

2007

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Recommended Citation

Tran-Nam, Binh; Vu, Linh; and Andrew, Brian, "Personal income tax reform in Australia: A specific proposal" (2007). *Faculty of Business - Papers (Archive)*. 438.
<https://ro.uow.edu.au/buspapers/438>

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Abstract

This paper examines the possibility that foreign aid financing for public capital accumulation in developing countries may lead to excess depreciation of capital. The depreciation rate on public capital is endogenised in a general equilibrium framework in which the government collects a consumption tax to finance maintenance and repair expenditures as well as public investment. Two simple cases are formulated and analysed to show that excess depreciation of public capital may result from budgetary and international aid and financing distortions that skew allocations to new investment rather than to maintenance of existing capital.

Keywords

personal, australia, tax, income, specific, reform, proposal

Disciplines

Business

Publication Details

Tran-Nam, B., Vu, L. & Andrew, B. H. (2007). Personal income tax reform in Australia: A specific proposal. *Economic Analysis and Policy*, 37 (2), 163-186.

PERSONAL INCOME TAX REFORM IN AUSTRALIA: A SPECIFIC PROPOSAL*

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Australian personal income tax (PIT) currently faces major problems. Recent calls for PIT reform have been made from many quarters of Australian society. This paper reports on some early findings of an ARC Linkage project on PIT reform. In the first phase of this project, STINMOD, a microsimulation model, is used to construct and test a series of hypothetical PIT packages in order to establish which packages can best deliver the required policy outcomes. Under the principles of revenue-neutrality and incrementality, a preferred PIT package with a broader tax base and a flatter tax rate structure is derived. It is shown that this PIT proposal outperforms the current PIT with respect to all traditional criteria for good tax policy.

1. INTRODUCTION

The governments of developed economies have been employing personal income taxation (PIT) as an important means to raise public revenue. PIT wields considerable influence over the three dimensions of public policy, namely resource allocation, income redistribution and macroeconomic stabilisation. In terms of aggregate revenue, PIT has been the most important single tax in most Organisation of Economic Co-operation and Development (OECD) countries.¹ This is particularly true in the case of Australia, which has traditionally relied on PIT as its most significant source

* This paper is derived from an ARC Linkage Project undertaken at Atax. Financial support from the ARC and CPA Australia is gratefully acknowledged. Comments from Garry Addison and Chris Evans, and from two anonymous referees helped to improve the paper. The authors are solely responsible for any remaining errors.

¹ In 2003, PIT (including social security contributions by employees) accounted, on average, for 33.4% of total tax revenue in OECD countries, making it the largest revenue source in the OECD (OECD, 2007: 60–61).

of revenue for the Commonwealth Government in particular and the government sector in general. PIT directly affects a large part of the Australian population, as currently about 55 per cent of the Australian population is required to lodge tax returns on an annual basis.²

Since the mid 1980s, many OECD countries have engaged in fundamental PIT reforms. These reforms have been driven by the efficiency criterion of good tax policy and, to a much lesser extent, equity and simplicity considerations. Australia's PIT reform has largely followed the OECD norm. In the 1980s and 1990s, the ALP Federal Government introduced a number of significant tax policy and administration reforms. These include, for example, tax base broadening (for example, the introduction of the Capital Gains Tax (CGT) and Fringe Benefits Tax (FBT) and the removal of a number of major tax concessions in 1985), significant reduction in PIT rates, self assessment and attempts to simplify the income tax law (for example, the Tax Law Improvement Project).

Since it was first elected to office in 1996, the Federal Coalition Government has been preoccupied with indirect and business tax reform. In fact, the re-election of the Howard Government in 1998 on the platform of a broad-based consumption tax reform proposal was unprecedented in Australia's federal history. Since the introduction of the Goods and Services Tax (GST) on 1 July 2000,³ the Coalition Government has not appeared to have any concrete plan for systemic PIT tax reform. In order to fulfill its election tax package, the Howard Government has moved the thresholds for the top tax brackets upward and reduced the top marginal PIT rates in recent Budgets.⁴ However, the basic structure of the Australian PIT system (in terms of tax base, tax rate and tax administration) has remained largely unchanged.

There has been a growing recognition in Australia that the process of tax reform is an unfinished business. Recent calls for PIT reform have been repeatedly made from virtually all sectors of the Australian community, including academia, think tanks, professional organisations, business and welfare lobbies, religious institutions and the political parties themselves (see, for example, ACOSS, 2003; Business Coalition for Tax Reform, 2005; Business Council of Australia, 2005; CPA Australia, 2004; Freebairn, 2005; Humphreys, 2005, Saunders, 2006, Tran-

² In the tax year 2003–04, about 11.0 million individual taxpayers lodged returns (ATO, 2006: 7) while the corresponding population was approximately 20.0 million (ABS, 2006a: 104, Table 5.1).

³ The introduction of the GST was not completely successful. Following the introduction of the GST, the real GDP growth rate declined markedly from 3.8% in 1999–2000 to 2.1% 2000–01 (ABS, 2006a: 667, Table 29.1).

⁴ Despite the Howard Government's pledge of revenue-neutral tax reform, the overall tax burden (tax revenue relative to GDP) increased from 31.5% in 1999–2000 to 32.0% in 2000–01, but fell to 31.6% in 2003–04 (ABS, 2006a: 647, Table 27.13 and 670, Table 29.5). Thus, the recent PIT cuts could be seen as the Government's attempt to maintain revenue neutrality.

Nam *et al.*, 2006; Turnbull and Temple, 2005). All of these calls have two points in common. Firstly, the current Australian PIT performs poorly in relation to the three traditional criteria for good tax policy, namely, equity, efficiency and simplicity. Secondly, a comprehensive, systemic reform is required to produce a sustainable PIT–transfer system that can generate sufficient revenue, protect the needy and yet deliver enhanced equity, efficiency, simplicity and transparency.

