Submission to the

Re:think Tax Discussion Paper

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THE CENTRE FOR INDEPENDENT STUDIES

Table of Contents

1. Introductory comments

This submission responds to the invitation for comments on the *Re:think* tax discussion paper released on 30 March 2015. The submission does not attempt to cover all the topics canvassed by the discussion paper. Section 2 comments on broad objectives and principles of tax reform, Section 3 covers what the author considers to be the issues of primary importance in reform, while Section 4 covers items of secondary importance. Finally, Section 5 deals with a few issues in the tax policy development process. In each case, in addition to discussing the issues and suggesting solutions, the submission answers specific questions posed in the discussion paper and draws attention to relevant publications in which the issues are discussed more fully.

The submission identifies directions for reform but makes no attempt to suggest sequencing or timing or to place its recommendations in the current budget context. It is recognised that not all the recommendations could be implemented at the present time, and that even in the medium to longer term they would imply a lower path for government expenditure than currently in prospect. However, this is the only way in which the benefits of smaller government and a lower overall tax burden can be achieved — an objective that underpins this submission.

2. Objectives and principles of tax reform

The government's stated objective of 'lower, simpler, fairer' taxes is commendable, but is open to different interpretations and therefore raises many questions as to its meaning.

'Lower' taxes should be taken to mean lower tax rates, at least on average. This is desirable. However, it is difficult to see how it can be achieved in the short to medium term, given current projections of government expenditure and the budget deficit. The first-round effect of lower tax rates would be to lower revenue. This would be partly unwound over time as lower tax rates produced an economic growth dividend (dynamic revenue gains), but even so there is likely to be a net revenue loss. This focuses attention on the nexus between tax reform and expenditure reform: the reality is that current projections for government expenditure must be lowered through expenditure savings measures if lower taxes are to be sustainable.

The *Re:think* discussion paper cites international comparisons of tax revenue/GDP ratios to claim that Australia's tax burden is relatively low. However, no comfort should be drawn from such comparisons. The average for developed countries is elevated as a result of the large public sectors and burdensome tax policies of European countries. There is no reason Australia should be guided by those policies, particularly when they have self-evidently contributed to the European crisis and acted as a handbrake on economic growth. Australia's tax/GDP ratio is also lower because private financing of retirement income is higher. An appropriate tax/GDP benchmark ratio for Australia would be 25%

(for all levels of government combined), with allowance for cyclical fluctuations around this level[1]

The current tax system imposes heavy costs in compliance, administration and uncertainty. Simplification is a worthy goal. However, this involves trade-offs with other objectives. Much of the complexity in the system is a result of attempts to fine-tune it for equity or integrity purposes. It must be accepted that simplification may require broad-brush solutions and rough justice. For example, many of the ideas currently circulating to make superannuation tax supposedly 'fairer' would also make the superannuation system more complex.

The goal of 'fairness' in the tax system is the most open to different interpretations as 'fairness' (or 'equity') involves value judgments. Most people think only of the vertical dimension of equity (even though horizontal equity is just as important), and there is a (sometimes implicit) presumption underpinning current tax policy controversies that the tax system is not sufficiently 'progressive' or redistributive. Three points can be made about this presumption. First, it is a value judgment, which this submission does not share. Second, it appears to be based on misinformation: as the *Re:think* discussion paper illustrates, the tax/transfer system is already highly redistributive. Third, it appears to overlook the economic costs of the high tax rates involved in a heavily redistributive system.

Policy options for individual taxes are often criticised on the grounds they would be 'regressive', or insufficiently 'progressive'. However, as pointed out in *Re:think*, judgments about the degree of redistribution should be based on the distributive effects of the tax/transfer system as a whole, not individual taxes. This submission agrees, subject to one qualification: if the tax/transfer system achieves its distributional objectives by relying too heavily on any one of its elements, this can produce self-defeating economic costs. Arguably this is now happening with personal income tax, which is highly progressive and imposes heavy deadweight economic costs as a result of high marginal rates (see discussion of personal income tax below).

One perverse consequence of the tendency to view every individual tax through the lens of 'progressivity' is that some taxes have been structured with graduated rates when it makes no sense to do so. State land tax is a case in point. Given that corporations, institutional investors and property trusts (rather than individuals) dominate the ranks of land tax payers, there is no correlation between the value of land holdings and the capacity to pay of the ultimate 'owners' of the land (e.g. superannuation fund members). The most sensible solution would be a flat land tax.

