

Income Tax Reform: Base Broadening to Fund Lower Rates

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Broadening the income tax base, or taxable sum, by removing special exemptions and deductions has been a characteristic of many tax reform programs in Australia and overseas. Usually the stick of a larger tax base is matched by the carrot of lower tax rates that can be funded in a roughly revenue neutral package. In addition, such a tax reform package contributes to greater tax neutrality and then increased economy-wide productivity, it simplifies the tax system and lowers costs of tax administration and compliance, and arguably the reform package contributes to greater horizontal tax equity. Introduction of the fringe benefits tax (FBT), capital gains tax (CGT) and some other base broadening measures in Australia in 1985 helped fund large tax rate reductions, including a drop in the top 60% rate to 49%. Replacing accelerated depreciation with depreciation over the economic life of plant, equipment and buildings in 2001 funded most of the drop in the Australian corporate tax rate from 39% to 30%. The very significant income tax reforms in the 1980s in New Zealand and the US involved removing many special exemptions and deductions, a larger tax base, and lower tax rates. This paper explores options to remove a number of special exemptions and deductions which reduce the current Australian income tax base and which have little or no justification on economic efficiency grounds, add to complexity and which are very uneven in their incidence. The efficiency and equity effects of using the up to \$10 billion a year gain in revenue to fund lower tax rates, particularly to bring the top rates down towards the 30% corporate tax rate, are explored.

The rest of the paper is structured as follows. Section 1 provides a list of potential current deductions and exemptions which lower taxable income and which have dubious if any good efficiency reasons. Some data is provided also on the likely first round revenue implications of broadening the tax base and on the incidence of the deductions and exemptions if they were to be removed. A reform option in which the extra revenue from the base broadening measures of Section 1 were used primarily to fund lowering the top personal income tax rate towards the corporate 30% tax rate is

sketched in Section 2. Section 3 evaluates some of the efficiency implications of the base broadening and lower top personal tax rate reform package in terms of reduced distortions to business organisation, financing and funding decisions, to the choice of mix of savings and investment choice options, and to the attraction of Australia for internationally mobile skilled labour and capital. A final section provides some concluding observations.

1. Some Options to Broaden the Income Tax Base

Information provided by the Australian Taxation Office (ATO, 2004) in “Taxation Statistics” for 2001-02 and by the Treasury (Australian Treasury, 2005) in its “Tax Expenditure Statement” provide a fruitful list of current exemptions and deductions which might be removed as part of an income tax base broadening component of a tax reform policy package. In this section we discuss the economic efficiency arguments for removing the exemption and deduction, the revenue effect, and the first round distributional incidence of the current deduction or exemption.

(a) Work Related Expenses

Data from the ATO show that in 2001-02 74% of individual taxpayers claimed a total of \$9.325 billion in work related expenses. The largest claims were for work related car expenses (\$3.7 billion), work related travel expenses (\$0.75 billion), work related uniform/clothing expenses (\$1.079 billion) and work related self-education expenses (\$0.679 billion). It is difficult on efficiency grounds to justify a deduction for travel costs from one place of work to another but not the costs of travel from home to work, to give some workers in some industries a deduction for uniform/clothing expenses but not in others, and to give a deduction for work related self education expenses once employed but not prior to employment. One option would be to eliminate all deductions for work related expenses. This would level the playing field, or not add to distortions with the current fairly ad hoc incomplete list of allowable deductions. It also would greatly reduce the number of people seeking professional tax advice which in 2001-02 was sought by 52 % of individual taxpayers who claimed an additional \$0.9 billion in deductions for the cost of managing tax affairs.

As shown in Table 1, deductions for work related expenses are skewed in favour of those on higher taxable incomes. Taxpayers at all income levels make claims for work

related expenses, with nearly three-quarters making a claim. However, while those with taxable incomes of \$50 000 a year or more represent 22% of taxpayers they made 37% of the dollar sum claims.