However, when it comes to the details, there is little agreement. In fact, the specific proposals appear to vary quite considerably, ranging from a radical, flat tax proposal (see Humphreys, 2005) to more conventional PIT reform proposals (see Turnbull and Temple, 2005). Perhaps the views put forward by researchers associated with the Centre of Independent Studies and published collectively in a single volume edited by Saunders (2006) are the most radical. Their main arguments and proposals can be summarised as follows:

- (a) Australia is not a low-taxing country in view of either the weighted average level of taxation in the OECD or Australia's main trading partners. Also, Australia has a comparatively high reliance on income taxation.
- (b) The government could get more revenue by cutting top marginal PIT rates (that is, Australia is currently on the falling side of a Laffer curve).
- (c) Families should be allowed to choose whether or not to pool part or all of their incomes for tax purposes (that is, the tax unit can be either the individual or the family).
- (d) Individuals should be allowed to earn at least a subsistence income before paying any income tax (that is, the tax free threshold should be substantially raised and indexed to inflation).
- (e) A proportionate income tax system is fair while a progressive income tax is not.
- (f) The preferred PIT–transfer reform package is a flat tax at 30 per cent, together with a very high tax free threshold and a negative income tax.

The primary purpose of this paper is to report some findings of an ongoing Australian Research Council (ARC) Linkage project on PIT reform, currently being undertaken by a research team at the Australian School of Taxation (Atax) of the University of New South Wales. Atax's industry partner for this project is CPA Australia, which has an active and long-standing interest in tax reform in Australia. However, it should be emphasised from the outset that this project is conducted by Atax researchers whose work is completely independent of CPA Australia. The emphasis of this paper is on the modelling aspect of the project. In particular, a "preferred" PIT reform package will be derived, proposed and discussed.

The remainder of the paper is organised as follows. Section 2 presents an overview of Australia's current PIT system. It also briefly reviews some of the well-known key defects of the Australian PIT system. Section 3 outlines the general principles and specific aims of the reform strategy, while Section 4 discusses the research methodology of the project. Section 5 presents a specific PIT reform package derived from a microsimulation exercise using STINMOD 05B. It is

shown that this package outperforms the current PIT system with respect to the traditional criteria for good tax policy. Some final remarks will then be provided in the concluding section.

2. OVERVIEW OF AUSTRALIA'S CURRENT PERSONAL INCOME TAXATION

Although PIT can be constitutionally levied by State Governments, the Commonwealth of Australia has been the sole imposer of PIT since 1942.⁵ The PIT is collected by the Australian Taxation Office (ATO) in accordance with the *Income Tax Assessment Act (ITAA) 1936* (Cth), *ITAA 1997* (Cth) and others, including the *Tax Administration Act 1953* (Cth). There are effectively three sources of taxation law in Australia:

- statute law (or legislation) made by the Parliament and contained in statutes such as the ITAA 1936 and ITAA 1997, along with regulations made under such Acts;
- case law (or common law) created by the decisions of courts and tribunals, and
- ATO practice and rulings (that is, the ways in which the ATO administers and applies the law through rulings, assessments and enforcement practices).⁶

The tax unit in Australia is the individual, although there are tax rebates to reflect demographic differences between families. Further, some classes of income may be split (property and business income) while others may not (wages and salaries; there is still some ambiguity regarding the treatment of personal services income, which may vary depending on the precise nature of the recipient entity). Thanks to the base broadening reforms of the 1980s, the definition of assessable income is now more comprehensive and includes earnings from employment or self-employment, rental income, interest, dividend income, capital gains, social security payments (unless exempted), etc.⁷ Double taxation of dividend income is avoided through the imputation system, which provides franking credits to resident shareholders. However, tax on business and investment income can often be reduced via the use of entities such as partnerships, companies and trusts. In addition, as in most

⁵ In 1942, the Commonwealth seized control of income tax under the Defence Power granted by s51(vi) of the Commonwealth Constitution and introduced the "uniform taxation system" which still operates today. Under this system, the States ceased to collect income taxes in order to receive grants from the Commonwealth. If any State Government attempts to collect any amount of income tax, its grant from the Commonwealth would be reduced by the same amount. It is thus not politically viable for any State Government to impose income taxes.

⁶ From a legal purist perspective, the Commissioner's rulings are not law but merely represent his view of the law.

⁷ Employees' fringe benefits do not form part of their taxable income as they are specifically taxed under the Fringe Benefits Tax.

countries, owner-occupied housing is treated preferentially via a CGT exemption and the non-inclusion of imputed rental income in the tax base, but interest on borrowing to finance such properties is not tax deductible and State governments impose stamp duty on housing purchases. In addition, there are many allowable deductions and concessions in the PIT system for individual non-business taxpayers, such as work related deductions, negative gearing, capital gains tax discount, and the Senior Australian Tax Offset. Australia relies on a comprehensive tax system in which realised income from all sources is combined and taxed at the same rate according to the legislated schedule. The only exception is capital gains.⁸ The PIT schedule is progressive, with five rates (excluding the Medicare levy) ranging through 0%, 15%, 30%, 40% and 45% for Australian residents. The current top tax bracket commences at \$150,000 per annum which corresponds roughly to 3.4 times the average weekly earnings in Australia.⁹

In terms of aggregate revenue, the PIT has been by far the largest single tax in Australia for many years. In 2003–04, PIT raised a net revenue of \$95.5 billion (ATO 2006: 10), accounting for about 67% of income tax revenue or about 48% of all Commonwealth tax revenue (ABS, 2006a: 647).¹⁰ Relative to the general government sector, PIT generated 39% of all tax revenue in 2003–04 (ABS, 2006a: 647, Table 27.13), while relative to the entire economy, PIT accounted for 12% of GDP in the same year (ABS, 2006a: 670, Table 29.5).

The administration of the Australian PIT has been an immense task, primarily because, under the current legislation, virtually all Australian individual taxpayers are required to submit their annual returns to the ATO. According to the latest taxation statistics available, 11.0 million individual taxpayers lodged returns in 2003–04 (ATO, 2006: 10). About 8.1 million returns (that is, 74% of the total number) were submitted by tax agents and 7.9 million returns (that is, 72% of the total) were lodged through electronic lodgment. Individual taxpayers had total income of \$414.1 billion, taxable income of \$394.7 billion and net tax payable of \$95.5 billion, giving an overall effective PIT rate of about 24.2% for all PIT taxpayers. Individual taxpayers claimed \$22.9 billion in total deductions, including \$11.1 billion in work-related expenses. Further, around 7.5 million individual taxpayers were assessed to be entitled to tax offsets and credits totalling \$11.6 billion.

To place Australia's reliance on PIT in an international context, Table 1 presents

⁸ If assets are held for 12 months or less, capital gains are included in assessable income. If assets are held for more than 12 months, only 50% of capital gains are included in assessable income. Assets acquired before 20 September 1985 are generally exempt from CGT.

⁹ In August 2006, the average of all employees' total earnings in Australia was estimated at \$839.50 per week, corresponding to an annual total earnings of \$43,654 (ABS, 2006b).

