POLICY BRIEFING

The case for tax reform: Personal Income Taxes

Summary

The main purpose of tax reform generally is simple: to raise the additional revenue Commonwealth and State Governments need to properly fund essential public services and infrastructure; and to do so in way that is fair and helps grow the economy and increase job opportunities.

This ACOSS Policy Briefing sets out the case for tax reform to personal income taxes. It is the result of extensive tax policy development work by the ACOSS Tax Working Group and ACOSS Tax Policy and Advocacy Member Network [i]. Responsibility for content and views expressed rests with ACOSS.

ACOSS proposes that personal income tax reform should be carefully staged. The first stage, which should be delivered in the upcoming 2016-17 Federal Budget, is broadening the personal income tax base. This would improve revenue adequacy, ensure people are paying their fair share and remove tax distortions from investment decisions to encourage stronger investment into the productive economy. Personal income tax reductions should be staged to occur in future Federal Budgets once revenue adequacy is restored, and when the case for returning the proceeds of 'bracket creep' is real.

The best starting point for tax reform is to strengthen Australia's main progressive tax bases: personal income tax system and land. A broader land tax to replace stamp duties should be negotiated with the States as part of reform of the federation[1].

In the 2016-17 Budget the first tax reform priority should be reform of personal income tax. By 'reform' we do not mean cuts in personal or company income tax. The eight successive personal tax cuts from 2002-10 were a major cause of the budget difficulties the Government now faces, and the case to address 'bracket creep' does not yet exist. Most people are still paying less now than they would have under the tax scales that applied before all those tax cuts, and will continue to do so until at least 2020.

We do not support personal (or company) income tax cuts at this time. With Budgets under pressure, and limited options for fair expenditure savings, tax cuts now would risk a repeat of the 2014-15 Budget cuts to essential benefits and services. Many of those, including the $80 billion cut in funds to the states for health care and schools, are still in place and must be restored.

---

[1] For the case for tax reform regarding stamp duties and land tax, see ACOSS (2016): The Case for Tax Reform: Stamp Duty Duties and Land Tax (April 2016)

April 2016

Nor is personal tax reform about raising the rates of tax people pay. Instead it should, first and foremost, ensure that everyone actually pays at their lawful tax rate. All too often, people on higher incomes who are 'well-advised' end up paying a lower tax rate than the rest of us. Tax avoidance by higher income-earners and companies has become a celebrated endeavour, and this must end. If tax shelters and loopholes were closed, broadening the base of the personal income tax system, then the revenue to fund essential services and infrastructure can be collected fairly, leaving room to address 'bracket creep' in the future when the case is real and the Federal Budget is a stronger position.

There has been much debate over tax concessions that currently substantially narrow the personal income tax base. The National Reform Summit in November 2015 agreed that addressing tax concessions "no longer fit for purpose" was a priority and common ground between business, community and unions. The main offenders include capital gains discounts and negative gearing (which do little to encourage productive investment in economic activity[2]), superannuation (which is wrongly targeted to high income earners), work related deductions (which often extend well beyond work related purposes) and private trusts and companies (which allow people to pay less tax than if they received income directly).

It is essential that the 2016-17 Federal Budget limits these tax concessions. If it does not, it is even more essential that political parties in the 2016 federal election campaign do not rule out action as a priority for the next Government. Any personal tax cuts should wait until at least 2020, when the case for addressing bracket creep is likely to emerge.

The ACOSS proposals to reform personal income taxes would raise an extra $6 billion a year in the short term (in 2017-18) rising to $12 billion by 2020-21. The reforms to be given first priority, ideally in the 2016-17 Federal Budget, are:

- Reducing the discount for capital gains from 50% to 25%;
- Limiting deductions for investment in assets such as rental property and shares and using part of the savings for a new investment incentive for rental housing;
- Tightening the tax treatment of private companies and trusts;
- Limiting work related deductions where work and personal spending overlaps (e.g. overseas conferences) and using the savings to introduce a 'standard deduction'.

