

## Restructuring the personal income tax system: who is proposing what?

In 2005 and early 2006 a number of proposals were put forward for restructuring the personal income tax system. This paper seeks to provide an outline of these suggestions. Readers are directed to papers cited for more details on any particular proposal.

Most of the following proposals also advocate substantial changes to the welfare payments system, particularly the Family Tax Benefit. Of course, the welfare and tax systems are directly related, but changes to the welfare system are outside the scope of this paper.

This paper does not comment on the analysis on which each proposal was based, or any estimates of budgetary costs/benefits where made. Nor does this paper attempt to evaluate any of the proposals. Each of the proposals was made with specific criteria in mind for what constitutes a 'good' tax system. Each reader will apply their own criteria on what constitutes a worthwhile restructuring of the personal income tax system in evaluating these proposals.

### Current system

The following table shows the personal income tax rates for the 2006–07 year

Table 1: Current income tax scales (2006–07)

Income Range \$	Tax Rate %
0 – 6000	0
6001 – 21 600	15
21 601 – 70 000	30
70 001 – 125 000	42
125 001 +	47

Source: *Tax Laws Amendment (Personal Income Tax Reduction) Act 2005*

### The proposals:

#### The Australian Council of Social Services

The Australian Council of Social Services (ACOSS) has identified several key measures for restructuring the personal income tax system. In its 2006–07 Budget submission, ACOSS emphasised curbing the use of private trusts, taxing termination payments made to high income earners, reforming the Fringe Benefits Tax concession, restricting claims for 'luxury' work expenses, and removing tax breaks for four wheel drive vehicles used as family cars.<sup>1</sup>

ACOSS estimates that these changes alone would add about \$1.7 billion to Commonwealth revenue in 2006–07.<sup>2</sup>

#### Australian Industry Group (AI Group)

The Australian Industry Group has proposed a series of personal income tax changes for the 2006–07 Budget focused on lower income earners. The aim of these changes is to 'inject substantially higher incentives into the tax system for lower income earners and to reduce income tax burdens'.<sup>3</sup> The following table illustrates the proposed changes to the personal income tax scales for the 2006–07 year under this set of proposals:

Table 2 Proposed income tax scales (AI Group)

Income Range \$	Tax Rate %
0 – 6000	0
6001 – 30 000	15
30 001 – 70 000	30
70 000+	42

Source: Australian Industry Group: [Building Incentive – An AI Group proposal to reduce the tax burden](#).

Other features of this proposal are:

- the low income tax offset would be increased from \$235 to \$435 p.a.
- the effective tax-free threshold for a single person would be raised from \$7567 p.a. to \$8900 p.a.<sup>4</sup>
- the phased removal of the superannuation fund income tax, and allowing the flow-through of research and development tax concessions to shareholders.<sup>5</sup>

The AI Group anticipates significant revenue recovery as taxpayers respond to the increased incentives.<sup>6</sup> The calculated costs of the above measures is \$8.5 billion. The reduction in the top marginal tax rate from 47 to 42 percent is estimated to cost about \$0.5 billion.<sup>7</sup>

#### Business Council of Australia (BCA)

Generally the BCA wants to increase the economic efficiency and international competitiveness of the Australian economy. It is recommending changes that will allow Australia to:

- continue to attract skilled labour;
- support workforce participation, and
- sustain strong levels of business activity and investment.<sup>8</sup>

The BCA has proposed:

- a reduction in the two highest steps in the personal rates tax to 30 per cent in the longer term, and
- a reduction of the second highest rate from 42 per cent to 40 per cent, and the highest rate from 47 per cent to 45 per cent as part of the 2006–07 Federal Budget. The top rate would then be reduced to 40 per cent in the 2007–08 Federal Budget.<sup>9</sup>

The proposed changes for the 2006–07 year are illustrated in the following table:

Table 3: Proposed income tax scales 2006–07 (BCA)

Income Range \$	Tax Rate %
0 – 6000	0
6001 – 21 600	15
21 601 – 70 000	30
70 001 – 125 000	40
125 001 +	45

Sources: *Tax Laws Amendment (Personal Income Tax Reduction) Act 2005* and Business Council of Australia 2005, [Taxation plan for future prosperity](#).