Other important principles for the tax system include stability, predictability and transparency. Further discussion of the guiding principles for tax reform can be found in Carling (2009).[2]

Answers to *Re:think* questions:

Question 1. Can we address the challenges that our tax system faces by refining our current tax system? Alternatively, is more fundamental change required, and what might this look like?

This depends on what is meant by ‘refining’ the current system as opposed to ‘more fundamental change’. Substantial benefits can be achieved within the broad parameters of the current system, but this would require more than just fine-tuning — for example substantial reductions in personal and corporate income tax rates. More fundamental structural changes — such as replacing the company income tax with a business cash flow tax or replacing personal income tax with an expenditure tax — may be desirable, but are not necessary for reform to achieve large benefits.

Question 3. How important is it to reform taxes to boost economic growth? What trade-offs need to be considered?

The tax system has a very important effect on the economy’s growth potential and this should be the main criterion for reform. However, this does not mean providing narrow tax incentives to promote particular industries or types of economic activity. There is a trade-off between the economic efficiency and equity criteria, and the current tax system is so highly progressive that greater weight should be given to economic efficiency. Distributional goals should be pursued mainly through the allocation of government expenditure.

Question 4. To what extent should reducing complexity be a priority for tax reform?

Reducing complexity should be a high priority, and this may necessitate some broad-brush solutions that place less weight on equity. The transparency of taxpayers’ contributions to funding government expenditure should not be sacrificed in the search for simplification.

Question 5. What parts of the tax system are most important for maintaining fairness in the tax system? Are there areas where fairness in the tax system could be improved?

Having regard to the heavy economic costs of high tax rates, vertical equity objectives are best pursued mainly through the allocation of government expenditure. Within the tax system, vertical equity is best pursued through personal income tax, but the system is already excessively ‘progressive’. One goal of reform should be to lower all personal income tax rates and make the structure less graduated (lower and flatter). Horizontal equity is another important (and often overlooked) dimension of ‘fairness’ and should be considered in designing all taxes. Existing arrangements for superannuation, capital gains, so-called negative gearing and dividend imputation have recently been widely criticised on grounds of ‘fairness’, but these arrangements on the whole are justified by tax policy principles.[3]

3. Issues of primary importance in tax reform

This section discusses the individual taxes or broad areas of taxation considered by this submission to be the key focus for tax reform.

(a) Personal income tax

Key issues:

- Marginal rates are excessive at all income levels.
- The rate scale is excessively graduated.
- The true rate scale is obscured by levies and offsets.
- Bracket creep is imposing non-transparent tax increases every year.

These issues are explored more fully in Carling (2010).[4] A summary of key points is provided here.

High effective marginal rates are too often seen only as a problem for low income earners facing work force participation decisions. This view of the issue is too narrow. Claims that high income earners are unresponsive to higher income tax rates rely on estimates of labour supply elasticities that fail to take account of the effect on entrepreneurial activity and investment in human capital.[5] The implications for wasteful tax planning and international location decisions of high income earners are also important. Now that the tax-free threshold has been substantially increased, the emphasis of reform should be on cutting marginal rates.

The Medicare levy and other like levies are nothing but a second income tax, imposing the same economic costs as the basic income tax. It is misleading to say that somebody's marginal rate at (say) $85,000 is 37% when in fact there is an additional 2% that takes the true marginal rate to 39%. The Medicare levy is false hypothecation, as the revenue it raises is in no way quarantined and in any case is grossly insufficient to finance Medicare. The rate scale is also distorted by the remaining Low Income Tax Offset, the phase-out of which raises effective marginal rates by another 1.5 percentage points from $37,000 to $66,667.

The phenomenon of bracket creep has been well publicised, sometimes as if it were the only problem with the personal income tax system. It is certainly a problem, as it results in unlegislated increases in average income tax rates. Discretionary adjustments to thresholds are then presented for political purposes as 'tax cuts', when they are merely handing back the proceeds of unannounced tax increases. The solution is to do what many other countries do, which is to apply automatic annual indexation of personal income tax thresholds. Legislative activity can then focus on marginal rates and threshold adjustments in real terms.

Recommendations:

- The top marginal rate should be no higher than 35%, and the second top rate 27%
- There should be no additional levies and no low income tax offset.
- Thresholds should be indexed to inflation annually under legislation providing for this to happen automatically.