Table 1 The Distribution of Claims for Work Related Expenses, 2001-02

Taxable Income (\$ per year)	Number of Taxpayers (million)	Percentage Who Claimed Work Related Expenses (%)	Expenses Claimed (\$ million)
6000-20000	1.914	62.3	1112
20001-50000	4.655	76.2	4791
50001-60000	0.731	83.2	1188
>60000	1.096	75.4	2234
Total	8.396	73.5	9325

Source: Compiled from ATO (2004), Table 5, Part C

The revenue gains by deleting deductions for work related expenses in 2001-02 would be in the range of \$3 to \$3.5 billion. The estimate is based on the marginal tax rates of taxpayers shown in Table 1, with some reduction in claims for costs of professional assistance in filling-in much simpler tax forms, and with some increase in claims by businesses either in additional business expenses or in higher compensating wage increases. The latter term clearly is difficult to quantify.

(b) Fringe Benefits Concessions

The under-valuation of the value of vehicles for private use is estimated by Treasury (2005) to reduce the tax burden by \$1.1 billion in 2003-04 compared with paying employees a salary and then purchasing a vehicle from after tax disposable income. This tax expenditure distorts the choice of form of remuneration and the mix of expenditure. It seems likely the benefits are skewed in favour of middle and high income earners, and they involve an element of horizontal inequity as between people who take all their remuneration as wages and salaries versus those who take a portion as a fringe benefit vehicle.

Other remaining elements of concessionary taxation of fringe benefits counted as tax expenditures by the Treasury (2005), but are not listed for removal in Table 2, include fringe benefits provided to many employees in the not-for-profit sector of the economy.

Table 2 Some Special Deductions and Exemptions Measured as Tax Expenditures, Revenue Cost 2003-04

Expenditure Item Deducted	Treasury Tax Expenditure Code	Annual Cost in \$ million
Fringe Benefit:		
Concessional statutory formula for deductible cost of vehicles	D25	1100
Capital Gains:		
CGT exemption on sale of small business for retirement income	C6	90
Venture capital exemption	E12	20
50% exemption for small business active asset sale	E13	240
Roll-over relief for small business	E14	75
50% CGT rate	E15	2530
Lump Sums:		
Concessional treatment of non-super termination funds	C3	850
Capped tax rates for lump-sum payments for unused leave	C4	190
Tax of 5% on unused leave accumulated before 1978	C5	85
Income Averaging:		
Authors, inventors, artists, etc	A48	8
Primary producers	B81	190
Primary Producers:		
Three-year depreciation of water capital expenses	B26	25

Accelerated depreciation of horticultural plants	B32	6
Farm management deposit scheme	B82	250
Cost valuation of livestock	B86	105
Remote Area Concessions:		
Remote zone tax offsets	A46	185
Remote area housing allowance	D15	80

Source: Drawn from Australian Treasury (2005)

(c) Capital Gains Tax Concessions

Concessions shown in Table 2 with the taxation of capital gains exceed \$3 billion a year. The largest concession is the halving of the tax rate for assets held for more than twelve months, costing \$2.5 billion a year. Small businesses receive additional concessions worth nearly \$0.5 billion a year in the form of roll-over relief, a 50% exemption for so called “active sales”, and an exemption for capital gains destined for retirement income. In addition, and not counted as a tax expenditure by the Treasury, capital gains tax is levied only on realised gains and not accrued gains, with this treatment representing a form of deferred tax or interest free loan to taxpayers with capital gains but not available to taxpayers with some other forms of capital income or to wage and salary earners.

The efficiency arguments for concessional taxation of capital gains in terms of effects on both the aggregate levels of saving and investment and on the compositions of aggregate saving and investment are ambiguous in theory and as yet not resolved by empirical evaluation. To a large extent the uncertainties about the inefficiencies of capital gains taxation arise because of the hybrid or mongrel system of taxation of different forms of capital income in Australia, and also internationally, whereby different forms of investment and saving face different tax systems and different effective tax rates. Investment and saving in owner occupied housing is accorded a consumption tax system tax treatment (no tax on the capital income earnings whether taken as imputed rent or as capital gains). By contrast, saving and investment through financial deposits, debentures and distributed corporate and unincorporated business income are given a nominal income tax treatment (with the annual earnings

effectively taxed at the personal rate). Retained corporate earnings face a flat 30% corporate tax rate, versus rates for income subject to a progressive personal tax rate schedule. Again, the taxation of superannuation is a mixed system and even varies as between employer versus employee contributions and between lump sum versus annuity withdrawals. As a result of these different tax systems, different forms of saving and investment face different effective tax rates. The effective tax rate on options returning capital gains is towards the lower end of the spectrum, but not as low as, for example, owner occupied housing. At a minimum, the very different effective tax rates on the different saving and investment choice options distort the composition of aggregate investment and saving.

