

It's Time for a Minimum Effective Taxation Rate

The Problem

Total government expenditure in Australia was 27% of GDP in 1972, is currently 39%, and is projected to reach 50% by 2050. This is unsustainable, particularly with the decline in our terms of trade. To achieve a surplus of 1% in 10 years, the Federal Government must make savings and/or increase taxes by \$65 billion per year. But tax revenue is in steep decline, the Coalition Government has implemented a 1.5% reduction in small business tax, and is most unlikely to increase aggregate personal taxation (other than via bracket creep). So, government expenditure must be reduced.

But it will be difficult to fill the budget gap through savings alone. The Coalition Government attempted to rein in spending in its first budget, but has been criticised for cutting support to those most in need. So, who among us should pay to fix Australia's budget?

Australia has one of the most equitable wealth distributions in the world: three and a half times more equitable than the USA, for example. We achieve this through a combination of strongly progressive taxation on the revenue side and targeted distribution of welfare benefits on the spending side. The wealthiest one-sixth of us pay two-thirds of all tax, and ABS data indicate that 80% of households pay no *net* tax when all government welfare expenditure, including health and education expenditure, is considered.

Nevertheless, the Coalition Government is under pressure from social welfare advocates, such as ACOSS, who point out that the wealthy are able to reduce their taxable income through legal devices, such as negative gearing and generous superannuation arrangements, which are not equitably available to the less well off. There are daily calls to correct this situation by restricting or abolishing negative gearing and altering superannuation arrangements that favour the wealthy. Most recently, the Reserve Bank of Australia has called for a review of negative gearing.

One problem with these calls is the great difficulty of ensuring that such restrictive measures do not cause significant 'off target' effects, such as disinvestment in the property industry impacting housing availability and broader flight from superannuation due to the perception of constant Government 'tinkering'. A more fundamental problem, however, is that whatever governments do to restrict such methods of reducing taxable income, those who are better off have the resources to seek alternative tax reduction measures.

The Proposed Solution: a Minimum Effective Taxation Rate

The alternative approach proposed here is to focus less on the various *methods* by which taxpayers seek to reduce their taxable income and more on actually *limiting the amount* of the reduction in taxable income that is permissible. The essence of the strategy proposed is to calculate a *minimum effective taxation rate* based on the *gross* annual income for each taxpayer. For example, a taxpayer with a gross income of \$300,000 can currently reduce their taxable income to \$180,000 by claiming total combined deductions of \$120,000 made up of interest payments and net losses on investment property and superannuation contributions. This results in a reduction in their taxation liability of nearly \$60,000. The reason for this is that the effective taxation rate on \$300,000, including the

Medicare and Budget Repair levies, is 39% (\$ 116,947), whereas the effective taxation rate on \$180,000 is 19.4% (\$58,147). In contrast, if the proposed *minimum effective taxation rate* on a gross income of \$300,000 were set by the Government at, say, 30%, the tax liability would be approximately \$90,000.

The impact of this *minimum effective taxation rate* strategy is that the taxpayer would have a strong motive to ensure that the tax deductions claimed, and thus the personal expenses incurred to achieve those deductions, did not *exceed* the tax benefits available. In the example above, if the taxpayer had claimed total combined deductions of \$60,000 rather than \$120,000, their taxable income would have been reduced to \$240,000, and their tax liability would have been \$87,547, significantly *less* than the tax liability calculated from the *minimum effective taxation rate* on \$300,000. That is to say, the proposed *minimum effective taxation rate* has no impact on the current taxation scales, allowable tax deductions etc., unless or until the total combined deductions claimed reduce the actual tax liability to a value that is lower than that calculated by the application of the *minimum effective taxation rate* to the reported gross annual income, at which point the *minimum effective taxation rate* prevails.

In this way, each taxpayer would self-regulate their investment, superannuation and other tax deduction strategies with regard to the minimum tax actually payable as a percentage of their gross income. It would not be possible, therefore, for taxpayers and their financial advisers to hunt for alternative tax reduction strategies. The only strategy available would be to minimise the reported gross annual income, and no doubt those most impacted by this policy change would seek to do so, but it is much more difficult to minimise gross income than to minimise taxable income. Most high income earners that would be motivated to act in this way would already be availing themselves of existing income splitting, family trust and company arrangements that reduce their gross reported income. Sudden reductions in reported personal annual gross income after implementation of this policy change would be easily susceptible to automatic detection and audit.

Practical Implementation

Clearly, the example given above is for simple illustration purposes only. It would be a matter for Government, based on Treasury advice, to determine the *minimum effective taxation rate* that should be applied to each level of gross income. An important consideration would be for Treasury to determine the *actual* effective taxation rates as a percentage of *gross* income currently being paid, and to plot these as a function of gross income level. For example, if the *actual* effective taxation rate for those on a gross income of \$300,000 averaged 25%, it might be reasonable to set the *minimum effective taxation rate* at 33% (the current marginal rate for those with taxable incomes exceeding \$37,000 is 32.5%).

Government might also wish to consider the *speed* with which the *minimum effective taxation rates* were introduced to provide time for taxpayers to change their personal investment arrangements and to avoid unintended disruptive effects in the economy. In the example given here, for instance, it might be reasonable to introduce the rate increment in 2% steps over the forward estimates (27%, 29%, 31%, 33%).

Treasury would be expected to recommend *adjustment* of the *minimum effective taxation rates* with changes in gross annual income so as to maintain the progressive steps in taxation rates already

observed according to taxable income. From a practical standpoint, however, particularly noting the currently documented impacts of bracket creep, it would not seem necessary or advisable to introduce the *minimum effective taxation rate* policy until gross annual income exceeded \$180,000, as this corresponds to the taxable income threshold above which the highest marginal tax rate currently applies. The exact income cut-off and the taper rates would need fine tuning based on Treasury modelling of the impacts of various *minimum effective taxation rate* scenarios.

From a Treasury standpoint, the proposed *minimum effective taxation rate* concept does have the advantage of bringing greater certainty to future projections of personal taxation revenue. At a macro level, Treasury analysis of *actual* effective taxation rates as a percentage of gross annual income will permit a clear understanding of the current *deficit* in personal taxation revenue relative to current revenue based on taxation of taxable incomes. It will then be possible to model the impact of a variety of *minimum effective taxation rate* scenarios on total revenue. It will also be possible to vary these rates gradually over time to minimise unforeseen negative impacts and to optimise both the efficiency and equity of the policy.

Provided that this *minimum effective taxation rate* policy was applied, at least initially, only to those with gross annual incomes above \$180,000, it would seem very likely to be received very well by the great majority of the Australian population. It would effectively neutralise the current criticism by ACOSS and others that the wealthy have an unfair advantage in taxation avoidance that is not available to the average PAYG wage earner. Likewise, it would reduce the clamour to rapidly implement changes to negative gearing and superannuation arrangements that might have untoward 'off target' effects, while not precluding more measured changes in these areas that were judged reasonable on longer term structural grounds.

Provided the *minimum effective taxation rates* were introduced initially at a level not much higher than the current *actual* effective taxation rates, and increased at a sufficiently gradual rate, it is likely that those impacted would also accept the policy.

The introduction of a *minimum effective taxation rate* is consistent with a long Australian tradition of progressive taxation, and greatly simplifies the incessant requirement for regulatory changes to limit personal tax avoidance.

Michael Feneley AM