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Political Economy of Tax Reform in Australia

Andrew Leigh*
Australian National University

This paper seeks to shed light on a puzzle in Australian public finance. Despite the fact that Australian public opinion is more strongly in favour of social spending than tax cuts, the last two Australian budgets have seen substantial reductions in top marginal tax rates. One possible reason that the tax cutting debate is so out of step with popular opinion may be that many commentators do not realise how low the income of the median Australian really is. I outline evidence from opinion polls on attitudes towards tax cuts. I then analyse the distribution of the 2005 and 2006 tax cuts across individuals and households and discuss how the income of the typical Australian is sometimes misrepresented in policy debates. I conclude with some suggestions about tax reform that may bring about a greater boost to social welfare than the reductions in top marginal tax rates.

United States Supreme Court Justice Oliver Wendell Holmes once said he paid his tax bills more readily than any other bills, knowing they were the price of "civilised society". British politician Edmund Burke took the contrary view: "To tax and to please, no more than to love and to be wise, is not given to men."

Announcing major personal income tax cuts in 2005 and 2006, Treasurer Peter Costello was clearly happier to throw his lot in with Burke than Holmes. In May 2005, the government announced personal income tax cuts amounting to $22 billion over four years. During 2005–06, conservative commentators lobbied for further cuts in tax rates, particularly at the top. In the May 2006 budget, Costello cut taxes by a further $37 billion over the next four years.

This paper seeks to shed light on a puzzle in Australian public finance: despite the fact that popular opinion in 2004 did not favour tax cuts, the government nonetheless implemented highly-regressive tax cuts in both 2005 and 2006. I suggest that one of the reasons for this could be that public debates often misrepresent the income of the typical Australian. Contrary to figures that are often reported, median income (the income of the typical Australian adult) is merely $27,000 per year.

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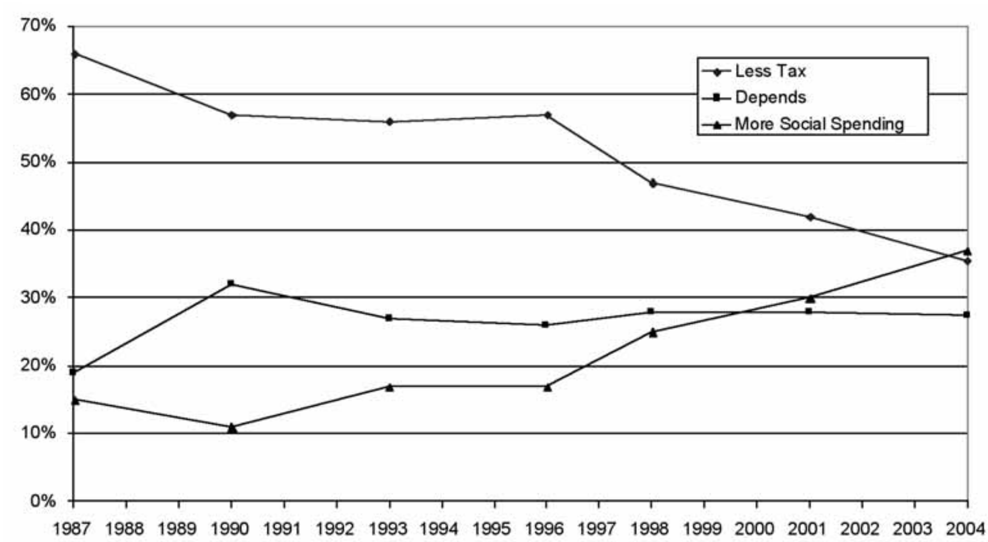
Public Opinion on Tax Cuts

For many years, the Australian Election Study has been asking respondents the question: "If the government had a choice between reducing taxes or spending more on social services, which do you think it should do?"[1] Figure 1 shows the responses to this survey over the past two decades. In the late-1980s, Australians clearly supported the tax-cutters, with those who wanted lower tax rates outnumbering those who wanted more social spending by a ratio of four to one. Yet from the mid-1990s onwards, the share of respondents supporting tax cuts has steadily declined. In 2004, for the first time since the survey began, more respondents favoured social spending (37 per cent) than supported tax cuts (36 per cent).

