

THE TAX REFORM CHALLENGE

Australian Parliamentary Library Lecture

Parliament House, Canberra

21st September 2011

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Introduction

When Niccoló Machiavelli wrote (originally in 1515) that “there is nothing more difficult to plan, more doubtful of success, nor more dangerous to manage than a new system - for the initiator has the enmity of all who would profit by the preservation of the old institution and merely lukewarm defenders in those who gain by the new ones”, he wasn’t referring specifically to taxation reform.

But he might well have been. That’s because once a taxation system has been around for any length of time, it’s inevitable that some of its characteristics – most notably, the favourable treatments which it confers on particular forms of income or expenditure relative to others, on particular types of business organization relative to others, or on particular categories of investment or economic activity relative to others – will become ‘capitalized’ into prices, or will in some other way have become valuable in their own right. And those who have derived some benefit, relative to others, from those characteristics of the taxation system will be staunch and unremitting in their defence of them; while those who have gained little or nothing from them, or who have indeed been disadvantaged in some way by them, though more numerous, will tend to say little.

I was somewhat surprised to have received an invitation to attend next month’s ‘Tax Forum’, since those whose task it was to determine who received invitations must surely have been aware that I would want to talk about some of the things that the Government would prefer that no-one did, such as the base and rate of the goods and services tax, the tax status of income paid by superannuation funds to people over 60, and ‘negative gearing’. I therefore want to acknowledge Treasurer Wayne Swan’s generosity of spirit in nonetheless inviting me to the Tax Forum.

My point of departure for any discussion about taxation reform the ‘canons’ of good tax design that were first laid out by Adam Smith (in 1774), namely, that (in his words):

- (i) “The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is in proportion to the revenue which they respectively enjoy under the protection of the state,
- (ii) The tax which the individual is bound to pay ought to be certain and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor and to every other person,
- (iii) Every tax ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the contributor to pay it, and
- (iv) Every tax ought to be so contrived as to take out of the pockets as little as possible, over and above that which it brings into the public treasury of the state.”

That is, the taxation system should ideally be *equitable* as between taxpayers and *certain* in its impact on each of them, *simple* to comply with, and *parsimonious* in its costs of administration and collection. As Neil Warren showed in his lecture here last week, these principles have been endorsed and upheld by a succession of inquiries into and official pronouncements upon the Australian taxation system over the last thirty five years.

I would add to Adam Smith’s canons two other principles which seem to me to make sense in today’s times:

- (v) the taxation system should neither preference nor penalize some types of income or expenditure, some categories of citizens or taxpayers, some forms of business organization, or some saving or investment vehicles over others, unless there is a clearly stated public policy rationale for doing so, and

- (vi) the taxation system should have regard to the possible consequences (including for the level of investment, labour force participation and economic activity, and for the amount of revenue collected) of substantial differences between Australia's taxation system and the taxation systems of other countries with which Australia has significant (or potentially significant) economic interactions.

That is, the taxation system should also ideally be, as far as possible, *neutral* as between the choices which taxpayers make as to how they earn and spend their income, how they constitute their businesses, and how and where they choose to invest their capital – unless there is some clear public policy objective served by having the taxation system treat some particular category of spending, or form of economic activity favourably or unfavourably, as for example in the case of taxes on tobacco products, alcoholic beverages or gambling, or in the case of tax breaks for long-term savings for retirement.

And the tax system should have regard to considerations of *international competitiveness*, and the possible effects of significant divergences between Australia's tax system and that of other countries on our capacity to attract or retain human or financial capital – which is not to say that there should be no such divergences, but simply that we should be aware of any possible consequences that such divergences may have, and be sure that those consequences are outweighed by the benefits (as we see them) of those divergences.

Australia's overall tax collections are neither 'excessive' nor manifestly 'insufficient'

I don't propose to say anything substantial here about the *overall level* of taxation in Australia. It's well known that by comparison with other OECD countries Australia's total taxation collections are very low: according to the most recent compilation taxes amounted to 27.1% of Australia's GDP in 2008, lower than all but five other OECD countries – the United States and Korea (for whom the proportion of GDP collected in taxation was less than 1 percentage point lower than in Australia), and three of the OECD's 'least developed' economies, Turkey, Chile and Mexico – and well below the (unweighted) OECD average of 34.8%.

In passing I would note that the proportion of GDP collected in tax by governments in the United States in 2008 was some 13 percentage points below the level of spending by those governments as a share of GDP in that year, so the commonly-made comparisons between Australian and US taxes is hardly one between apples and apples.

I would however also note that if one adds to official taxation collections some of the payments which are made more or less compulsorily by households for purposes which, in many other OECD countries are paid for through taxes, such as employer superannuation contributions (which amounted to about 5¾% of GDP in 2007-08) and private health insurance premiums (just over 1% of GDP), then the resulting total is not significantly below the OECD average.