Answers to *Re:think* questions:

Question 6. What should our individuals income tax system look like and why?

The rate scale should be lower and flatter for the reasons discussed above. There should be no levies and no low income tax offset.

Question 8. At what levels of income is it most important to deliver tax cuts and why?

There should be tax cuts at all income levels, in the form of reductions in marginal rates, for the reasons discussed above. It is wrong to think high earners are unaffected by high marginal rates.

Question 9. To what extent does taxation affect people's workforce participation decisions?

It has a strong effect on work force participation decisions, but that is not the only reason to lower income tax. Effects on investment in human capital, entrepreneurial activity, tax planning and international location decisions are also important.

Question 13. What creates incentives for tax planning in the individuals income tax system? What could be done about these things?

It is high marginal rates that create incentives for wasteful tax planning. Marginal rates should be substantially reduced.

(b) Company income tax

Key issues:

- Reducing the 30% rate of company income tax
- Single rate is better than tiered company tax
- The gap between the company tax rate and the top marginal rate of personal tax is problematic.

The *Re:think* discussion paper, and before it the Australia's Future Tax System review, have mounted a persuasive case for a large reduction in the company income tax rate. The economic incidence of the tax falls mainly on wage earners and shareholders.

Reducing the company tax rate would be one of the most effective ways to spur the economy's long-run potential growth rate, and should therefore be a high priority for tax reform.

Australia has lagged behind the international trend for corporate income tax rates to decline and has been left with an internationally uncompetitive rate. The benefit to growth through higher investment would generate additional revenue and, over time, help offset the first-round revenue loss from a company tax cut. A two-tier company tax system with a lower rate for smaller companies (as proposed in the 2015-16 federal Budget) is a retrograde step. The rate should be lowered uniformly.

The gap between the company tax rate and the top personal income tax rate is a problem that would be exacerbated by a reduction in the company tax rate. However, as argued above, the top personal rate should also be reduced by at least as much as the company rate. If this does not happen, it should not be used as a reason not to reduce the company rate.

Recommendation:

- The company income tax rate should be reduced for all companies to no more than 25%, and preferably closer to 20%.

Answers to *Re:think* questions:

Question 24. How important is Australia's corporate tax rate in attracting foreign investment? How should Australia respond to the global trend of reduced corporate tax rates?

The corporate income tax rate is a very important influence on the level of both foreign and domestic investment. Australia should catch up with the international trend to lower tax rates.

Question 25. Is the dividend imputation system continuing to serve Australia well as our economy becomes increasingly open? Could the taxation of dividends be improved?

The dividend imputation system may be less important to the level of investment in a more open economy, but the case for imputation as a mechanism to avoid double taxation of dividends remains strong. If imputation did not exist, some other form of relief from double taxation would likely take its place, as is the case in many other countries.

(c) Taxation of savings

Key issues:

- Policy on the taxation of savings should be based on two key principles: avoiding double taxation of savings; and taxing the income from savings at lower rates than labour income.
- In addition, superannuation tax policy should recognize the very long lock-in period for superannuation contributions and earnings.
- Viewed in this way, the tax treatment of savings that is currently labelled 'concessional' is by and large justified with reference to tax policy principles and serves economic efficiency objectives.
- But the disparities in the treatment of different types of saving are excessive.
- A Scandinavian type dual income tax system that taxes most income from capital at a low, flat rate should be considered.

A more complete discussion of these issues is contained in Carling (2015).[6]

It is nothing new for tax concessions for savings to be criticised, but at this time of entrenched budget deficits and a new emphasis in public debate on perceptions of 'fairness' these concessions have come under more critical scrutiny than ever before. Much of this criticism is based on a misuse of data, ignorance of the original justification for concessions, and distorted notions of 'fairness'.

With respect to the data, criticism of tax concessions typically relies heavily on the official estimates of tax expenditure published in the annual Tax Expenditure Statement. However, the inherent limitations of such estimates are usually overlooked and they are misinterpreted even against the advice of the Treasury, which is responsible for the estimates. As a result, the discussion of superannuation tax, for example, typically begins from the false premise that concessions in this area are 'costing' more than $30 billion a year. It would help avoid such misconceptions if Treasury would cease publishing tax expenditure estimates for savings based on the comprehensive income benchmark, and instead use the more appropriate comprehensive expenditure tax benchmark.