These proposed changes are estimated to cost \$1.45bn in 2006-07, \$4.68 billion in 2007-08 and \$5.10 billion in 2008-09.<sup>10</sup>

The Council did not make substantial comment on other measures to fund the proposed cuts in personal income tax rates. However, it did note that there was limited scope to fund tax reductions from the current fiscal surplus. Further improvements in government program efficiency, improved workforce participation and capability, and expenditure restraint are identified as key elements of any restructuring of the tax system.<sup>11</sup>

### Business Coalition for Tax Reform

In February 2006 the Business Coalition for Tax Reform (Business Coalition) put forward three alternatives for the reform of Australian's personal income tax system.<sup>12</sup> The Business Coalition is also concerned to increase the efficiency and competitiveness of the Australian economy.<sup>13</sup> The first two of these alternatives are illustrated in the following table:

Table 4: Proposed income tax scales (Business Coalition)

Modest alternative tax rates %	Income range \$	Midway alternative proposed tax rate %	Income range \$
0	0 – 6000	0	0 – 8600
15	6001 – 21 600	15	8601 – 21 600
28	21 6001 – 70 000	25	21 601 – 70 000
40	70 001 – 125 000	35	70 000+
47	125 000+		

Source: Business Coalition for Tax Reform 2006, [Personal income tax reform: public discussion paper](#), pp. 39–42.

The 'modest' change alternative would be accompanied by an increased low income tax rebate (to \$375 per annum compared with \$235 per annum currently). The Medicare Levy would remain at 1.5 per cent. All current deductions would remain in place and it would be funded from current surpluses and spending restraint on the part of the Federal government.<sup>14</sup>

The 'midway' alternative would also leave the Medicare Levy at 1.5 per cent, but the Business Coalition notes that this particular proposal leaves room for the levy to be raised to cover the cost of health care. The Business Coalition suggests that the Levy might be raised to between 3 to 7 per cent, depending on the costs to be covered.<sup>15</sup> The existing tax rebates would be simplified and some would be retained. Funding for the 'midway' package would come from the removal of a number of existing deductions and tax rebates, the ongoing budget surplus, Federal government spending restraint and a revised system for the taxation of passive income.<sup>16</sup> The Fringe Benefits Tax rate would be aligned with the highest marginal tax rate.<sup>17</sup>

The Business Coalition's third alternative is a proposal for major restructuring of the personal income tax system:

- a flat tax rate of 20 per cent
- a tax free threshold of \$10 000 p.a.
- a separate tax regime for passive income (i.e. from investments, trusts etc.) and
- a lower discount rate on Capital Gains Tax, changing from 50 to 25 per cent (the Business Coalition notes that this would still result in a lowered rate of Capital Gains Tax under the proposed tax rate).

To fund the proposed changes, the Business Coalition suggests the removal of a wide range of deductions and tax offsets, including negative gearing. Federal government spending restraint would also assist funding these proposals.<sup>18</sup>

The Business Coalition has not expressed any preference for any of the above alternatives. They have costed the three proposals as follows:

- the modest proposals at about \$8 billion in 2006-07<sup>19</sup>
- the midway proposal would have a total cost of about \$10 billion in 2006-07,<sup>20</sup> and
- the major reform proposal would cost between \$27 billion and \$29 billion a year.<sup>21</sup>

### Dr C. Emerson MP

Dr Craig Emerson MP, has argued for the abolition of the 42 per cent marginal tax rate.<sup>22</sup> The following table shows his proposed personal income tax scales in the 2006-07 year.

Table 5 Proposed income tax scales (Emerson)

Income range \$	Tax rate %
0 – 6000	0
6001 – 21 600	15
21 6001 – 125 000	30
125 001 +	47

Sources: *Tax Laws Amendment (Personal Income Tax Reduction) Act 2005* and Dr Emerson 2005, [New thinking for a new century: getting our priorities right in tax reform](#).