So I would conclude that there is no compelling case, based on comparisons with other OECD countries, that the total level of taxation collected by Australian governments (on average over the course of the business cycle) should be either much lower or much higher than it is at present.

But Australia's taxation system is a long way from 'ideal'

However I would argue that the Australian taxation system departs, in some cases egregiously, from all of the principles of good tax design that I spelled out a few moments ago.

I've previously said elsewhere that if you were the newly installed Treasurer or Finance Minister of some newly-independent nation and that for some reason you hired a consultant to advise you how to create a taxation system that encouraged the accumulation of wealth through borrowing and speculating, whilst penalizing the accumulation of wealth through working and saving, the consultant would hand you a copy of the *Australian Income Tax Assessment Act* – because that's precisely what Australia's income tax system (in particular) does.

It imposes the highest rates on wage and salary income – that is, income from *working* – and on income from the most common forms of *saving* (bank, building society and credit union deposits). By contrast, Australia's tax system taxes income from investments (other than deposits) at substantially lower rates than identical amounts of income when derived from working. And if those investments are funded wholly or partially by debt, it provides a subsidy which serves to reduce the amount of tax payable on the income from those investments even further.

For most people on relatively high wage or salary incomes, tax rates aren't as high as they used to be, as a result of the substantial increases in the thresholds at which the top rate becomes payable that were implemented during the last term of the Howard Government. However, for people lower down the income scale, the interaction of the income tax system with the income tests on various forms of social security payments can result in them facing effective marginal tax rates considerably above those paid by those earning the highest incomes – in some cases of over 60%, according to the Henry Review (2010, Volume 1: 21). These high effective marginal tax rates can, and according to at least some research do, adversely affect the willingness of some people, especially women with children, to enter paid employment.

By contrast, the Australian income tax system provides substantial incentives for people to borrow in order to acquire property, shares or other assets whose value they expect to increase over time. Unlike in most other countries, it's always been possible in Australia to deduct any excess of interest payments on loans taken out to fund an investment over the income produced by that investment in order to reduce the tax payable on wage or salary income. Since the Howard Government's decision, in 1999, to tax capital gains at half the rate applicable to the same amount of wage and salary income, a decision which was supported by the then Opposition, 'negative gearing' has become a means not only of deferring tax, but also permanently reducing it.

The Henry Review (2010, Volume 1: 67) demonstrated that the real (ie, after inflation) effective marginal rate of tax on savings varied from negative on highly geared investment properties and superannuation savings by top-rate taxpayers to almost 80% on bank deposits.

I will say more about 'negative gearing' later on in this talk. For now, however, I simply wish to make the point that a tax system which imposes its highest effective rates of tax on the income of relatively modestly-paid workers and on the forms of saving most commonly used by people on relatively modest incomes, while providing *de facto* subsidies to investment vehicles most commonly used by people on relatively high incomes, can hardly be considered either 'equitable' or 'neutral'.

A tax system which over two-thirds of taxpayers feel they can't comply with without the assistance of an agent – a higher proportion than any other OECD country except Italy (Henry 2010, Volume 1: 6) – could hardly be considered 'simple' (or, for that matter, 'certain in its impact).

And taxes such as the GST which cost the Tax Office \$1.36 to collect for every \$100 of revenue raised (compared with 94¢, on average, for other taxes) can hardly be considered 'parsimonious in their costs of collection and administration (and that's without taking account of the compliance costs incurred by taxpayers themselves).

So if 'idealism' has any meaning at all, there is a compelling case for further substantial reform of the Australian taxation system. And of course the Henry Review made one.

Of course, idealism doesn't get you very far in Australian politics these days, and as I observed at the beginning of this talk the quote from Machiavelli's *The Prince* is particularly applicable in the context of tax reform, since it is by definition impossible to 'do' tax reform – as distinct from tax cuts – without creating losers as well as winners. And the Australian political system (and the Australian media) nowadays give much greater prominence to the concerns of losers – whether 'deserving' or 'undeserving' – from any public policy change than they do to those of winners (as I learnt, to give a different example, from more than five years of presiding over the distribution of the Tasmanian Government's grants to arts organizations).

In addition, it's not possible at the moment, nor is it likely to be possible in the next few years, for governments to 'do' tax reform the way the Howard Government did it in 2000, by drawing upon a large budget surplus to over-compensate massively those who would otherwise be adversely affected by proposed tax reforms.

And that, presumably, is one of the reasons why the Treasurer has ruled out consideration of some of the things that I personally think *should* be on the agenda at next month's Tax Forum, and also why when the Shadow Treasurer Joe Hockey earlier this year proposed some other things that *should* be part of any serious discussion of tax reform (such as the tax status of trusts), he was promptly slapped down by a number of his colleagues, and by his Parliamentary Leader.