The policy justification for these savings tax concessions varies but the basic justification, as acknowledged by the *Re:think* paper and the AFTS review, is that savings income should be taxed more lightly than labour income. This is the basic justification for the capital gains tax discount and superannuation concessions, although in each case there are other unique considerations as well. In the case of dividend imputation, the justification is to prevent double taxation of dividends, and in the case of so-called negative gearing it is that the expenses incurred in generating income should be deductible for tax purposes.

Regarding the 'fairness' dimension, concessions are too often viewed as a social benefit to be 'targeted', which they are not. The fact that high income earners receive a disproportionate share of the dollar benefits is unexceptional as they are in the best position to save and invest, and must be balanced by the fact that they also pay a disproportionate share of personal income tax. Further, the flat design of superannuation taxes (with the exception now of contributions tax) brings major simplification benefits as it means that funds can be administered without regard to the personal tax situations of members. That benefit is lost once graduated taxes are imposed, such as the suggested 15% tax on earnings of funds in pension mode subject to a tax-free threshold.

The most appropriate benchmark for taxation of superannuation is the so-called ‘EET’ system, which means that contributions and fund earnings go untaxed but end-benefits are subject to individuals’ full marginal rates in retirement. Under this benchmark, much of the objection to the alleged ‘cost’ of the current system disappears, as tax expenditure is much lower or even non-existent. That is not to say the superannuation tax system is beyond improvement. However, the past pattern of frequent changes is undesirable and further change should only be made if a compelling case can be made. Many changes have been suggested, but most of them have been poorly thought through and are based on misinformation and faulty analysis.

Any new review of superannuation taxation should observe the following principles:

- Use the EET system as the benchmark for measuring tax expenditure.
- Apply taxes and concessions in a non-discriminatory, neutral way.
- Any changes should not add complexity, and preferably reduce it.
- Ensure the system is fiscally sustainable for the long term.
- Any adverse changes should not be retrospective in effect, and should recognise that current participants have made long-term plans under the current and previous rules.

The uneven treatment of different types of savings is undoubtedly an issue. However the main outlier is interest income, which is taxed at full marginal rates. This treatment is inappropriate and it would be wrong to even out the tax treatment of savings by increasing tax on non-interest forms of savings income. A better solution would be to discount interest income for tax purposes. A more far-reaching approach would be to introduce a Scandinavian type dual income tax, with one scale for labour income subject to a tax-free threshold and a single low, flat rate for capital income (interest, capital gains, company income, dividends, net rent) without a tax-free threshold. Such an approach should be explored as an alternative to the current mixed approach. Even within such a scheme, however, there would be a case for treating superannuation concessionally in recognition of the very long-term lock-in effect of contributions.

Recommendations:

- The government should cease issuing tax expenditure estimates for savings income based on a comprehensive income benchmark and use only a comprehensive expenditure tax benchmark.
- The 50% capital gains tax discount should not be reduced.
- So-called ‘negative gearing’ deductions should continue to be allowed unless rent income is taxed at concessional rates.

- Changes to dividend imputation should be considered only in the context of a very large cut (e.g. to 20%) in the company tax rate. Ideally, the company tax rate would be cut and imputation would continue.
- The ideal superannuation tax system is EET, but the problems in making the transition from the current system to EET would be insurmountable. Given that, current arrangements are broadly appropriate and distributional issues are greatly exaggerated.
- Consideration should be given to a dual income tax system that taxes company income, capital gains, dividends, net rent and interest income at the same low, flat rate (say, 20%) without a tax-free threshold. Superannuation contributions and earnings should continue to be taxed at lower rates in recognition of the very long lock-in period.

Answers to *Re:think* questions:

Question 18. What tax arrangements should apply to bank accounts and debt instruments held by individuals?

Interest income is currently taxed too heavily. It should be discounted for tax purposes so as to bring the effective tax treatment more into line with other forms of savings income.

Question 19. To what extent is the rationale for the CGT discount, and the size of the discount, still appropriate?

The rationale for the 50% CGT discount remains appropriate. If anything, the discount should be increased rather than reduced.

Question 20. To what extent does the dividend imputation system impact savings decisions?

The dividend imputation system has a strong effect on the allocation of savings (as well as on company behavior) and its removal would constitute a major upheaval. In its absence there would need to be some other form of relief from double taxation of dividends.

Question 22. How appropriate are the tax arrangements for superannuation in terms of their fairness and complexity? How could they be improved?