The priorities for use of this money over the next four years should be the following:

1. Restore cuts to essential services;
2. Reduce the Budget deficit.

[2] See ACOSS (2015): [Fuel on the fire: negative gearing, capital gains tax and housing affordability]

After 2020, provided funding for essential public services and infrastructure and the overall Budget are in a sustainable position, the following tax reform steps should be taken:

3. Introduce a 'standard work related deduction' and restructure the income tax scale to return the proceeds of 'bracket creep' to most taxpayers;
4. Extend the same 25% discount to interest income and rent as applies to capital gains (as proposed by the 'Henry Report' [3]), to reduce the distortion of investment decisions and encouragement of speculative activity by the tax system.

Superannuation reform should also be undertaken, as part of a long-term retirement incomes plan. Reform of super tax concessions is badly needed, not to pay for tax cuts today but to improve retirement incomes for low and middle income earners and help with the cost of health and aged care in the future[4]. This Federal Budget should curb excessive super tax breaks for higher income-earners and close personal income tax avoidance opportunities, including by:

- Replacing the flat 15% tax for super contributions with a two-tier rebate off each person's marginal tax rate. The rebate would be 100% of all contributions up to a low annual level (e.g. $250) and 20% for additional contributions up to a contributions cap (e.g. $15,000) that is substantially lower than the present one ($30,000 to $35,000). This should be designed to give everyone the same tax break for all contributions up to the annual cap (increasing concessions for low income earners and reducing them for high income earners), and would be revenue-neutral.
- Extending the existing 15% tax on fund earnings to the 'pension phase', offset by a 15% rebate for retirees whose taxable income is below the tax free threshold. The purpose of this reform should be to ensure that everyone contributes to the cost of future health and aged care services according to their capacity. It is estimated to raise $4 billion a year (and rising) by 2020, over half the 2014 Budget funding cut to State health services.

Governments have tinkered at the margins of a flawed superannuation system for too long – introducing high income surcharges and low income contributions and then abolishing them. It is time to restructure the superannuation system so that reform is both fair and enduring.

The income tax treatment of companies, including international ones, should be reformed to encourage investment to grow the economy and close down tax avoidance opportunities. This will be the subject of a future ACOSS tax reform publication.

[3] Australia's Future Tax System (2009), Report.

[4] For more information on our retirement income proposals see ACOSS (2015): [Tax talks 4: Three foundations for a secure retirement]

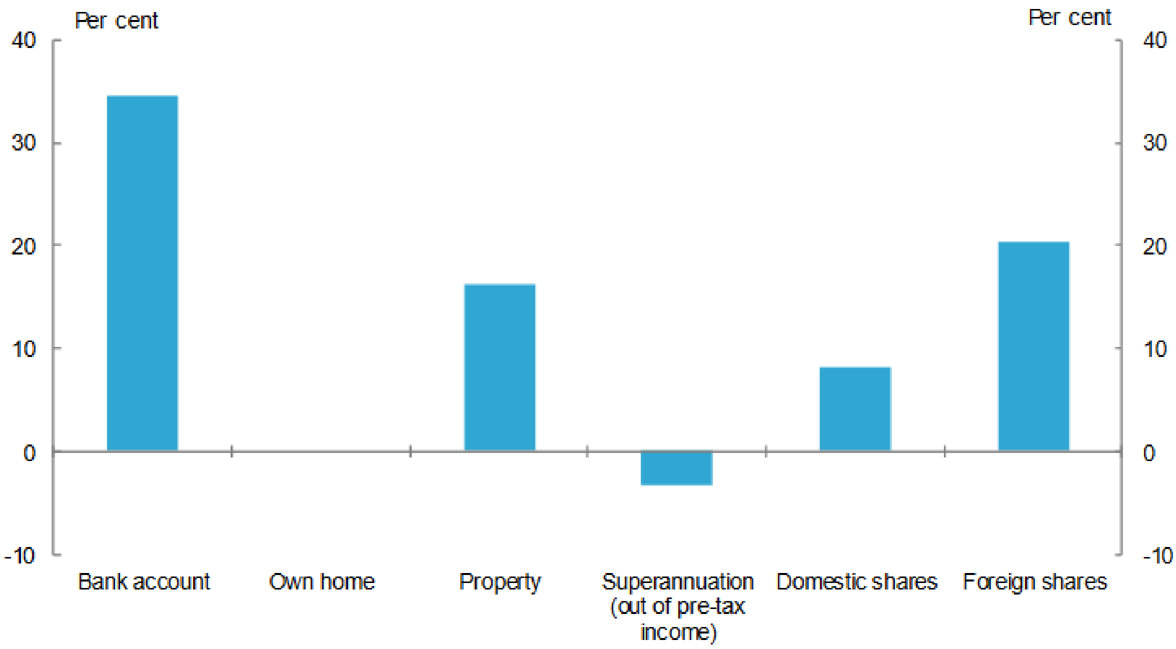
1. What is tax reform for?