¹⁰ These ratios are derived by combining data provided by the ATO and ABS, which are not strictly compatible, possibly due to some statistical adjustments.

PIT and social security contributions by employees as a percentage of total tax receipts in selected OECD member countries in 2003. Unlike most other member countries of the OECD, Australia does not impose social security contributions on employees. When social security contributions by employees are excluded from PIT revenue, Australia's reliance on PIT appears to be very high relative to the rest of the OECD. However, when social security contributions are incorporated into the PIT base, Australia's reliance on PIT becomes more similar to those found in other OECD member countries. While Australia has a higher reliance on PIT than Japan, the UK and the OECD as a whole (in terms of simple average), it relies relatively less on PIT than most other comparable countries such as Canada, Germany, New Zealand and the US.

TABLE 1

**PIT AND SOCIAL SECURITY CONTRIBUTIONS BY EMPLOYEES
(AS A PERCENTAGE OF TOTAL TAX RECEIPTS) IN SELECTED
OECD COUNTRIES, 2003**

Country	PIT	Social Security Contributions by Employees	PIT and Social Security Contributions
Australia	38.5	0.0	38.5
Canada	34.5	6.3	40.8
Germany	23.9	17.7	41.6
Japan	17.5	16.5	34.0
New Zealand	41.9	0.0	41.9
UK	28.7	7.5	36.2
US	35.3	11.7	47.0
EU Average	35.0	9.4	44.4
OECD Average	24.9	9.4	33.4

Source: OECD (2007: 60–61).

The tax literature has identified many problems in the Australian PIT–transfer system. Some of the main issues, discussed by reference to the traditional criteria for good tax policy, are summarised below.

2.1 Revenue Security

Revenue security is important, not only to those who are dependent on government support (welfare recipients in particular), but also to taxpayer confidence in general. The Australian PIT base has been undermined over the years by a combination of allowable deductions and exemptions, tax planning (deliberate shifting of work and investment from relatively highly taxed options to lower taxed options), tax avoidance (abusive tax planning) and tax evasion. The estimation of the extent of tax evasion arising from the cash economy is difficult and very sensitive to the

underlying assumptions used to construct it. Numerical estimates of the size of the Australian cash economy relative to official GDP range from 4.8% (see ABS, 2003) to 13.6% (see Bajada, 2001).¹¹ Although Bajada's estimate has been criticised by many as being implausibly high (see, for example, ABS, 2003 and Breusch, 2005), recent studies have nevertheless suggested that Australia has a resilient cash economy which is not particularly responsive to tax reform.

2.2 Equity

Equity in taxation is concerned with the principles of horizontal and vertical equity. Both these principles are violated primarily due to the use of tax planning which arises from a variety of tax exemptions, concessions, deductions and shelters currently available in the Australian PIT system. Tax planning and tax avoidance tend to favour high-income individuals and income from capital. In 2002–03, for example, only 9% of all individual taxpayers paid tax at the top marginal rate (CPA Australia, 2004: 18). For many high-income persons, their marginal tax rate is closer to the company tax rate of 30% than to the maximum individual rate (including Medicare levy) of 46.5%, due to the use of private trusts, partnerships and companies, salary sacrifice, negative gearing and income splitting (ACOSS, 2003: 20–22). Covick (2004) went as far as using the term “two nations” to describe the differences between those taxpayers who are part of the PAYG system and those taxpayers who use trusts, partnerships and companies in a complex web of tax returns by the whole family to minimise their overall tax liabilities. As a result, the actual overall progressivity (and capacity to reduce inequality) of the Australian PIT system is nowhere as high as suggested by the statutory tax scale.

A glaring example of the inequality of the system is the taxation of capital income, where a dollar of income can be taxed in seven different ways depending on the entity that receives the income and the concessions granted within the system. One dollar of capital income can be taxed at:

- (a) 46.5% if it arises from an investment held for less than one year;
- (b) 30% if earned by a company;
- (c) 23.25% if treated as a capital gain;
- (d) 15% if earned by a superannuation fund;
- (e) 0% if it is a superannuation fund capital gain;
- (f) 11.675% if it is a capital gain of a small business; **or**
- (g) 0% if the asset was an operating asset of a small business, was held for 15 years, and the proprietor is over 55 years of age.

A system which provides such a range of choices and tax regimes for an identical item cannot be horizontally equitable.

¹¹ Note that the ABS estimate refers to an upper bound estimate of underground activity missing from GDP in 2000–2001, while Bajada's estimate refers to the cash economy in December 2000. A difference in the scope of the two approaches is that the ABS estimate does not include illegal activity while Bajada's estimate does.

2.3 Efficiency

Efficiency in taxation is concerned with the loss in output resulting from tax-induced distortions in taxpayers' behaviour. A traditional criticism of the Australian PIT has been that the maximum marginal tax rate (46.5%) is too high and the thresholds for the top marginal tax rates in Australia are too low (relative to domestic earnings or by international standards). These act as a disincentive to work effort and disadvantage Australia in its international competition for skilled labour. However, the problem of low thresholds for the top marginal tax rates has been substantially addressed by recent federal budgets, which raised the two top thresholds, especially the highest threshold, quite significantly. Using Budget and ABS data, and making adjustments for work related expenses, it is estimated that the top tax threshold as a multiple of full-time average annual earnings has risen steadily from 1.5 in 2003–04 to 2 in 2004–05, 2.5 in 2005–06 and potentially over 3 in 2006–07 (Treasury, 2006; ABS, 2006b).

More persistent is the problem of high effective marginal tax rates (EMTRs) caused by the interaction between the tax and social security systems.¹² Australian households that receive a composite income made of wage/salary and a social security payment related to their family status or benefit category tend to face very high EMTRs, which can be more than or close to 100% in some cases. High EMTRs act as poverty traps, which discourage unemployed adults from seeking work (unemployment traps), or employed adults from working longer hours (low income traps). Recent changes announced in federal budgets have improved the EMTR situation but more can still be done.

Concerning investment, the combination of the preferential treatment of owner-occupied housing, negative gearing and the CGT discount appears to encourage an overinvestment in residential dwellings, particularly rental housing, with potentially harmful consequences, especially when financed by high levels of debt.

