

Australian Tax Reform
Public Policy Foundations and Challenges

Keynote address to the Australasian Tax Teachers Association Annual Conference
University of NSW
21 January 2016.

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SLIDE 1 TITLE

SLIDE 2 INTRODUCTION - KEYNES

In this address I have been asked to reflect on where tax policy in Australia has come from and the challenges that the tax system will face in the future.

The tax system that we built over the course of the 20th century was designed to meet the needs of an advanced liberal democratic society. Tax policy was deeply entwined with broader public policy.

Even though the first half of the last century globally was characterised by widespread extremism and populism, leading to great wars and other conflicts, liberal democracy proved resilient and ultimately prevailed.

Keynes in 1926 captured the essence of the liberal democratic task – seeing it as a balancing act.

“The political problem of mankind is to combine three things: economic efficiency, social justice and individual liberty.” J.M. Keynes, *Liberalism and Labour*, 1926

As we see resurgent populism and extremism in the world today – in the face of very challenging financial and economic conditions – I think we continue to face the liberal democratic balancing act identified by Keynes.

SLIDE 3 AUSTRALIAN BALANCING ACT

The key point here is that we can re-weight the elements of this balancing act, but we cannot and must not disregard completely any one of the elements. Australia has been quite innovative in the way it has done this – we have our own ways of achieving results, and we must continue to have the courage and insight to do this.

Tax reforms in the last 20 years of the last century were carefully designed to meet all three goals – and as a result they have ultimately gained support and proven politically sustainable.

Australians have come to embody these elements in their sense of the world

- They are relatively economically literate and understand economic basics
- They long have had quite a strong sense of what is fair, in many dimensions
- They also have a strong individual streak – and expect reward for having a go.

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SLIDE 4 – THREE POLICY MODELS

Three policy models (or structures) lie at the heart of Australian public policy, and hence Australian tax policy.

There can be no full understanding of the Australian tax system without understanding the basic drivers and features of these models.

First, Australia's social policy model, which is characterised by strong effective progressivity, the tight targeting of most social assistance programs, and the associated development of dual public/private human service delivery systems (such as government and non-government schools and hospitals).

- Apart from considerable redistribution through parts of the tax system itself, about \$300 billion (2/3) of our annual tax take is used for the expenditure or transfers side of this model. That is, it is directly or indirectly handed back to the household sector, on a needs basis, as direct cash or as privately consumed services that they would otherwise fully pay for themselves.

Second, Australia's private wealth model, which favours particularly both housing and superannuation, and also includes a dividend imputation system that largely integrates the personal and company tax systems. Much of this model is supported by large tax expenditures – concessional tax rates or exemptions – or reflects a structural half way house between the theoretical concepts of comprehensive income tax and so-called expenditure tax (or is also sometimes likened to a dual tax system treating capital and labour income somewhat differently).

Third, Australia's federation model, which has developed strong versions of both vertical fiscal imbalance and horizontal fiscal equalisation. The features of this model also embody the competing considerations of efficiency, equity and liberty. Although rarely front of mind for many Australians, it is fundamental to the way both our democracy and our social model works. While the Commonwealth role within the arrangements essentially makes possible a degree of spatial equity of access to core public services, the states have become not just service providers on the subsidiarity principle but also service advocates within the overall democratic framework.

SLIDE 5 TAX POLICY CONSEQUENCES

Tax policy analysts and some vested interests often talk of tax in ways that ignore these underlying models. Instead they talk in abstract terms, typically supported by mainstream economics, about simplified tax arrangements based on versions of optimal taxation – often simplified as advocating the meeting of revenue targets through the lowest rate on the broadest base. They sometimes dream of flat rates, which in Australia on the basis of national accounting aggregates could in theory be as low (for current revenues) as 22% on all net incomes and 17% on all private consumption – or perhaps a flat 19-20% on both.

But this is not a feasible, sustainable approach to tax reform. It ignores the central place of the three policy models in the expectations Australians have of public policy. Each of the models has its own strong constituency, often overlapping. In my view, each also has its own strong rationale – even legitimacy – in public policy and hence in tax design.