Figure 1: Attitudes to Taxes and Social Spending



While the Australian Election Study provides the best long-run series on attitudes towards taxes and services, more recent surveys show a similar pattern. For example, AC Nielsen asked a series of questions about preferences for tax cuts versus spending in 2004-06.[2]

- 2004: "Economists predict that the Federal Government will have an extra 5 to 10 billion dollars available to spend in next month's budget. Would you prefer to see this extra money used to provide an income tax cut, or would you prefer the money to be spent on services?" The results were: 22 per cent tax cut, 75 per cent services, 3 per cent don't know.

- 2005: "Economists predict that the Federal Government will have a surplus to spend in next month's budget. Would you prefer to see this extra money used to provide an income tax cut, or would you prefer the money to be spent on services?" Responses were 29 per cent tax cut, 68 per cent services, 4 per cent don't know.

1 Data for 1987-2001 from Grant (2004). Data for 2004 from the Australian Election Study 2004 codebook. See also Norton (2004).

2 The 2005 totals do not add to 100 per cent, due to rounding.

- 2006: “The Federal Treasurer recently announced a large budget surplus. Which of the following should be the highest priority for the government — reducing taxes and charges or increasing spending on services and infrastructure?” And this time, voters’ preferences were 29 per cent tax cut, 68 per cent services, 3 per cent don’t know.

While the wording of the AC Nielsen question has differed slightly from survey to survey, voters appear to consistently oppose tax cuts by a margin of at least two to one.

The same surveys that ask about attitudes to tax-cutting also provide an insight into why it is that tax cuts do not garner more support. Asked in the 2004 Australian Election Study whether they agree with the proposition that “High income tax makes people less willing to work hard”, 65 per cent of respondents agreed. But a majority of voters also think that “Income and wealth should be redistributed towards working people.” One way of regarding progressive taxation is as a trade-off between deadweight cost and equity. The results from the Australian Election Study and AC Nielsen surveys suggest that most Australians do not think that the deadweight cost inherent in present levels of taxation is so large as to justify reductions in tax rates.

In this sense, the attitudes of voters probably mirror those of academic economists, who would most likely agree that taxation reduces work incentives, but also favour reducing inequality. Although I have been unable to find a recent survey of the attitudes of the economics profession towards tax cuts, my guess would be that most Australian economists would have opposed the tax cuts in the 2005 and 2006 budgets.[3]

A Distributional Analysis of the 2005 and 2006 Tax Cuts

The effect of the tax cuts announced in the 2005 and 2006 budgets has been to significantly change the tax schedules applying in Australia.[4] Table 1 sets out the tax rates applying in the 2004-05 tax year and the 2006-07 tax year. I take account of personal tax rates (applying to all taxpayers) and the low-income tax offset (applying to all Australian tax residents). However, I do not take account of rebates, deductions and benefits that are specific to the elderly, regional residents, or taxpayers with children. Likewise, my analysis does not take account of changes in the distribution of government expenditure.

3 A 2001 survey of members of the ACT branch of the Economic Society of Australia (Argy 2001) did not ask respondents about cutting top tax rates, but the survey did find strong support among economists for the propositions that government should be concerned with inequality (questions 17 and 18), and that reforming the tax-transfer system was a promising way of reducing unemployment (question 14). Similarly, a 1992 survey of economics professors in Australia found that 49 percent agreed that the distribution of income in Australia should be more equal: Anderson and Blandy (1992).

4 For a thorough comparison of how Australian personal income tax rates compare with other developed nations, see Warburton and Hendy (2006).

Table 1: Tax Rates

2004–05		2006–07	
Taxable income	Marginal Tax rate (%)	Taxable income	Marginal Tax rate (%)
$0 – $6,000	0	$0 – $6,000	0
$6,001 – $21,600	17	$6,001 – $25,000	15
$21,601 – $58,000	30	$25,001 – $75,000	30
$58,001 – $70,000	42	$75,001 – $150,000	40
$70,001 +	47	$150,001 +	45
Low income tax offset		Low income tax offset	
Maximum value	$235	Maximum value	$600
Phaseout range	$21,600 – $27,475	Phaseout	$25,000 – $40,000
Tax progressivity		Tax progressivity	
Reynolds–Smolensky Index	5.85	Reynolds–Smolensky Index	5.42

Notes: Low-income tax offset is non-refundable (ie. it cannot reduce tax liability below zero), and is available only to Australian tax residents, and phases out at 4 per cent. Reynolds–Smolensky Index is the difference between the pre-tax gini coefficient and the post-tax gini coefficient, and is calculated using data from the 2004 wave of the HILDA survey, with incomes increased by 8 per cent to take account of income growth since the survey was conducted.