Dr Emerson has suggested that funding for this proposal may come from, amongst other sources, tighter targeting of Family Tax Benefit payments and reviewing the tax treatment of trusts.<sup>23</sup> He has suggested that abolishing the 42 per cent tax rate would cost about \$5 billion in 2007-08.<sup>24</sup>

### Ernst and Young

Authors working for the international accountancy firm of Ernst and Young note that, ideally, Australia's tax system should be capable of raising revenue without altering individuals' decisions to work, save and invest.<sup>25</sup> In practice, however, income taxes impose a high net cost on the nation as a whole by:

- discouraging individuals from working and saving
- reducing the level of investment in Australia by residents and foreign investors, and
- reducing the quality of investment in Australia by distorting patterns of investment.<sup>26</sup>

They also note international trends for countries to structure their tax systems to attract both financial and human capital. To enhance Australia's competitive position, to maximise its workforce participation and reduce the tax imposed on capital the authors propose the following tax scales in 2006-07:

Table 6 Proposed income tax scales (Ernst and Young)

Income Range \$	Tax Rate %
0 – 6000	0
6001 – 21 600	15
21 601 – 70 000	30
70 001 – 125 000	40
125 001 +	45

Source: Earnest and Young, *Taxation of investment in Australia: the need for ongoing reform*, February 2006, p. 7.

In the 2007-08 federal Budget the proposal would see a further reduction in the top marginal rate to 40 per cent.<sup>27</sup>

The proposed changes are part of a range of tax cuts designed to stimulate investment. Apart from taking issue with the current capital gains tax regime they do not appear to provide further comment on how the personal income tax cuts, and other changes, are to be funded.<sup>28</sup>

The authors note that the indicative cost of moving to the proposed personal income tax scale to be between \$1.43 billion

and \$1.86 billion in 2006–07, depending on how rapidly these changes were undertaken.<sup>29</sup>

### Professor John Freebairn

The current Director of the Melbourne Institute for Applied Economic and Social Research, Professor John Freebairn, has proposed the removal of the two top marginal tax rates and their replacement with a rate towards 30 per cent.<sup>30</sup> The following table illustrates the proposed personal income tax scale in the 2006–07 year:

Table 7 Proposed income tax scale (Freebairn)

Income Tax Thresholds \$	Tax Rate %
0 – 6000	0
6001 – 21 600	15
21 601 – 70 000	30
70 001+	35(*)

Sources: *Tax Laws Amendment (Personal Income Tax Reduction) Act 2005* and Freebairn 2005 *Income tax reform: base broadening to fund lower rates*, \* Professor Freebairn did not specify a new top marginal rate, he simply suggested that it be towards 30 per cent. An ambitious base broadening package may produce a top marginal income tax rate of 30 per cent.

Professor Freebairn proposes that these changes may be funded by:

- the removal of various tax deductions relating to workplace expenses and primary production
- increasing Capital Gains Tax to 30 per cent, and
- increasing the superannuation fund income tax rate.

Professor Freebairn did not separately cost this particular proposal.

### Mr J. Humphreys

Perhaps the most radical suggestion comes from former Treasury economist and author Mr John Humphreys, who proposes:

- the abolition of the progressive personal income tax scales and their replacement with a 30 per cent flat tax
- a tax free threshold of \$30 000 p.a.
- payments be made to individuals with incomes below \$30 000 on a sliding scale, no matter what their circumstances (such arrangements are sometimes referred to as negative income tax)
- abolition of the Medicare Levy, and
- abolition of welfare payments, replaced by the above payments.

These changes would, in part, be funded by:

- setting the rate of the Fringe Benefits Tax and Capital Gains Tax at 30 per cent
- raising the Superannuation Fund Income Tax rate to 30 per cent, but all taxes on end benefits would be abolished, and
- removing most of the current tax deductions.<sup>31</sup>

Mr Humphreys suggests that, roughly, this proposal would increase revenues by about \$15 billion a year over the longer term, if all of these proposals were adopted.<sup>32</sup> He noted that further costing should be undertaken to confirm this point.