More controversial is the net effects of current income taxation on the aggregate levels of saving and investment. Income taxation, including that on capital gains at concessional rates, distorts decisions against saving relative to current consumption. However, an aggregate revenue neutral tax package with a decrease in taxation of capital income means an offsetting increase in taxation of labour income which results in aggravated distortions to work versus leisure and other decisions in the labour market. Resolving the net effects of the different effective tax rates on distortions to economic decisions in the capital and labour markets, and the associated loss of national productivity, is a non-trivial empirical exercise which has not been undertaken to date for Australia.

Individuals in 2001-02 declared \$6.4 billion in net capital gains and paid \$2.5 billion in capital gains taxes for an average tax rate of 40%. Companies paid \$1 billion on \$4.8 billion of net capital gains, and funds paid \$0.4 billion on \$2.9 billion of net capital gains. For individuals as shown in Table 3, while there are individuals at all income levels who report capital gains, 66% of the net capital gains were in the hands of the top tax bracket taxpayers even though they represent only 13% of all taxpayers. That is, the benefits of special exemptions and deductions for capital gains taxation are highly skewed in favour of those with high taxable incomes.

Table 3 Distribution of Personal Capital Gains by Taxable Income, 2001-02

Taxable Income (\$ per year)	Taxpayers with Capital Gains (%)	Net Capital Gains (\$ million)	Share of Total Capital Gains (%)
<20000	7.2	313	5.2
20001-50000	9.5	1293	21.5
50001-60000	13.3	426	7.1
>600000	18.9	3990	66.2
Total	10.4	6025	100.0

Source: Data from ATO (2004), Table 2: Capital gains tax

(d) Lump Sums

Some lump sum payments to employees, other than superannuation, are given a concessional tax treatment relative to the income taxation of wages and salaries. On efficiency grounds there is no logical argument to treat one form of labour remuneration differently from another form of remuneration. The Treasury Tax Expenditure statement estimates the revenue cost for 2003-04 of three of these items shown in Table 2 at over \$1.1 billion.

While there will be some low income people who benefit from the concessional tax treatment of lump sum payments, the majority of payments in dollars are received by people at the end of their career and on higher income levels.

(e) Income Averaging

The choice of an annual accounting period in assessing taxable income is arbitrary, if not a long established convention. Against a progressive income tax schedule, those with more variable incomes and the same average over many years will pay more tax than those with a more stable income. On both efficiency and equity grounds a case therefore can be made for some form of general income averaging. Australian taxation allows primary producers to average over a five year interval, and averaging is allowed for some artists, inventors and sportspeople. However, averaging is not generally available, including for unincorporated businesses tied to agriculture, other

businesses with fluctuating incomes, and many employees have fluctuating incomes, including part-time employees and women with career interruptions. The efficiency and equity arguments for providing averaging for a small subset of taxpayers, and not generally for all taxpayers, are weak at best. Then, removal of the current selective concessions seems a viable alternative tax simplification strategy.

The Treasury Tax Expenditure statement (Treasury, 2005) estimates for 2003-04 the revenue loss of the current selective availability of income averaging at \$198 million, with almost all going to primary producers (see Table 2).

(f) Primary Producers

While the 2001 reforms of business income taxation of 2001 removed most of the special exemptions and deductions in the measurement of taxable business income, a number of costly concessions for primary producers were not removed as a part of this more comprehensive income tax base reform package. Some of the remaining concessions shown in Table 2, which are drawn from the Treasury (2005) estimates of tax expenditures, are accelerated depreciation allowances for some water investments and horticultural plants, the cost valuation of livestock, and the system of deferred taxation of income invested in farm management deposits. For 2003-04 the concessions are estimated to have cost \$280 million. These special concessions favour some forms of primary production activity over other avenues of agricultural production, and they favour over-investment in the agricultural sector relative to other sectors of the economy.