2.4 Simplicity

Simplicity of taxation is concerned with the operating costs (compliance and administrative costs) of the tax system. In this sense, the PIT system in Australia is complex for two main reasons already stated. First, virtually all individual taxpayers are required to lodge annual tax returns, irrespective of how simple or complex their personal tax affairs may be. Secondly, the legal complexity of the PIT gives rise to both high tax computational and planning costs. The growing legal complexity of the PIT system in Australia is also clearly evidenced by the growth of the proportion of individual taxpayers relying on the services of tax agents for the completion and lodgment of their returns. This ratio has increased tremendously from approximately

¹² In terms of interaction with the PIT, the following categories of social security payments are relevant: unemployment benefits, family and child benefits, pensions and sole parent benefits, along with a range of means-tested tax offsets like the low income offset and the Medicare charge phase-in provision.

38% to 40% in 1977–78 (McKinstry and Baldry, 1997) to around 74% to 77% from 1996–97 to 2003–04 (ATO, 2006). An OECD survey conducted in 2004 (relating to the financial year immediately before the survey year) showed that Australia was the second highest agent-dependent country in the developed world (OECD, 2005, Table 9).¹³ A personal taxpayer¹⁴ survey conducted by an Atax research team in late 1995 found that the most common reason (60.2%) for people seeking professional tax advice is to comply with the legal requirements of tax obligations (Evans *et al.*, 1996: 12).

In this (now dated) comprehensive study of the compliance costs arising from federal taxes, Evans *et al.* (1997: 20) found that, in 1994–95, personal taxpayers (excluding sole traders), spent, on average, 8.5 hours per annum on tax affairs and almost \$100 on tax adviser costs. In aggregate terms, the compliance costs accounted for 4% of the net income tax revenue collected from personal taxpayers. This does not include the tax compliance costs associated with the use of trusts, companies and partnerships for asset protection and tax planning purposes. When sole traders were included, individual compliance costs accounted for 5.6% of the relevant tax revenue (Evans *et al.*, 1997: 65). Although there is no updated study of PIT compliance costs, it seems reasonably safe to remark that, as the overall level of complexity has increased, tax planning and compliance costs have not shown any sign of declining.

The above summary discussion suggests that a comprehensive, systemic reform of the Australian PIT is long overdue. The next section will discuss the principles of tax reform and research methodology adopted in this ARC Linkage project.

3. PRINCIPLES OF TAX REFORM

It may be helpful to briefly consider the meaning of tax reform prior to discussing the guiding principles of PIT reform adopted in this paper. Despite its widespread usage, the meaning of tax reform is neither well understood nor unambiguously agreed upon.¹⁵ There are two fundamental difficulties in assessing whether a tax change is a reform or not. Firstly, it is difficult to measure with certainty the general equilibrium impact of a tax change. Secondly, a genuine tax reform typically gives rise to both winners and losers, so that it may be difficult to determine the overall and specific effects of the tax change under consideration. In this paper, tax reform is identified and assessed in terms of the equity, efficiency and simplicity criteria

¹³ According to this report, 77% of all individual income tax returns in Australia were prepared with the assistance of tax agents. Only Italy (with 96%) had a higher figure than Australia. The percentages for other jurisdictions included: Canada: 45%; Ireland: 70%; Korea: 46%; New Zealand: 30%; UK: 53%; and USA: 56%.

¹⁴ Personal taxpayers mean individual non-business taxpayers (that is, sole traders are excluded).

¹⁵ For a critical examination of the meaning of tax reform, the interested reader is referred to Tran-Nam *et al.* (2006).

for good tax policy. Given these criteria of assessment, the reform method adopted in this ARC Linkage project is based on two general principles: revenue neutrality and an incremental approach. Each of these will be elaborated in turn below.

Firstly, a specific tax reform can be either revenue neutral, revenue decreasing or revenue increasing. This project adopts the principle of revenue neutrality for three main reasons:

- politically speaking, it preserves the status quo as far as possible, so the proposed reform is more likely to be accepted;
- it provides a safeguard to the level of government expenditure; and
- holding tax revenue constant makes it easier to determine whether the proposed tax change is truly a reform or not (in this case we can focus on whether the social and economic costs of taxation as a result of the proposed change have reduced or not).

Note that the meaning of revenue neutrality is not unambiguous in the context of Australian PIT reform. It is capable of several different interpretations. A revenue-neutral PIT reform can be interpreted as a PIT change that keeps the PIT burden (that is, ratio of PIT revenue over GDP) unchanged. It may also be interpreted as a PIT change that holds constant the overall tax burden (that is, ratio of total tax revenue over GDP). Since the GST has yielded more revenue than forecast, the overall tax burden in Australia has increased slightly as a result of the GST-based reform. Thus, a revenue-neutral PIT reform in this sense means a PIT change that maintains the pre-2001 level of overall tax burden, which was about 31.5% of GDP (see ABS, 2006a: 647, Table 27.13 and 670, Table 29.5).

In this paper, revenue neutrality is said to be achieved if the proposed PIT reform package generates approximately the same amounts of forecast revenue as the government PIT package, including bracket creep. Once chosen, revenue neutrality then becomes a constraint of tax reform. Note that a tax change cannot simultaneously satisfy revenue neutrality (in the sense of holding PIT revenue collection constant relative to the current regime) and the distributional constraint (that no group is worse off in the post-tax income sense as a result of the change). We must accept the fact that under a revenue-neutral tax change proposal, some groups stand to gain while others necessarily lose out.

Secondly, tax policy in any pluralistic, democratic society like Australia is typically a result of the interplay between the government, industries, labour unions and pressure groups that constitute the corporate state. The inertia of the tax system is strong, so that tax reform is often a long, strenuous and divisive process fraught with compromises and missed opportunities. But clearly the minimalist approach to PIT change adopted by the Coalition Government so far is grossly inadequate. Expanding the thresholds of top marginal tax rates and changes to the low income offset and Senior Australian Tax Offset reduce some of the disincentive problems associated with the PIT system, but are by themselves insufficient for developing a sustainable PIT model for the future.

A slow approach involving continuous small adjustments can generate a perception of uncertainty and/or instability and is therefore undesirable as a reform strategy. At

the same time, the “big bang” approach which seeks to move the current tax system to the “targeted” one in one large change is typically not possible, given the various constraints¹⁶ (especially the informational constraint) facing the tax policy makers. In particular, a big bang approach involving a radical PIT reform proposal such as a flat tax is most unlikely to be accepted by the government or the community.

