | 34,000 | 0.30 | 38,000 | 0.30 | 42,000 | 0.30 | 47,000 | 0.30 | 52,000 | 0.30 |
| 63,000 | 0.42 | 63,000 | 0.42 | 63,000 | 0.42 | 63,000 | 0.42 | 63,000 | 0.42 | 63,000 | 0.42 | 63,000 | 0.42 | 63,000 | 0.42 | 63,000 | 0.42 | 63,000 | 0.42 | 65,000 | 0.42 |
| 80,000 | 0.47 | 81,000 | 0.47 | 82,000 | 0.47 | 83,000 | 0.47 | 84,000 | 0.47 | 85,000 | 0.47 | 86,000 | 0.47 | 87,000 | 0.47 | 88,000 | 0.47 | 89,000 | 0.47 | 90,000 | 0.47 |
| Scenario 1: Maximising the taxfree threshold, 3.5% per annum increase in average weekly earnings | | | | | | | | | | | | | | | | | | | | | |
| 0 | 0.00 | 0 | 0.00 | 0 | 0.00 | 0 | 0.00 | 0 | 0.00 | 0 | 0.00 | 0 | 0.00 | 0 | 0.00 | 0 | 0.00 | 0 | 0.00 | 0 | 0.00 |
| 6,000 | 0.17 | 7,000 | 0.17 | 7,500 | 0.17 | 8,500 | 0.17 | 9,500 | 0.17 | 11,000 | 0.17 | 12,500 | 0.17 | 14,000 | 0.17 | 15,500 | 0.17 | 17,000 | 0.17 | 19,000 | 0.17 |
| 22,000 | 0.30 | 23,000 | 0.30 | 24,000 | 0.30 | 25,000 | 0.30 | 26,000 | 0.30 | 27,000 | 0.30 | 28,000 | 0.30 | 29,000 | 0.30 | 30,000 | 0.30 | 31,000 | 0.30 | 32,000 | 0.30 |
| 63,000 | 0.42 | 63,000 | 0.42 | 63,000 | 0.42 | 63,000 | 0.42 | 63,000 | 0.42 | 63,000 | 0.42 | 63,000 | 0.42 | 63,000 | 0.42 | 63,000 | 0.42 | 63,000 | 0.42 | 63,000 | 0.42 |
| 80,000 | 0.47 | 80,000 | 0.47 | 80,000 | 0.47 | 80,000 | 0.47 | 80,000 | 0.47 | 80,000 | 0.47 | 80,000 | 0.47 | 80,000 | 0.47 | 80,000 | 0.47 | 80,000 | 0.47 | 80,000 | 0.47 |
| Scenario 2: Maximising the income level at which the average tax rate reaches 35%, 4.75% per annum increase in average weekly earnings | | | | | | | | | | | | | | | | | | | | | |
| 0 | 0.00 | 0 | 0.00 | 0 | 0.00 | 0 | 0.00 | 0 | 0.00 | 0 | 0.00 | 0 | 0.00 | 0 | 0.00 | 0 | 0.00 | 0 | 0.00 | 0 | 0.00 |
| 6,000 | 0.17 | 7,000 | 0.17 | 8,000 | 0.17 | 9,000 | 0.17 | 10,000 | 0.17 | 11,000 | 0.17 | 12,000 | 0.17 | 13,000 | 0.17 | 14,000 | 0.17 | 15,000 | 0.17 | 16,000 | 0.17 |
| 22,000 | 0.30 | 23,000 | 0.30 | 24,000 | 0.29 | 25,000 | 0.29 | 26,000 | 0.28 | 27,000 | 0.28 | 28,000 | 0.27 | 29,000 | 0.26 | 30,000 | 0.26 | 31,000 | 0.26 | 31,000 | 0.26 |
| 63,000 | 0.42 | 63,000 | 0.41 | 63,000 | 0.40 | 63,000 | 0.39 | 63,000 | 0.38 | 63,000 | 0.37 | 63,000 | 0.36 | 63,000 | 0.35 | 63,000 | 0.34 | 63,000 | 0.33 | 63,000 | 0.32 |
| 80,000 | 0.47 | 81,000 | 0.46 | 82,000 | 0.45 | 83,000 | 0.44 | 84,000 | 0.43 | 85,000 | 0.42 | 86,000 | 0.41 | 87,000 | 0.40 | 88,000 | 0.39 | 89,000 | 0.37 | 90,000 | 0.35 |
| Scenario 2: Maximising the income level at which the average tax rate reaches 35%, 3.5% per annum increase in average weekly earnings | | | | | | | | | | | | | | | | | | | | | |
| 0 | 0.00 | 0 | 0.00 | 0 | 0.00 | 0 | 0.00 | 0 | 0.00 | 0 | 0.00 | 0 | 0.00 | 0 | 0.00 | 0 | 0.00 | 0 | 0.00 | 0 | 0.00 |
