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Closing the tax loopholes

A Buffett rule for Australia

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TAI

Policy Brief

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Our philosophy

As we begin the 21st century, new dilemmas confront our society and our planet. Unprecedented levels of consumption co-exist with extreme poverty. Through new technology we are more connected than we have ever been, yet civic engagement is declining. Environmental neglect continues despite heightened ecological awareness. A better balance is urgently needed.

The Australia Institute's directors, staff and supporters represent a broad range of views and priorities. What unites us is a belief that through a combination of research and creativity we can promote new solutions and ways of thinking.

Our purpose—'Research that matters'

The Institute aims to foster informed debate about our culture, our economy and our environment and bring greater accountability to the democratic process. Our goal is to gather, interpret and communicate evidence in order to both diagnose the problems we face and propose new solutions to tackle them.

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Introduction

With large parts of the 2014 budget not passed by the Senate, Prime Minister Tony Abbott has asked Senators for alternative ways to reduce the budget deficit.[1] One alternative is a "Buffet rule" for Australia – named after billionaire investor Warren Buffett, who commented that his secretary should not pay a higher average rate of tax than he does.

This paper is the first in a series of policy proposals that would not only reduce Australia's budget deficit, but do so in a fairer and more equitable way than the measures rejected by the Senate.

The Government does not seem to understand the key reason why the federal budget is in deficit. The deficit exists not because spending has grown excessively, but because tax revenue has not grown to match spending requirements.[2] In the 12 years before the GFC spending was 24.1 per cent of GDP. It is currently 1.6 per cent higher at 25.7 per cent of GDP. The ratio of tax to GDP is now lower declining from 25 per cent of GDP in the 12 years before the GFC to its current level of 22.8 per cent of GDP. Clearly, the drop in tax revenue is a much larger contributor to the budget deficit than the increase in spending.

While the revenue problem seems clear, the government's approach to reducing the budget deficit has been primarily to reduce spending. In doing so, the government is trying to match spending to unusually low levels of tax revenue and as a result it is being forced to make cuts to services that are extremely unpopular. Some of these measures are cuts to pensions, higher education and the introduction of a Medicare co-payment. Many people view these as an attack on universal education and health care. A survey by the Australia Institute found that only 19 per cent of people supported cutting spending if access to universal education and health was reduced, while 58 per cent were opposed to such cuts.[3]

The 2014 budget was widely seen as unfair – it targeted spending which affects low and middle income earners, but seemed to leave corporate Australia and people on higher incomes relatively untouched. A survey by the Australia Institute found that 75 per cent of people agreed that if the federal government is going to reduce the deficit then it should do so without impacting low income households. As this paper and the rest of the series will show, there is no shortage of budgetary measures open to the Government that will improve the budget balance in a fair and equitable way.

Progressive taxation

Taxation is an important part of Australian society. It provides the institutions, structures and services that have allowed Australia to thrive and become one of the richest nations in the world. The largest single tax in Australia is income tax which makes up almost 50 per cent of federal government's tax take.[4]

Income taxation is a progressive tax, which means that as income rises people pay a larger percentage of their income in tax. There is very little disagreement with progressive taxation. A survey by the Australia Institute found that only 24 per cent of people disagreed with progressive income taxes.[5]