The current tax arrangements for superannuation should be benchmarked against an EET system. It is not entirely clear what the results would be, but most likely it would show that tax expenditure is very low or non-existent. The structure of superannuation tax is broadly appropriate, and criticism of its 'fairness' is overblown. Any further changes should only be made if there is a compelling case, and should be guided by a set of principles.

Question 23. What other ways to improve the taxation of domestic savings should be considered? How could they be applied in the Australian context?

Consideration should be given to a Scandinavian type dual income tax, with one scale for labour income and a low, flat rate for capital income.

Question 25. Is the dividend imputation system continuing to serve Australia well as our economy becomes increasingly open? Could the taxation of dividends be improved?

The dividend imputation system remains relevant in that it prevents double taxation of dividends. However it does involve some complexity. Any move away from imputation should be accompanied by a large cut in the company tax rate and some alternative form of relief from double taxation of dividends.

(d) State stamp duties

Key issues:

- States' dependence on inefficient and distorting stamp duties for around one-third of total tax revenue.

A more complete discussion of this issue is contained in Carling (2008).[7]

Stamp duties on real property transfers, insurance and motor vehicles are among the least economically efficient (highest marginal deadweight cost) of all taxes in the system, yet the states rely on them for around one-third of total state tax revenue. Stamp duty on real property transfers dominates in revenue terms and exhibits very strong bracket creep characteristics, which have made it the states' strongest 'growth tax' over the long term. Revenue is highly volatile, which complicates state budget management. As a tax on housing transactions, stamp duty discourages welfare-enhancing housing choices. As a tax on business property, it is embedded in the business cost structure and cascades through the system. The stamp duties on insurance and motor vehicles have the disadvantages of transaction taxes, and to the extent they take the form of consumption taxes they double up on the GST that applies to these items.

Abolition of stamp duties would leave a large hole in state budgets that would need to be filled at least in part by greater dependence on payroll and land taxes, a broader or higher rate of GST, or the transfer of some taxing power that the states do not currently exercise such as personal income tax. Greater use of payroll and land taxes would have to include a substantial broadening of the bases for these taxes by removing existing exemptions, such as the land tax exemption for principal residences.

Swapping stamp duties for higher GST revenue has the disadvantage that it would leave the states even more dependent on Commonwealth revenue and less in control of their own finances. Any change in the GST should give priority to base-broadening ahead of a higher rate.

Recommendation:

- State stamp duties should be abolished and replaced with broader payroll and land taxes and some broadening of the GST base.

Answers to *Re:think* questions:

Question 51. To what extent are the tax settings (that is, the rate, base and administration) for the GST appropriate? What changes, if any, could be made to these settings to make a better tax system to deliver taxes that are lower, simpler, fairer?

The base of the GST should be broadened as a trade-off for removing selected stamp duties. However, some existing GST exemptions are justified on competitive neutrality grounds. Beyond base broadening, the GST rate should only be increased in exchange for further abolition of stamp duties, and only if the states are granted wider access to other taxes under their control.

Question 52. What are the relative priorities for state and local tax reform and why? In considering reform opportunities for particular state taxes, what are the broader considerations that need to be taken into account to balance equity, efficiency and transitional costs?

The highest priority for state tax reform is abolition of stamp duties on real property transfers, insurance and motor vehicles. These should be replaced by broadening the bases of payroll tax, land tax and the GST. For local government, the existing tax base is adequate and appropriate.

(e) Vertical fiscal imbalance

Key issues:

- States' existing tax powers are insufficient for them to be sovereign in their sphere.
- State sovereignty is being compromised by excessive dependence on Commonwealth grants, particularly tied grants.
- States need access to more efficient tax bases to reduce their reliance on Commonwealth grants and inefficient taxes.

These issues are discussed more fully in Carling (2007).[8]

The problems associated with Australia's very high degree of vertical fiscal imbalance are well known (confusion of accountability, inefficient resource allocation, and so on). One of the criteria for tax assignment to the different tiers of government is that the allocation of tax powers should equip each level of government with the capacity to finance its own expenditure responsibilities. Taxing powers need to be decentralised to a similar degree to expenditure responsibilities so that each government can set its own priorities and be clearly responsible and accountable to its voters. In practice, no federation lives up to this standard, but Australia falls short to a larger extent than most. This is partly because states have declined to use fully the tax powers available to them, but also because they are effectively barred from doing so by extra-constitutional practices.