| 6,000 | 0.17 | 7,000 | 0.17 | 8,000 | 0.17 | 9,000 | 0.17 | 10,000 | 0.17 | 11,000 | 0.17 | 12,000 | 0.17 | 13,000 | 0.17 | 14,000 | 0.17 | 15,000 | 0.17 | 16,000 | 0.17 |
| 22,000 | 0.30 | 23,000 | 0.30 | 24,000 | 0.30 | 25,000 | 0.30 | 26,000 | 0.30 | 27,000 | 0.30 | 28,000 | 0.30 | 29,000 | 0.30 | 30,000 | 0.30 | 31,000 | 0.30 | 31,000 | 0.30 |
| 63,000 | 0.42 | 63,000 | 0.42 | 63,000 | 0.42 | 63,000 | 0.42 | 63,000 | 0.42 | 63,000 | 0.42 | 63,000 | 0.42 | 63,000 | 0.42 | 63,000 | 0.42 | 63,000 | 0.41 | 63,000 | 0.40 |
| 80,000 | 0.47 | 80,000 | 0.47 | 80,000 | 0.47 | 80,000 | 0.47 | 80,000 | 0.46 | 80,000 | 0.46 | 80,000 | 0.45 | 80,000 | 0.45 | 80,000 | 0.45 | 80,000 | 0.45 | 80,000 | 0.44 |
| Scenario 3: A flat marginal tax rate of 35%, 4.75% per annum increase in average weekly earnings | | | | | | | | | | | | | | | | | | | | | |
| 0 | 0.00 | 0 | 0.00 | 0 | 0.00 | 0 | 0.00 | 0 | 0.00 | 0 | 0.00 | 0 | 0.00 | 0 | 0.00 | 0 | 0.00 | 0 | 0.00 | 0 | 0.00 |
| 6,000 | 0.17 | 8,500 | 0.19 | 11,000 | 0.21 | 13,500 | 0.23 | 16,000 | 0.25 | 18,500 | 0.27 | 21,000 | 0.29 | 23,500 | 0.31 | 26,000 | 0.33 | 28,000 | 0.34 | 30,000 | 0.35 |
| 22,000 | 0.30 | 25,000 | 0.30 | 28,000 | 0.31 | 31,000 | 0.31 | 34,000 | 0.32 | 37,000 | 0.32 | 40,000 | 0.33 | 43,000 | 0.33 | 46,000 | 0.34 | 49,000 | 0.35 | 50,000 | 0.35 |
| 63,000 | 0.42 | 63,000 | 0.41 | 63,000 | 0.40 | 64,000 | 0.39 | 64,000 | 0.38 | 64,000 | 0.37 | 64,000 | 0.36 | 64,000 | 0.35 | 65,000 | 0.35 | 65,000 | 0.35 | 65,000 | 0.35 |
| 80,000 | 0.47 | 80,000 | 0.46 | 80,000 | 0.45 | 80,000 | 0.44 | 80,000 | 0.43 | 80,000 | 0.41 | 80,000 | 0.40 | 80,000 | 0.39 | 80,000 | 0.37 | 80,000 | 0.36 | 80,000 | 0.35 |
| Scenario 3: A flat marginal tax rate of 35%, 3.5% per annum increase in average weekly earnings | | | | | | | | | | | | | | | | | | | | | |
| 0 | 0.00 | 0 | 0.00 | 0 | 0.00 | 0 | 0.00 | 0 | 0.00 | 0 | 0.00 | 0 | 0.00 | 0 | 0.00 | 0 | 0.00 | 0 | 0.00 | 0 | 0.00 |
| 6,000 | 0.17 | 7,500 | 0.19 | 9,000 | 0.21 | 10,500 | 0.23 | 12,000 | 0.25 | 13,500 | 0.27 | 15,000 | 0.29 | 16,500 | 0.31 | 18,000 | 0.33 | 19,000 | 0.34 | 20,000 | 0.35 |
| 22,000 | 0.30 | 24,000 | 0.30 | 26,000 | 0.31 | 28,000 | 0.31 | 30,000 | 0.32 | 32,000 | 0.32 | 34,000 | 0.32 | 36,000 | 0.33 | 38,000 | 0.34 | 40,000 | 0.34 | 40,000 | 0.35 |
| 63,000 | 0.42 | 63,000 | 0.42 | 63,000 | 0.41 | 63,000 | 0.41 | 63,000 | 0.39 | 63,000 | 0.38 | 63,000 | 0.37 | 63,000 | 0.36 | 63,000 | 0.35 | 63,000 | 0.35 | 63,000 | 0.35 |
| 80,000 | 0.47 | 80,000 | 0.45 | 80,000 | 0.43 | 80,000 | 0.42 | 80,000 | 0.41 | 80,000 | 0.40 | 80,000 | 0.39 | 80,000 | 0.38 | 80,000 | 0.37 | 80,000 | 0.36 | 80,000 | 0.35 |

