

Three Ideas on Tax Reform

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Three ideas on tax reform

Oliver Wendell Holmes, of the US Supreme Court, once said he paid his tax bills more readily than any other bills, knowing they were the price of “civilised society”. Conservative British politician Edmund Burke took a contrary view: “To tax and to please, no more than to love and to be wise, is not given to men.”

Announcing major personal income tax cuts in May, Treasurer Peter Costello was clearly happier to throw his lot in with Burke than Holmes. In the 2005 Budget, Costello offered tax cuts amounting to \$22 billion over four years, with a larger share going to the richest 5 percent of households than to the poorest 50 percent.¹ Indeed the benefits were so heavily skewed towards well-off Australians that I argued at the time it was the most regressive set of tax reforms in recent Australian history.²

Yet the surprise of recent months has not been that the May tax cuts were so generous to the rich, but that so many people since then have argued for further tax cuts to be targeted towards affluent Australians. Malcolm Turnbull and Jeromey Temple, the Business Council of Australia, the Australian Chamber of Commerce and Industry, and the Centre for Independent Studies are among those who have fiercely advocated lowering top tax rates.³

In the first part of this paper, I argue that those who advocate lowering top tax rates are out of step with the views of most Australians. Contrary to figures that are often reported, the income of the average Australian is merely \$26,000 per year, which is near the bottom of the 30 percent tax bracket.

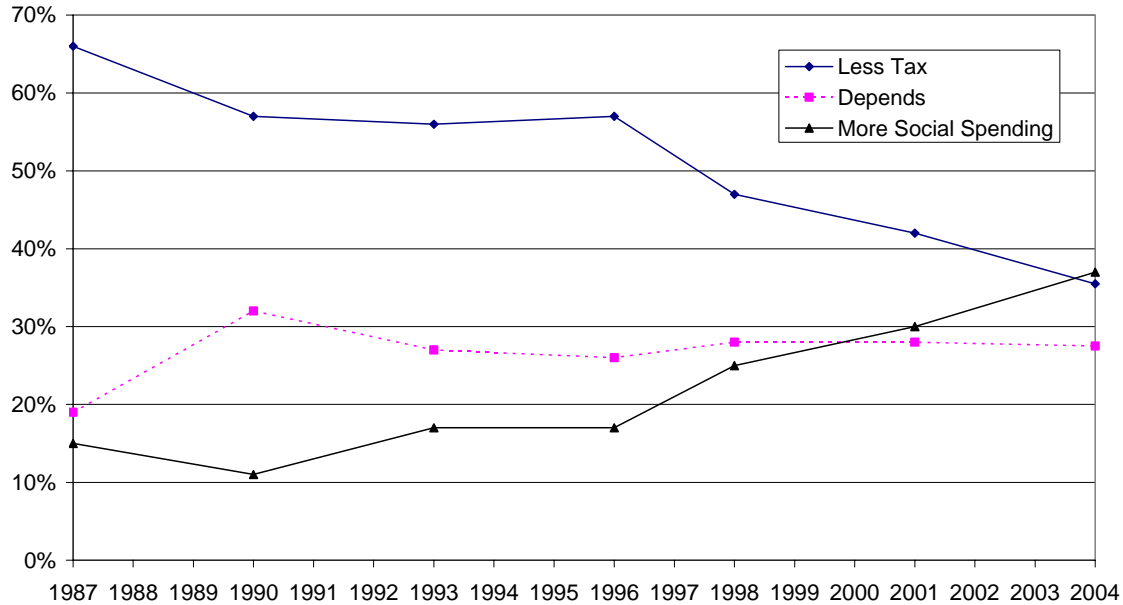
Instead, in the second and third parts of this paper, I advocate reforms that would benefit those who need help most:

- We should simplify our tax filing system by allowing most people the option of not filing a return.
- We should reduce effective marginal tax rates at the bottom, where the rates are highest, and the problem of joblessness most acute.