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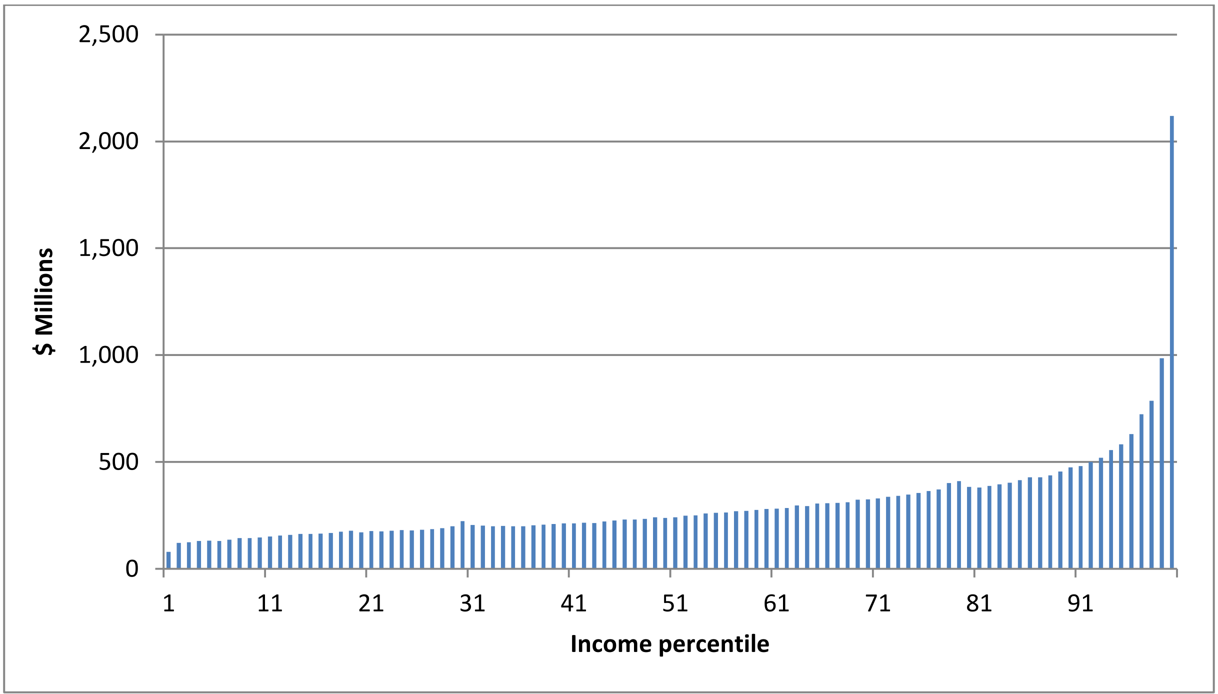
1. Griffiths (2014) *Prime Minister Tony Abbott signals budget compromise, calls on crossbenchers to offer alternatives*
2. Australian Government (2014b) *Statement 10: Historical Australian Government Data*
3. TAI (2015) *Australia Institute Survey - March*
4. Australian Government (2014a) *Budget Strategy and Outlook*
5. TAI (2015) *Australia Institute Survey - March*

The progressive nature of Australia's income tax system is undermined by the many deductions that can be claimed. These deductions allow taxpayers to substantially reduce the tax they pay on their incomes. Many deductions are complex and relate to investment income from shares, real estate and superannuation funds. Because many deductions relate to investments, the people who benefit from them are those who can afford such investments – high income earners.

The extent to which tax deductions accrue to high income earners is clear from Australia's taxation statistics. Figure 1 below shows the amount of money claimed through income tax deductions for each income group in Australia.

Figure 1 – Deductions at income percentiles[6]



Source: ATO (2014a)

Figure 1 shows that deductions claimed rise steadily with income through low and middle income earners, but then increase exponentially for taxpayers with high incomes. The top one per cent of income earners, people earning about $300,000 per year, claimed over $2 billion worth of tax deductions – the same amount as the bottom 16 per cent.

In fact, Australian Tax Office statistics show that 75 individuals earned more than $1 million in 2011-12, but paid no income tax at all.[7] They did this by finding tax deductions that reduced their taxable incomes to levels below the income tax threshold. In total, these 75 people had pre-tax income of $195 million, but reduced their taxable income to a mere $82. Each of these individuals earned more than a million dollars for the year but had an average taxable income of just $1.09.

Reducing one's taxable income does not come cheap. The Australian Tax Office statistics show that these 75 people paid, on average, almost $860,000 each to manage their tax affairs. Paying this money makes sense for high income earners - the tax saved is greater than the cost of saving it. But from the point of view of society it represents a flow of income

[6] Income percentiles groups tax payers into 100 groups based on their taxable income. The 1st percentile is the group with the lowest taxable income while the 100th percentile is the group with the highest taxable income.