1. Marginal tax rate.

Figures 2.1–2.10 show the average tax rates that would be payable at different multiples of average weekly earnings. Under Scenario 1, with both levels of increase in earnings, the average tax rate at 0.25AWE drops to zero across the decade. At 0.5AWE, the average tax rate would drop from 16 per cent to 5 per cent (4.75% wage rise) or to 11 per cent (3.5% wage rise). At higher multiples of AWE, the average tax rates remain constant or increase slightly (especially for the 3.5% wage rise case).

Reflecting its design, this is a scenario that provides all of the benefit to income levels under average weekly earnings.

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

Under this scenario, the tax-free threshold is constrained to rise to $16,000 over the decade. The top marginal tax rate would fall from 47 per cent to 35 per cent if earnings rose at 4.75 per cent per annum and to 44 per cent if earnings rose by 3.5 per cent. This difference shows clearly how much greater the reform can be if real earnings continue to rise at the higher level. At the higher assumed level of earnings rises, all taxpayers would have an average tax rate below 35 per cent by 2015/16. At the lower assumed level of earnings rises, all those with earnings under $180,000 would have an average tax rate below 35 per cent.

As expected, under this scenario, the falls in average tax rates are lower at lower incomes than those achieved under Scenario 1, although the rise in the tax-free threshold still produces good falls in average tax rates for those on 0.25AWE (Figures 2.1 and 2.2). These gains gradually fade as incomes rise to AWE where there is little change in the average tax rate payable with this scenario (Figures 2.5–2.6). Above average weekly earnings, the falls in average tax rates rise as income rises, especially where real earnings increase at the higher level. At 6AWE, for example, the average tax rate would fall from 42 per cent to 33 per cent if incomes rose at the higher rate, equivalent to a cut in tax of about $30,000 per annum in 2005 dollars.