Together, the tax changes in the 2005 and 2006 budgets reduced marginal tax rates, increased tax thresholds, and boosted the value of the low-income tax offset. How can we sum up these changes? One approach is to use the Reynolds–Smolensky index (Reynolds and Smolensky 1977), which is simply the difference between the pre-tax gini coefficient and the post-tax gini coefficient.

With data from the most recent wave of the Household, Income and Labour Dynamics in Australia survey (HILDA), I estimate the Reynolds–Smolensky index under both sets of tax scales. The 2004–05 tax scales reduced the gini coefficient by 5.85 points, while the 2006–07 tax scales reduced the gini coefficient by 5.42 points. Consequently, the tax cuts in the 2005 and 2006 budgets were responsible for about a half-point rise in the post-tax gini coefficient.[5]

Another way of analysing the distribution of the tax cuts is to plot the distribution of the tax cuts across individuals and households. Since the Australian taxation system operates on an individual basis (rather than a family basis), analysing the distribution of incomes across individuals shows how the changes affected potential taxpayers. Alternatively, since households are typically assumed to pool resources, a household analysis may provide a better sense of how the tax cut affected the spending power of rich and poor Australians. Therefore, I plot the cumulative distribution of the tax cuts both across individuals (Figure 2) and households (Figure 3). In each chart, the diagonal line represents the distribution that would be observed if each adult/household received the same tax cut.

5 Note that this is based only on the ‘mechanical’ effect of taxes on the income distribution. Since the elasticity of taxable income with respect to the after-tax share is likely to be positive, the net effect of the tax cuts will probably be to increase inequality further still.

Figure 2: Distribution of Tax Cuts Among Individuals

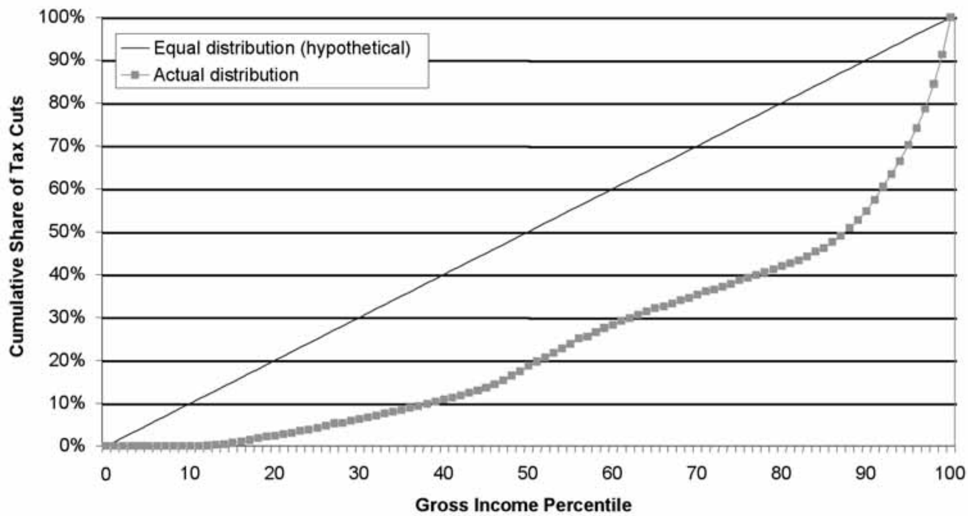
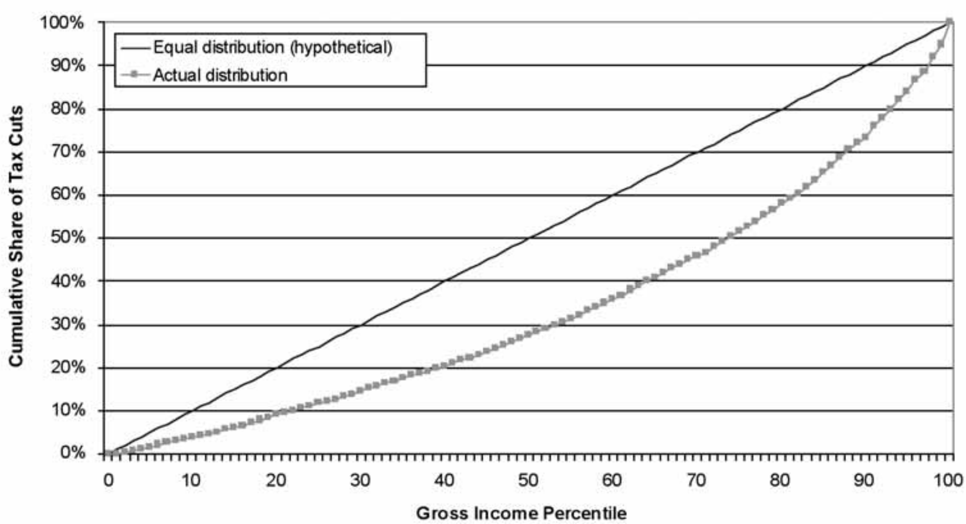


