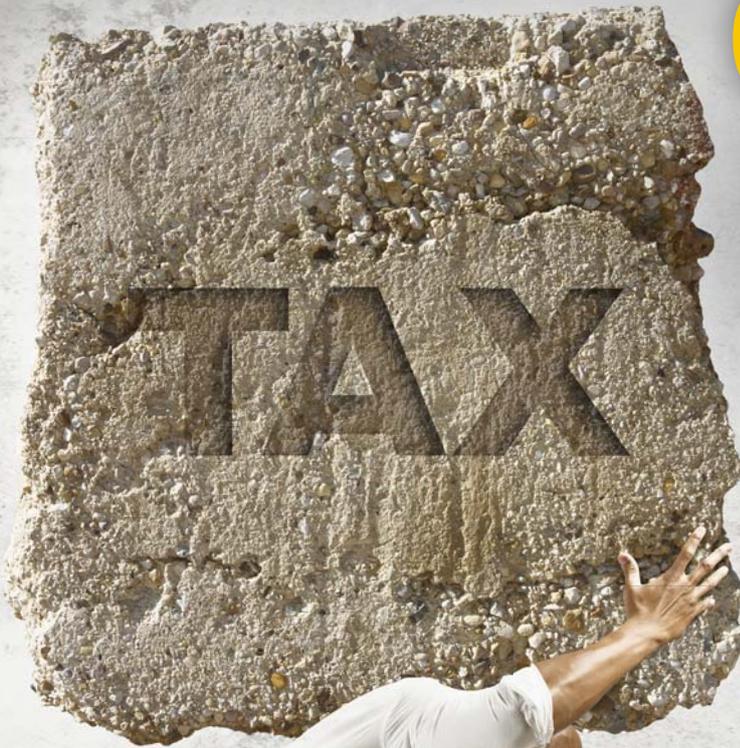


THE CASE FOR PERSONAL INCOME TAXATION CUTS

The weight of a heavy tax on personal income directly impacts the incentive to work, writes **Darcy Allen**.



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Tax reform would benefit by following one simple motif: don't tax what you want more of. It follows that cutting income tax rates should be a boon for the Australian economy—freeing up labour markets, incentivising work, and stimulating entrepreneurship. If only politics were that simple.

With tax reform on the agenda, and at a time when Australia faces some of the highest income tax rates in the world, why should we cut and simplify—if not completely abolish—personal income taxes?

Australian income earners are burdened with one of the highest marginal rates in the developed world. And the problem only seems to be worsening. In 2016 Australia's top marginal personal income tax rate, thanks in part to the 'deficit levy', has ballooned to 50.5 per cent (for those without adequate private health insurance). As the IPA's Mikayla Novak has shown, income tax payments in 1960 (adjusted for inflation), took away 6 per cent of gross household income. By 2014 that figure had risen to 13 per cent.

Stealthy bracket creep has exacerbated the burden of such high income taxation. Bracket creep—when inflation pushes taxpayers into higher non-indexed tax brackets—has suspiciously remained a minor tax reform issue. The government's *Re:think* discussion paper notes that in the decade leading up to 2024-25, 2 million additional taxpayers will move up into the third income tax bracket, while the number of taxpayers in the top two tax brackets will increase from 27 to 43 per cent. It is no wonder the Australian

government relies far too heavily on income and direct taxation.

Though putting aside the debate over the tax mix, why are income taxes so bad? The real pain of income tax is not confined to the impact of bracket creep on our bank balances; the danger is in how income tax influences individual decisions. In short, income tax distorts the flexibility and responsiveness of our economy by decreasing our incentive to work, pushing us away from productive labour and towards leisure activities. The incentive to earn income is hampered by constant marginal decisions—'What am I going to take home?' or 'Is this tax deductible?'—which are entirely the product of state interference.

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These behavioural distortions at the individual level are a clear and tangible upshot yet they can be misunderstood as short term and unimportant. In reality, it is the abstract combination of these distortions—and how they combine in the complex arrangement we call an economy—which hurts Australia. This is obvious based on the distribution of taxpayers: income earners visibly cluster on incomes just below each tax bracket.

If these distortions exist, then why aren't governments acting upon them? As with many policy issues, income tax debates are shackled by a lack of counterfactuals.



■ (AAP/Mick Tsikas)

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While we can be confident high tax leads to misallocated labour and capital markets, we can never see what income could have been earned or which entrepreneurial endeavours undertaken because we can't see a world where such taxes didn't already exist. In part, this is why the economic distortion and efficiency arguments fall on deaf ears.