At a time when Commonwealth and State budgets are under pressure, we face a choice between strengthening public revenue and cutting services and benefits. The stark implications of that choice were revealed in the 2014-15 Federal Budget when the Government proposed to cut benefits for unemployed young people, reduce indexation of pensions, withdraw payments for families living in poverty and to cut funding for State health services and schools by $80 billion.

There are better savings options on the expenditure side, such as shifting health spending from hospitals to primary and preventive care, but most require long term planning. Most of the less socially damaging Budget savings that can be quickly implemented have already been made.

Ad hoc increases in tax rates are not the answer either. The tax system treats different kinds of saving and investment inconsistently in ways that harm the economy: for example the low taxation of capital gains together with 'negative gearing' encourages speculative investment in housing. Some people, especially women on low incomes, are discouraged from re-entering paid employment by taxes and social security income tests. Raising higher taxes off a flawed income tax 'base' could make these problems worse.

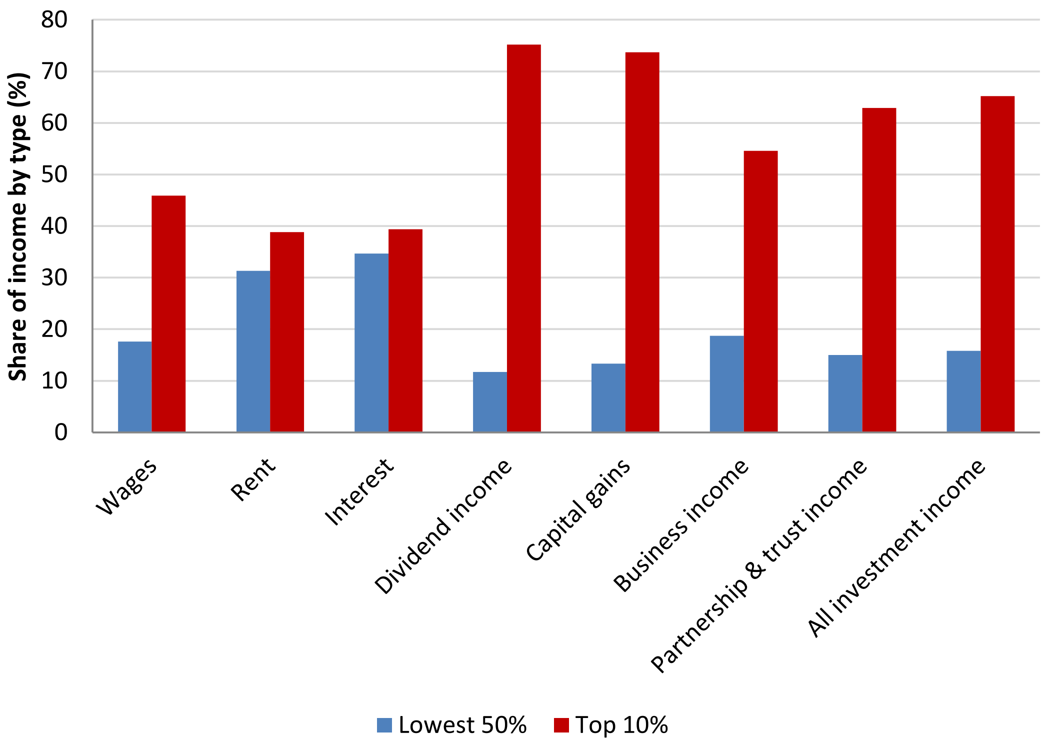
Investment incomes are taxed inconsistently: Effective tax rates on different investments held for 25 years



Source: Australian Government (2015): [Re:think - tax discussion paper]

The best solution is to strengthen the personal income tax base by limiting shelters, loopholes and inconsistencies so that more revenue can be raised from the same tax rates. This would improve fairness and help grow the economy at the same time, because it is people on higher incomes who are 'well advised' that benefit most from tax shelters while the majority of people have to pay more to make up the lost revenue.