Figure 3: Distribution of Tax Cuts Among Households



As Figure 2 demonstrates, the tax cuts in the 2005 and 2006 budgets were strongly skewed towards high-income individuals. Among individuals, the richest 1 per cent received 9 per cent of the tax cuts; the richest 5 per cent received 26 per cent of the tax cuts; and the richest 10 per cent received 43 per cent of the tax cuts. By contrast, the poorest 50 per cent of adults received just 19 per cent of the tax cuts.

Among households, the distribution of the tax cuts was still skewed towards the rich, though to a lesser extent than across individuals. Figure 3 shows that the richest 1 per cent of households received 5 per cent of the tax cuts; the richest 5 per cent received 13 per cent of the tax cuts; and the richest 10 per cent received 24 per cent of the tax cuts. At the other end of the distribution, the poorest 50 per cent of households received 27 per cent of the tax cuts.

Misperceptions of Average Income

How do we reconcile the fact that the typical voter does not favour tax cuts with the large and regressive tax cuts in the 2005 and 2006 budgets? One possible explanation is the strong tax-cutting campaign that took place between the two budgets. Among those who fiercely advocated lowering top tax rates during this period were Malcolm Turnbull and Jeromey Temple (2005), the Business Council of Australia (2005), and the Centre for Independent Studies (Saunders 2006).

Another factor may have been that opinion leaders did not properly appreciate the distribution of income in Australia. For the most part, the taxation rates applying to most politicians, journalists, business executives and think-tank staffers (and indeed, to academic economists) are not those that apply to the average voter. In all these professions, six-figure salaries are common. Yet only 4$^1/_2$ per cent of Australian adults have an income that exceeds $100,000 per year, and only 1$^1/_2$ per cent have an income that exceeds $150,000 per year.

Anecdotal evidence suggests that many of those participating in or reporting on tax debates are not aware that the median adult income in Australia is as low as $27,000 (near the bottom of the 30 per cent tax bracket). One of the reasons for this is that the reporting of "average" income in Australia focuses on a measure of earnings which is not that of the typical voter. Table 2 shows that switching between different measures can drastically affect the estimates of what is "average". Changes in the perception of what is 'normal' can quickly affect the terms of the tax debate.

Table 2: What's Average?

Typical person's income (median adult income)	$27,000
Use mean instead of median	$37,000
Also ignore those who don't work	$42,000
Also ignore those who work part-time	$56,000

Source: Rows 1 and 2 are from the 2004 wave of the HILDA survey, increased by 8 per cent to take account of income growth since the survey was conducted. Rows 3 and 4 are "All employees total earnings" and "Full-time adult total earnings", from ABS *Average Weekly Earnings, Australia, Cat No 6302.0*, February 2006 (released 18/05/2006), multiplied by 52. All figures are rounded to the nearest thousand dollars.