What that means of course, is that effective tax rates of 40 to 50 percent (or even more) at the margin are inevitable, given revenue needs, since these models together dictate that much of the theoretically potential tax bases are exempt or taxed only lightly.

SLIDE 6 A “NEW TAX SYSTEM”

In 2000, the Australian government introduced what it called “a new tax system”. In substance this touch of hyperbole signified the culmination of the tax reform journey that had been broadly mapped out 25 years earlier with the publication of the Report of the Asprey Taxation Review Committee. The result was a tax system that had somewhat broader bases and lower rates than had existed until the mid-1980s.

These tax reforms were intended to complement, and be part of, a much broader suite of economic reforms giving Australia a more open, flexible and competitive economy.

Broader bases and lower rates in the income taxes (including capital gains and fringe benefits) were a particular focus of the Hawke-Keating government while sales taxes were reformed on similar lines mainly with the introduction of the flat rate GST² by the Howard Government in 2000.

It would be wrong, however, to see the post-2000 Australian tax system as no more than a reflection of the reform mantra of broader bases and lower rates. Rather, while the reforms worked in that direction, the tax system that we have today also reflects the continuing goals of successive governments to support the other key Australian policy systems.

Not surprisingly, after many years of operation of these tax arrangements, significant clientele effects have emerged. For example, Australians hold high levels of wealth in real estate, and our burgeoning superannuation funds hold high levels of domestic (and foreign) equity investment. The holding of debt instruments by local investors is not favoured by Australian tax laws, and so a disproportional share of Australia’s foreign liabilities take the debt form³.

SLIDE 7 THE PROBLEMS NOW

So why do we still talk of tax reform? What has gone wrong since the “new tax system” was introduced?

First, there is evident STRUCTURAL weakness in the robustness of tax revenues – falling as a share of nominal GDP by about 2% of GDP which is \$30b per year. This in part reflects business and individuals responding to the incentives embedded in the existing tax system.

- At the same time, public sector social spending has increased in Australia (and in the OECD generally), which has put increased pressure on the fiscal position of

² Strictly speaking the exemptions and input tax arrangements for certain items means that it is not a flat rate across the board, and second tier taxes (some of which have cascading effects on other areas of consumption) also persist in a range of areas such as tobacco, alcohol, luxury cars, insurance, gambling and fuels.

³ At 30 September 2015, Australia’s net international investment position comprised net debt of \$994 billion (62 per cent of GDP), whereas overseas equity holdings by Australians (especially portfolio investment by superannuation funds) actually exceeded (direct and portfolio) foreign investment holdings in Australia by \$71 billion.

governments. For Australia, the increase in such spending as measured by the OECD has been from 17.2 percent of GDP in 2000 to 19 percent of GDP in 2014.⁴

Second, there have been structural changes in the Australian economy driven by underlying changes in demography, technology and global production patterns. Manufacturing has declined, while mining and some services have increased their economic shares, and this has carried through to have a range of implications for Australia's social, wealth and federation models.

Third, there has been a continuation of the longstanding trend towards greater international factor mobility, particularly for highly skilled employees, intangible property, and financial capital (including for direct foreign investment). With this, there has been some increase in harmful international tax competition, as countries have introduced favourable regimes for intangible capital, notably patent boxes and regimes that facilitate base erosion and profit shifting (BEPS) and several have reduced company tax rates (most notably the UK). This increased international mobility and competition tends to raise the supply responsiveness of tax bases to the taxes imposed upon them, and hence increases the economic efficiency costs of these taxes.

SLIDE 8 POLICY RESPONSE

Faced with the resulting fiscal squeeze, and the constraints of structural change and factor mobility, the choices facing governments essentially challenge the three public policy models underpinning the Australian tax system. The tax reform agenda today is essentially built on these potential adjustment issues, but political leaders have not clearly set out any clear vision of what this might entail.