1. Why those who advocate tax cuts for the rich are out of step with most Australians

For many years, Australian surveys have been asking respondents the question: “If the government had a choice between reducing taxes or spending more on social services, which do you think it should do?”⁴ In the late-1980s, Australians clearly supported the tax-cutters, with those who wanted lower tax rates outnumbering those who wanted more social spending by a ratio of four to one. But according to the 2004 survey, more Australians favour social spending than want tax cuts. Remember too, that the 2004 survey preceded the tax cuts announced in the 2005 budget. It therefore seems very unlikely that the average voter today supports cutting top tax rates.

Attitudes to Taxes and Social Spending



The same surveys that ask about attitudes to tax-cutting also provide an insight into why it is that tax cuts do not garner more support. Asked in 2004 whether they agree with the proposition that “High income tax makes people less willing to work hard”, 65 percent of the population agree. But a majority of voters also think that “Income and wealth should be redistributed towards working people”. In this sense, the attitudes of voters probably mirror those of academic economists, who would most likely agree that taxation reduces work incentives, but also favour reducing inequality. Although I have been unable to find a recent survey of the attitudes of the economics community towards tax cuts, my guess would be that most Australian economists would oppose further reductions in top tax rates.⁵

Why are those who want more tax cuts for the rich so out of step with public opinion? One possible reason is that the taxation rates applying to most politicians, journalists, business executives and think-tank staffers (and indeed, to academic economists) are not those that apply to the average voter. In all these professions, six-figure salaries are common. Yet only 4 percent of Australian adults have an income that exceeds \$100,000 per year.

Tax Rates 2005-06

<u>Taxable income</u>	<u>Tax on this income</u>
\$0 – \$6,000	Nil
\$6,001 – \$21,600	15c for each \$1 over \$6,000
\$21,601 – \$63,000	\$2,340 plus 30c for each \$1 over \$21,600
\$63,001 – \$95,000	\$14,760 plus 42c for each \$1 over \$63,000
Over \$95,000	\$28,200 plus 47c for each \$1 over \$95,000

In 2005-06, those earning over \$63,001 paid a marginal tax rate of 42 percent, while those earning over \$95,000 paid a marginal tax rate of 47 percent. But surprisingly few people are in the 42 percent and 47 percent tax brackets.⁶ According to data from the Household, Income and Labour Dynamics in Australia survey (HILDA), the income of the average Australian adult is just \$26,000 per year, placing them near the bottom of the 30 percent tax bracket.

Erroneous views about what the typical adult earns are largely to the way in which earnings are often reported. The following table shows how misreporting income can quickly change the terms of the debate.

How the income of the typical Australian gets inflated in policy discussions

Typical person's income (median adult income)	\$26,000
Error #1: Use mean instead of median	\$35,000
Error #2: Also ignore those who don't work	\$42,000
Error #3: Also ignore those who work part-time	\$56,000

Source: Rows 1 and 2 are from the 2003 wave of the HILDA survey, increased by 7.5% to take account of income growth since the survey was conducted. Rows 3 and 4 are "All employees total earnings" and "Full-time adult total earnings", from *ABS Average Weekly Earnings, Australia, Cat No 6302.0*, August 2005 (released 17/11/2005).

The first error that is frequently made is to use the mean income instead of the median income. Mean income is the total income in society divided by the number of adults. If the incomes of highly paid corporate lawyers rise, mean incomes go up too. But median income is the income of the person at the 50th percentile – a measure of what the typical person has in their pocket. In some instances (such as national accounting), mean incomes are the right measure to use. But when we want to know what the average person earns, we should look at median income. The intuition for this is simple – just as the median house price tells a house-buyer what the typical house costs (and is not sensitive to the sale of a waterfront mansion), so median incomes tell us what the typical voter has in their pocket.

The second error is to exclude incomes of those not working. For policymaking purposes, those out of employment should matter as much (if not more) than those in employment. Yet commentators frequently ignore the unemployed when making statements about what a typical person earns. Average wages are not the same thing as average incomes.