(g) Remote Area Concessions

Over the years political lobbyists have sought and locked in special tax concessions as an offset for the higher costs of living in remote Australia. In general, higher living costs in remote Australia, or in any other tagged region for that matter, reflects social opportunity costs. An efficient economy would locate businesses and households in such areas only if the returns match the opportunity costs, and employees would seek appropriate compensating pay differentials. In effect, the remote zone tax offset and remote area housing allowance estimated to cost \$265 million in 2003-04 is a subsidy to businesses and individuals who choose to locate in remote Australia. In the majority of cases the recipients of these subsidies are among the higher paid members

of Australian taxpayers. Then, neither efficiency nor equity arguments support retention of special allowances for remote Australia in computing taxable income.

2. Possible Reform Packages

If, as in the past, political and other restrictions on acceptable tax reform are to include approximate aggregate revenue neutrality and to result in a small number of net large losers, both relative to the status quo, close links have to be drawn between the revenue gains from base broadening and the tax rate reductions they fund. In this restrictive context some observations on the funding and distributional effects of some general rate reduction options are noted.

The base broadening measures discussed in the preceding section were estimated to raise between \$9 and \$10 billion a year in current dollars, that the savings would come from all levels of taxable income, but that most of the base broadening measures would fall on those with higher incomes. Clearly the aggregate sum could be increased further if other base broadening measures were pursued, including reducing or ending the 30% private health insurance subsidy, the first home owners scheme subsidy, and other tax expenditures identified by Treasury (2005). Since the base broadening measures were justified in part to reduce current tax distortions which reduce productivity and national income and in part to reduce tax complexity and associated taxpayer and tax collector operating costs some efficiency dividend in terms of a more productive economy and larger tax base will itself generate extra funds. Further, the lower tax rates funded by the base broadening measures also will reduce taxation distortions and provide incentives for a larger and more productive economy. Compiling estimates of the magnitude of the fiscal dividend from tax reform inevitably is a challenging and controversial exercise, but neither should such efficiency gains be ignored and arbitrarily set to zero either.

In the current environment of non-indexation of the tax brackets, because of fiscal creep, income tax revenue as a share of GDP rises with increases in both nominal and real incomes over time. Arguably, some of the revenue gains from fiscal creep could be used as a component of a package to fund lower tax rates.

An idea of the order of magnitude of fundable personal tax reductions, assuming no changes in the current tax thresholds, is provided in Table 4 for 2003-04. Reducing all rates by one percentage point would cost about \$3.2 billion. Cost reductions for the different brackets as a result of the bracket changes in July 2004 and planned for July 2005 will cost more in case of the current 30% bracket (which will be widened) and reduced for the top two brackets (which come in at higher and higher income levels). The top two rates could be reduced to the corporate 30% rate for a total annual outlay of between \$10 and \$12 billion.

Table 4 Estimated Revenue Costs of Reducing Personal Income Tax Rates, 2003-04

Rate Reduction	Revenue Cost in \$ million
17% to 16%	1245
30% to 29%	1330
42% to 41%	185
47% to 46%	560
Reduce all rates by 1 percentage point	3240

Source: Computed from the Melbourne Institute Tax and Social Security Simulation Model.

Revenue neutrality and maintaining a broad sense of equity across taxpayers on average across the different tax brackets suggests a small reduction of no more than two percentage points for the bottom brackets, and more substantial reductions in the top two brackets, in excess of five percentage points but not enough to go to all the way to a 30% rate in the first instance. Clearly there will be some redistribution among taxpayers within each tax bracket. Those who now are not beneficiaries of the exemptions and deductions to be removed will be clear winners with the lower tax rates. Up to 40% of taxpayers with incomes <\$50000 are likely to be winners in this category, but less than 20% of those with higher incomes would not lose some exemptions and deductions. Those who currently are large beneficiaries of the to-be-removed deductions and expenses will not be fully offset by the lower tax rates. For many, the loss of foregone deductions and exemptions will approximate the gains from lower tax rates. Behavioural responses to the new set of incentives, and the

national efficiency gains and a resulting larger economy driven by the more efficient tax system, will in time further reduce the numbers of losers and the magnitudes of any losses.

3. Arguments to Lower the Top Tax Rates

A number of arguments for greater efficiency and greater simplicity in income taxation by bringing the top 42% and 47% tax rates down towards the 30% corporate tax rate can be made. An ambitious base broadening package might fund a top personal tax rate of 30%, a capital gains tax rate of 30%, being a small increase on the present 23.5%, and the current 30% corporate rate.