Nonetheless, since I think these things should be on the tax reform agenda, and because I may not get the chance to talk about them at the Tax Forum, I am going to talk about some of them now.

The rate and base of the goods and services tax

It does seem to me particularly extraordinary that consideration of the rate and base of the GST should be completely *verboten* by both sides of politics. It was the Coalition that brought it in originally, and they wanted to impose it on a broader base than it applies to at present. And the Labor Party's fraternal colleagues in Europe – where the value added tax or VAT as it is known in that part of the world was specifically devised by 'social democratic' parties in order to pay for the Western European welfare state – seem perfectly happy to preside over GSTs that impose rates of no less than 15%, in most cases of at least 20%, and in three cases of as high as 25%.

It's true that (as I noted earlier), the GST is an expensive tax to collect. But its relatively high collection costs are in large part the result of the 'boundary issues' that arise from the exemptions from it – the need to determine whether, as Justice Richard Edmonds of the Federal Court pointed out earlier this month, Italian mini ciabatta is a 'cracker' (and therefore subject to GST) or 'bread' (and therefore exempt from it). New Zealand's GST has almost no exemptions, and it is much cheaper to administer.

As the Henry Review pointed out (Volume 1: 286), 'a narrower GST does not make it fairer, but adds complexity'. The highest-income quintile (fifth) of Australian households spend almost six times as much on GST-free food as the lowest-income quintile: as a result, more than one-third of the \$6 billion of revenue foregone as the result of the exemption of food from the GST benefits households in the top 20% of the income distribution.

Moreover, the exemption of some 40% of (total, ie household and government) consumption from the GST is adding to the financial pressures facing State and Territory Governments as a result of the significant slowing in consumer spending growth in recent years.

As noted in this year's Budget Papers (Australian Government 2011: 5-15), expenditure on items subject to the GST is declining both as a share of GDP and as a share of consumption spending, in part because prices of goods and services not subject to the GST have been rising at a faster rate than prices of goods and services which are subject to the GST.

If these trends continue – and it's hard to think of compelling reasons why they won't – it would seem inevitable that the Federal Government is going to have to increase the rate or base of the GST (or both), or that State and Territory Governments will have to jack up the limited number of narrow and inefficient taxes under their control, in order to ensure that waiting lists at public hospitals, class sizes in public schools, and crowding on public transport don't increase beyond politically tolerable limits.

And, really, the choice between those two options is surely a 'no-brainer'. And as the Government is now doing with its proposed carbon tax, it is perfectly possible to compensate those lower-income households who would be adversely impacted by an increase in the rate or base of the GST through the income tax or transfer payment systems.

'Negative gearing'

Among the more egregious instances of how the Australian taxation system departs from principles of good tax design such as fairness and simplicity – and, I would argue, also departs needlessly from considerations of international competitiveness – is the way in which it allows the costs associated with financing an investment to be offset not only against the income produced by that investment, but also against other income, through what is popularly known in this country as 'negative gearing'.

It is perhaps a telling indication of just how generous Australia's tax system is to investors in this regard, compared with those of other countries, that one usually needs to explain to foreigners what the term 'negative gearing' actually means (see for example RBA 2003: 40-45).

'Negative gearing' originally allowed taxpayers in effect to *defer* tax on their wage and salary income (until they sold the property or shares which they had acquired with borrowed money, on which they were paying more in interest than they received by way of dividends or rent). However, after the Howard Government's 1999 decision to tax capital gains at half the rate applicable to other income (instead of taxing inflation-adjusted capital gains at a taxpayer's full marginal rate), 'negative gearing' became a vehicle for *reducing* as well as deferring tax liabilities. And the availability of depreciation on buildings adds to the way in which 'negative gearing' converts ordinary income taxable at full rates into capital gains taxable at half rates.

It's therefore hardly surprising that 'negative gearing' has become much more widespread over the past decade, and much more costly in terms of the revenue thereby foregone.

In 1998-99, when capital gains were last taxed at the same rate as other types of income (less an allowance for inflation), Australia had 1.3 million tax-paying landlords who in total made a taxable profit of almost \$700mn. By 2008-09, the latest year for which statistics are presently available, the number of tax-paying landlords had risen to just under 1.7mn: but they collectively lost \$6.5bn, largely because the amount they paid out in interest rose almost fourfold (from just over \$5bn to almost \$20bn over this period), while the amount they collected in rent 'only' slightly more than doubled (from \$11bn to \$26bn), as did other (non-interest) expenses. If all of the 1.1mn landlords who in total reported net losses in 2008-09 were in the 38% income tax bracket, their ability to offset those losses against their other taxable income would have cost over \$4.3bn in revenue foregone; if (say) one fifth of them had been in the top tax bracket then the cost to revenue would have been over \$4.6bn.