[7] ATO (2014a) *Individual tax: Selected items, by total income and taxable income, 2011–12 income year*

away from the government and towards millionaires and tax advisors. Tax saved by these people just means more tax that has to be raised from the rest of society.[8]

The unfairness of this situation was famously pointed out by US billionaire investor, Warren Buffett, who said that he did not think it was fair that his secretary paid a higher effective tax rate than he did. He compiled a spreadsheet of his office staff, their income and effective tax rates, finding that although he was, unsurprisingly, the highest income earner, he also paid the lowest rate of tax.[9]

This led to the idea of the “Buffett rule” in the United States.[10]

The Buffett Rule

The idea of the Buffett rule is to charge a minimum average rate of tax on very high income households based on their total income. This applies to their income before they go through the process of making tax deductions. This would mean that if very high income households are able to make large deductions to reduce their taxable income to low levels they would still pay a reasonable amount of tax based on their total income.

It should be noted that there are sound policy reasons for some tax deductions and this rule would not prevent them. It merely places a limit, so that high income earners can’t end up paying a lower average rate of tax than middle income earners.

Under a Buffett rule, it does not matter if high income earners pay the best tax advisors to find ways to minimise the amount of tax they pay, they will still be forced to pay 35 per cent of their total income in tax. This reduces the advantage of the tax industry searching for new tax loopholes and reduces the value to very high income households from buying the knowledge of these loopholes.

The result is a more progressive tax system where less time, effort and money is spent in the endless game of cat and mouse as loopholes are discovered, exploited and sometimes removed.

A Buffett rule in Australia

There are a number of different things to consider before introducing a Buffett rule in Australia. The tax is designed to target high income earners who aggressively minimise the amount of tax they pay. As discussed above it is mainly very high income earners who have the ability to do this. A minimum income threshold should therefore be set so that the new tax only applies to very high income earners.

As shown above, people who earn $300,000 or more per year are in the top one per cent of income earners in Australia.[11] These people are most likely to take advantage of tax deductions, so this seems an appropriate threshold for an Australian Buffett rule and is used in the modelling below.

[8] The other interesting aspect of these 75 people is that they have structured their income away from wages and towards investment income. Investment income is a better way to earn an income if you want to reduce the tax you pay. The 75 individuals earned a total of $195 million in income, but only 3.5 per cent of this came from wages and salaries.

[9] Stein (2006) *In Class Warfare, Guess Which Class Is Winning*

[10] The National Economic Council (2012) *The Buffett Rule: A basic principle of tax fairness*

[11] ATO (2014b) *Percentile distribution of taxable individuals, by taxable income and gender, 2011–12 income year*

The Buffett rule also requires a tax rate to be paid on total income. People earning exactly $300,000 per year with no deductions, the minimum income that the new tax would apply to, would pay an average rate of tax of 36 per cent. The Buffet rule tax rate should be set just below this rate, at perhaps 35 per cent.

It is also important to note that this tax acts as a floor on the amount of tax paid. So this tax would not apply to someone earning $300,000 or more who paid an average rate of tax above 35 per cent. The tax only applies if someone earning $300,000 or more, through tax deductions reduces their average rate of tax below 35 per cent. Many high income earners do not aggressively minimise the amount of tax they pay and for them this new rate of tax will not apply.

Revenue collected from a Buffett rule in Australia

To estimate the revenue that might be collected by an Australian Buffet rule, The Australia Institute commissioned modelling from the National Centre for Social and Economic Modelling (NATSEM). NATSEM used STINMOD, their economic model, to calculate the revenue and distributional effects of implementing such a tax.[12]

NATSEM estimated that a Buffett rule, with the parameters discussed above, would raise an additional $2.5 billion per year.