Should we adjust the social model? There are many alternative approaches, (and they are not mutually exclusive). We could -

- Take something from the bottom – reduce benefit rates, or raise co-payments (some of this was attempted in the 2014 budget package, generating strongly adverse political reactions); or
- Strengthen targeting further – shift even more to means tested client funding models in health, schools, universities – which potentially has implications also for the federation model. The distributional effect of these policies is largely to take from the “middle”; or
- Further increase progressivity – take more from the top. While this has possible implications for the economy, it is in fact the default “do nothing” option via bracket creep, with increases in income taxes the main source of budget repair in the Commonwealth forward estimates. A temporary 2% increase in the top personal rate of income tax also fits this model, as did the now often forgotten 0.5% increase in the Medicare levy to partly fund the national disability insurance scheme⁵; or
- Take from all – most readily by increasing the GST while not fully compensating any group to the extent that extra revenues are required. As we shall see shortly, most of the revenue shortfall has in fact come from declining indirect taxes, so a policy along

⁴ OECD.stats accessed January 2016 at stats.oecd.org/Index.aspx?DataSetCode=SOCX_AGG

⁵ The Medicare levy increase is often forgotten in fiscal discussions – both sides of politics declare their support for no increase in the tax share of GDP compared with the benchmark averages of the early 2000s, which implicitly means that they are promising to hand back the Medicare levy increase through tax cuts rather than apply it to its stated purpose of better disability services.

these lines (if limited in its extent) merely restores the original parameters of the “new tax system”.

Should we adjust the wealth model? Again there are options.

- Some advocate addressing issues in fitness for (retirement) purpose of the superannuation and even housing concessions (particularly in the means tests). I will outline some of these issues a little later. Meanwhile, the additional fiscal costs of ramping up the superannuation guarantee to 12 percent while leaving these design faults was a central concern of the Henry review, and presents as a further threat to fiscal sustainability in years to come.
- There are also issues in whether we should better balance what is effectively a dual tax model for companies. While there is a case for reducing the company tax rate, it is not clear that it is efficient or sustainable to maintain the most generous extensions of the imputation system (such as full refundability of franking credits) or to ignore entirely the potential for maintaining or increasing the tax burden on the substantial location or other immobile rents derived in Australia.
- Others have also identified options for more restrictively treating interest deductions and losses particularly in areas related to property, where tax features (such as the concessional capital gains tax) create unintended benefits⁶.

Is there scope to adjust the federation model?

- At the state/local level, there is scope for reform of both the payroll tax (although reform here might work much better if part of a national reform scheme relating to labour taxation) and for land related taxes (again, probably best seen as part of a broader change in the national tax arrangements relating to property).
- Even more fundamentally, shifts in funding models (including towards a stronger client basis for health and education, and also user charging in roads and transport) are potentially very major agendas as well, where taxes play a part only in much larger policy reform models.

⁶ It is interesting to note that the UK has reduced or eliminated property deductions such as capital allowances as part of its policy reforms, and land taxes in the UK are much more revenue-productive than in Australia.

SLIDE 9 TIMING and OBJECTIVES

The Henry review, conducted in the aftermath of the collapse of Lehmann Bros., warned that these might not be the right times for tax reform. Even now, there is very great global economic uncertainty in the face of unprecedented financial imbalances (continued near zero interest rates and money printing).

Equally, at the political level, we have not won any clear battles on defining what our reform objectives should be.

The policy of “leaving everything on the table”, while understandable and reasonable for a time, means we have made little real progress in getting objectives clear. Some have sought to rule out revenue increases and others have insisted that any reform must be fair, but the meaning of these statements is unclear. For example, it is not clear if the revenue benchmark for “no increases in the tax take” is the current diminished collections or those presented in the forward estimates or other long term commitments as a share of GDP. So there may be only a weak consensus foundation for any policy package ultimately chosen.