This is a pretty large subsidy from people who are working and saving to people who are borrowing and speculating (since those landlords who are making 'running losses' on their property investments expect to more than make up those losses through capital gains when they eventually sell them).

And it's hard to think of any worthwhile public policy purpose which is served by it. It certainly does nothing to increase the supply of housing, since the vast majority of landlords buy established properties: 92% of all borrowing by residential property investors over the past decade has been for the purchase of established dwellings, as against 82% of all borrowing by owner-occupiers.

Precisely for that reason, the availability of 'negative gearing' contributes to upward pressure on the prices of established dwellings, and thus diminishes housing affordability for would-be home buyers.

Supporters of 'negative gearing' argue that its abolition would lead to a 'landlord's strike', driving up rents and exacerbating the existing shortage of affordable rental housing. They repeatedly point to what they allege happened when the Hawke Government abolished negative gearing (only for property investment) in 1986 – that it 'led' to a surge in rents, which prompted the reintroduction of negative gearing in 1988.

This assertion is actually not true. If the abolition of 'negative gearing' had led to a 'landlord's strike', as proponents of 'negative gearing' repeatedly assert, then rents should have risen everywhere (since 'negative gearing' had been available everywhere). In fact, rents (as measured in the consumer price index) only rose rapidly (at double-digit rates) in Sydney and Perth. And that was because in those two cities, rental vacancy rates were unusually low (in Sydney's case, barely above 1%) before negative gearing was abolished. In other State capitals (where vacancy rates were higher), growth in rentals was either unchanged or, in Melbourne, actually slowed.

However, notwithstanding this history, suppose that a large number of landlords *were* to respond to the abolition of 'negative gearing' by selling their properties. That would push down the prices of investment properties, making them more affordable to would-be home buyers, allowing more of them to become home-owners, and thereby reducing the demand for rental properties in almost exactly the same proportion as the reduction in the supply of them. It's actually quite difficult to think of anything that would do more to improve affordability conditions for would-be homebuyers than the abolition of 'negative gearing'. It would certainly do more than continuing to give large amounts of cash to would-be first-time homebuyers through grants or stamp duty concessions, which historically have served only to increase the prices of existing dwellings and ended up in the pockets of vendors.

There's no evidence to support the assertion made by proponents of the continued existence of 'negative gearing' that it results in more rental housing being available than would be the case were it to be abolished (even though the Henry Review appears to have swallowed this assertion).

Most other 'advanced' economies don't have 'negative gearing': yet most other countries have higher rental vacancy rates than Australia does. In the United States, which doesn't allow 'negative gearing', the rental vacancy rate has in the last 50 years only once been below 5% (and that was in the March quarter of 1979); in the ten years prior to the onset of the most recent recession, it has averaged 9.1%. Yet here in Australia, which does allow 'negative gearing', the rental vacancy rate has never (at least in the last 30 years) been above 5%, and in the period since 'negative gearing' became more attractive (as a result of the halving of the capital gains tax rate) has fallen from over 3% to less than 2%. During that same period, rents rose at rate 0.8 percentage points per annum faster than the CPI as a whole; whereas over the preceding decade, rents rose at exactly the same rate as the CPI.

I'm not advocating that 'negative gearing' be abolished for property investments only, as happened between 1986 and 1988.

That would be unfair to property investors. Personally, I think 'negative gearing' should be abolished for all investors, so that interest expenses would only be deductible in any given year up to the amount of investment income earned in that year, with any excess 'carried forward' against the ultimate capital gains tax liability, rather than being used to reduce the tax payable on wage and salary or other income (as is the case in the United States and most other 'advanced' economies).

But I'd settle for the recommendation of the Henry Review (Volume 1: 72-75), which was that only 40% of interest (and other expenses) associated with investments be allowed as a deduction, and that capital gains (and other forms of investment income, including interest on deposits) be taxed at 60% (rather than 50% as at present) of the rates applicable to the same amounts of wage and salary income.

This recommendation would not amount to the abolition of 'negative gearing'; it would just make it less generous than it is at the moment. It would be likely, as the Henry Review suggested, 'to change investor demand toward housing with higher rental yields and longer investment horizons [and] may result in a more stable housing market, as the current incentive for investors to chase large capital gains in housing would be reduced'.

I could even accept the Henry Review's recommendation that 'these reforms should only be adopted following reforms to the supply of housing and reforms to housing assistance' which it makes elsewhere, even though (as I've argued earlier) I disagree with the Henry Review's concern that these reforms 'may in the short term reduce residential property investment' (emphasis added).

