

TITLE: What the rich would do to avoid tax

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PUBLICATION: Australian Financial Review

PUBLICATION DATE: 16/07/2013

LINK:

http://www.afr.com/p/opinion/what_the_rich_would_do_to_avoid_YDdhxWIRNLI2KqOuR52EO

Is economics a science?

When we teach economics students, we usually tell them that they are learning about “the science of the efficient allocation of scarce resources”. But when we listen to public debate, often economists don’t sound very scientific. While it is often said that science can’t proceed without failure, it’s rare to hear an economist admit that they were wrong.

If this is the case, how can we economists expect to be taken seriously when taking part in policy debate?

Consider this claim made recently by professor Judith Sloan: “I have worked it out. Let’s think about the top 1 per cent. If you imposed a 75 per cent average tax rate ... you would only raise between \$20 million and \$30 million. It is just peanuts.”

Is such a claim scientific? Can it be verified or rejected? Are her “calculations” even close to describing the reality of the Australian tax system?

According to the Australian Taxation Office, the top 1 per cent of income earners made about \$59 billion in 2010-11, the latest year for which there is data. If that income was taxed at an average 75 per cent, the tax paid would be \$44.4 billion which, compared with the \$23.5 billion actually paid, would give an increase of \$20.9 billion in tax revenue. That is about 1000 times as much as Professor Sloan “calculated”.

Put another way, if you wanted to collect an additional \$20 million from the top 1 per cent of income earners then you would only need to increase the top tax rate by 0.1 per cent.

The potential revenue from an increase in the tax rate payable by the top 1 per cent of income earners cited above is based on the assumption that there is no “behavioural response”. That is, the numbers assume that high income earners will not significantly alter their working or earning habits.

While it is of course possible that the wealthy would rather be poor – or rather live overseas – than pay higher taxes, it is highly unlikely that a 0.2 or a 0.5 per cent increase in the top tax rate would drive much change. Indeed, the recent NDIS levy of 0.5 per cent is projected to deliver around \$3 billion per year. That's about 100 times as much as Professor Sloan thought would be raised by a much larger tax increase.

THE REVERSE SITUATION

We can reverse engineer Professor Sloan's result.

To get the almost-no-tax-revenue-change she describes, pretax earnings for the top 1 per cent would have to fall from \$59 billion to \$31.3 billion. After tax, their incomes would fall from \$35.5 billion to \$7.8 billion. Are they really that determined to avoid paying tax?

Professor Sloan appears to believe that the work ethic of the rich is incredibly sensitive to their income – give them a percentage cut in their remuneration and their work effort declines by an even bigger percentage. Imagine the head of one of our top 50 companies telling their board that because of a tax increase they will be working a lot less.

Of course it would be an error to ignore behavioural responses to policy change, but exaggerating them enormously in this case is likely to be far more misleading.

When Professor Sloan made the claim that a massive increase in tax would collect only “peanuts”, I was sitting across from her on a stage in a debate organised by the St James Ethics Centre.

In front of around 800 people, in a debate which was televised and can be viewed online, I said that Professor Sloan was completely wrong in her calculations. I bet her “a bottle of the best wine I could find” that a tax of 75 per cent would collect “bucketloads” more than the \$20 million to \$30 million she described. A bet she can be heard to accept.

One of us is completely wrong. One of us owes the other a great bottle of wine. But is economics scientific enough to decide who?

Economics can and should play an important role in the development and discussion of public policy. But if economists can disagree by three orders of magnitude about the likely impact of a policy, or they can't admit when they are wrong, then they will add little more to the public debate than confusion and newspaper copy.

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