Again, reflecting its design, there are gains in this scenario for those on low incomes but also large gains for those on high incomes.

***Scenario 3: A flat tax of 35 per cent***

Under this scenario, the tax-free threshold would rise to $30,000 in 2015/16 if the higher increase in earnings were to apply and to $20,000 if the lower rate were to apply. In some ways, this could be described as a more extreme example of Scenario 2 in that the benefits to those on low incomes would be even higher than under Scenario 2 but the benefits to those on high incomes would be even higher again. The gains at low and high incomes would be paid for by those on middle incomes for whom average tax rates would rise especially if earnings rise more slowly than in recent years.

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

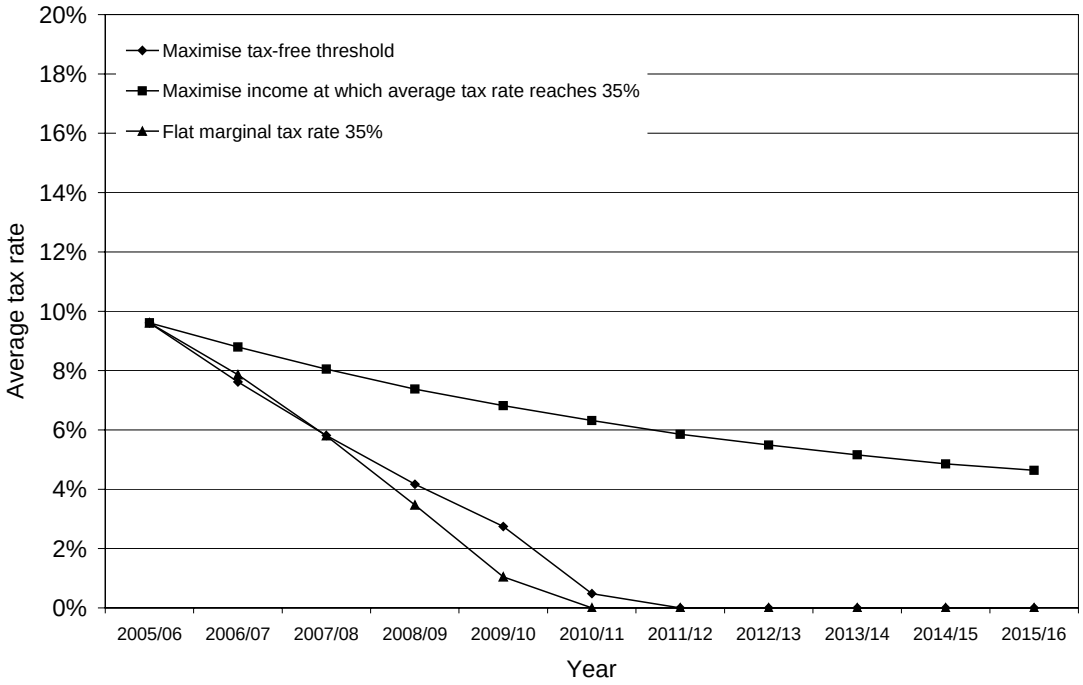



**Figure 2.2. Average tax rate on quarter average weekly earnings, 3. 5% per annum increase in average weekly earnings**

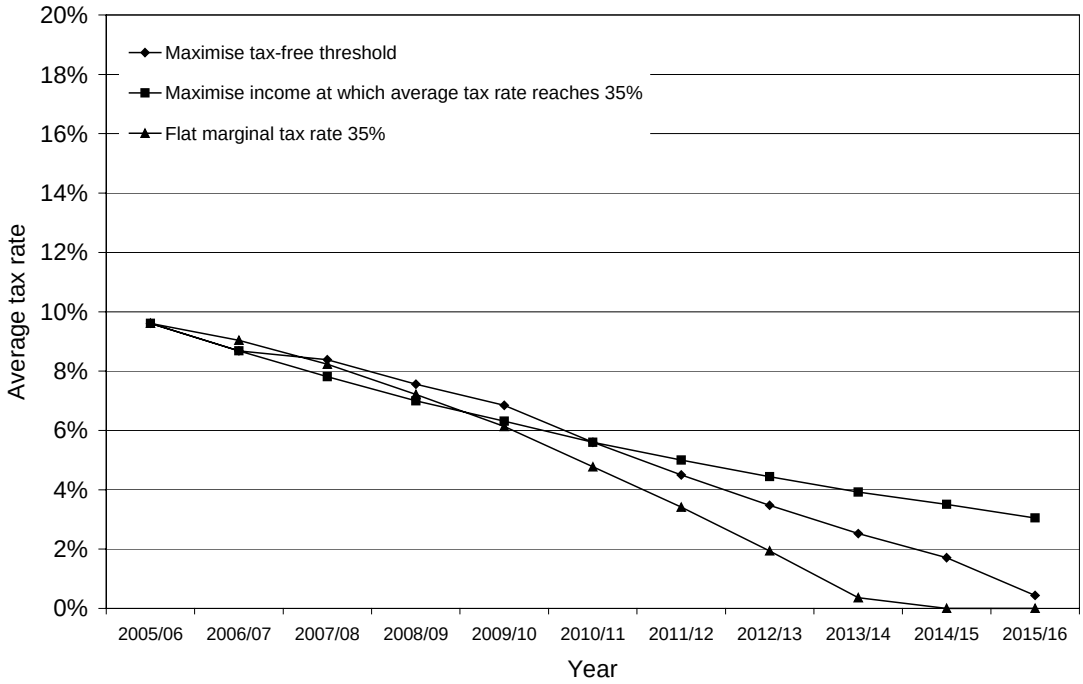


**Figure 2.3. Average tax rate on half average weekly earnings, 4.75% per annum increase in average weekly earnings**

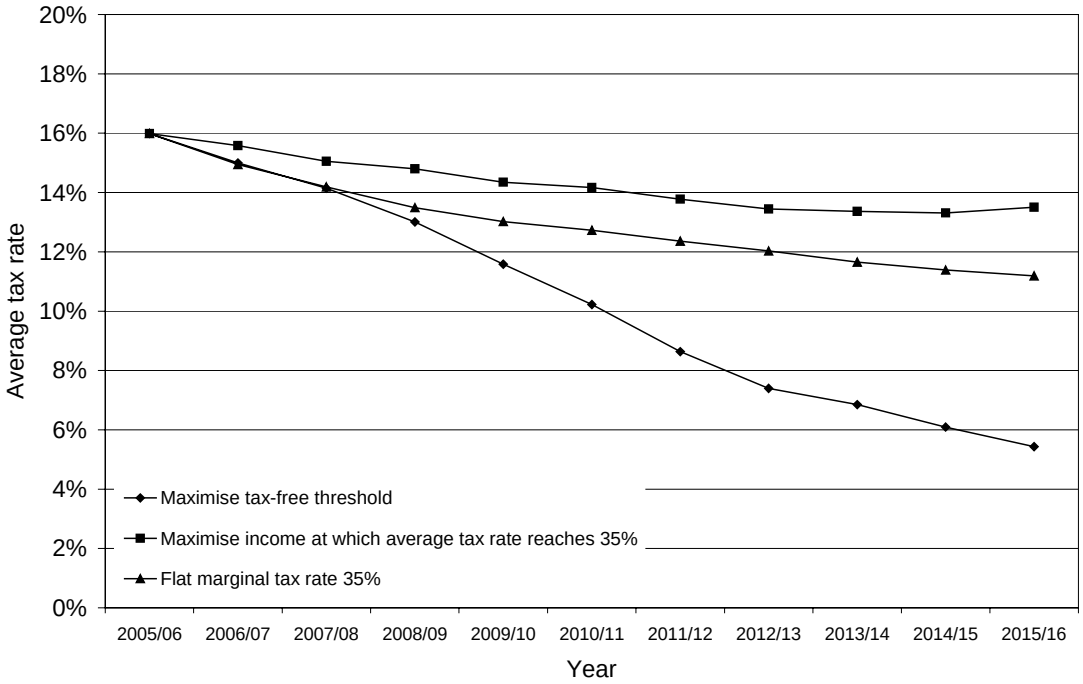



**Figure 2.4. Average tax rate on half average weekly earnings, 3.5% per annum increase in average weekly earnings**

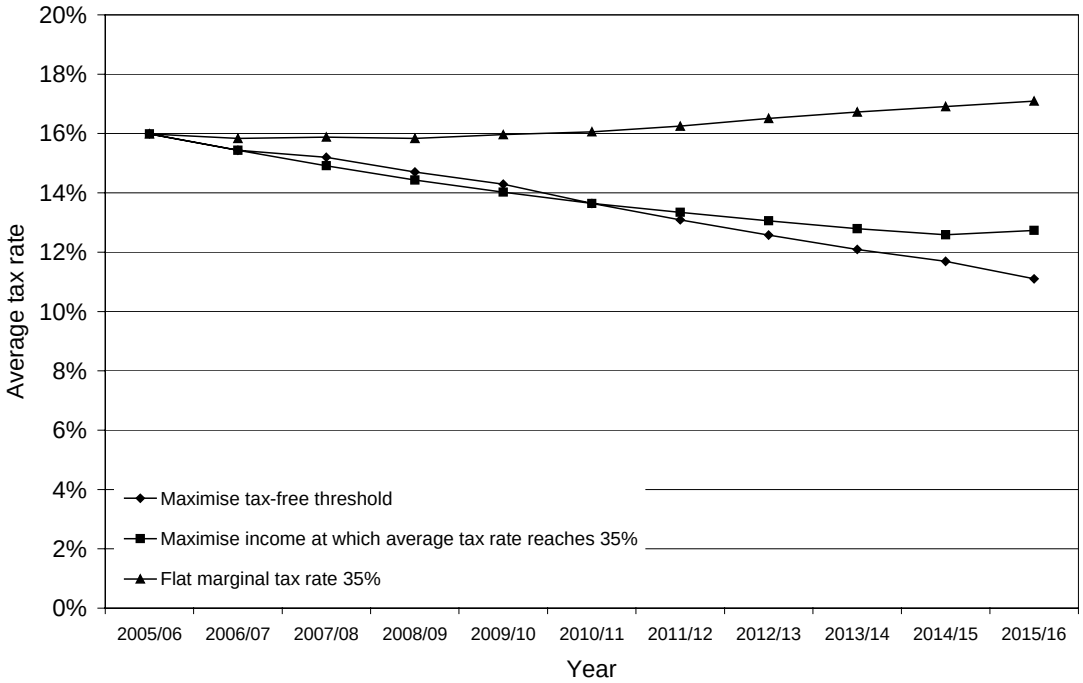