### Professor P. McDonald and Dr R. Kippen

McDonald and Kippen's preferred approach is to have the personal income tax system slowly change to a point where the average tax rate reaches 35 per cent, with the tax free threshold increasing to \$16 000 over the next decade. These changes would occur in the following manner:

- raising the tax free threshold by \$1000 per annum over a 10 year period

- decreasing the top marginal tax rate (47 per cent) contingent on the rate of increase in real wages. If the rate of increase is above two per cent the top marginal tax rate would be reduced by one per cent per annum, and
- adjusting other tax rates and thresholds consistent with these changes.<sup>33</sup>

The following table illustrates the expected changes to the personal income tax rates and thresholds under this proposal.

Table 8: Proposed income tax scales (McDonald and Kippen)

2006–07		2015–16	
Income range \$	Tax rate %	Income range \$	Tax rate %
0 – 7000	0	0 – 16 000	0
7001 – 23 000	17 (15)	16 001 – 31 000	17(15)
23 001 – 63 000	30	31001 – 63 000	26
63 001 – 81 000	41	63 000 – 90 000	32
81 001 +	46	90 001 +	35

Source: P. McDonald and R. Kippen, 'Reform of income tax in Australia: a long-term agenda', Australian National University, *Working Papers in Demography*, No. 95, March 2005<sup>34</sup>

McDonald and Kippen did not separately cost the budgetary impact of this proposal.

### Mr J. Pope

Western Australian tax policy researcher, Jeff Pope, from the Tax Policy Research Unit, School of Economics and Finance, Curtin University, has suggested the following personal income tax scales.

Table 9: Proposed income tax scales (Pope)

Income range \$	Tax rate %
0 – 12 000	0
12 001 – 21 600	17 (now 15)
21 601 +	30

Source: 'Reform of the personal income tax system in Australia', *Economic Papers*, Vol. 24, 4 December 2005, p. 324.<sup>35</sup>

These changes would be funded by not allowing expense deduction from personal tax assessable income, raising the GST rate to 15 per cent and setting the Capital Gains Tax rate to 30 percent.<sup>36</sup> The likely cost of this proposal would be about \$22 billion.<sup>37</sup>

### Mr M. Turnbull MP and Mr J. Temple

Liberal MP, Malcolm Turnbull and ANU researcher, Jeromey Temple, have not proposed specific changes to the tax system. Rather, they note that the removal of a range of personal tax deductions, some reform of the current Family Tax Benefit payments and changes to the current Capital Gains Tax regime will make cuts in personal income tax rates very affordable.<sup>38</sup>

### Concluding Comments

There are clear differences in extent of proposed reforms, from totally new approaches (Pope and Humphreys) to adjustments in the existing system. Most proposals favour immediate change, with only one proposing a series of gradual changes in personal income tax arrangements (McDonald and Kippen).

Many proposals favour aligning Fringe Benefits Tax and Capital Gains Tax rates with the proposed top marginal rate of 30 per cent. Most proposals envisage funding these changes by substantial changes in the availability of tax deductions and rebates at all levels of the tax system.

Several proposals suggest that the costs of restructuring the personal income tax system, and other changes to the overall tax system, can be met from ongoing budget surpluses. However, the 2002–03 Budget's Intergenerational Report projected that, on the

basis of then policy and economic trends, the Commonwealth budget was projected to be in deficit by 2017–18.<sup>39</sup> Ongoing budget surpluses cannot be assumed to be a source of funding for the restructuring of the taxation system.

Simply cutting marginal tax rates can have some effect on the disposable income of low and some middle income families receiving Family Tax Benefit A and B, in that their immediate disposable income is increased.<sup>40</sup> But the amount by which these families benefit is not large. If a family receives these benefits, the gross income at which the amount of tax they pay exceeds the benefits they receive can be as high as \$44 951.<sup>41</sup>

Cutting marginal tax rates would raise the income level at which total benefits paid to families exceed or equal the tax paid by them. Such a development can be argued to be regressive, because it extends payments designed to benefit lower income earners to those of a higher income.