Table 1 – Revenue from an Australian Buffett rule

Revenue raised (pa)	Number of households affected	Average impact of affected households
$2,492 million	31,524	$79,053

Source: NATSEM

This is a considerable amount of revenue and shows the extent to which very high income households are using deductions to reduce their taxable income. This extra revenue would be raised from 31,524 households and this would mean that these very high income households would pay on average an additional $79,000 per year in tax. The modelling also gives us some demographic details about the people that the additional revenue will be raised from.

Income distribution

NATSEM modelling provides a breakdown of income distribution by decile of those who would pay more tax. As expected all the revenue is raised from those in the top 10 per cent of households by income. This measure will only impact on very high income households.

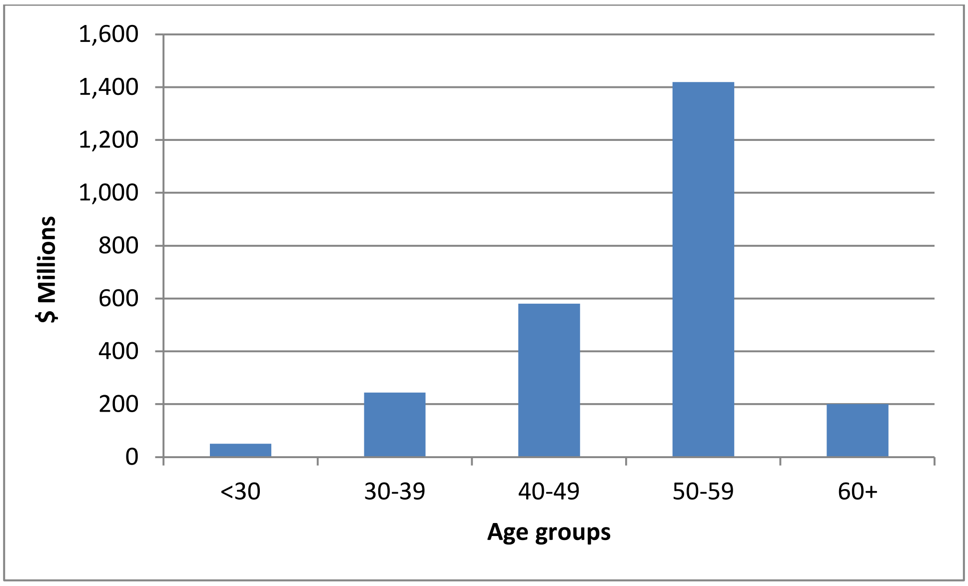
Age

When we look at the break down by age we find that those affected are primarily in their 50s with 57 per cent of the income raised from those between 50 and 59. 23 per cent comes from those aged 40 to 49, while only eight per cent comes from those 60 plus and two per cent from those under 30. It is interesting to see the drop off in revenue gained after those

[12] STINMOD (Static Incomes Model) is NATSEM's static microsimulation model of Australia's income tax and transfer system. The model is mostly used to analyse the distributional and individual impacts of income tax and income support policies and to estimate the fiscal impact for government and the distributional impacts of policy reform for families. The model is based on Australian Bureau of Statistics survey data and uses a range of techniques and other data sources to update the survey data to the current financial year. For more information on STINMOD see appendix A.

affected reach 60. Presumably this is because they move from well-paid employment to living off their retirement savings.