The third error is to exclude those who work part-time. Since Australia has a high rate of part-time employment, this again inflates the estimate. As the above table shows, combining all three errors produces a fallacious estimate of \$56,000, more than twice the typical person's income. Such errors can have serious consequences for the policy debate. On 19 November 2004, when mean annual earnings of full-time workers rose above \$50,000 for the first time, the *Sydney Morning Herald* headlined a story "The \$50,000-a-year worker – but that's just average". Yet the typical voter has an income of just \$26,000.

Distribution of Individual and Household Income

<u>Individual Income</u>		<u>Household Income</u>	
	Individual Pre-Tax		Household Pre-Tax
Percentile	Income (Adults only)	Percentile	Income
5%	\$2,138	5%	\$13,164
10%	\$6,007	10%	\$20,478
25%	\$12,010	25%	\$36,550
Median	\$25,908	Median	\$65,747
75%	\$47,795	75%	\$101,676
90%	\$70,859	90%	\$144,657
95%	\$91,493	95%	\$181,675

Note: Incomes are the sum of market income, private transfers, Australian and foreign pensions and benefits, family tax transfers and child care benefits. Windfall (irregular) income is excluded. Data is from the 2003 wave of the HILDA survey, increased by 7.5% to take account of income growth since the survey was conducted.

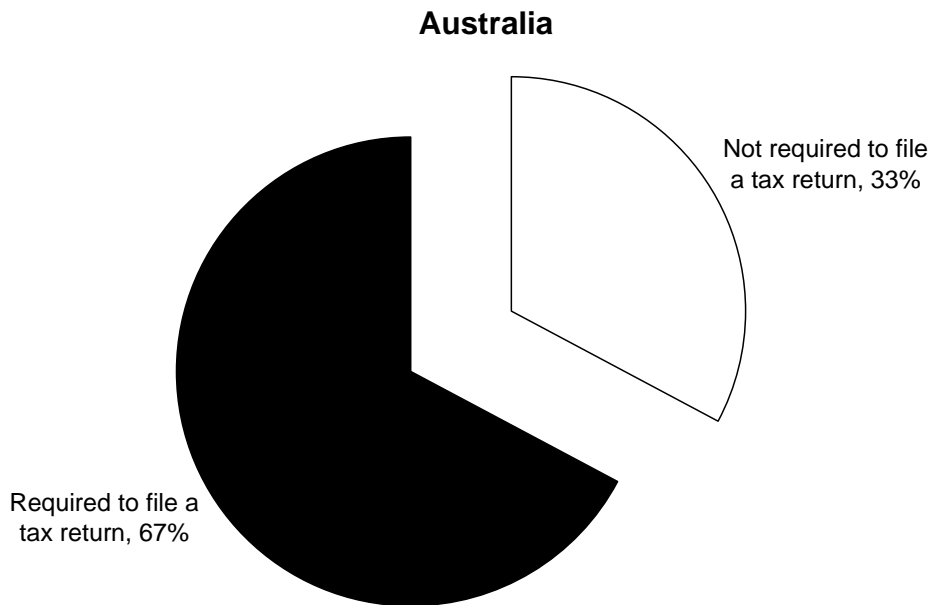
Even if we combine incomes within a family, the typical household income is just \$66,000, meaning that half of all Australian households get by with less than \$66,000. Policy debates must acknowledge the fact that most Australian households are still well out of the top tax brackets.

Politicians should not make policy simply by following opinion polls. In some instances, long-term reforms are the right option for the country, despite being initially unpopular. But when only one in three voters supports cutting top tax rates, the tax-cutting brigade should pause to consider whether they have it right. And when reporting on tax cuts, journalists should make sure that they keep in mind what the typical Australian actually earns.