SLIDE 10 INDIRECT TAXES

There has been a substantial decline in the relative contribution of GST (as a share of GDP) due to the restoration of savings rates and switches in consumption patterns, and even larger declines in the other indirect taxes (through free trade agreements or unilateral tariff reductions reducing customs revenues, frozen nominal fuel excises, and other excise policies designed to reduce harmful consumption (tobacco, certain types of alcoholic beverages and gambling).

Most of this change, even though often desirable from a social and economic perspective, has been unfunded and so contributes to the sustainability challenges of the Australian social, wealth and federal models. What these mean for taxes, particularly indirect taxes themselves, is that change, perhaps just in the form of recalibration rather than reform, is needed just to stand still – that is to restore the new tax system revenue levels and hence also the original distributional position.

SLIDE 11 SUPERANNUATION

Tax concessions are largely missing the retirement income purposes of the scheme, so are not entirely fit for purpose.

- Access to (tax free) superannuation for early retirement (age 60)
- Large inheritances left by many (often while continuing to access large public sector support for incomes or health and age care costs)
- Yet little or no longevity cover, with the degree of public support often increasing with age so that it still the public purse that underwrites the longevity risks
- Skewed distribution of tax expenditures favouring the higher wealth/income groups, due to flat rate tax arrangements instead of flat rate of subsidy/rebates.

A range of other concessions (e.g. pension means tests and housing) similarly are highly skewed favouring those with the highest means.

SLIDE 12 REAL PROPERTY

Compared with the other advanced English speaking countries, Australia appears to under tax property (and to do so inefficiently). Property taxes take a higher share of GDP in Canada, NZ, UK and US.

Yet real property is an efficient tax base.

Features like negative gearing and means test exemptions add to the concessional treatment of property.

Apart from an efficient universal land tax, there is also considerable scope for policy innovation, such as HECS style coverage of longevity/health risks (linked to charges to estates rather than incomes).

SLIDE 13 COMPANY TAX

There is continuing international company rate (and base) competition, with an aggressive group of countries charging under 20% (includes the UK).

Australia uses a lot of its fiscal opportunity cost through dividend imputation (made progressively more generous e.g. by refundability of credits). We need to continually monitor this, although the benefits of the system are also very considerable.

To maintain our rate of investment, is 25 the new 30 (rate) or is the priority to make the system much more friendly (even a 20% rate or same rate as for superannuation funds) for an expanding set of new companies and those entering the "mittelstand"? The latter could be a strongly pro-competition and innovation approach but has not been much discussed. On the other hand, since most large companies appear to have substantial rents (especially immobile rents) at the base of their business models, there is less obvious advantage in reducing the tax on them. This highlights the need for tax architectures to be considered holistically rather than in a piecemeal way.

SLIDE 14 SUMMARY

Regardless which if any potential options are taken up in the four areas identified above, we can be confident that there is very little scope for actually delivering real personal tax cuts, noting that personal income tax and consumption taxes come from much the same pockets. Whether there is a switch in part from direct to indirect taxation would not greatly change the total household tax burden. The overall tax effect on the income distribution would be very little changed.

Rather, at the heart of debates on taxation policy are the issues of expectations about the 21st century role of governments. At the outset I drew on the same challenges identified by Keynes a century ago and have identified the policy models or structures that represent Australia's answers to those challenges.

The role of the tax system in this is now, again, under stress, but we have many choices in the way we respond. On the one hand there are many who claim that international factor mobility and competition demands that taxes fall and with them the extent of the role of government. But this is putting all the weight on economic efficiency and little on social justice and individual liberty.

On the other hand, the course of history also moves the other way. The same technologies that increase mobility of the factors of production also increase the mobility of ideas including extremist and populist ones, and the means to pursue them, and they also bring increases in social vulnerability. These bring new demands and hence costs of government – supporting social models, supporting flexible workforce policies (by underpinning education, child care, and other critical services), and regrettably in addressing deepening security threats which ultimately risk our individual liberty.

Whatever else may seem to drive the further developments in the tax system, these will continue to be the central issues in the years ahead, and tax reform will be sustainable only if it carefully balances and supports the foundations of our continuing liberal democracy.