Lower top income tax rates will lead not only to lower rates per se and hence lower incentives to reorganise economic decisions to reduce tax paid, but also they will result in more comparable effective tax rates across different forms of business organisation and across different options for saving and investment. With lower incentives and rewards for changing decisions to utilise different tax rates on different choice options to minimise tax, national productivity can be expected to rise with both the reduction of the distortion or deadweight costs of taxation and with less wasteful diversion of scarce resources to tax administration and compliance. Examples of reductions in differences in effective tax rates and in the distortions to business organisation and funding decisions include: incorporation versus unincorporated and the formation of trusts; contractors versus employees; the payment of dividends versus retained earnings; and debt versus equity financing. Even with the continuation of the different tax systems for different investment and savings options, including consumption base (eg on housing), nominal income tax base (eg on financial loans and borrowings, and on distributed corporate income), and mixed systems (eg on superannuation), both lower rates and more comparable tax rates across the different choice options reduce tax distortions to choices among the different savings and investment options. That is, the quality or society wide productivity of a given quantum of aggregate saving and investment would increase.

In the context of Australia as a small player in the global economy, lower tax rates on the incomes of the internationally mobile capital and skilled labour inputs are likely to entice more of these resources, both those with an Australian initial location as well as

those with an initial overseas location, to locate in Australia. The owners of most skilled labour and capital resources in choosing an Australian or an international location place considerable weight on the after tax return to be gained from the alternative locations. Clearly there is uncertainty and legitimate argument about the magnitude of the elasticity of supply of skilled labour and of capital to an Australian location if the after-tax return from location in Australia were to be increased with a reduction of the present 46% and 42% rates towards the 30% corporate rate; but there is no doubt that the elasticity exceeds zero and also that it is less than the small country infinity extreme. Importantly, an increased inflow of skilled labour and of capital will increase the mix of these resources in production with the internationally immobile unskilled labour input. In turn, productivity of the unskilled labour in time will rise justifying higher real wages for the majority of unskilled Australians who will become winners also in the intermediate run from the lower top tax rates.

The foregoing argument for lowering the top tax rates is an application of the well established theory of optimal taxation. That is, economic efficiency is enhanced by relatively low tax rates on factors with a high supply elasticity (to Australia), in this case the internationally mobile skilled labour and capital, and relatively higher tax rates on factors with a low supply elasticity (to Australia), in this case the internationally immobile unskilled labour. Further, the economic burden of the present high statutory income tax rates on the relatively higher elastic supplied factors will be passed on to the other factors as lower pre-tax returns than otherwise. To the extent that in Australia most internationally mobile and therefore high elasticity of supply factors face the higher income tax rates, and that the relatively internationally immobile are among the low to middle income earners, means that lowering the top tax rates is a crude application of optimum tax theory in which the majority of Australians will benefit.

Lower top tax rates and a flatter income tax rate schedule reduces the logic of claims for income tax averaging measures for most, on average, middle and high income earners.

4. Concluding Observations

There are good efficiency and simplicity arguments to remove a large number of special exemptions and deductions in the measurement of taxable income in Australia. Base broadening measures have been identified which would generate up to another \$10 billion a year. While the base broadening measures would affect some tax payers at all income levels, most of the revenue gains would come from extra tax paid by those on higher incomes. Arguably the measures also would improve most notions of horizontal equity.

A package of base broadening measures and lower tax rates, especially at the upper income levels, that would roughly be revenue neutral and which contains the number of losers was suggested. For example, the \$10 billion gained from base broadening could finance a reduction in the lower rates by up to two percentage points, and of rates in the top two tax brackets by five or more percentage points. The latter would work to bring the top personal rate and the capital gains tax rate closer to the 30% corporate tax rate. The resulting more comparable effective tax rates on different choice options, as well as the lower rates, will reduce distortions to decisions about the structure and operation of businesses and about the composition of saving and investment. The ensuring more productive economy, together with the effect of lower tax rates making Australia a relatively more attractive location for internationally mobile skilled labour and capital, will in time generate dynamic economic growth gains which flow to low income as well as to high income taxpayers.

References

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