This paper argues that the most viable option for PIT reform in Australia is the incremental approach. This approach seeks to move the current PIT system to the “ideal” PIT system in a series of two or three carefully crafted tax packages. This reform strategy is consistent with the advice offered by leading public finance economists such as Cedric Sandford (1993: 228). The PIT reform proposal in each stage of the process should be sufficiently familiar in terms of tax structure to be well recognised and ultimately accepted by both tax policy makers as well as the taxpaying community. Yet each reform proposal should also make visible improvements to the PIT system in terms of well defined criteria to justify its implementation. Because of the federal election cycle, the incremental approach takes a long time to complete and needs to be commenced by a government that enjoys broad electoral support.

4. RESEARCH METHODOLOGY

As a way to move the PIT reform debate in Australia forward, this ARC Linkage project employs an integrated, multi-stage research methodology. This approach combines various research techniques in an innovative way to take into account the views of virtually all stakeholders in the tax reform process: the researchers themselves, other tax experts, taxpayers and tax practitioners. Each stage of this research methodology is briefly explained below.

The first phase of the project aims at finding a specific PIT package that can be considered as a suitable candidate for the first stage of the incremental process described above. It is conducted with the aid of STINMOD version 05B. STINMOD is a microsimulation model of the Australian tax and transfer system, developed by NATSEM at the University of Canberra. This static model can be used to assess the immediate impact of policy changes on family incomes and government expenditures. As a policy tool, STINMOD can produce simulated results at the individual level. Thus, the distributional impact of a policy measure across different family types can be assessed. At the same time, estimates of the aggregate outcome can be derived by summing the individual results. This tool is widely used by Treasury and other departments to estimate the impact of public policy changes. Details of the components and assumptions of STINMOD are given in Lambert (1994).

The second phase of the project subjects some of the central issues and concepts underpinning these models to scrutiny and analysis by a panel of international tax experts (using a Delphi methodology), in order to establish strengths and potential weaknesses in the models, and seeks to establish a consensus around one single

¹⁶ These include domestic political and institutional constraints, international trade grouping constraints, distributional constraints and informational constraints.

“preferred” model. The Delphi methodology, as commonly understood in modern usage, “operates on the principle that several heads are better than one in making subjective conjectures ... and that experts will make conjectures based upon rational judgement rather than merely guessing” (Weaver, 1971: 268). It is a dialectical process designed to foster the exploration and distillation of expert opinion (Helmer, 1983). This Delphi methodology combines quantitative and qualitative techniques to explore future possibilities in systematic and iterative rounds of anonymous testing involving a panel of international experts. The experts have been drawn from Australia and from countries with comparable PIT regimes, such as the UK, the USA, Canada and New Zealand. These experts have responded to a series of open-ended propositions relating to the design and operation of the PIT with a view to establishing whether a consensus on key PIT reform issues can be developed.

The third phase of the project surveys tax community attitudes to this expert-derived model in order to establish levels of potential resistance/acceptance by key stakeholders. In particular, a large-scale mail survey of taxpayers and a large-scale e-survey of tax practitioners will be conducted. The taxpayer questionnaire will be sent by ordinary mail to about 4,000 Australian individuals selected at random and stratified by their income levels. This questionnaire seeks to obtain participants’ demographic and economic backgrounds, their attitudes toward general PIT reform options and, more specifically, their acceptance/rejection of the preferred PIT model derived during the first phase of this project. Particular attention will be paid to ensure that a minimum response rate of 20% will be obtained (for example, accurate addresses, questionnaire design, pilot testing, cover letter) and a high degree of representativeness of the effective sample (for example, through stratification of the relevant population). The e-survey will be sent by email to about 3,000 tax practitioners. The participants of this tax practitioner e-survey will be chosen at random from the membership database of CPA Australia, the industrial partner in this ARC Linkage project.

In summary, the three major methodologies involved – micro-simulation, Delphi methodology and survey – feed off each other and into each other as an iterative loop. The results of the Delphi study and surveys can be used to fine tune or revise the preferred model to reflect the expert and community feedback.

5. PERSONAL INCOME TAX REFORM: A SPECIFIC PROPOSAL

This section reports on the process and findings of the first phase of the ARC Linkage project. In this process, the government’s 2006–07 PIT system for Australian residents (as summarised in Table 2) is taken to be the benchmark for comparison. STINMOD is first used to simulate the aggregate revenue and distribution of disposable income associated with this benchmark. STINMOD is then used to construct and test a series of hypothetical PIT packages in order to establish which packages can best deliver the required policy outcomes. Before proceeding to state the preferred model obtained, it is worthwhile discussing briefly the crucial features of STINMOD modelling and the general approach to constructing PIT reform packages.

TABLE 2
THE 2006–07 PIT STRUCTURE*

Taxable Income	MTR (%)
\$0 – \$6,000	0
\$6,001 – \$25,000	15
\$25,001 – \$75,000	30
\$75,001 – \$150,000	40
more than \$150,000	45
Low Income Offset	\$600 for annual taxable income < \$25,000

*excluding Medicare levy.

Source: Treasury (2006, Table 1).

STINMOD contains most of the significant tax and social security elements, and its database is drawn from the last population census. It is based on a number of assumptions such as an inflation rate of 2.5% per annum, a population growth rate of 1.5% per annum and a taxable income growth rate of 3.5% per annum. STINMOD is a static model in the sense that it does not take into account changes in labour supply, saving and investment (second round effects) in response to changes in the PIT–transfer system.¹⁷ As a result, the estimated results of any PIT package which improves efficiency tend to be on the conservative side. STINMOD allows users to vary the tax rate but not the tax base in an automatic fashion. To estimate total revenue and distributional impacts arising from tax base broadening, additional calculations using spreadsheets need to be made. The combined effects of tax rate changes and tax base broadening are then obtained by adding the two separate effects. This process yields a close approximation of the impact of a simultaneous change in tax rates and tax base.

As stated previously, any revenue-neutral PIT package that exhibits a familiar progressive tax scale is said to be feasible. Obviously there are many feasible PIT packages that can be constructed by STINMOD. To discriminate feasible packages further, we employ the well accepted principle of tax base broadening and tax rate lowering. Base broadening helps not only to fund lower rates, but also to reduce tax-induced distortions. Lowering tax rates, particularly EMTRs, may reduce the obstacles to people's willingness to work. This efficiency enhancing measure is desirable, especially in the context of population aging that will confront Australia in the future.

The current Australian PIT system has many special exemptions and deductions which reduce the tax base, have little or no justification on efficiency grounds, add to complexity and are of much more value to those on higher incomes. Three main

¹⁷ In a recent study of the impact of marginal tax rates on labour supply, Gruen (2006) found that Australia's high-income earners are less responsive to tax cuts than those on middle and lower incomes.