The tax treatment of trusts

There are over 270,000 trusts in Australia (Henry Review Volume 1: 209). People use them for all sorts of purposes, including ensuring the smooth transfer of business assets (particularly those used in primary production) from one generation of owners to the next, protecting assets from vengeful ex-spouses and other aggrieved relatives, and so on – and there is nothing illegitimate about that. However the use of trusts also often confers significant tax advantages, particularly by allowing income to be split among family members (although the most recent Budget significantly reduced the opportunity to divert trust income to children).

Although the Howard Government gave serious consideration to taxing trusts as companies, and more recently Shadow Treasurer Joe Hockey advocated the same idea, the Henry Review was surprisingly lukewarm towards this and other propositions to reduce the tax advantages which can be availed of by people who operate their business activities through trusts (Volume 1: 84-85 and 185-191). In particular, the Henry Review's assertion that further limiting the opportunities to 'alienate savings income' through trusts would have 'potential downsides ... for the overall progressivity of the tax system and for other taxpayers' (Volume 1: 84) is hard to understand (and the Review doesn't give reasons for it). Nor is it at all clear why the Review thought that taxing trusts as companies 'would be poorly targeted' (Volume 1: 85).

I remain of the view that no tax advantages should accrue to users of trusts (and that's despite the fact that I now have one myself), and that the existence of trusts should be of no effect for tax purposes. Changing the tax system to that end would have no impact on the ability of people to use trusts for the entirely legitimate purposes I've just mentioned; but it would enhance the fairness and integrity of the tax system.

The taxation of superannuation payments

One of the worst taxation decisions made in the past 20 years (and there's a fair bit of competition for this 'honour', in my opinion) was the decision announced in the 2006 Budget to exempt entirely from income tax superannuation benefits paid to people aged 60 and over. This was presented at the time as a 'dramatic simplification' of the tax system as it applies to superannuation, and as an incentive to continue working at older ages (Australian Government 2006: 1-10). Again I should note in passing that this was a decision from which I expect to benefit personally, in due course.

Coming after the introduction of the so-called 'Senior Australians Tax Offset' (or SATO) which allows people of pension age to pay less tax on a given amount of income than younger people, for no reason other than that they are of pension age.

Clearly, both sides of politics think there are votes to be had in providing tax breaks for older folks, since both these measures were introduced by the Coalition, while the present Government explicitly precluded the Henry Review from even considering the tax-free status of superannuation payments to 60-and-overs – although that didn't stop the Review from observing that 'income from work should be taxed on a more consistent basis, whether it comes from wages and salaries, fringe benefits *or superannuation contributions*, and noting that 'superannuation benefits from a taxed source for people aged 60 are more' are 'not directly from work but have similar characteristics' (Volume 1: 37-38, emphasis added); or that the SATO should be removed and replaced as a transitional measure with an offset that takes account of the Review's proposed new scales and that the new offset should be 'reduced over time' (Volume 1: 34).

However, I can think of no legitimate public policy objective which justifies some people paying less tax than others on the same amount of income purely because of their age. And I would add that the cost of these tax breaks for old folks will continue to increase over time, as a result of demographic change, thereby increasing the burden on other taxpayers.

That's not to say that I'm opposed to simplification of the way in which superannuation savings are taxed. Nor am I against superannuation savings being preferentially taxed relative to other forms of saving, because encouraging greater self-provision for retirement, and the growth of pools of 'patient capital' are legitimate public policy objectives.

However I also don't believe it's necessary for the tax system to be as generous as it currently is, especially to high-income earners, in order to achieve those legitimate public policy objectives. I think there's a very good argument on fairness grounds for converting the 15% rate currently applicable to superannuation contributions and earnings by superannuation funds into a 15% rebate on the tax otherwise payable (at each taxpayer's marginal rate) on income in those forms.

Taxation of 'resource rents', and business income more generally

One of the few recommendations of the Henry Review which was taken up immediately (or, at least, at the same time as the Review was released having been kept under wraps for almost six months after it was handed to the Government) was that for a resources rent tax, which Kevin Rudd, in keeping with his love for acronyms, dubbed the 'RSPT' or 'Resources Super Profits Tax'.

This proposal was, in my view, poorly conceived, in particular because it relied on the commercially unrealistic assumption that financiers would regard as credible a Government promise to repay investors for 40% of their stake in failed mining ventures, in exchange for taking (in addition to the company tax ordinarily payable) a 40% share of the profits of successful ones.

That would have required financiers to believe that, amidst a slump in commodity prices (the most plausible scenario under which there would be a lot of failed mining ventures), when the government would likely be running a large budget deficit, it would willingly add to that deficit by handing over billions of dollars to investors in failed mining ventures. I think that's less likely than that Tasmania will get its own team in the Australian Football League while Andrew Demetriou remains its CEO than that a future government would honour such a promise in such circumstances.