The first switch that is frequently made is to use the mean income instead of the median income. Mean income is the total income in society divided by the number of adults. Median income is the income of the person at the 50th percentile – a measure of what the typical person has in their pocket. In some instances (such as national accounting), mean incomes are the right measure to use. But when we want to know what the average person earns, we should look at median income. The intuition for this is simple — just as the median house price tells a house-buyer what the typical house costs (and is not sensitive to the sale of a waterfront mansion), so median incomes tell us what the typical voter has in their pocket.[6]

The second switch is to exclude incomes of those not working. For policymaking purposes, those out of employment should matter as much (if not more) than those in employment. Yet commentators frequently ignore the unemployed when making statements about what a typical person earns. Average wages are not the same thing as average incomes of all voters.

The third switch is to exclude those who work part-time. Since Australia has a high rate of part-time employment, this again inflates the estimate. As Table 2 shows, combining all three changes produces an "average earnings" estimate of $56,000, more than twice the typical person's income. Such changes can have serious consequences for the policy debate. On 19 November 2004, when mean annual earnings of full-time workers rose above $50,000 for the first time, the *Sydney Morning Herald* headlined a story "The $50,000-a-year worker — but that's just average". Yet the typical voter has an income of just $27,000.[7]

Table 3: Distribution of Individual and Household Income (2006-07)

Individual Income		Household Income	
	Individual Pre-Tax		Household Pre-Tax
Percentile	Income	Percentile	Income
5	$2930	5	$14,245
10	$6642	10	$20,923
25	$12,683	25	$36,071
Median	$27,000	Median	$69,276
75	$49,680	75	$106,553
90	$73,637	90	$151,971
95	$97,095	95	$196,761
99	$184,680	99	$311,040

Note: Incomes are the sum of market income, private transfers, Australian and foreign pensions and benefits, family tax transfers and child care benefits. Windfall (irregular) income is excluded. Data is from the 2004 wave of the HILDA survey, increased by 8 per cent to take account of income growth since the survey was conducted. All estimates exclude those aged under 18, and are weighted using person-weights.

Table 3 shows the distribution of individual and household incomes in Australia. As discussed above, the fact that the Australian taxation system taxes individuals rather than

6 A substantial literature exists on the application of median-voter models to progressive taxation (see for example Perotti 1993; Roemer 1999).

7 This is the figure derived when all adults comprise the basis of measurement. These closely match voters on the electoral rolls.

families means that *individual* income is the best way to gain a sense of how tax reforms affect people on different incomes. But even if we combine incomes within a family, the typical household's income is only about $69,000, meaning that half of all Australian households get by with less than $69,000. Policy debates must acknowledge the fact that most Australian households are still well out of the top tax brackets.[8]

Politicians should not make policy simply by following opinion polls. In some instances, long-term reforms are the right option for the country, despite being initially unpopular. But when only 36 per cent of the electorate supports cutting tax rates, those in favour of further reductions should pause to consider whether they have it right. And when discussing tax cuts, journalists should make sure that they accurately report what the typical Australian actually earns.

Conclusion

Despite the fact that Australian public opinion is more strongly in favour of social spending than tax cuts for the rich, the last two Australian budgets have seen substantial reductions in top marginal tax rates for the richest Australians. One possible reason that the tax cutting debate is so out of step with popular opinion may be that many commentators do not realise how low the income of the median Australian really is. Those who advocate cutting the top marginal tax rate — which in 2006–07 will be 45 per cent for those earning over $150,000 — should acknowledge that they are advocating a tax cut that will affect only the richest $1^1/_2$ per cent of Australian adults.

'Tax reform' need not focus solely on reductions in top marginal tax rates. For example, Australian policymakers could focus on reducing the deadweight cost caused by the administrative burden of the taxation system. Just as New Zealand's recent simplification of the tax filing system reduced the number of taxpayers required to file annual returns, Australia could do the same (see Evans 2004). Or we might consider following the example of Britain and the United States, which have introduced negative income taxes to reduce effective marginal tax rates on the poor, and encourage the transition from welfare into work (see Dawkins 2001; Banks et al. 2005). Both reforms would be likely to bring about a greater boost to social welfare than the reductions in top marginal tax rates that have preoccupied Australian policymakers over recent years.

8 Another factor is that some people with incomes that put them in the top two tax brackets are able to manipulate their incomes to minimise their effective tax burden, thorough vehicles such as family trusts. Others may engage in direct tax avoidance, but we do not know whether tax avoidance as a share of income is higher among the rich, since Australia has never carried out a tax audit based on a random sample of all personal income taxpayers.

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