PIT base broadening measures are:¹⁸

- removal of most, if not all, deductions for work-related expenses;
- removal of concessional tax rates on capital gains; and
- limiting tax relief for negatively-gearred investment deductions to income and capital gains derived from those investments.

In terms of the rate structure, among these competing packages, it seems useful to focus on a PIT package with the following properties:

- a lower number of tax rates, for example, three rates; and
- a smaller gap between the top marginal tax rate and the company tax rate.

Taking the current PIT–transfer system as the benchmark, STINMOD was used to construct and examine a large number of hypothetical PIT packages. Using the principles of incrementality and revenue neutrality as primary selection criteria, and tax base broadening, lower tax rates and smaller number of tax brackets as secondary selection criteria, our ‘preferred’ PIT package can be summarised in Table 3 as follows.

TABLE 3
PROPOSED PIT PACKAGE*

Taxable Income	MTR (%)
\$0 – \$24,599	13
\$24,600 – \$69,999	26
\$70,000 or more	38
Low Income Offset	\$900 for annual taxable income < \$25,000
Work Related Deductions (WRDs)	Remove all WRDs and provide a \$300 rebate to each taxpayer who claims WRDs
CGT discount	Remove CGT discount and exempt the first \$5,000 of capital gains per annum

* excluding Medicare levy.

The main features of the proposed PIT package are as follows:

- *Tax base broadening*: WRDs and CGT discount are practically abolished. They are replaced by some simple and plausible rebate or exemption, respectively. Due to the lack of disaggregated data, the effect of quarantining interest deductions for negatively geared assets cannot be quantified with a reasonable degree of accuracy. Thus, the partial removal of negative gearing was not attempted at this stage of the project.¹⁹

¹⁸ Other base broadening measures could potentially include the removal of concessional Fringe Benefits Tax treatment of motor vehicles, concessional tax rates on many forms of lump sum remuneration, remote area concessions and income averaging. However, these are not considered in this present paper.

¹⁹ If disaggregated data on negative gearing is made available by the ATO, the effect of the partial removal of negative gearing can be modelled. This would be an appropriate task for the next PIT proposal.

- *Tax rate structure:* The proposed statutory tax rate structure is somewhat flatter than the benchmark structure. There are only three rates as opposed to five rates in the current PIT system and the proposed top rate is lower than the current top rate (38% vs 45%).
- *Tax free threshold:* There is no tax free threshold in the proposed package. Maintaining or increasing the current tax free threshold is very costly and relatively more beneficial to high-income individuals. The adverse effect of the removal of the tax free threshold on low-income individuals is compensated with an increase of \$300 in the low income offset (from \$600 to \$900 for annual taxable incomes below \$25,000).

It is now time to examine the above PIT proposal more closely.

5.1 Revenue Impact

First and foremost, it is necessary to demonstrate that the proposed package is revenue neutral in the sense that it generates approximately the same revenue as the benchmark (the 2006–07 PIT system). This is shown in Table 4 below.

TABLE 4
REVENUE IMPACT OF THE PROPOSED PIT PACKAGE
(\$ MIL), 2006–07

Government loses from change in tax rates and thresholds	5,609.96
Government gains from removing CGT Discount	-3,988.00
Government gains from removing WRDs	-3,544.65
Loss from extra \$300 low income offset	2,655.00
Final Impact: Government loses	732.31

Sources: STINMOD and authors' own calculations.

Keeping in mind that the PIT revenue in 2006–07 would be close to \$100 billion, Table 4 shows that the proposed PIT package is approximately revenue neutral. Note that the revenue gap between the benchmark and the proposed package tends to be overstated due to the static nature of STINMOD. Since STINMOD does not capture the efficiency enhancement of the proposed package (to be shown later), the forecast revenue of the proposed PIT package would be slightly understated, causing the revenue gap to be slightly overstated.

Strictly speaking, it is also necessary to demonstrate the revenue sustainability of the proposed reform in the future. This is beyond the scope of the current paper. Suffice it to say that bracket creep and the broadening of the tax base would guarantee revenue sustainability into the future.

5.2 Distributional Impact

The distributional impact of our PIT proposal, by disposable income decile and family type in 2006–07, is summarised in Table 5.

TABLE 5
CHANGE IN WEEKLY DISPOSABLE INCOME (\$), 2006–07

Income decile	Family type			
	Married with no children	Married with children	Sole parent	Single adult
One	0.00	0.08	0.00	0.00
Two	4.24	3.80	1.63	3.56
Three	3.92	3.49	1.83	3.51
Four	4.17	1.30	1.39	1.30
Five	3.39	0.00	8.94	0.33
Six	1.24	3.07	10.34	6.09
Seven	0.77	1.30	8.54	9.53
Eight	5.78	6.14	13.39	17.01
Nine	10.02	5.56	7.10	13.08
Ten	-19.38	-11.65	6.87	9.94

Sources: STINMOD and authors' own calculations.

Under the proposed package, Australian residents, except married couples in the top income decile, are on the average either no worse off (people in the bottom decile) or better off in the sense of disposable income. Since the proposed package redistributes income from the top income group to lower income groups, the overall level of post-tax income inequality (as indicated by a summary measure such as the Gini coefficient) is likely to decrease.²⁰

5.3 Efficiency Impact

STINMOD is unable to compute the efficiency gains or losses associated with any PIT package. However, from a theoretical perspective, as our proposal has a flatter tax rate structure, it should have a beneficial effect on labour supply. In particular, the gap between the proposed top marginal tax rate (38%) and the company tax rate (30%) is much smaller than that between the current top rate (45%) and the company rate. This would greatly reduce taxpayers' incentive to engage in wasteful and distorting tax arbitrage and planning activities.

To substantiate the claim that the proposed PIT package has a lower tax rate structure, the EMTRs for 10 different family types at varying levels of private income are computed. The EMTR for a particular family type is calculated using the following formula:

$$\text{EMTR} = 1 - \frac{\text{Change in family disposable income}}{\text{Change in family earnings}}$$

where disposable income is defined as the total amount of income, including government benefits, received by a family, less any tax paid. Because of the

²⁰ The estimation of the Gini index typically requires unit record data which is not available from STINMOD.

interaction between income tax and the social security system, the EMTR can be close to or can exceed 100% at present.