However, the *principle* underlying the Henry Review's recommendation - namely, that the return to the Australian people from the exploitation of mineral and energy resources should be based on the profits derived from the extraction and sale of those resources, rather than on the volume of resource production - is one that I (and most other economists) strongly support. And I think it's regrettable that, in the backlash against the poorly conceived and badly sold 'RSPT', the Government has backed down to the point of imposing tax at barely more than half the rate initially proposed, and will apply it to only two minerals, coal and iron ore. Why, for example, shouldn't gold-mining be brought within this taxation regime now that gold is trading at not far below US\$2,000 per ounce?

I would have thought there are two other proposals that could usefully be considered here.

The first is simply to extend the existing Petroleum Resource Rent Tax arrangements - which have been applied to offshore oil and gas projects since the 1980s, and which clearly haven't acted as a deterrent to what has become a very substantial amount of investment in the oil and gas sector - to onshore mining ventures.

The second is simply to stipulate that, for as long as the 'mining boom' lasts (and it would be possible to define that by reference to the Reserve Bank's commodity price index, or the 'terms of trade', being above some prescribed level such as its value in, say, the 2004-05 financial year), the company tax rate on income from mining will be, say, 33% - and, perhaps, that the company tax rate on income from all other activities will be, say, 27% - or whatever combination of higher and lower rates than the current 30% produces a revenue-neutral outcome.

There's a precedent for this in the exemption that applied to income from gold-mining from the 1930s until the early 1990s - if it is possible to apply a tax rate of zero to income from a particular form of mining, and a different rate to company income from all other sources, then it surely should be possible to impose one tax rate on income from mining of all types and a different rate on income from all other sources.

There's also a precedent in the present Government's proposal to apply a lower rate of company tax to small companies than to larger ones (a proposal which, incidentally, I don't support - I don't see any legitimate public policy reason why small businesses should pay tax at a lower rate than large ones, any more than I see a legitimate public policy reason why old people should pay tax at a lower rate than young people).

It is possible that mining companies could seek to avoid a higher rate of company tax by conducting profitable non-mining activities through other entities, and other forms of 'transfer pricing' (eg, attributing to their mining businesses costs which are actually incurred for other purposes). However I don't see that it would be any greater a problem with this proposal than it is with company tax more generally, and the ATO already has various tools available to monitor the incidence of 'transfer pricing' and respond where it has grounds to believe that avoidance is taking place.

I think that either of these approaches would be both more practical and more 'saleable' than the 'Minerals Resource Rent Tax' which the Government is now proposing.

State taxes

The last area that I propose to discuss today is that of State taxes. As Australia's second Prime Minister Alfred Deakin predicted almost 110 years ago, the Constitution (and the way in which it has been interpreted by the High Court) left the States 'legally free, but financially bound to the chariot wheels of the Central Government (La Nauze 196: 347). The States' and Territories' revenue-raising capacities fall short of their expenditure responsibilities by a margin that has few if any parallels among other federal systems.

Moreover the taxes which the States and Territories are constitutionally able to impose are, for the most part, ones which fall foul of almost all of the principles of good tax design which I mentioned at the beginning of this talk.

Of course, the States and Territories haven't helped their situation by mismanaging the tax powers which they do have:

- in the case of payroll tax, their largest 'own' revenue source, they have, for most of the period since it was transferred to them by the McMahon Government in the early 1970s, narrowed the base (in order to curry favour with small business owners) and raised the rate (in order to offset the loss of revenue that would otherwise have resulted) – the opposite of what good tax reform should be all about;
- States and Territories have similarly narrowed the base of stamp duties and land tax (their second and third largest 'own' revenue sources) in order to curry favour with first-home buyers and home-owners more generally – thereby, I might add, adding to upward pressure on housing prices (since these tax breaks invariably get capitalized into the price of land) without doing anything to increase home ownership rates – and necessitating higher rates of tax on those not so favoured;
- States and Territories 'gave away' death duties in the late 1970s and 1980s, in what ultimately amounted to a 'zero sum game' as far as each State or Territory was concerned but deprived all States and Territories of a tax source that meets most of the afore-mentioned criteria except that of simplicity; and
- States and Territories have never actively pursued regaining the income tax powers of which they were stripped 'temporarily' for war-time purposes in the 1940s.

I don't have the same concern with payroll taxes as many others. Australian payroll taxes are lower than the payroll taxes or, as they're generally called in Europe, 'social security taxes' that typically fund all or part of many OECD countries' pension or health care systems. And despite their allegedly adverse effects on job creation, they haven't prevented Australia from attaining and remaining pretty close to full employment in recent years.

