Inquiry into Treasury Laws Amendment (Income Tax Relief) Bill 2016

Submission to Senate Economics Legislation Committee

This submission responds to the Government's 2016 Budget proposal to raise the threshold for the 37% personal income tax rate from $80,000 to $87,000 from 1 July 2016. This would provide a tax cut worth approximately $6 per week for tax-payers earning above $87,000.

We **recommend** that the Bill be rejected since the proposed tax cuts are unfunded and their cost is estimated to rise to $1.2 billion in 2019 ($4 billion over the next four years), which would have to be met from other sources such as more spending cuts. It is unconscionable that at the same time this Bill is being considered, Social Security Bills before the Parliament propose cuts to payments for the poorest households, including $50 a week for a sole parent with two teenage children with no private income and $47 for an unemployed 23 year old.

Further, the proposed tax cuts are poorly targeted towards individuals in the top 20% of taxpayers. We **recommend** that the Committee request modelling of their impact on households across the income distribution, which could be quickly undertaken by Treasury.

If tax cuts are implemented in coming years, there is a case for introducing an extra step in the personal tax scale to take better account of the very different economic circumstances of individuals earning $80,000 (who are currently taxed at a marginal rate of 32.5%) and $180,000 (who face a marginal rate of 47%), rather than a 'blanket' $6 tax cut for all taxpayers earning more than $80,000.

There is a case for offsetting the impact of income tax 'bracket creep' over time, but for now the argument for this is not real. Due to eight successive personal tax cuts from 2002 to 2010, most taxpayers are still paying a lower rate of tax overall than they would have paid on the same income in 2002, and will continue to pay less up until around 2020. Those unaffordable tax cuts were a major cause of the Government's present budget difficulties.

In today's difficult budget environment, any income tax cuts should be paid for by closing shelters and loopholes in the personal tax system, as has been done in the past. This would improve fairness because more people would actually pay tax at their legislated tax rate. Under the present system 'the many' have to pay more to offset revenue losses from the tax avoidance activities of 'the few'.

We advocate tightening of the tax treatment of capital gains, negative gearing, superannuation, work related deductions and private trusts and companies to save approximately $12 billion per year, half of which could be used to finance future personal tax cuts, for example in 2020 when the impact of 'bracket creep' is more significant.

September 2016

Who benefits?

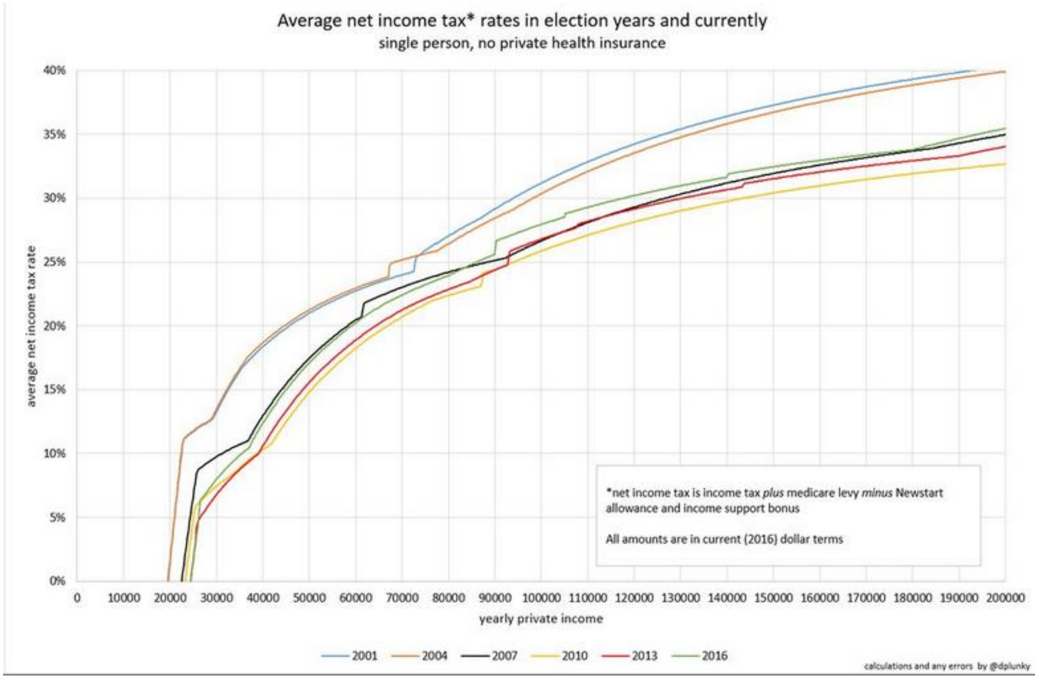
Currently, taxpayers earning between $37,001 and $80,000 have a marginal tax rate of 32.5% and those earning between $80,001 and $180,000 have a 37% marginal tax rate.

The Explanatory Memorandum estimates that 3.1 million taxpayers earning more than $80,000 will receive a tax cut if the Bill is passed. This represents approximately the top 20% of personal taxpayers. The tax cut increases to a maximum of $6 per week for those earning over $87,000.

Is a tax cut justified right now?

The main argument for the proposed tax cuts is to offset the impact of income tax 'bracket creep'. However, due to eight successive personal tax cuts from 2002-10 most people are still paying less now than they would have under the tax scales that applied before 2002 (figure 1) and will continue to do so until at least 2019[4].