1. Australian Council of Social Services, [Australian Council of Social Services, Recommendations for the federal budget 2006/07](#), pp. 13, 14.
2. *ibid.*
3. Australian Industry Group, [Building incentive – an AI Group proposal to reduce the tax burden](#), December 2005, p. 3.
4. *ibid.*
5. Australian Industry Group, ‘Tax review needs to focus on what would make the most difference’, *Media Release*, 26 February 2006; and Australian Industry Group, [Pre budget Submission, The 2006–07 Budget](#), November 2005.
6. *ibid.*, p. 5.
7. Australian Industry Group, [Building incentive – An AI Group proposal to reduce the tax burden](#), December 2005, pp. 3, 6.
8. Business Council of Australia, [Taxation plan for future prosperity](#), April 2005, pp. 2–3.
9. *ibid.*, p. 3. These proposals were made before the 2005–06 budget and the announcement of the 2006–07 personal income tax rates.
10. *ibid.*, p. 69.
11. *ibid.*, p. 55.
12. Business Coalition for Tax Reform, [Personal income tax reform: public discussion paper](#), 2 February 2006, p. 31 and following.
13. *ibid.*, p. 4.
14. *ibid.*, pp. 39–40.
15. *ibid.*, p. 41.
16. Passive income is income arising from investments, and includes income arising from capital gains and deductions arising from negative gearing.
17. *ibid.*, pp. 41–45.
18. *ibid.*, pp. 46–54.
19. *ibid.*, p. 39.
20. *ibid.*, p. 46.
21. *ibid.*, pp. 58–59.
22. C. Emerson, ‘[New thinking for a new century: getting our priorities right in tax reform](#)’, *Labor Progressive Essay*, 25 August 2005, p. 10.
23. *ibid.*, p. 6–7.
24. *ibid.*, p. 11.
25. A. Capito, T. Hughes, J. Wallace and T. Stolarke, *Taxation of investment in Australia: the need for ongoing reform*, Ernst and Young, February 2006, pp. 2–3.
26. *ibid.*

27. *ibid.*, p. 7, 68.
28. *ibid.*, p. 16, 59 and following.
29. *ibid.*, p. 68. In making this estimate the authors have relied on the work done by Temple and Turnbull.
30. J. Freebairn, *Income tax reform: base broadening to fund lower rates*, Paper presented to the Sustaining Prosperity Conference, Melbourne Institute of Applied Social and Economic Research, Melbourne 31 March – 1 April 2005, p. 11.
31. J. Humphreys, ‘[Reform 30/30: rebuilding Australia’s tax and welfare systems. Perspectives on Tax Reform \(10\)](#)’, *Centre for Independent Studies Policy Monograph 70*, Sydney, December 2005, p. 10.
32. *ibid.*, p. 9.
33. P. McDonald and R. Kippen, ‘Reform of income tax in Australia: a long-term agenda’, Australian National University, *Working Papers in Demography*, No. 95, March 2005, p. 8, 14.
34. *ibid.*, p. 7. Again, this proposal was made before the most recent round of reductions announced in the 2005–06 budget. Adjustment in rates calculated against the rates as they stood immediately before May 2005.
35. J. Pope, Tax Policy Research Unit, School of Economics and Finance, Curtin University, ‘Reform of the Personal Income Tax System in Australia’, *Economic Papers*, Vol. 24, 4 December 2005, p. 324. This paper was written before the 2005–06 Budget and the reduction in the lowest marginal tax rate to 15 per cent. I have added the 15 per cent marginal tax rate to Mr Pope’s proposal to reflect this change.
36. *ibid.*, pp. 323, 327–328.
37. *ibid.*, p. 326.
38. M. Turnbull MP and Mr Jeromey Temple, *Taxation reform in Australia: some alternatives and indicative costings*, August 2005, p. 31.
39. The Hon. Peter Costello, Treasurer, [2002–03 Budget Paper No. 5](#), Overview.
40. K. Bremner, ‘[Net tax thresholds for Australian families](#)’, *Treasury Economic Round-up*, Winter 2005, Canberra, 1 September 2005, p. 40.
41. The Hon. Peter Costello MP, Treasurer, [Budget Paper No. 1](#), 2005–06, pp. 5–16.

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