Figure 2 – Impact of an Australian Buffett rule by age

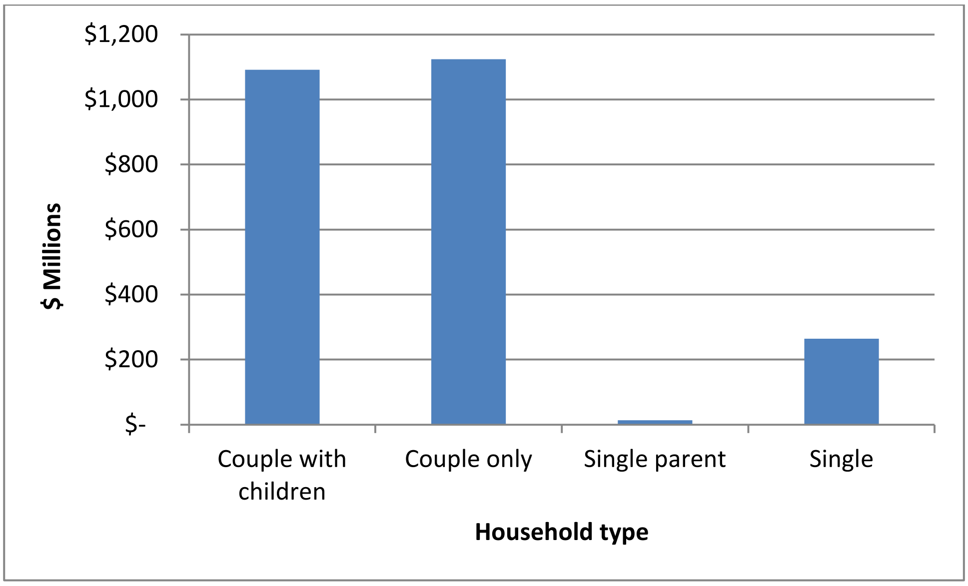


Source: NATSEM

Household type

The impact of the new tax by household type shows that couples and couples with children make up about 90 per cent of those paying the new tax. Only 11 per cent are single and only one per cent are single parents.

Figure 3 – Impact of an Australian Buffett rule by household type



Source: NATSEM

Gender

The modelling also shows that the new tax is predominately paid by men who would pay 90 per cent of the tax. This is not surprising given men are far more likely to be high income earners than women.

Table 2 – Impact of an Australian Buffett rule by gender

Sex	Revenue raised (pa)	Per cent of revenue raised
Male	$2,241 million	90%
Female	$251 million	10%

Source: NATSEM

Conclusion

One option that would assist the Abbott Government return the federal budget to surplus would be the implementation of a Buffett rule in Australia.

Very high income earners in Australia are currently able to structure their financial affairs in a way that substantially reduces the amount of income tax they pay. In some instances people earning more than a million dollars in just one year can avoid paying income tax altogether. This means that other tax payers must pay more in order for the government to provide the same amount of services to society.

Such a system is inequitable as people on lower incomes do not have the flexibility to take advantages of many of these tax loopholes. They also cannot afford to pay the substantial sums of money required to manage their tax affairs in this way.

While it is important for governments to continue to close tax loopholes, a Buffett rule reduces the value to very high income households of pursuing these tax loopholes.

Modelling commissioned by The Australia Institute estimates that $2.5 billion per year would be raised from a Buffet rule tax arrangement in Australia. This would apply only to very high income earners. This tax simply allows Australia’s progressive income taxation system to operate in the way in which it was intended. That is taxing high income earners at higher rates than low income earners.

Appendix A

STINMOD, or the Static Income Model, is a microsimulation economic model developed by the National Centre for Social and Economic Modelling (NATSEM), which is used to simulate the effects of changes to policy on Australian household incomes. The model allows for detailed assessment of changes to differing levels of specificity, ranging from a population, to a cohort, to a group of individuals, to a household, and to individuals.

The model is static as it does not assess its dependent variables across more than one period. This means it does not take into consideration behavioural change, and instead gives 'day after' impacts of a change to the government's system of tax and transfers. In other words, the model's primary focus is on the initial change, rather than change on change.

The model's database is based on data from the Australian Bureau of Statistics, in particular the Household Income and Expenditure Survey and other related catalogues. STINMOD categorises its basefiles into demographic, income and household composition, which allows the modeller to simulate multivariate impacts of policy change. The model is regularly updated for income and population changes, and the parameter datasets of income source are adjusted with policy changes.

The model simulates the adjusted household income in response to exogenous changes, or shocks, in both entitlement and liability, which produces outputs that give indications to the topline and distributional effects of that change on the population. Because of the microsimulation foundations of the economic model, STINMOD can granulate the results to focus on "cameos", or effects on targeted specific groups, as well as estimating broader effects.

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