There is an important distinction between the allocation of tax powers and the allocation of tax revenue. The states receive the GST revenue but lack the power (individually or collectively) to determine GST policy. More revenue sharing is not the solution to vertical fiscal imbalance. It is clear from judicial interpretation of the constitution that certain taxes are off limits to the states, but this need not apply to personal income tax. The most obvious way for states' revenue autonomy to be enhanced is for the Commonwealth to allow then to impose a surcharge on top of Commonwealth personal income tax. To avoid any increase in total personal income tax at the time of the change, the state impost should be fully offset by a reduction at the Commonwealth level. Then over time, states individually would be free to vary their surcharge up or down. The Commonwealth's loss of revenue would be offset by a cut in tied grants to the states. In effect, for state budgets, personal income tax would replace a portion of tied grants. This scheme is further discussed in Carling (2014).[9]

Although states have substantial flexibility at the margins to make tax and spending choices, this is not sufficient to significantly reshape the structure of state finances away from the present unhealthy degree of dependence on Commonwealth revenue. This broad structural dependence has created a culture of control on the part of the Commonwealth and one of dependency on the part of the states and can only be overcome by large changes in the architecture of Commonwealth-state finances.

Recommendation:

- States should be given access to the personal income tax base through a 'piggy-back arrangement on top of Commonwealth personal income tax, offset fully by a reduction in Commonwealth personal income tax and tied grants to the states.

Answers to *Re:think* questions:

Question 53. Does each level of government have access to tax revenue bases to finance new spending decisions? If not, should arrangements change to achieve this? How should they change? How important is it that the national government levies taxes on mobile bases? Could some taxes be shared?

All levels of government probably do have such access at present, though whether they are willing to use it is another matter. However, the question as posed misses the point that whether or not states have sufficient flexibility at the margins of spending and tax, they are too heavily dependent on Commonwealth grants. This dependence has created an unhealthy culture of control on the part of the Commonwealth and one of dependence on the part of the states. It also confuses accountability and responsibility in the minds of the public. Some vertical fiscal imbalance will always exist, but the present degree of imbalance is excessive.

4. Issues of secondary importance in tax reform

The reforms discussed above in the areas of personal and company income tax, taxation of savings, state taxation and federal-state relations would accomplish most of the available gains from tax reform. There are also a number of issues of secondary importance that would fine-tune the system for further gains.

(a) Fringe benefits tax

Key issues:

- Imposition on employer at top marginal rate rather than employee at own marginal rate.
- Exemptions for certain not-for-profit entities.

There is no reason to discriminate against fringe benefits by taxing them all at the top marginal rate, and transparency would be better served by fringe benefits being included in individuals' tax assessments at their own marginal rate rather than being paid by employers. The FBT exemptions for certain not-for-profit entities are an illogical way of assisting these entities through what amounts to a wage subsidy.

Answers to *Re:think* questions:

Question 16. To what extent does our fringe benefits tax system strike the right balance between simplicity and fairness? What could be done to improve this?

It is neither simple nor fair in the horizontal equity sense. It would be better to include the value of fringe benefits in individuals' assessments and apply their own marginal rate.

Question 17. To what extent are the concessions and exemptions in the fringe benefits tax system appropriate?

Current FBT exemptions for certain not-for-profit entities are anomalous. They are an illogical way of assisting such entities through a wage subsidy.

(b) Indirect taxes

Key issues:

- The uneven taxation of different types of alcoholic drinks.
- Role of the luxury car tax.

- Whether current arrangements achieve efficient road user pricing.
- User charges should not contain hidden taxes.

As has been well canvassed, the taxation of alcohol content varies substantially between wine, beer, spirits and cider. There seems no logical reason for such disparities. While taxation of alcohol should be rationalised, calls for an increase in the overall level for social and health reasons should be resisted as more targeted solutions would be more effective.

The rationale for the luxury car tax is weak. So-called luxury cars are singled out as the only 'luxury' items subject to a consumption tax on top of GST.

Fuel excise, vehicle registrations fees, motor vehicle stamp duty and tolls on selected roads and bridges are all at least partially justified as road user charges. However they are unlikely to be achieving efficient road user pricing. Technology now permits far more sophisticated road user charging than was possible even ten years ago. State governments should make greater use of such technology and rely less on the current array of taxes and charges — in particular, motor vehicle stamp duty should be abolished. User charges should be set to achieve cost recovery and no more. Charges such as the passenger movement charge and passport pricing should be reviewed to ensure they are not over-recovering costs and imposing hidden taxes.