Some incomes are more equal than others: Share of income by income type



Source: Australia's Future Tax System Review (2008): Architecture of Australia's tax and transfer system.

2. What should the first priorities be?

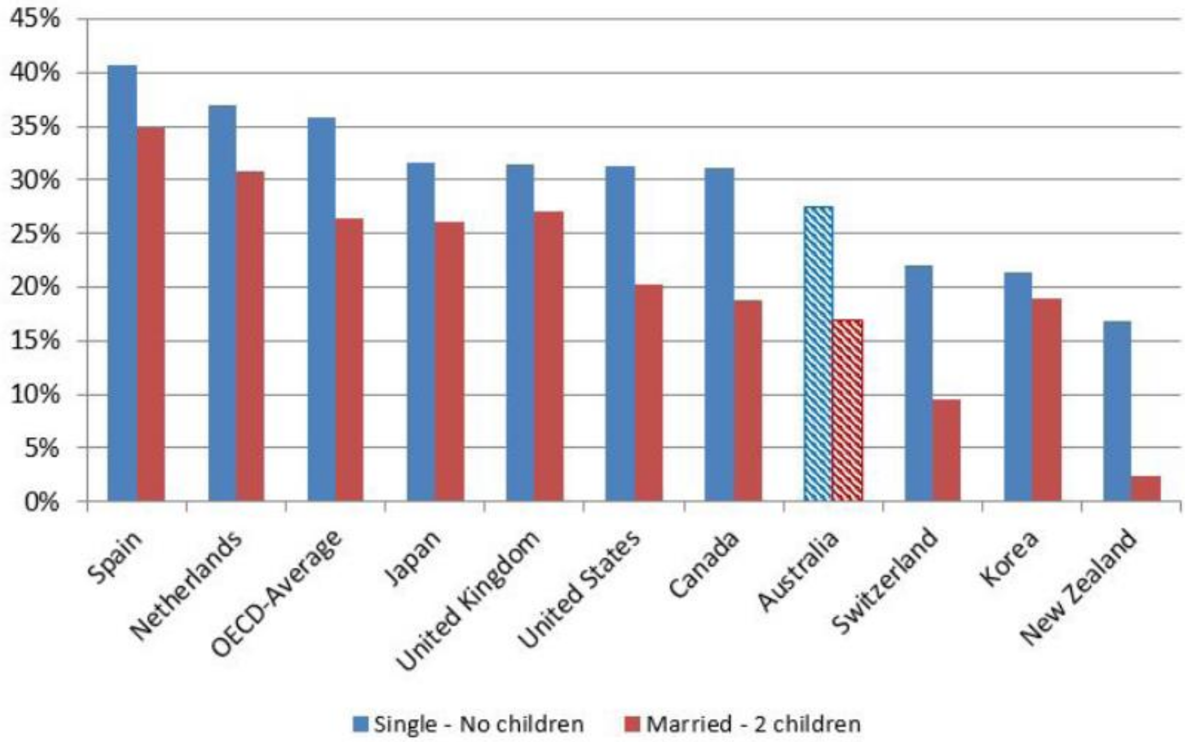
Our priorities include strengthening the personal income tax base and taxes on land[5]. If properly designed, these are fair and efficient taxes that do little harm to the economy.

Contrary to much of the public debate on tax, Australia's income tax 'take' is not high by international standards: a fulltime worker on an average wage pays less income tax overall than

[5] ACOSS (2016): *Op. Cit.*

their counterpart in the United States[6]. The top marginal tax rate has little or no impact on workforce participation or saving decisions by the men with high incomes who mostly pay it [7].

Australia's personal income tax for an average worker is low by international standards



Source: Stewart et al (2015): A stocktake of the tax system and directions for reform. Tax Transfer Policy Institute, ANU Canberra. Note: Income tax plus employee social security contributions minus social security payments for a worker on average fulltime earnings (2013)

Reform of the taxation of superannuation should also be given high priority. It is now widely recognised that our superannuation tax breaks are not fit for their main purpose: to improve retirement incomes and reduce reliance on the Age Pension. Low wage-earners, most of whom are women, are penalised by the tax system for saving through superannuation, while high income earners receive the largest tax breaks per dollar invested. The main problem is the flat 15% tax on contributions, which means that an executive earning $200,000 (on the top tax rate) saves 34 cents per dollar invested in super while a cleaner on $10,000 (below the tax free threshold) faces a tax penalty of 15 cents.