The detailed EMTR results are presented in the Appendix. Without base broadening, the proposed tax scale gives rise to higher EMTRs in only six cases out of a total of 131 cases in this simulation exercise. In all other cases, the EMTRs are either unchanged or reduced. When base broadening is taken into account, for illustrative purposes, the EMTRs are estimated for a sample of only four major family types. Since the top three disposable income deciles do not have EMTR problems, we focus on the bottom seven deciles. Further, only the removal of WRDs is taken into account, as CGT changes do not affect the bottom seven deciles. The simulation results show that base broadening has no impact on the EMTRs faced by those selected family types belonging to the bottom seven disposable income deciles. The results in the Appendix suggest that, in terms of EMTR, the proposed PIT package outperforms the current PIT system in almost all cases.

5.4 Simplicity Impact

An important benefit of this PIT proposal is its simplification potential. Tax base broadening through a partial or complete removal of WRDs and CGT discount will reduce compliance costs (both computational and tax planning costs) to personal taxpayers, administrative costs to the ATO and revenue losses to the government (arising from allowable deductions for the costs of managing tax affairs). Focusing on WRDs alone, this is so because, under the existing structure, many personal taxpayers claim WRDs (6.8 million claimants in 2003–04)²¹ and the time spent on keeping records of deductions is the largest single compliance task performed by personal taxpayers (see Evans *et al.*, 1996: 37). Under a number of conservative assumptions, Vu and Tran-Nam (2006) estimated the reduction in aggregate tax operating costs of PIT due to the removal of WRDs alone at about \$1.03 billion in 2002–03. This monetary estimate does not include possible reductions in psychological costs that may arise from the elimination of WRDs.

A further benefit is that the PIT proposal can pave the way for reduced annual filing for personal taxpayers, especially those with less complex tax affairs, as persuasively argued by Evans (2004). He identified key ‘enablers’ that permit a simpler tax regime for most individual taxpayers in New Zealand and the UK:

- a small number of tax rates (sometimes without a tax-free threshold);
- a cumulative, comprehensive and accurate tax withholding regime at source; and
- no deductions for work related expenses.

Since tax rate simplification and the removal of WRDs are already included in the proposed PIT package, Australia simply needs to further strengthen its existing

²¹ This figure refers to allowed claims only. Those personal taxpayers whose WRD claims are not allowed would also incur compliance costs in terms of record keeping and tax return preparation.

PAYG provisions (particularly in respect to contractors who are akin to employees) and introduce a more comprehensive tax withholding regime on domestic interest and dividend income.

6. SUMMARY CONCLUSIONS

The current Australian PIT system suffers from major weaknesses relating to the traditional criteria for good tax policy. However, since tax reform means different things to different people, finding a consensus among a range of diverse options has proven very difficult to date. Recognising the importance of PIT reform, the ARC awarded an ARC Linkage grant to a research team at Atax, University of New South Wales. The aim of this project is to develop a sustainable PIT which not only achieves improved equity, efficiency and simplicity, but which also commands greater community acceptance and support. To this end, the Atax team utilises an integrated, multi-step research methodology which includes microsimulation modelling, a Delphi study and large-scale surveys. This paper reports on the process and outcomes of the first phase of this project.

In the first phase of this ARC Linkage project, STINMOD, a microsimulation model has been employed to construct and test a large number of feasible PIT packages in order to establish which package(s) can best deliver the required policy outcomes. The set of all feasible reform packages is defined by two principles of reform: revenue neutrality and incrementality. The preferred PIT package broadens the tax base by essentially removing WRDs and the CGT discount to fund lower tax rates (top marginal tax rate of only 38%). The preferred package also removes the tax-free threshold, but compensates those who would lose most by increasing the low income offset from \$600 to \$900 per annum. This proposed package is found to be revenue neutral and to substantially outperform the current PIT system with respect to the traditional criteria for good tax policy. It improves the disposable income of virtually all personal taxpayers and is less intrusive and distorting of economic decisions than the current system. The proposed PIT package appears to be an excellent candidate to move the reform debate forward.

PIT reform of a systemic and coherent nature is a long and difficult process. The conception and enactment of tax reform requires strong political will and control. Since the process of tax reform may involve several governments, it must start as soon as possible. In fact, the current Federal Coalition Government is in an excellent position to initiate this reform process. Politically speaking, it enjoys broad electoral support and controls the Senate. Economically speaking, favourable fiscal conditions currently prevail and the external imbalance has not yet created an economic crisis. Thus, the time for PIT reform is now and it would be a sadly wasted opportunity if the Government does not push ahead with comprehensive PIT reform quite soon.

APPENDIX

COMPARISON OF EMTRs BY FAMILY TYPE UNDER
ALTERNATIVE TAX REGIMES**Family type 1: Couple both working with no dependant**

Annual private income (\$)	EMTR (%) under benchmark regime	EMTR (%) under proposed regime	Change in EMTR (%)
0	0.0	0.0	0.0
1,612	50.0	50.0	0.0
6,500	75.0	60.0	-15.0
20,436	83.9	81.9	-2.0
23,972	68.9	66.9	-2.0
24,596	61.5	72.5	11.0
24,960	80.5	76.5	-4.0
35,256	95.5	91.5	-4.0
35,724	35.5	31.5	-4.0
99,996	42.5	40.5	-2.0
104,000	42.5	40.5	-2.0

Family type 2: Couple both working with one dependant

Annual private income (\$)	EMTR (%) under benchmark regime	EMTR (%) under proposed regime	Change in EMTR (%)
0	0.0	0.0	0.0
1,612	50.0	50.0	0.0
6,500	75.0	60.0	-15.0
19,084	63.0	61.0	-2.0
24,960	82.0	78.0	-4.0
26,416	90.9	86.9	-4.0
28,548	102.9	98.9	-4.0
31,772	95.5	91.5	-4.0
35,724	35.5	31.5	-4.0
38,428	55.5	51.5	-4.0
51,220	31.5	27.5	-4.0
74,984	41.5	39.5	-2.0
90,688	71.5	69.5	-2.0
94,744	41.5	39.5	-2.0
99,996	42.5	40.5	-2.0
104,000	42.5	40.5	-2.0

Family type 3: Couple both working with two dependants

Annual private income (\$)	EMTR (%) under benchmark regime	EMTR (%) under proposed regime	Change in EMTR (%)
0	0.0	0.0	0.0
1,612	50.0	50.0	0.0
6,500	75.0	60.0	-15.0
19,084	63.0	61.0	-2.0
24,960	82.0	78.0	-4.0
28,548	94.0	90.0	-4.0
32,396	102.9	98.9	-4.0
35,724	54.0	50.0	-4.0
37,024	35.5	31.5	-4.0