**Figure 2.5. Average tax rate on average weekly earnings, 4.75% per annum increase in average weekly earnings**

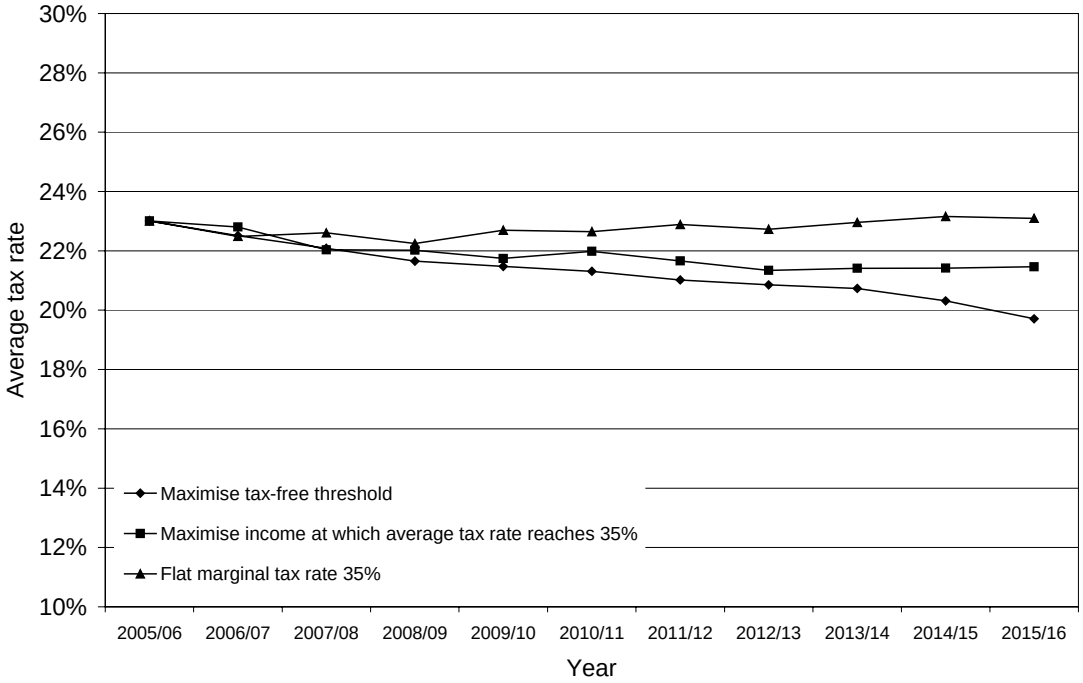



**Figure 2.6. Average tax rate on average weekly earnings, 3.5% per annum increase in average weekly earnings**

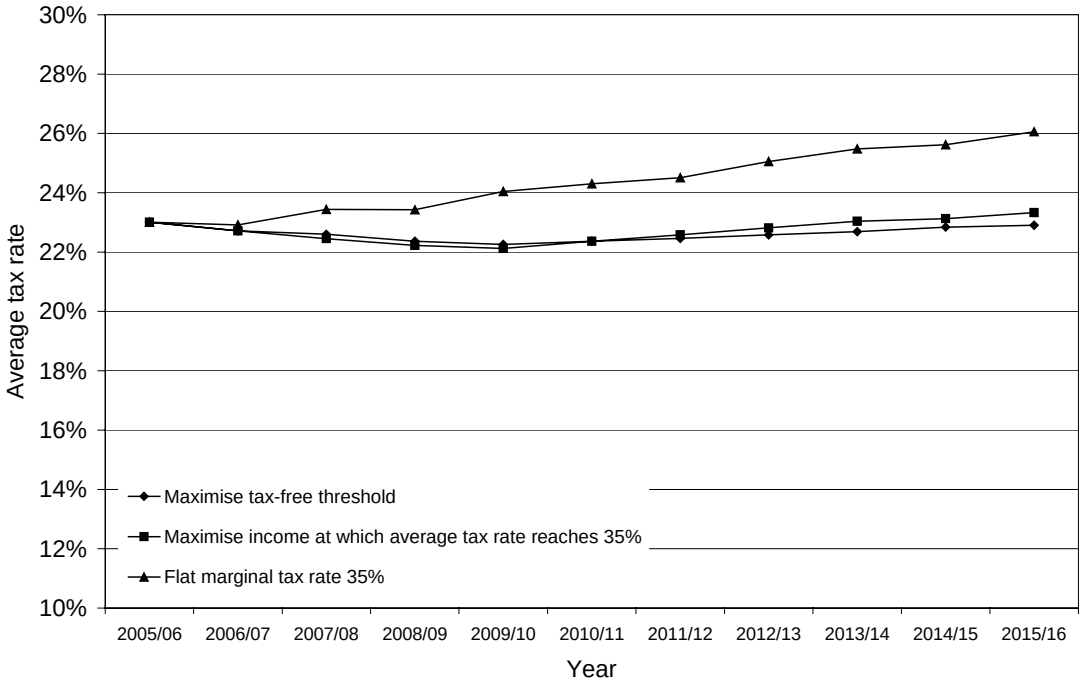


**Figure 2.7. Average tax rate on twice average weekly earnings, 4.75% per annum increase in average weekly earnings**

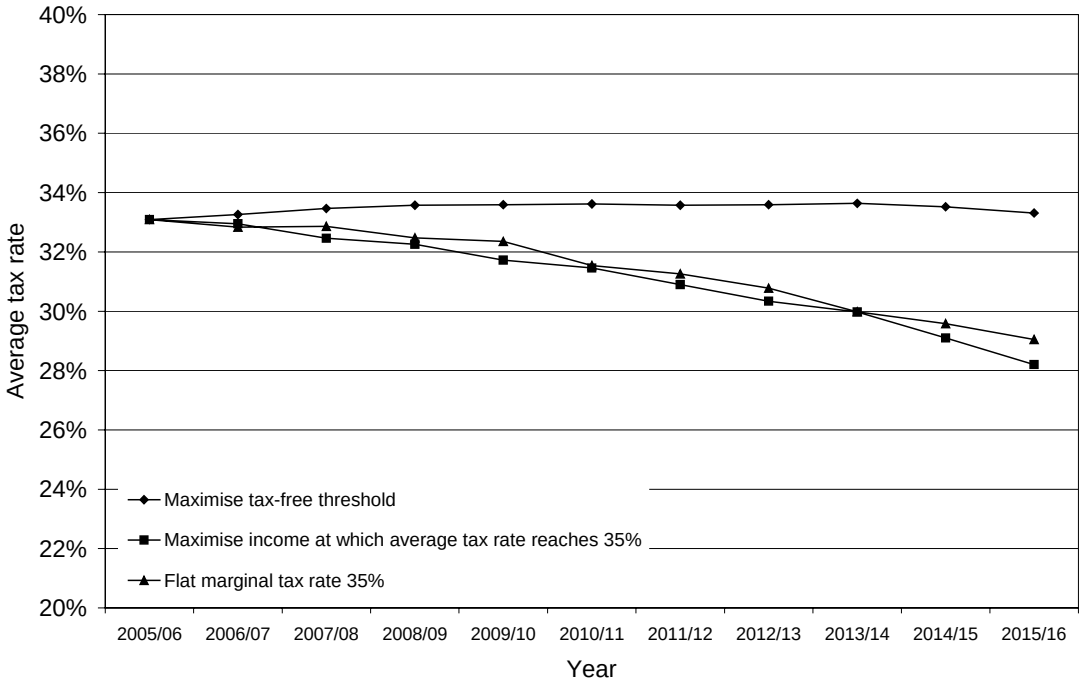



**Figure 2.8. Average tax rate on twice average weekly earnings, 3.5% per annum increase in average weekly earnings**

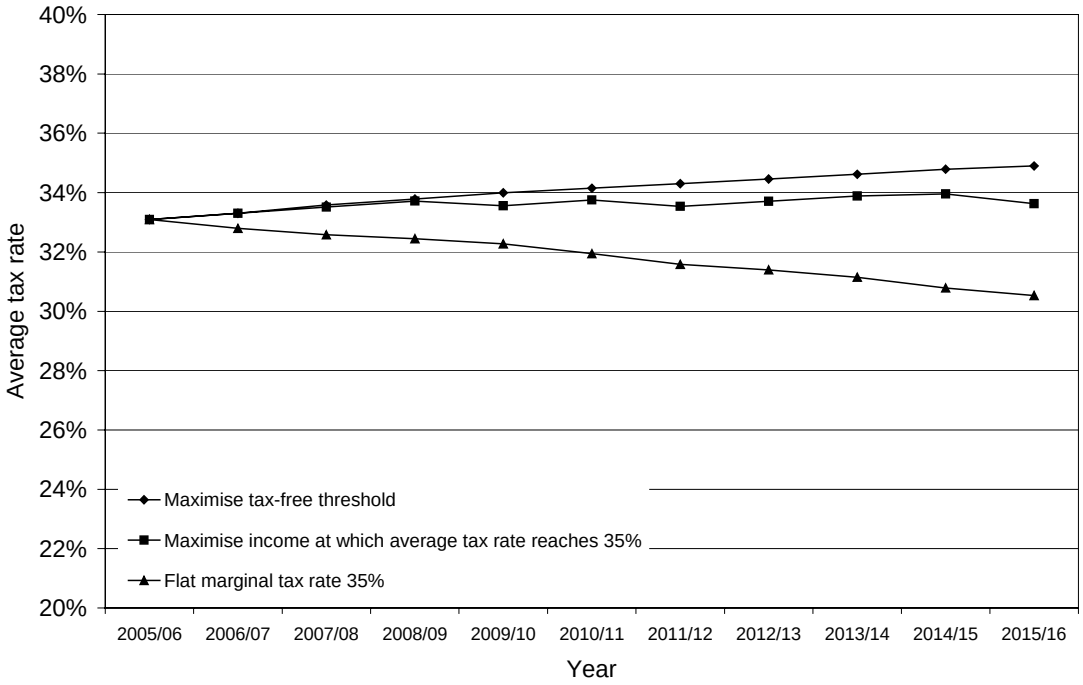


**Figure 2.09. Average tax rate on six times average weekly earnings, 4.75% per annum increase in average weekly earnings**