Another, less widely acknowledged problem with the tax treatment of superannuation, is that the investment income of super funds is not taxed once people reach retirement and their

[6] The overall average tax rate in Australia in 2015 was 22.7% compared with 23.6% in the USA (including State income taxes and employee social security taxes).
[7] Dandie, S. and Mercante, J. 2007, 'Australian labour supply elasticities: Comparison and critical review,' Working paper no. 2007-04, Australian Treasury, Canberra.

fund pays them a pension (this is in addition to the exemption from tax of superannuation benefits, which we do not oppose). This leaves a growing gap in the income tax system for retirees that will deprive future governments of the revenue they need to fund health and aged care services for an ageing population. Simply put, it means that many people with substantial wealth or income can avoid paying income tax altogether once they reach 60 years of age.

3. A 'fairer personal tax' plan

ACOSS is developing a series of reform 'packages' to raise public revenue more fairly and efficiently. Each of these responds to our key objectives – raising revenue, improving fairness, improving housing affordability, growing the economy, ensuring decent retirement incomes and services, and securing a robust revenue base for States and Territories. It is not necessary or desirable to try to roll all of these elements of tax reform into one big 'package'.

The first of the reform packages we propose is a 'fairer personal income tax plan'. Its starting point is that the tax system would be fairer and the economy would benefit if personal income was taxed more consistently by closing shelters and loopholes and by taxing investment income in a more consistent way.

This would help fund essential services and infrastructure without the need to increase marginal tax rates. Over time, it would make room to adjust the income tax scale to restore the proceeds of 'fiscal drag' or 'bracket creep'. The goal here should not be to restore overall personal income tax levels to their 'low point' in 2010 following eight annual tax cuts [8]. Since those tax cuts were paid for using the temporary revenue windfall from the mining boom, they were never affordable in the long run. A fiscally responsible approach is to restore the average tax rates that applied in 2002, before those eight tax cuts were given.

At a time of slow growth in wages, the so-called bracket creep 'problem' is not yet real. It will take at least another four years before most people are paying more income tax than they would have paid under the 2002 tax scales (see table below). The priority now should be to broaden the personal income tax base by closing off tax shelters and loopholes, to put essential services on a secure footing and restore cuts to programs such as health care, schools and affordable housing, not to cut personal or company income taxes.

The table below shows the average tax rates (overall percentage of income paid in tax, not marginal rates) paid by people on different income levels between 2003 and 2019.

[8] http://www.lewistaxation.com.au/tax/historic-tax/personal-income-tax-prior-years

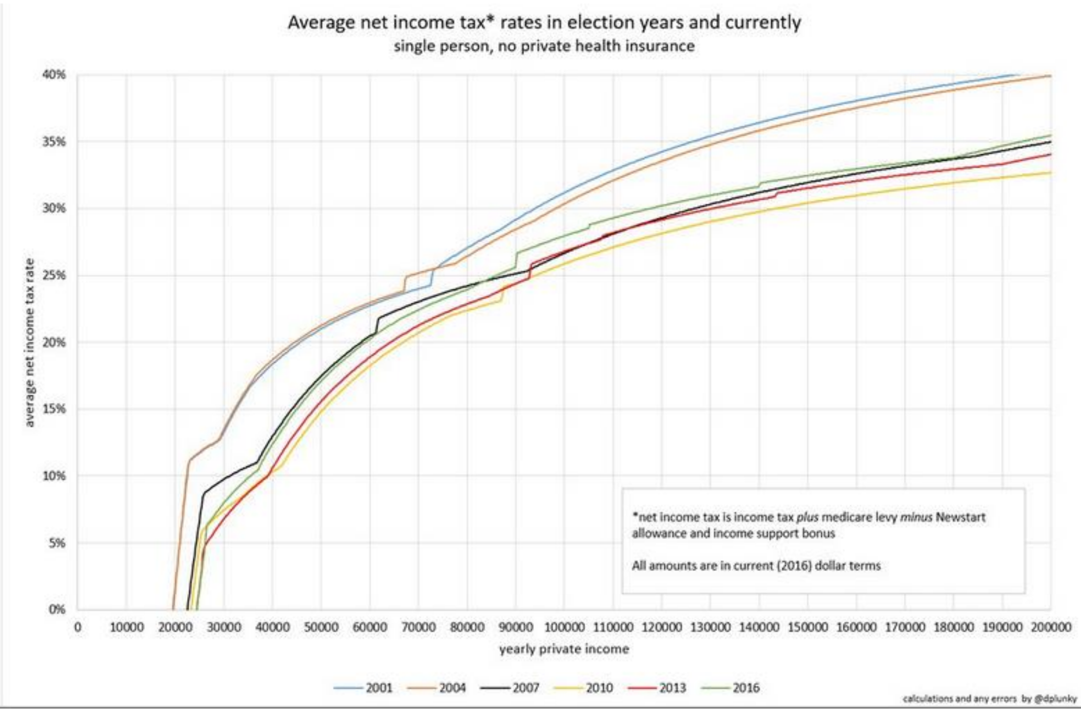
Average tax rates at different incomes (2003-2019)