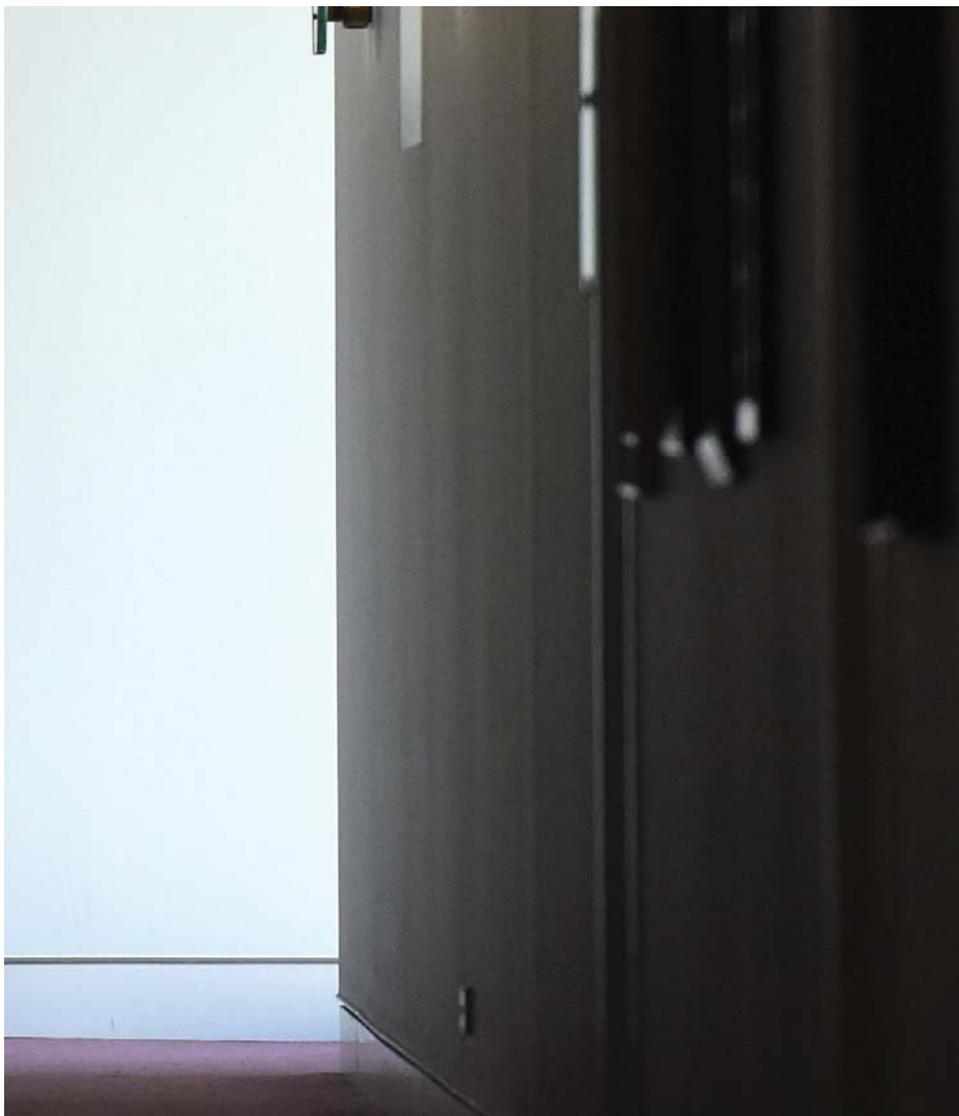
In a globalised world with a mobile, highly skilled labour force, the distortions of income tax catalyse emigration. Highly skilled

➤ **INCOME TAXES ARE BECOMING CAPTURED BY SPECIAL INTEREST GROUPS. THIS IS WHY THE COMPLEXITY OF INCOME TAX IS FRIGHTENING.**

individuals attempt to reduce their tax burden by shifting their labour from high-taxing to low-taxing jurisdictions. While taxation rivalry and competition is a fantastic process for a free and low-taxing world, failing to compete in this

global game is dangerous. Australia's score card doesn't look good: our personal income tax rates are in the top ten highest worldwide.

It also seems income taxes are becoming captured by special interest groups. This is why the complexity of income tax is frightening. Anyone who has attempted an online tax return through eTax will know this well. And while eTax doesn't quite meet its objective to 'keep it quick and keep it smart'—confusing even the most financially literate—we can learn



a lot by putting on our public choice economics and rent-seeking glasses. Many income tax ‘loopholes’—from Family Tax Benefits to disaster levies—can have the characteristics of concentrated benefits and diffused costs. That is, only a few people receive the benefit from the policy, while many others bear the cost (in this case, the government generating revenue from somewhere else). As the famous economist Mancur Olson said, this makes rent-seeking ‘distributional coalitions’—who burden nations and

hurt economic growth. Thus, it seems this lobbying by stakeholders seeking benefits is increasingly infesting our income tax system.

Australia would do well to make our income tax system more simple and transparent—clearing out our attic of special interests. This notion drives the argument for flat taxes. A flat tax is where all income levels are treated the same—that is, burdened with the same flat tax rate. The more you earn, the more tax you pay—supposedly creating a fairer, simpler,

> EVEN GIVEN THE STRONG ECONOMIC CASE FOR PERSONAL INCOME TAX CUTS—DISTORTIONS, INEFFICIENCIES, BRACKET CREEP—THE SPECIAL INTERESTS DEEP WITHIN OUR INCOME TAX SYSTEM BOTH NECESSITATE AND INHIBIT TAX REFORM.

and more efficient system. The main benefit of a flat tax is to do away with complexity. More specifically, it does away with the progressiveness of our taxation system—a progressiveness which generates dispersed costs and distributional coalitions in the first instance.

A flat tax, in contrast, with no exemptions, deductions, and levies disperses the costs of changes in taxation policy far more evenly across the polity. Of course, the political likelihood of such an income taxation system is dubious, largely due to the reasons outlined above: many people will squeal. Particularly given that the best flat income tax rate is zero.

Even given the strong economic case for personal income tax cuts—distortions, inefficiencies, bracket creep—the special interests deep within our income tax system both necessitate and inhibit tax reform. Income taxes have become a bastion of rent-seeking. An ideal income tax system must strive for two simultaneous objectives. First, we must lower our income tax rates to increase the incentive to work and regain our international labour competitiveness. Second, we must simplify the growing complexity of income taxes to push out rent-seeking and reign in our heavy compliance burden. If all else fails, we should revert to that very simple lesson—don’t tax what you want more of—and Australia will become a more free and prosperous nation. 