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38,428	55.5	51.5	-4.0
63,960	31.5	27.5	-4.0
94,276	71.5	69.5	-2.0
101,452	72.5	70.5	-2.0
102,388	42.5	40.5	-2.0
104,000	42.5	40.5	-2.0

Family type 4: Couple one working with no dependant

Annual private income (\$)	EMTR (%) under benchmark regime	EMTR (%) under proposed regime	Change in EMTR (%)
0	0.0	0.0	0.0
1,612	50.0	50.0	0.0
6,500	60.0	60.0	0.0
21,268	15.0	13.0	-2.0
24,960	34.0	26.0	-8.0
28,912	54.0	50.0	-4.0
31,252	35.5	31.5	-4.0
39,988	31.5	27.5	-4.0
74,984	41.5	39.5	-2.0
99,996	42.5	40.5	-2.0
104,000	42.5	40.5	-2.0

Family type 5: Couple one working with one dependant

Annual private income (\$)	EMTR (%) under benchmark regime	EMTR (%) under proposed regime	Change in EMTR (%)
0	0.0	0.0	0.0
1,612	50.0	50.0	0.0
6,500	75.0	60.0	-15.0
19,084	63.0	61.0	-2.0
24,960	82.0	78.0	-4.0
26,416	90.9	86.9	-4.0
28,548	102.9	98.9	-4.0
31,772	95.5	91.5	-4.0
35,724	35.5	31.5	-4.0
38,428	55.5	51.5	-4.0
51,220	31.5	27.5	-4.0
74,984	41.5	39.5	-2.0
90,688	71.5	69.5	-2.0
94,744	41.5	39.5	-2.0
99,996	42.5	40.5	-2.0
104,000	42.5	40.5	-2.0

Family type 6: Couple one working with two dependants

Annual private income (\$)	EMTR (%) under benchmark regime	EMTR (%) under proposed regime	Change in EMTR (%)
0	0.0	0.0	0.0
1,612	50.0	50.0	0.0
6,500	75.0	60.0	-15.0
19,084	63.0	61.0	-2.0
24,960	82.0	78.0	-4.0
28,548	94.0	90.0	-4.0
32,396	102.9	98.9	-4.0

35,724	54.0	50.0	-4.0
37,076	35.5	31.5	-4.0
38,428	55.5	51.5	-4.0
63,960	31.5	27.5	-4.0
94,276	71.5	69.5	-2.0
101,452	72.5	70.5	-2.0
102,388	42.5	40.5	-2.0
104,000	42.5	40.5	-2.0

Family type 7: Sole parent with one dependant

Annual private income (\$)	EMTR (%) under benchmark regime	EMTR (%) under proposed regime	Change in EMTR (%)
0	0.0	0.0	0.0
1,612	50.0	50.0	0.0
6,500	75.0	60.0	-15.0
22,360	15.0	13.0	-2.0
24,960	34.0	30.0	-4.0
31,564	54.0	50.0	-4.0
34,164	35.5	31.5	-4.0
38,428	55.5	51.5	-4.0
51,220	31.5	27.5	-4.0
90,688	71.5	69.5	-2.0
94,744	41.5	39.5	-2.0
99,996	42.5	40.5	-2.0
104,000	42.5	40.5	-2.0
102,388	42.5	40.5	-2.0
104,000	42.5	40.5	-2.0

Family type 8: Sole parent with two dependants

Annual private income (\$)	EMTR (%) under benchmark regime	EMTR (%) under proposed regime	Change in EMTR (%)
0	0.0	0.0	0.0
1,612	50.0	50.0	0.0
6,500	75.0	60.0	-15.0
22,360	15.0	13.0	-2.0
24,960	34.0	30.0	-4.0
34,268	54.0	50.0	-4.0
37,024	35.5	31.5	-4.0
38,428	55.5	51.5	-4.0
63,960	31.5	27.5	-4.0
94,276	71.5	69.5	-2.0
101,452	72.5	70.5	-2.0
102,388	42.5	40.5	-2.0
104,000	42.5	40.5	-2.0

Family type 9: Pensioner aged couple with no dependant

Annual private income (\$)	EMTR (%) under benchmark regime	EMTR (%) under proposed regime	Change in EMTR (%)
0.0	0.0	0.0	0.0
6,032.0	40.0	40.0	0.0
12,532.0	67.1	82.4	15.3
13,572.0	52.3	67.6	15.3

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14,300.0	41.2	56.5	15.3
29,328.0	67.9	65.1	-2.8
63,232.0	65.2	62.0	-3.2
64,272.0	31.5	27.5	-4.0
64,636.0	31.5	27.5	-4.0
99,996.0	42.5	40.5	-2.0
104,000.0	42.5	40.5	-2.0

Family type 10: Single adult

Annual private income (\$)	EMTR (%) under benchmark regime	EMTR (%) under proposed regime	Change in EMTR (%)
0	0.0	0.0	0.0
1,612	50.0	50.0	0.0
6,500	75.0	60.0	-15.0
11,544	74.0	81.0	7.0
15,028	66.6	73.6	7.0
20,852	16.5	14.5	-2.0
24,960	35.5	31.5	-4.0
49,972	32.5	28.5	-4.0
74,984	42.5	40.5	-2.0
104,000	42.5	40.5	-2.0

	Disposal income (\$ pw) without base broadening	Disposal income (\$ pw) with base broadening	EMTRs with base broadening
Couple 1 working with 2 dependants			
Low income (13% MTR)	641.00	644.77	Unchanged
Middle income (26% MTR)	738.00	736.43	Unchanged
Upper income (38% MTR)	1,124.00	1,111.95	Unchanged
Couple both working with 2 dependants			
Low income (13% MTR)	726.00	729.77	Unchanged
Middle income (26% MTR)	823.00	821.43	Unchanged
Upper income (38% MTR)	1,150.00	1,137.95	Unchanged
Sole parent with 1 dependent			
Low income (13% MTR)	443.00	447.72	Unchanged
Middle income (26% MTR)	739.00	737.43	Unchanged
Upper income (38% MTR)	1,124.00	1,111.95	Unchanged
Single adult with no dependent			
Low income (13% MTR)	291.00	295.72	Unchanged
Middle income (26% MTR)	426.81	427.78	Unchanged
Upper income (38% MTR)	1,025.00	1,012.95	Unchanged

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