	2003	2007	2011	2015	2019
Highest earning 10%	34.7	30.7	31.7	32.9	33.2
70% - 80%	22.7	21.1	21.1	22.6	24
50% - 60%	18.9	15	14.1	16.2	18.2
Lowest earning 50%	10.2	6.6	5	5.9	7.6

SOURCE: NATSEM research cited in '*The Australian*: David Uren 30 March 2016 [Tax bracket creep to hit poorer half of workers the hardest]

As the graph below shows, average personal income tax rates this year are still lower than in 2001.

Overall personal tax rates are still lower now than they were in 2001



Source: David Plunkett (https://twitter.com/DPlunky) Note: The top (blue) line is the average (not marginal) tax rate on personal income at different income levels in 2001; the third (green) line is the same for 2016. Newstart Allowance is included as a 'negative income tax' for those with very low private incomes.

Another high priority for this Budget should be reform of superannuation tax concessions. This should be part of a wider retirement incomes policy, not simply used as a trade-off for personal tax cuts. Our retirement income policy proposals are outlined in a separate ACOSS publication [9].

[9] ACOSS (2015), *Op.Cit.*

4. Our proposals

The ACOSS 'fairer personal income tax plan' has four components:

(1) **Investment income** would be taxed more fairly and consistently by:

- Reducing the Capital Gains Tax (CGT) 'discount' for individuals and trusts from 50% to 25%.
- Removing inequitable exemptions for small business assets from CGT.[10]
- Restricting 'negative gearing' by restricting deductions for passive (i.e. not active business) investment in major investment asset classes yielding capital gains (including rental and commercial property, shares, agricultural schemes and collectables) so that they can only be offset against income from the same investment (including future capital gains).
- Using part of the proceeds of the above reform to pay for a new two-tier rental housing investment incentive for investment in new rental housing construction, with an emphasis on affordable housing.
- Over time, applying the same 25% discount to personal income from interest and housing rent as applies to capital gains, as proposed in the Henry Report[11]. This would reduce taxation of the inflation component of investment returns, reduce the tax bias towards investments yielding capital gains, and improve housing affordability.

(2) **Labour income** would be taxed more fairly and efficiently by:

- Introducing a standard deduction to partly replace work related deductions (above which much tighter substantiation would be required), and capping or otherwise restricting claims in areas such as self-education, motor vehicles and home offices where the boundary between personal consumption and work related costs is unclear.
- Tightening the income tax treatment of non-superannuation employment termination payments (other than redundancy payments) so that they are taxed more like wages and less like superannuation.

---

[10] This requires attention to improving access to superannuation for self-employed people since many small businesses use their business assets for retirement saving purposes.
[11] Australia's Future Tax System Review (2009), Report.

(3) **Investment and business entities** would be taxed more fairly and consistently by:

- Taxing private trusts in like manner to companies.
- Taxing undistributed profits in private companies (including private trusts taxed as companies) at the top marginal tax rate plus Medicare Levy, minus a reinvestment allowance based on the value of business assets.

(4) **Tax expenditures** (concessions with a public policy purpose) would be regularly reviewed as part of the annual budget process, and those which are equivalent to direct expenditures should be accounted for within relevant portfolio budgets (for example, the tax concession associated with the private health insurance rebate would be brought to account in the Health budget):

- Tax expenditures that are not fit for purpose and cost effective would be curbed or abolished.

