Senate Standing Committee on Economics,
ANSWERS TO QUESTIONS ON NOTICE,
Treasury Portfolio
Budget Estimates
1 June – 3 June 2010

Question: BET 397

Topic: **Personal Income Tax**

Hansard Page: **Written**

Senator EGGLESTON asked:

1. Would there be merit in adopting Recommendation 2 of the Henry Review, that is, a higher tax free threshold and either a flat rate or fewer marginal rates?

2. What would be the cost of raising the tax-free threshold to $25,000? And to $16,000? And to $37,000?

I refer to the 50 per cent discount for the first thousand dollars of interest income.

3. How does this make the tax system simpler?

4. I refer to page 38 of Budget Paper 2 which shows related changes to the departments of Human Services, FAHCSIA, DEEWR, Health and Ageing, and Veteran's Affairs, as well as the ATO. Are the rules of these departments for payments made simpler by this policy?

5. If the policy does not make the tax system simpler, does it make it fairer? How?

6. Finally, does this policy make the tax system stronger?

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Answer:

1. Would there be merit in adopting Recommendation 2 of the Henry Review, that is, a higher tax free threshold and either a flat rate or fewer marginal rates?

- The Australia's Future Tax System Review (the Review) found there would be benefits in moving to a high tax free threshold and a simple progressive personal income tax rate structure involving fewer marginal rates.
- A higher tax free threshold would remove complexity for individual taxpayers and reduce compliance and administrative burdens by facilitating the removal of structural tax offsets such as the Low Income Tax Offset.
  - A higher tax free threshold would also improve the interface between the tax and transfer systems by reducing the need for individuals to interact with both systems at any one time.
- The Review also found advantages in having fewer marginal tax rates with a single marginal rate applying over a long income range as this would help avoid high effective marginal rates of tax that might act as a disincentive for work and also a disincentive for saving.

2. What would be the cost of raising the tax-free threshold to $25,000? And to $16,000? And to $37,000?

- This question would require an analysis of a hypothetical policy to increase the tax-free threshold to various levels, together with unspecified other elements including changes to structural tax offsets and interactions with the transfer system. The Government has not announced such a policy.

I refer to the 50 per cent discount for the first thousand dollars of interest income.

3. How does this make the tax system simpler?

- The Government indicated in the 2010-11 Budget that its objective in introducing a 50 per cent tax discount for interest income is to reduce the variation in the taxation treatment of alternative savings vehicles through a more consistent tax regime for savings. Interest income is currently taxed in full at the individual's marginal rate whereas income from other forms of saving, such as capital gains, receives a significant discount.
  - This disadvantages Australians who prefer to hold their non-superannuation savings in interest-earning investments such as deposits in banks, building societies and credit unions.
- The Government also indicated that it expected the discount to help promote deposits held in banks, building societies and credit unions as a tax effective savings vehicle. Deposits typically represent a high proportion of funding for small lenders.

4. I refer to page 38 of Budget Paper 2 which shows related changes to the departments of Human Services, FAHCSIA, DEEWR, Health and Ageing, and Veteran's Affairs, as well as the ATO. Are the rules of these departments for payments made simpler by this policy?

- The 50 per cent discount for interest income announced in the 2010-11 Budget will not affect the rules determining eligibility for transfer payments.
  - These rules, known as income tests, will continue to be based on adjusted taxable income.
  - Further, the discount will not affect the service delivery of payments to eligible recipients.
- The interest discount is estimated to increase Government expenditure because taxpayers claiming the discount will have a reduced adjusted taxable income for the purpose of determining eligibility for some transfer payments and other concessions.
  - This will result in some individuals and families becoming eligible for transfer payments or eligible for a larger payment.
- This primarily affects Family Tax Benefit, but will also affect other payments such as the Baby Bonus, Child Care Benefit, Education Tax Refund, Commonwealth Seniors Health Card (CSHC) and the Pensioner Supplement (which is linked to eligibility for the CSHC).

5. If the policy does not make the tax system simpler, does it make it fairer? How?

- At present, most interest income is taxed at the individual's marginal rate, while capital gains can receive a 50 per cent discount. This means that individuals are taxed even on the portion of the interest that just represents compensation for inflation.

- A 50 per cent discount for interest income will reduce the tax paid on this type of income, including the portion of interest that compensates for inflation.

  – This is in line with the Australia's Future Tax System (AFTS) Review which advocated a more consistent treatment of savings income.

- The interest income discount will be of benefit to small savers, including low- and middle-income earners, who are more likely to put their extra non-superannuation savings into interest-earning deposits.

6. Finally, does this policy make the tax system stronger?

- The Government's Budget measure introducing a 50 per cent tax discount for interest income can be seen to promote equity and policy consistency by reducing the variation in the taxation treatment of alternative savings vehicles through a more consistent tax regime for savings.

7. What are the characteristics of a strong tax system?

- The need to raise sufficient revenue to meet the Government's spending requirements (over the course of an economic cycle) is a key characteristic of any tax system. In the Australian context, the Australia's Future Tax System Review identified five criteria against which the effects of the tax system can be judged.

  – Equity – individuals with similar economic capacity should be treated in the same way, while those with greater capacity should bear a greater net burden. The system should also take into account exposure to complexity and the distribution of compliance costs and risk.

  – Efficiency – revenue should be raised and redistributed at the least possible cost to economic efficiency, administration and compliance.

  – Simplicity – the system should be easy to understand and comply with, with low administration costs.

  – Sustainability – the system should have the capacity to meet changing revenue needs of the Government on an ongoing basis without recourse to inefficient taxes.

- Policy consistency – tax and transfer policies should be internally consistent, with rules in different parts not contradicting each other. The policy should also be consistent with the broader objectives of the Government.

- Against these criteria, the Australia's Future Tax System Review articulated the characteristics of a strong tax system for Australia in its vision of a 21st century tax system as follows:

  "A 21st century tax and transfer system should meet its purposes efficiently, equitably, transparently and effectively. Critically, it would support per capita income growth rates at the upper end of developed country experience by encouraging high workforce participation, a more efficient pattern of saving, and stronger investment in education and physical capital. It would be robust, capable of supporting large structural change, dealing with unforeseeable external shocks and encouraging patterns of economic activity that prove fiscally and environmentally sustainable. It would support economic dynamism and diversity. Through both its direct and indirect effects, it would support the commitment to exploit opportunities to reduce compliance costs and make interactions with the tax and transfer system, more certain, and more understandable. It would enhance the accountability of governments to their citizens."

  (Australia's Future Tax System – Report to the Treasurer, Page xvii)