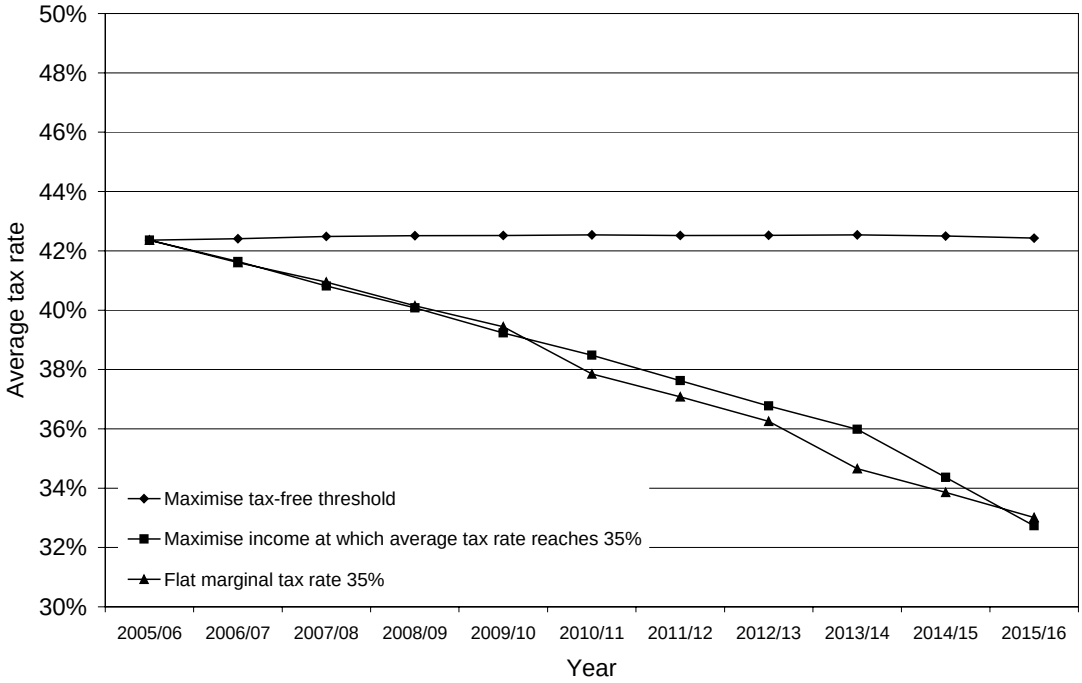
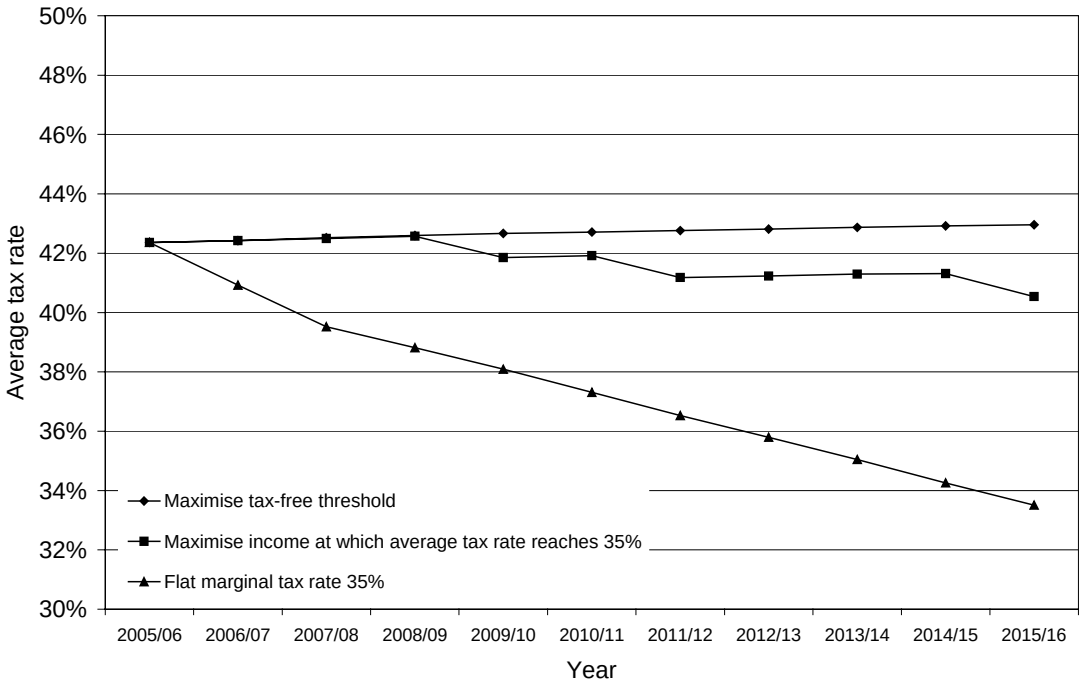



**Figure 2.10. Average tax rate on six times average weekly earnings, 3.5% per annum increase in average weekly earnings**



## A best-case scenario

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

With Scenario 2, average tax rates would not rise at any income level so long as earnings rose by at least the lower rate assumed here. Gains at income levels under average weekly earnings are largely independent of the rate of increase in earnings because an increase in the tax-free threshold to $16,000 is locked in. At average weekly earnings, the average tax rate would fall from 23 per cent to 21 per cent if earnings rose at the higher rate and would remain unchanged if earnings rose at the lower rate. Thus, the variation is small when earnings change. At income levels above average weekly earnings, under Scenario 2, the fall in average tax rates is contingent upon the rate of increase of earnings. Substantial falls are feasible if earnings increase at the higher rate and more moderate if earnings increase at the lower rate. Thus, the more that high-income earners are successful in raising the earnings of all, the higher are the tax cuts that they themselves receive. This would be an interesting way to structure incentives for high-income earners.

## The proposal in simple terms

We propose that the tax-free threshold be increased by $1,000 per annum for the next 10 years and that this reform is locked in. In addition, we propose that the top marginal tax rate be reduced contingent upon the real rate of increase in earnings. If the real increase of earnings is above two per cent, the top marginal tax rate would be reduced by one percentage point per annum. If the real increase of earnings is half this level, then the top marginal tax rate would be reduced by half a percentage point per annum. If real earnings do not rise at all, then the top marginal tax rate would remain fixed. Other tax rates and thresholds would be adjusted to be consistent with these changes, as indicated in Table 2.

## Conclusion

We demonstrate in this paper that it would be possible over a decade to increase the tax-free threshold to a level well above the single adult rate of Newstart Allowance and to reduce the gap between the company tax rate and average income tax rates to less than five percentage points over a wide range of incomes. The modelling is contingent upon the continuation of a positive gap between rises in incomes and rises in prices as has been the case over the past decade (an increase in real earnings). The models demonstrate how the fruits of such an advantageous economic situation can be distributed between the government and taxpayers in a way that promotes work incentives, maintains vertical equity and allows the government’s revenue to continue to grow in real terms.

If a long-term reform agenda were to be set in place from the May 2005 budget, annual adjustments to the direction of the reform could be made at each successive budget in the light of actual economic outcomes (inflation and earnings growth).

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## Appendix A. Estimating population by level of taxable income

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

**Table 3. Estimated weekly and annual taxable income by population of those submitting tax returns, 2005/06**

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

Source: Department of the Parliamentary Library, 2004.