However I agree with the Henry Review (among others) that stamp duties and insurance taxes are very bad taxes. Although they are relatively simple and certain to collect, they offend all of the other principles of good tax design I mentioned earlier. Stamp duties, in particular, discourage the construction of new dwellings, and inhibit people from moving location in order to obtain new or better employment (and hence detract from the efficiency of the labour market). They are also inequitable as they result in people with similar incomes and wealth paying different amounts of tax because they buy and sell a taxed good more or less frequently. Finally because they are taxes on the volume of transactions the revenue from them is highly volatile, and can lead State and Territory Governments into unsustainable fiscal positions.

I think there's a strong case, based on the principles of good tax design, for abolishing stamp duties entirely and replacing them with a more broadly-based land tax which includes owner-occupied properties (and which could be collected by local governments in exchange for a small commission, thereby allowing State Governments to abolish their revenue offices if they also outsourced the collection of payroll taxes to the ATO). Low-income owner-occupiers such as retirees could be catered for by allowing them to defer land taxes as a charge against their estates (as some local governments already do with municipal rates), although one can imagine the howls of protests from the would-be inheritors of otherwise unencumbered properties at this suggestion. Obviously there would need to be some transitional arrangements for people who had recently purchased properties to ensure they weren't unfairly taxed twice, but they would not be too difficult to devise.

State and Territory insurance taxes are high by international standards, and are 'one of the least efficient taxes available to the States' (Henry Review, Volume 2: 472-3). They encourage 'under-insurance' – and to the extent that lower-income households are more likely to 'under-insure' they are inequitable for that reason. Where they are used to fund, for example, fire or ambulance services, they are also unfair in the sense that those who take out the form of insurance subject to tax for that purpose in effect subsidize those who choose not to, without there being any public policy rationale for such a cross-subsidy.

However they do raise nearly \$5bn in revenue for State and Territory Governments. The best way to pay for their abolition would be as part of a 'reform package' incorporating a broadening of the base and/or an increase in the rate of GST.

One final point I want to make under the heading of State taxes is to express dismay at the prospect of substantial changes to the way in which the revenues from the GST are carved up among the States and Territories. The Gillard Government obviously expects the review which it has commissioned of those arrangements to recommend changes which will favour the larger States – otherwise it wouldn't have appointed to conduct it a former Premier of each of the two largest States, both of whom are on the record as favouring changes to those arrangements which would benefit New South Wales and Victoria, balanced only by an accountant from Adelaide.

Yet I would have thought that if the Government really believes that it is important to ensure that the benefits of the mining boom are fairly shared – that, as Wayne Swan put it in the third sentence of his Budget Speech, 'national prosperity reaches more lives, in more corners, of our patchwork economy' – then the last thing it should be contemplating is making fundamental changes to a system which in effect redistributes income from rich States to poor ones. Nor do I understand what it is about such a system which is so troubling to a Labor Government which, one might have thought, believed almost instinctively that redistributing income from rich to poor was a Good Thing.

I readily acknowledge that Australia takes the practice of horizontal fiscal equalization much further than other federal systems. But that's one of the reasons why the difference in living standards between Tasmania and Western Australia is a lot less than the corresponding difference between, say, Mississippi and Connecticut, or between Newfoundland and Alberta –something from which I would have thought most Australians take some comfort.

It's particularly galling to see Western Australia, which for most of the 78 years since the Commonwealth Grants Commission was established (after Western Australia voted to secede from the Commonwealth) has been a beneficiary of the Commission's recommendations, at the forefront of demands for changes to these arrangements now that it has become a 'net contributor' to the GST pool rather than a 'net beneficiary'. Western Australia's attitude is a bit like that of a pensioner who has won the lottery and complains about losing his pension and having to pay income tax

There has never been any principle that a State or Territory is entitled to all of the revenue from a particular form of taxation raised by the Commonwealth Government within that State or Territory's borders – any more than there is an expectation that State or Territory Governments will spend the revenues from the payroll or land taxes, or stamp duties on land transfers, in the local government areas in which they are collected.

The Western Australian Government in particular doesn't adhere to that principle on its own turf. Since coming to office, the Barnett Government has – at the behest of its junior partner, the WA Nationals – had a policy called 'Royalties for Regions', under which 25% of its income from mining royalties is paid into a fund which is in turn spent on infrastructure, 'strategic regional and community services projects' and 'the provision of contestable grant funding'.

But even though over 80% of these royalties come from the Pilbara, in the north of the State, there is absolutely no requirement that 80% of the monies spent through the 'Royalties for Regions Fund' be spent there. And it isn't: a large proportion of it is spent in the WA Nationals' heartland, to the south and south-east of Perth. So it is the height of hypocrisy for the Western Australian Government to demand that it is entitled to any fixed percentage of the GST revenue collected west of the 129th parallel.

Why bother with tax reform?