5. What would the extra revenue be used for?

The extra revenue obtained from these changes (approx. $6 billion p.a. in the short term and $12 billion in 2020-21) would, as a first priority, be used to restore funding for essential health, education and community services, reduce poverty, and reduce the budget deficit.

After five years, provided funding for essential services and the overall Budget are on a sustainable path, remaining additional revenue would be used to restructure the personal income tax scale to restore typical overall tax rates for low and middle income earners to the levels that prevailed before the unaffordable round of eight consecutive income tax cuts beginning in 2002. This would require changes to the tax scales after 2020.

Revenue from less concessional tax treatment of capital gains would over time be used to equalise the tax rates applying to capital gains, housing rents, and interest as proposed by the Henry Report[12].

[12] Australia's Future Tax System Review (2009):*Ibid*

'Fairer personal tax' reform proposals

Option:	Expected impact:	Revenue: ($ billions)
A. Taxation of investment income		
1. Reduce the CGT discount from 50% to 25%, phased in (in equal steps) over 10 years	Reduced tax bias towards investments yielding capital gains (esp. housing), curbing excessive growth in house prices This would strengthen economic growth since investment decisions would be based more on the quality of investments than tax 40% of capital gains accrue to the top 10% of taxpayers, who would pay more tax	$0.5B in 2017-18 ($2.5B in 2020-21)
2. Remove the following inequitable CGT concessions for small business assets: • the additional 50% discount (a total tax saving of 75%); • the exemption for assets held for over 15 years; and • the exemption for gains used for 'retirement purposes'.	Improved equity in the tax treatment of assets between those held by small businesses and other investors Reduced tax bias for business owners to invest in assets yielding capital gains (mainly property) This would strengthen economic growth through more efficient investment Closure of avoidance opportunities (e.g. delaying disposal until retirement to reduce CGT to zero) Would mainly affect wealthier small business owners	$1B in 2017-18 ($1.3B in 2020-21)
3. (a) Restrict deductions for passive (i.e. not active business) investment in major investment assets yielding capital gains (including rental and commercial property, shares, agricultural schemes and collectables) so that they can only be offset against income from the same investment (including future income such as capital gains)	This reform would improve housing affordability by reducing growth in home prices and encouraging investment in new (especially affordable) housing The proposed investment incentive would encourage institutional investment in housing (which does not benefit from 'negative gearing') improving housing security for tenants It would strengthen economic growth by removing a tax bias towards speculative	$0.3B in 2017-18 ($1B in 2020-21)

Option:	Expected impact:	Revenue: ($ billions)
(b) Use part of the revenue saved for a new investment incentive for new and affordable rental housing (c) Existing investments would be 'grandfathered'	property investment and taking some of the heat out of 'housing booms' Over time, it would reduce household debt	
B. Taxation of labour income		
4. (a) Restrict work related deductions in areas where income generation overlaps with personal spending (e.g. self education, cars, home offices) (b) Use the revenue saved to introduce a standard deduction as part of the proposed restructure of the personal tax scale (see below)	This would be achieved by a combination of deduction 'caps' and tighter definitions and substantiation requirements Higher income earners and professional workers affected most Constrains over-claiming of deductions Need to maintain justifiable deductions so that employees and self-employed people are treated consistently	$1B in 2017-18 ($2B in 2020-21)
5. Tighten the taxation of non-retirement, non-redundancy termination payments: 'Grandfathering' arrangements for previous tax concessions for these payments (e.g. 'golden handshakes' and unused leave) would be removed	These termination payments, which disproportionately go to high income-earners, would be taxed like wages above a modest annual threshold	$0.3B in 2017-18 ($0.2B in 2020-21)
C. Taxation of entities (private companies and trusts)		
6. Tax private trusts as companies: Private trusts (discretionary and fixed) would be taxed as companies.	This would mainly affect relatively wealthy investors and business owners Less than 1/20 of private trusts are farm trusts	$1.5B in 2017-18 ($1.8B in 2020-21)