2. Why we should simplify the tax filing system

Most tax reform plans are focused on cutting top tax rates. The theory behind this is simple: since taxes deter work, they impose a “deadweight cost”. But reducing tax rates has another consequence – it means that there is less revenue available to pay for national security, unemployment benefits, schools, pensions, hospitals and roads. As the previous section of this paper has shown, most Australians acknowledge this trade-off. They recognise that taxes reduce work, but they tend to prefer more social spending to lower top tax rates.

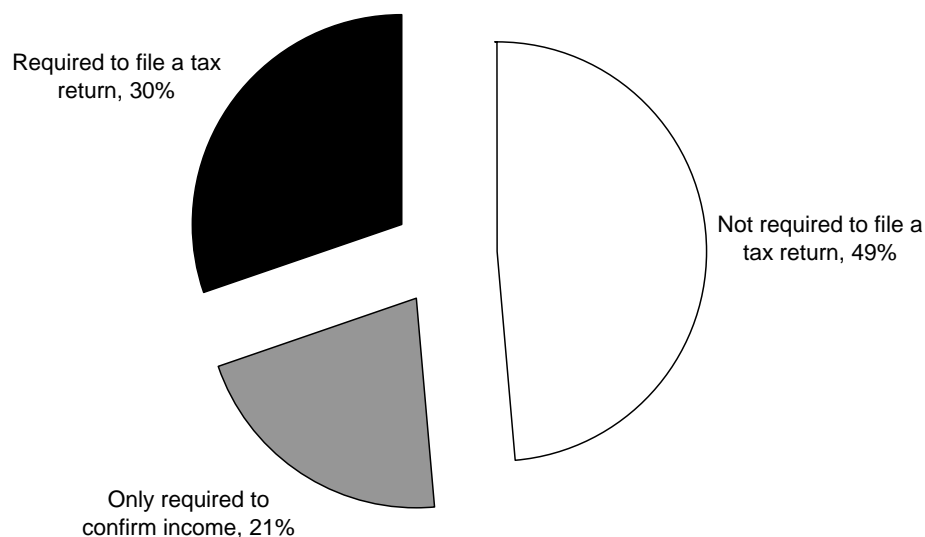
What is often missed in Australian tax debates is that reduced work incentives are not the only deadweight cost of taxation. As everyone who spends the last weekend in October filling in tax forms knows, another deadweight cost of taxation is the administrative burden. Getting your receipts in order and ploughing through the Tax Pack takes time that could be spent doing more productive activities. In 2002-03, the most recent year for which taxation statistics are available, two-thirds of Australian adults filed a tax return. By contrast, just one in five British adults now file tax returns.⁷



How much time do we take to do our taxes? In 1994-95, Binh Tran-Nam and his co-authors surveyed a representative group of Australian taxpayers, and asked them how much time they took to file their returns.⁸ On average, they found that Australian personal taxpayers spent 8.5 hours each year on their tax affairs. Multiplying this by their hourly wage rate, they found that tax compliance costs each taxpayer around \$210. In today's wages, the cost of tax compliance is probably more like \$300 per person (though electronic filing may have helped a little).⁹ This means that the cost to taxpayers of complying with the personal income taxation system is \$3 billion per year.

To see how we could reduce the cost of tax compliance, we only have to look across the Tasman. Back in the mid-1990s, three-quarters of New Zealand adults were required to file tax returns. In 1999, New Zealand dramatically simplified its tax system, freeing most adults from the requirement of filing. In the most recent tax year, half of all adult New Zealanders – those whose only sources of income were wages, interest or dividends – were not required to file a return. Another one-fifth receive a statement from the tax office setting out what the authorities thought they owed, which they had to correct or confirm (this can be done with a telephone call). Only three in ten New Zealand taxpayers now file tax returns.

New Zealand



One reason the New Zealand tax system allows nearly three-quarters of personal taxpayers not to file a return is that theirs is a simpler tax system than ours. Many of the tax deductions available in Australia do not exist in New Zealand. Indeed, some have argued that Australia should follow New Zealand in abolishing deductions and lowering tax rates.