I noted earlier that it would be very difficult to achieve much if anything by way of meaningful or substantial tax reform in the near term, because of the seemingly much greater political difficulties nowadays associated with pursuing any reform that creates losers as well as winners, and because of the absence of a fat surplus that can be used to 'over-compensate' the losers. Nonetheless, it is perhaps worth reminding ourselves what could be at stake if Australia doesn't achieve substantial and meaningful tax reform over the medium term.

First, the likelihood is that our tax system will become increasingly dysfunctional in the absence of meaningful reform.

According to the projections contained in this year's Budget Papers, by 2014-15 the various forms of income taxes will account for 74.7% of total Commonwealth Government tax collections, the highest ever recorded, and up from less than 70% in the years immediately after the last round of major tax changes in 2000, one of whose objectives was to shift the 'tax mix' from direct to indirect taxation. Within that total, personal income tax will account for 47.7% of total Commonwealth tax collections, the highest since 2002 (before the Howard Government began cutting personal income taxes in each of its last five budgets). This is likely to generate significant political pressure for income tax cuts, at a time when such tax cuts would likely be unwise on broader macro-economic policy grounds (as the Howard Government's were).

Over the same period, GST revenues are expected to continue to decline to less than 3.3% of GDP, half of one percentage point of GDP less than their peak in the years 2002-03 through 2004-05. This is likely to put further pressure on the finances of State and Territory Governments, especially those of the smaller States and the Territories which are more dependent on GST revenues than the larger States.

Second, as I've argued extensively elsewhere (Eslake and Walsh 2011; Eslake 2011), Australia has a productivity problem: over the past decade, labour productivity growth has averaged just 1.5% per annum, down from 2.1% per annum during the 1990s, while 'multi-factor' productivity growth has slowed from 1.6% per annum during the 1990s to zero over the past decade (and to -1.0% per annum over the past five years).

As a result, as Treasury Secretary Martin Parkinson noted earlier this year, “the rate of improvement in the living standards of Australians, at least that part measured by incomes, has already begun to deteriorate, even with the sustained and unprecedented rise in the terms of trade” (2011: 15). If this productivity slump were to continue, then once the current mining boom comes to an end (whenever that might be), the rate at which Australians’ living standards continue to improve will slow more sharply, and could perhaps even turn negative.

The causes of this productivity slowdown are complex, and there are no simple solutions to it. But tax reform can certainly play a role in reversing it, not least by removing distortions and reducing ‘dead weight losses’ associated with the existing structure of taxes, and by encouraging the movement of labour and capital into activities more capable of generating faster rates of productivity growth rather than into areas which attract favourable tax treatment. The Henry Review estimated that its four major proposed reforms could lift output by 2-3 percentage points, or \$25-40 billion in 2010-11 prices (Henry Review, Overview: xviii and Volume 1: 74).

Third, the distribution of income and wealth in Australia has become less egalitarian over the past decade – not by nearly as much as in the United States (or, for that matter and ironically, the People’s Republic of China), but nonetheless by enough to warrant some consideration in the context of any discussion about tax reform.

According to data released this month by the Australian Bureau of Statistics (2011a, 2011b), the share of ‘equivalized household disposable income’ accruing to the top quintile (fifth) of the income distribution has increased by 1.8 percentage points over the ten years to 2009-10, to 40.2%, while the share accruing to the bottom two quintiles has fallen by 0.5% (to 19.8%). The share of household net worth owned by households in top quintile of the wealth distribution has increased by 3.4 percentage points (to 62.4%) since 2003-04, while the share of net worth owned by the bottom two quintiles has fallen by 0.8 percentage points to 6.3%. And changes to the tax system over the past decade have played some role in these trends. Although the wealthiest fifth of households pay a higher proportion of their income in tax (18.0%) than households lower down the wealth distribution, that proportion has fallen by more than that for households in any other quintile since 2003-04 – by 4.2 percentage points, compared with 4.1 percentage points for households in the second highest wealth quintile, and between 2.5 and 3.6 percentage points for households in the bottom three quintiles.

I have never been, am not now, and almost certainly never will be a ‘socialist’ in the traditional sense of that term, one who places an absolute priority on achieving greater equality in the distribution of income and wealth. However, I’m also conscious that widening inequalities in income and wealth distribution, beyond some point, can have adverse economic as well as social consequences – including, as we’ve seen in the United States over the past two decades, unsustainable increases in the level of household debt, as households whose incomes have stagnated or declined in real terms (while those of a tiny minority have continued to grow apace) borrow in an attempt to maintain levels of consumer spending that their incomes can no longer support.

Of course, whether arguments such as these can serve as sufficient reason for political leaders to put substantial and meaningful tax reform back on the political agenda remains to be seen. Sadly, I am not holding my breath.

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