

# **INCOME TAX REFORM: Base Broadening to Fund Lower Rates**

John Freebairn  
University of Melbourne

# Base Broadening for Lower Rates: An Old and Tested Idea

- Australia
  - 1985
    - CGT, FBT, and others
    - Top 60% rate to 49%
  - 2001
    - Reduced deductions for depreciation, and ...
    - Corporate rate from 39% to 30%
- Many other countries

# Pay-offs from a More Comprehensive Income Tax Base

- Reduce tax distortions to decisions  
→ increase in efficiency and productivity
- Simplicity and lower costs of tax compliance and administration  
→ save resources for more productive uses
- Improve horizontal equity
- Fund lower tax rates  
→ reduced tax distortions

# Some Special Exemptions and Deductions for Removal, \$2003-04

Work related expenses	\$ 3000 to \$ 3500 million
Fringe benefits	\$ 1100 million
Capital gains	\$ 2955 million
Lump sums	\$ 1125 million
Income averaging	\$ 198 million
Primary production	\$ 386 million
Remote areas	\$ 265 million

# Package that is Revenue Neutral and Small Number of Large Losers

- Rate reductions with current income brackets
  - Bottom rates down by 1 to 2 percentage points
  - Top two rates down by 5 to 10 percentage points, but not all the way to 30%
- Winners and losers
  - Win: lose no deductions and lower rates
  - Lose: gain of lower rate < loss of deductions
  - Many: lower rate win approximates loss of deductions
  - Positive sum game from efficiency and simplicity

# Efficiency Gains of a 30% Rate for the Top Personal, Capital Gains and Corporate Rates

- Remove many tax distortions to the choice of business structure and their decisions
- Reduce the variance of effective tax rates on different savings and investment choice options
- Increase the attraction of Australia for the location of high skilled labour and for capital
  - A form of optimal taxation
  - In time, low wage unskilled workers also become winners through higher real wages

# Conclusions

- Broadening the income tax base by reducing many special exemptions and deductions makes sense alone.
- In addition, it can fund lower rates with additional efficiency and productivity benefits
- Roughly revenue neutral packages involving base broadening and lower rates with a limited number of large winners and losers could be devised