But we can make life easier for Australian taxpayers without doing anything so radical. A much simpler reform would be as follows. In August of each year the Australian Taxation Office (ATO) – knowing how much you earned from various sources – should send you a tax statement, setting out your income and tax liability. In other words, the tax forms should be “pre-populated” with the information already held by the ATO. If a taxpayer then wishes to claim certain deductions, they are free to file a return. But if not – and provided the taxpayer’s only income is from wages, dividends and interest – they have the option of not filing a tax return. All the taxpayer would then have to do is let the ATO know that he or she agrees with the assessment, and then claim a refund or pay the excess tax.

Simplification could not take everyone out of the personal tax system. Self-employed workers and landlords would still have to file a tax return. But like New Zealand, we could spare around three-quarters of Australian adults from wrestling with the Tax Pack, from keeping receipts through the year, and from fretting as 31 October looms. The beauty of such a reform is that it can be implemented with any set of tax rates – lower or higher than those we have today. We do not have to cut top tax rates to make tax filing simpler.

In an era when the ATO deducts most tax at source, why should we spend hours every year telling the tax office what it already knows? Instead, it would be better to exempt most

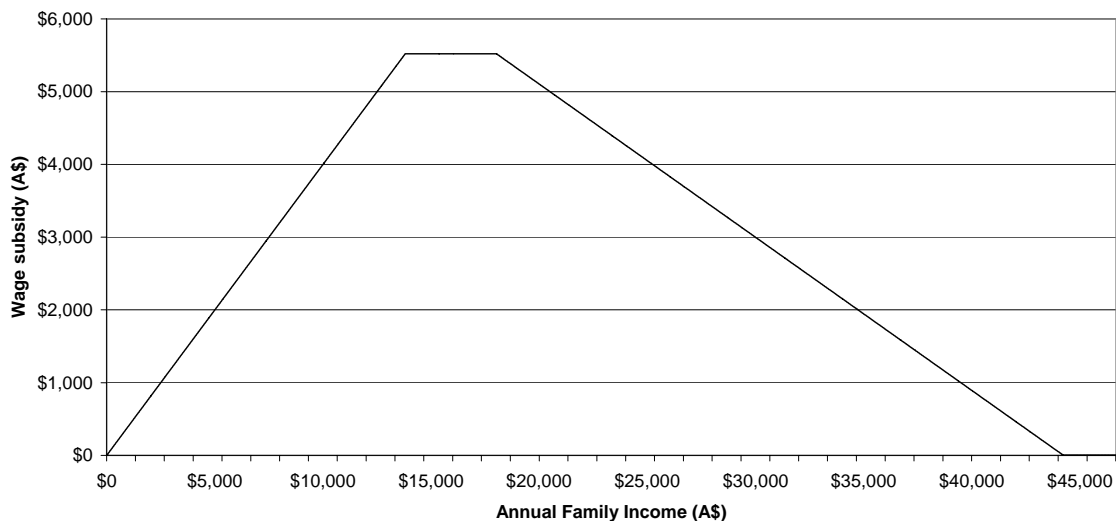
taxpayers from the requirement to file a tax return, so long as the ATO already knows about all the income that they have earned. By saving taxpayers eight hours of work, such a reform would give most Australians the equivalent of an extra public holiday each year.

3. Why we should focus on the effective marginal tax rates faced by the poor, not the rich

Rather than focusing on tax rates faced by the rich, a more productive national tax debate would target attention where it is needed most – to reducing the marginal tax rates faced by the poor. In recent years, many other developed countries have done just that. In the United States, welfare reforms implemented under President Clinton used a combination of sticks and carrots to bring about a large rise in workforce participation. Most importantly, the US provides poor families with an earned income tax credit (EITC) worth up to \$5,500 Australian dollars per year. And the EITC worked. Careful studies afterwards concluded that more of the rise in US employment over the 1990s was due to carrots (the EITC) than sticks (such as time limits on welfare receipt).¹⁰ This provides a clear policy lesson for other countries seeking to move more people off welfare: if you want to be successful, an EITC should be part of the solution.¹¹