Answers to *Re:think* questions:

Question 54. To what extent does Australia have the appropriate mix of taxes on specific goods and services? What changes, if any, could improve this mix?

The broad mix is appropriate but there are specific design issues with each tax.

Question 55. To what extent are the tax settings (i.e. the rates and bases and the administration) for each of these indirect taxes appropriate? What changes, if any, could be made to these indirect tax settings to make a better tax system to deliver taxes that are lower, simpler, fairer?

The luxury car tax is illogical and should be abolished. Taxation of alcohol should be rationalised to achieve more even taxation across categories, without increasing the overall level. It is doubtful that the current array of road user taxes and charges is achieving efficient road user pricing. User charges in general should be reviewed to avoid over-recovery of costs and imposition of hidden taxation.

(c) Work-related expenses

Key issue:

- Complexity and uncertainty in the current arrangements for deductions.

The principle of tax deductibility of expenses directly incurred in earning income should apply to work-related expenses. However, current arrangements are unsatisfactory. There is too much uncertainty about what is deductible and too much opportunity to over-claim. This deduction accounts for a disproportionate amount of the contentious interaction between the ATO and wage and salary earner taxpayers. The 'rough justice' of a standard deduction would strike a better balance between simplicity and fairness, even if it over-compensated some and under-compensated others.

Answers to *Re:think* questions:

Question 15. To what extent do our arrangements for work-related expense deductions strike the right balance between simplicity and fairness? What could be done to improve this?

Current arrangements are too complex and uncertain. They do not strike the right balance. A standard deduction would be superior.

5. Tax policy development

Key issues:

- Basis of the tax expenditure statement.
- Dynamic estimates of revenue effects of tax policy changes.
- Full-year effects vs four-year totals.

As discussed above in section 2 (c), the practice of basing tax expenditure estimates for taxation of savings on a comprehensive income benchmark should cease. This practice biases the public debate towards excessively high taxation of savings. A comprehensive expenditure tax benchmark should be used.

Assessments of the revenue effects of tax policy options should allow for second-round effects on the economy. For example, a cut in the company tax rate would lead to higher economic growth in the medium to long term, generating additional tax revenue growth that would partly offset the static revenue cost of the tax cut. The GST tax reform package in 2000 included such a 'growth dividend' and this should be the norm. Conversely, the adverse impact of tax increases on growth should be factored in to estimates of revenue gains.

The practice of stating revenue effects of tax policy changes as the summation of annual effects over four years or longer has become commonplace in budgets and other policy announcements. This is regrettable, because multi-year sums are generally meaningless and misleading. There are two reasons for this: policy changes are usually intended to be permanent; and a four-year summation usually masks a much higher revenue effect in the final year, when the change has become fully effective, than in the first year of implementation. The focus should shift to quoting two figures to summarise the revenue effect of policy changes: the effect in the year of implementation; and the annual (and ongoing) effect in the first full year of operation.

Endnotes

[1] Robert Carling and Stephen Kirchner, *Fiscal Rules for Limited Government: Reforming Australia's Fiscal Responsibility Legislation,* CIS Policy Monograph 92 (The Centre for Independent Studies, Sydney, 2009).
[2] Robert Carling, 'Ten Principles for Tax Reform', *Policy,* vol 25, no 3, Spring 2009 (The Centre for Independent Studies, Sydney, 2009).
[3] For further discussion of this point see Robert Carling, *'Right or Rort? A Dissection of Australia's Tax Concessions'*, CIS Research Report 2, April 2015 (The Centre for Independent Studies, Sydney, 2015).
[4] Robert Carling, *The Unfinished Business of Australian Income Tax Reform,* CIS Policy Monograph 108, 2010 (The Centre for Independent Studies, Sydney, 2010).
[5] For discussion of investment in human capital, see Michael Keane, *The Tax-Transfer System and Labour Supply,* presented to Conference on Australia's Future Tax System (Melbourne, 18 – 19 June 2009).
[6] Robert Carling, *Right or Rort? A Dissection of Australia's Tax Concessions,* CIS Research Report 2, April 2015 (The Centre for Independent Studies, Sydney, 2015).
[7] Robert Carling, *'State Tax Reform: Progress and Prospects',* CIS Policy Monograph 82, 2008 (The Centre for Independent Studies, Sydney, 2008).
[8] Robert Carling, *'State Taxation and*
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