Option:	Expected impact:	Revenue: ($ billions)
This would not apply to collective investment vehicles (e.g. 'unit trusts') or certain categories of excluded trusts including complying superannuation funds, disability trusts, and trusts established pursuant to court orders.	Private trusts and companies would be taxed more consistently (including an up-front 28.5% withholding tax and denial of 'flow through' of investment concessions such as building depreciation) Tax avoidance through avoidance of CGT, income splitting, and tax evasion through concealment of income would be more difficult	
7. Increase tax rate on undistributed profits in private companies: Private company income retained within the company would be taxed at the top marginal tax rate plus Medicare Levy (instead of 28.5%), minus a reinvestment allowance based on the value of business assets This would also apply to private trusts taxed as companies (see above)	This would prevent high-income personal investors and business owners from taking advantage of the gap between their marginal tax rate and the 28.5% company tax rate to avoid tax on their personal income by diverting income into 'cashbox companies' Those whose marginal tax rate is less than 28.5% could reduce the tax to their own marginal rate by paying themselves a higher wage or dividend	$1B in 2017-18 ($1.3B in 2020-21)
	D. Tax expenditures	
8. Annual review of tax expenditures: Tax expenditures that are similar to direct expenditures would be reviewed annually as part of the annual expenditure review process. These tax expenditures would be accounted for within relevant portfolio budgets (for example, the tax elements of the private health insurance	This would subject tax concessions to the same rigorous review process as direct expenditures, many of which have the same objectives For example the Private Health Insurance Rebate is a direct expenditure and the exemption of this rebate from personal income tax is a tax expenditure This would improve budget transparency and yield budget savings, which would fall disproportionately on high income earners since they benefit most from tax expenditures	$0.5B in 2017-18 ($1B in 2020-21)

Option:	Expected impact:	Revenue: ($ billions)
rebate would be brought to account in the Health budget).		
Overall revenue impact of above savings measures		
Budget savings from curbs on the above tax shelters	More people (especially those with higher incomes) would pay tax at their proper marginal rate.	$6.1B ($12.1B in 2020-21)
Future income tax reductions (these would be implemented post-2020)		
A. Restructure of personal income tax scale		
1. Restructure the personal income tax scale to restore typical tax rates for most taxpayers to the levels that prevailed before the eight tax cuts from 2002: Priority would be given to a standard work related deduction (in effect a higher tax free threshold for labour income), increasing the next two tax thresholds ($18,200 and $37,000) and splitting the present $80,000 - $180,000 tax bracket in two to better reflect different taxpayer's ability to pay	Low and middle income earners would gain proportionately more and high income earners proportionately less. Income tax rates for many individuals affected by social security income tests (producing high effective tax rates) would be reduced. Tax rates need not change but the lower thresholds would increase. The new tax bracket would ensure that differences in ability to pay tax across the (very large) $80,000 - $180,000 bracket are properly recognised. All taxpayers would benefit and low and middle income earners would benefit most.	Cost: $6B in 2020-21 comprising $4B for rate scale changes and $2B for the standard deduction
B. Equalise tax treatment of major classes of investment income		
2. Introduce a 25% discount for investment income in the form of interest or housing rents. This would be phased in as budget circumstances permit.	Interest, housing rent and capital gains would be taxed more consistently (though capital gains would still only be taxed once the asset is sold) This would improve the efficiency of investment and increase economic growth.	Cost: not modelled at this stage

Option:	Expected impact:	Revenue: ($ billions)
We expect that this would be paid for by the above reductions in tax concessions for capital gains.	It would help shift the goals of rental property investment from capital gains towards rental income, improving housing security for tenants Low and middle income earners would benefit disproportionately from lower tax rates on interest income.	

Note: More detail on some of these proposals is provided in ACOSS (2016): [Budget Priorities Statement 2016-17]

[i] This paper reports on the first stage of extensive tax policy development work underway at ACOSS, on which we are being advised by a Working Group of ACOSS members and academics. Responsibility for content and views expressed rests with ACOSS. The Working Group comprises:
Rick Krever (Monash University), Julie Smith (ANU), Nicholas Gruen (Lateral Economics), Miranda Stewart (ANU), Helen Hodgson (Curtin University), Ian Yates (COTA Australia), Marion Bennett (Mission Australia), Carolyn Kelshaw (Baptist Care Australia), Kasy Chambers (Anglicare Australia), Greg Ogle (SACOSS), Mike Bailey (NCOSS), and Llewelyn Renders (VCOSS).