The US is not the only country to have this kind of EITC program. Britain provides a EITC of up to \$7,000 annually to induce low-income parents into the workforce. Belgium, Finland, Germany, Ireland and the Netherlands also use EITCs to boost workforce participation.¹² Such EITC programs are also known as negative income taxes. They operate as wage subsidies, typically increasing in value as workforce participation rises. For example, a family with two children earning below \$13,000 in the United States receives an EITC equivalent to 40 percent of their earnings.

Wage Subsidy for a Family with Two Children in the United States (2002)



Despite their obvious appeal for increasing the labour force participation of lower-skilled workers, Australia has largely eschewed EITCs. While the so-called “five Economists” proposal in 1998 received broad support among academic economists, the federal government took little notice.¹³ Existing Australian wage subsidy programs tend to be narrowly targeted at particular groups (such as apprentices, older workers, the disabled and Indigenous people), or operate only for a very short time.

Over the past quarter-century, economic change has left some behind, particularly unskilled men. As Paul Frijters and Bob Gregory have recently shown, the fraction of adult men without a full-time job has risen significantly since the 1970s.¹⁴ Since the late-1970s, the proportion of men aged 25-64 working full-time has fallen from 85 percent to 75 percent. Many of those who have dropped out of the labour force have moved on to income support, including the rapidly-growing Disability Support Pension.

Why does it matter if employment rates have fallen? The best reason to worry about employment rates is for the sake of children growing up in workless households. In the early-1980s, one in ten children lived in a household in which no adult was in employment. Today, one in seven Australian children live in a jobless household.¹⁵ From careful research, we know that children do better in households with at least one parent in the labour force. Even apart from the extra income that comes from parental employment, the experience of growing up in an environment where parents prepare for work every day is more likely to prepare children for the world of work themselves. Otherwise, joblessness may persist across generations. This is a far more pressing policy problem than work incentives for the rich.

One factor contributing to low labour force participation rates in some households is the high effective marginal tax rates faced by welfare recipients. While the highest marginal tax rate faced by the rich is 47 percent, those seeking to move from welfare to work can often face marginal tax rates of 60 percent or more. An EITC could help by reducing these high effective marginal tax rates. The international research shows that earned income tax credits can be a viable solution, and should be on the policy menu of forward-thinking politicians.

Conclusion

This paper has argued that the push to cut top marginal tax rates is fundamentally misguided, since Australian public opinion is more strongly in favour of social spending than tax cuts for the rich. One reason why the tax cutting debate is so out of step with popular opinion may be that many commentators do not realise how low the income of the median Australian really is.

Instead of cutting tax rates on the rich, we should focus on making the tax system simpler for ordinary Australians. Like New Zealand, Australia could dramatically simplify the tax

filing system, saving many of us the hassle of poring over the Tax Pack for a weekend, and reducing the \$3 billion deadweight cost of the personal income tax system that comes from compliance costs alone.

Lastly, we should consider offering an EITC to encourage the transition from welfare into work. Effective marginal tax rates are higher on the poor than on the rich, and making work more attractive may be a way of breaking the intergenerational cycle of poverty and joblessness.