**Table 4. Estimated annual taxable income by population of those submitting tax returns, 2005/06**

| Income range | Midpoint | Population | Income range | Midpoint | Population | Income range | Midpoint | Population |
|---|---|---|---|---|---|---|---|---|
| 0 – 1,565 | 783 | 192,059 | 50,091 – 51,657 | 50,874 | 109,586 | 100,183 – 101,748 | 100,966 | 42,773 |
| 1,565 – 3,131 | 2,348 | 220,055 | 51,657 – 53,222 | 52,439 | 106,279 | 101,748 – 103,314 | 102,531 | 41,359 |
| 3,131 – 4,696 | 3,913 | 252,133 | 53,222 – 54,788 | 54,005 | 105,218 | 103,314 – 104,879 | 104,096 | 39,839 |
| 4,696 – 6,261 | 5,479 | 288,886 | 54,788 – 56,353 | 55,570 | 103,252 | 104,879 – 106,444 | 105,662 | 38,453 |
| 6,261 – 7,827 | 7,044 | 330,997 | 56,353 – 57,918 | 57,136 | 99,788 | 106,444 – 108,010 | 107,227 | 37,201 |
| 7,827 – 9,392 | 8,609 | 379,247 | 57,918 – 59,484 | 58,701 | 97,683 | 108,010 – 109,575 | 108,792 | 36,084 |
| 9,392 – 10,958 | 10,175 | 437,513 | 59,484 – 61,049 | 60,266 | 96,935 | 109,575 – 111,140 | 110,358 | 34,891 |
| 10,958 – 12,523 | 11,740 | 456,495 | 61,049 – 62,614 | 61,832 | 97,546 | 111,140 – 112,706 | 111,923 | 33,609 |
| 12,523 – 14,088 | 13,306 | 436,193 | 62,614 – 64,180 | 63,397 | 99,748 | 112,706 – 114,271 | 113,488 | 32,439 |
| 14,088 – 15,654 | 14,871 | 376,606 | 64,180 – 65,745 | 64,962 | 101,046 | 114,271 – 115,836 | 115,054 | 31,383 |
| 15,654 – 17,219 | 16,436 | 308,564 | 65,745 – 67,310 | 66,528 | 99,954 | 115,836 – 117,402 | 116,619 | 30,441 |
| 17,219 – 18,784 | 18,002 | 266,712 | 67,310 – 68,876 | 68,093 | 96,475 | 117,402 – 118,967 | 118,184 | 29,434 |
| 18,784 – 20,350 | 19,567 | 237,543 | 68,876 – 70,441 | 69,658 | 90,606 | 118,967 – 120,533 | 119,750 | 28,353 |
| 20,350 – 21,915 | 21,132 | 221,056 | 70,441 – 72,006 | 71,224 | 83,980 | 120,533 – 122,098 | 121,315 | 27,366 |
| 21,915 – 23,480 | 22,698 | 217,252 | 72,006 – 73,572 | 72,789 | 78,947 | 122,098 – 123,663 | 122,881 | 26,475 |
| 23,480 – 25,046 | 24,263 | 207,822 | 73,572 – 75,137 | 74,354 | 75,050 | 123,663 – 125,229 | 124,446 | 25,680 |
| 25,046 – 26,611 | 25,828 | 189,938 | 75,137 – 76,703 | 75,920 | 72,288 | 125,229 – 126,794 | 126,011 | 24,831 |
| 26,611 – 28,176 | 27,394 | 180,491 | 76,703 – 78,268 | 77,485 | 70,662 | 126,794 – 128,359 | 127,577 | 23,919 |
| 28,176 – 29,742 | 28,959 | 179,484 | 78,268 – 79,833 | 79,051 | 68,888 | 128,359 – 129,925 | 129,142 | 23,086 |
| 29,742 – 31,307 | 30,524 | 186,916 | 79,833 – 81,399 | 80,616 | 66,356 | 129,925 – 131,490 | 130,707 | 22,335 |
| 31,307 – 32,873 | 32,090 | 199,439 | 81,399 – 82,964 | 82,181 | 64,047 | 131,490 – 133,055 | 132,273 | 21,664 |
| 32,873 – 34,438 | 33,655 | 206,337 | 82,964 – 84,529 | 83,747 | 61,963 | 133,055 – 134,621 | 133,838 | 20,948 |
| 34,438 – 36,003 | 35,221 | 205,597 | 84,529 – 86,095 | 85,312 | 60,101 | 134,621 – 136,186 | 135,403 | 20,178 |
| 36,003 – 37,569 | 36,786 | 197,218 | 86,095 – 87,660 | 86,877 | 58,114 | 136,186 – 137,751 | 136,969 | 19,476 |
| 37,569 – 39,134 | 38,351 | 181,200 | 87,660 – 89,225 | 88,443 | 55,978 | 137,751 – 139,317 | 138,534 | 18,842 |
| 39,134 – 40,699 | 39,917 | 163,332 | 89,225 – 90,791 | 90,008 | 54,031 | 139,317 – 140,882 | 140,099 | 18,276 |
| 40,699 – 42,265 | 41,482 | 150,556 | 90,791 – 92,356 | 91,573 | 52,272 | 140,882 – 142,448 | 141,665 | 17,672 |
| 42,265 – 43,830 | 43,047 | 140,556 | 92,356 – 93,921 | 93,139 | 50,702 | 142,448 – 144,013 | 143,230 | 17,022 |
| 43,830 – 45,395 | 44,613 | 133,331 | 93,921 – 95,487 | 94,704 | 49,026 | 144,013 – 145,578 | 144,796 | 16,430 |
| 45,395 – 46,961 | 46,178 | 128,881 | 95,487 – 97,052 | 96,269 | 47,224 | 145,578 – 147,144 | 146,361 | 15,895 |
| 46,961 – 48,526 | 47,743 | 122,934 | 97,052 – 98,618 | 97,835 | 45,581 | 147,144 – 148,709 | 147,926 | 15,418 |
| 48,526 – 50,091 | 49,309 | 115,137 | 98,618 – 100,183 | 99,400 | 44,098 | 148,709 + | 175,000 | 69,546 |
| **Total** | | | | | | | | 10,875,277 |