Figure 1: Overall personal tax rates are still lower now than they were in 2001



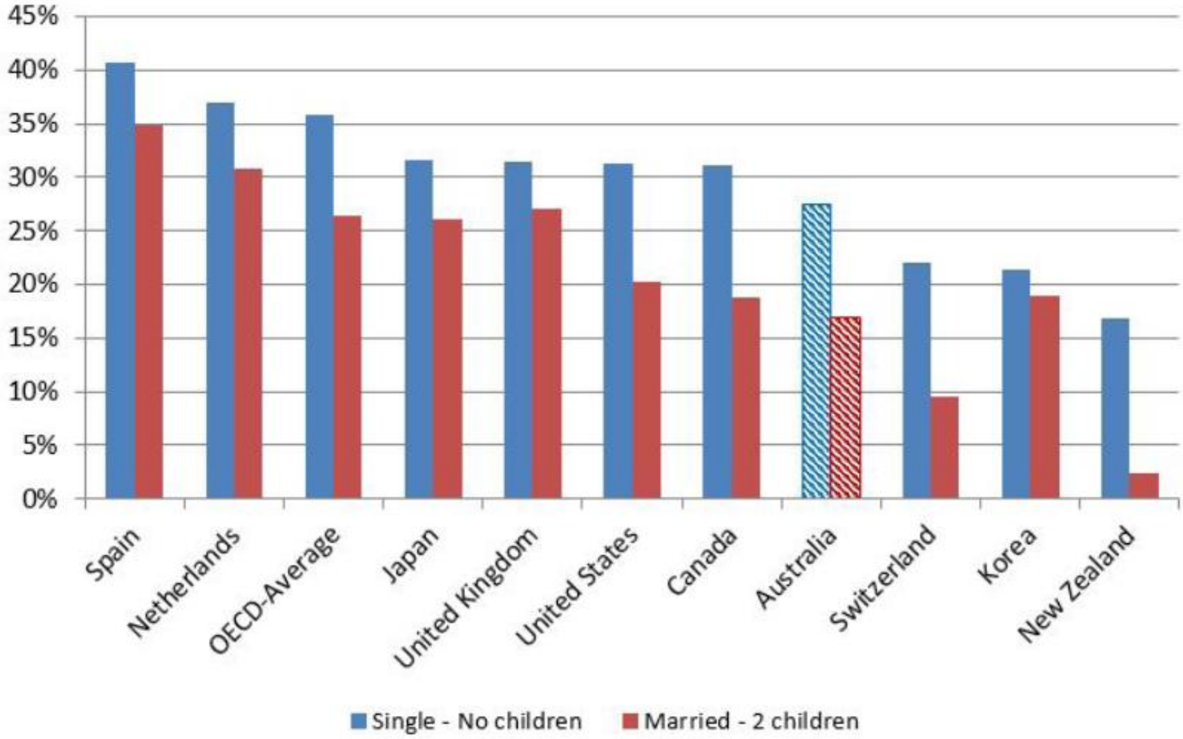
Source: David Plunkett (https://twitter.com/DPlunky) Note: The top (blue) line is the average (not marginal) tax rate on personal income at different income levels in 2001; the third (green) line is the same for 2016. Newstart Allowance is included as a 'negative income tax' for those with very low private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

The difference between marginal and average (or overall) tax rates is not widely understood. Many people think that they pay their marginal tax on all of their income. Yet, due to the tax free threshold and other tax rates lower down the scale, the average tax rate for individuals

[4] See also NATSEM research cited in '*The Australian*: David Uren 30 March 2016 Tax bracket creep to hit poorer half of workers the hardest, which projects 'bracket creep' forwards to 2019.

earning around the average fulltime wage (approximately $82,000) is approximately 27%, well below their marginal rate of 37%. Average tax rates for average fulltime workers in Australia are low by wealthy country standards, and lower than in the United States and United Kingdom (figure 2).

Figure 2: 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)

A one-sided Budget strategy

The Bill is being considered at the same time as legislation – mostly carried over from the 2014 Budget – to cut $7 billion over the next four years from social security payments, mainly affecting people at risk of poverty. If passed, those Bills would cut $60 a week from the income of a sole parent with two teenage children and $47 from the income of a 23 year old applying for unemployment payments.

These and other spending cuts will in effect contribute to the $4 billion cost (over the next four years) of the proposed personal tax cuts in this Bill together with $5 billion in business income tax cuts.

These spending cuts are a clear sign that the Government lacks the revenue it needs to meet the most basic needs of the community; a fiscal challenge that will grow as the population ages. In today's tight budget conditions, the Government's fiscal target to hold tax revenue at or below 23.9% of GDP is misconceived.

A better approach to personal tax reform

When the time comes to offset the impact of 'bracket creep' for personal taxpayers - we think this will be needed around 2020 to restore average tax rates for most people to where they were before the eight unaffordable tax cuts in the 2000s - this should be paid for by closing shelters and loopholes in the personal tax system. The tax reform proposals below would raise approximately $12 billion in 2020, half of which could be used to fund personal tax cuts. The remainder would be used to strengthen funding for essential services and help restore the Federal Budget to balance over time[5].

(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%. ($2.5B in 2020-21)
- Removing inequitable exemptions for small business assets from CGT. ($1.3B in 2020-21)
- 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. ($1B in 2020-21)

(2) **Labour income** would be taxed more fairly and consistently 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. ($2B in 2020-21)
- 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. ($0.2B in 2020-21)

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

- Taxing private trusts in like manner to companies. ($1.8B in 2020-21)
- 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. ($1.3B in 2020-21)

(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

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[5] For more detail see ACOSS (2016), 'The case for tax reform: Personal Income Taxes,' ACOSS Policy Briefing.

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 (for example the SAPTO to the extent that it extends beyond pension recipients) would be curbed or abolished ($1B in 2020-21)