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Notes

- ¹ Andrew Leigh, 2005, [A Household Analysis of the Tax Changes Proposed in the 2005 Budget](#), Australian National University, 16 May 2005.
- ² Andrew Leigh, 2005, [Lies and Statistics](#), *Australian Financial Review*, 28 May, p.63.
- ³ See for example Malcolm Turnbull and Jeromey Temple, 2005, [Taxation Reform in Australia: Some Alternatives and Indicative Costings](#), 29 August, Sydney: Office of Malcolm Turnbull MP. See also Business Council of Australia, 2005, [Taxation Action Plan for Future Prosperity](#), April, Melbourne: BCA. The Centre for Independent Studies has published ten papers in its Perspectives on Tax Reform series, most of which argue for lowering top tax rates. The most recent is John Humphreys, 2005, [Reform 30/30: Rebuilding Australia's Tax and Welfare Systems](#). 30 November, Sydney: CIS.
- ⁴ Data for 1987-2001 from Richard Grant, "[Less tax or more social spending: twenty years of opinion polling](#)", Parliamentary Library Research Note No.57 2003-04, 24 May 2004. Data for 2004 from the Australian Election Study 2004 codebook.
- ⁵ A 2001 survey of members of the ACT branch of the Economic Society of Australia did not ask respondents about cutting top tax rates, but the survey did find strong support among economists for the propositions that government should be concerned with inequality (questions 17 and 18), and that reforming the tax-transfer system was a promising way of reducing unemployment (question 14). See Fred Argy, 2001, "Economic Rationalism in Australia - survey of Members of the Economic Society of Australia, ACT Branch", *Economic Papers* 20(1): 1-14.
- ⁶ Another factor is that some people with incomes that put them in the 42 percent or 47 percent tax brackets are able to manipulate their incomes to minimise their effective tax burden, thorough vehicles such as family trusts. Others may engage in direct tax avoidance, but we do not know whether tax avoidance as a share of income is higher among the rich, since Australia has never carried out a tax audit based on a random sample of all personal income taxpayers. .

- ⁷ Number of UK taxpayers from Chris Evans, 2004, “Diminishing returns: The case for reduced annual filing for personal income taxpayers in Australia” *Australian Tax Review* 33: 168-181. UK adult population data from Statistics UK.
- ⁸ Tran-Nam, B., Evans, C., Ritchie, K. and Walpole, M., 2000, “Tax Compliance Costs: Research Methodology and Empirical Evidence from Australia”, *National Tax Journal* 53(2): 229–252.
- ⁹ According to [RBA figures](#) (Table G06 - Average Weekly Earnings - National Accounts), average wages were around \$630 in the financial year 1994-95, and \$922 in the June 2005 quarter. Using this ratio, \$210 in 1994-95 is equivalent to \$307 today.
- ¹⁰ Jeffrey Grogger, 2003, [The Effects of Time Limits, The EITC, and Other Policy Changes on Welfare Use, Work, and Income Among Female-Headed Families](#), *Review of Economics and Statistics*, 85(2): 394–408; Bruce D. Meyer And Dan T. Rosenbaum, 2001, [Welfare, the Earned Income Tax Credit, and the Labor Supply of Single Mothers](#), *Quarterly Journal of Economics*, CXVI, 1063-1114.
- ¹¹ For a general discussion of the EITC, see V. Hotz and J. Scholz. 2003. “The Earned Income Tax Credit,” in R. Moffitt (ed), *Means-Tested Transfer Programs in the United States*. Chicago: University of Chicago Press, chapter 3; Nada Eissa and Hilary Hoynes, 2005, [Behavioral Responses to Taxes: Lessons From the EITC and Labor Supply](#), NBER Working Paper 11729. Cambridge, MA: NBER.
- ¹² For a cross-country survey of EITC-type programs, see James Banks, Richard Disney, Alan Duncan and John Van Reenen, 2005, “The Internationalisation of Public Welfare Policy” *Economic Journal*, 115:C62-C81.
- ¹³ See Peter Dawkins, 2001, “The ‘Five Economists’ Plan’; The Original Ideas and Further Development”, Paper for Conference on Creating Jobs: The Role of Government, 6-7 Sept 2001.
- ¹⁴ Paul Frijters and Bob Gregory, 2005, “From Golden Age to Golden Age: Australia’s ‘Great Leap Forward’?”, Working Paper, Australian National University.
- ¹⁵ Peter Dawkins, Paul Gregg and Rosanna Scutella, 2005, “Employment Polarisation in Australia”. *Economic Record* 81(255): 336-350.