Tax Discussion Paper: Submission

I am in agreement with most of the Re:think paper.

In this submission I seek to highlight the importance of tax reform packages involving a number of different tax changes, rather than assessments of individual taxes and reform options. When there are multiple objectives, including revenue, efficiency, equity and simplicity, in general one needs multiple policy instruments, and in this case changes to a number of tax instruments. Consideration also has to be given to a time path of adjustment as tax reforms initiate changes in incentives inducing changes in decisions resulting in changes of prices and quantities, often with adjustment periods in excess of a decade.

1. The Case for Reform

Re:think provides a compelling case for tax reform as one of many policy initiatives to raise national productivity. Higher productivity is the key to sustained increases in real income per capita if society expectations of more and more government goods and services, and more and more funds to support private consumption are to be met. The large range of estimated distortion costs for the different taxes indicate the potential gains (Chart 2.9 and details in the support Treasury Working Paper 2015-01). For example, replacing conveyance duty with a cost of 72 cents per dollar of tax transfer revenue with an approximate revenue neutral broad based land tax with a negative marginal efficiency cost generates a net efficiency gain of at least 70 cents per dollar; there are very few, if any, productivity gain options elsewhere in the public or private sector of the economy!

In general, as argued in AFTS, the Mirrlees Review for the UK, the NZ Tax Task Force, and elsewhere, productivity enhancing tax reform involves one or both of approximate aggregate revenue tax reform packages with:

- Comprehensive bases through the removal of special exemptions and deductions (not supported by market failure correction arguments) and a lower tax rate, and
- Tax mix changes which replace high distortion cost taxes with lower distortion cost taxes.

Both options also are likely to bring greater simplicity with lower costs of tax administration and tax compliance (again with examples in Re:think).

The design of tax reform packages also need to consider implications for the other tax objectives, and in particular revenue and equity.

For this submission, I accept an approximate aggregate revenue neutral objective. Clearly, the share of government in the economy is an important issue, but this discussion can be considered independent of arguments about the general design of the tax system. The only point I make is that a more efficient tax system in time leads to a more productive economy, larger tax bases and more revenue than continuation of the current distorted system.

In considering example tax package reform options, I proceed on an assumption that the package should aim for about the same degree of overall tax system vertical equity as current. But, with some latitude on horizontal equity. Clearly, equity is very much an ethical and political issue, and one in which there are, and legitimately can be, many different views.

Even if one accepts the status quo distribution of the tax burden as a reference point, there are numerous challenges in its measurement. First, consideration should be more heavily weighted on the longer run equilibrium effects rather than the night-after effects with no decision responses. Taxes have a quasi-constitutional basis, with infrequent substantial design changes. As argued in Re: think, the long run economic incidence of a tax often is very different to the statutory incidence. For example, most agree that GST and excise tax while paid by business are passed forward to buyers as higher prices. A more contentious case is the incidence of corporate income tax; a reduction initially benefits shareholders, but in the case of resident shareholders much is recaptured with personal income tax under the imputation system; in the long run, much of the lower corporate income tax accrues to employees as higher wages, but the adjustment period extends over a decade or more (pages 77-81). Second, household circumstances change from year to year. For example, the vertical incidence of the GST is much less regressive if one takes an average over time rather than a particular year (Chart 8.3), and ABS data indicating that those in the bottom quintile spend more than twice their income, which is unsustainable over a longer period. One might consider equity over a life cycle rather than a one year snapshot. Third, to the extent that a productivity improving tax reform package increases real per capita income, the long run is a positive-sum game, rather than the zero-sum game assumption of a night-after assessment.

2. Some Examples of Potential Tax Reform Packages

By way of illustration, this section describes and assesses some tax reform packages. They are designed to improve national productivity, subject to the constraints of aggregate tax revenue neutral, and to minimise net losses to those on lower incomes relative to the status quo over the medium term.

Implementation of one or more of the example tax reform packages, and clearly there are many other reform options, will require time. Key players and the public will need to be informed and convinced of

- Deficiencies of the current tax system and the pay-off or benefits for the reform package. That is, why change?
- A transparent description of the reform package, its implementation, together with quantification of the time path of adjustment and assessment of revenue and distribution effects.

(a) Tax Mix Change: Replace conveyance duty with a broad based land tax

The current narrow base state land tax with a progressive rate schedule and state conveyance duty on the transfer of property would be replaced by a flat rate increase in land tax on the current local government rate base. A doubling of the average local government rate would be an approximate revenue neutral tax mix change by the states. Preferably, the unimproved land value would be used generally, with replacement of improved value used now by some local governments.

More nuanced reforms might consider: different land tax rates for commercial, residential and primary production land; phased transition paths; some grandfathering for recent payees of stamp duty; and, a default government reverse mortgage for the "income poor and asset rich". The ACT currently is embarked on such a reform; and the reform has been proposed by other state tax reviews, including for Victoria, NSW and last yeas SA, as well as by AFTS.

The reform package could be a coordinated reform involving all states, or a state by state reform.

Large productivity gains are on offer from the proposal. Conveyance duty as a transaction tax distorts the reallocation of land and property from lower value to higher value uses when there are changes in household circumstances, including employment location and family size and other demographics, and changes in business circumstances, including the effects of changes in technology and product markets. A comprehensive base and a flat rate land tax causes no such distortions, and has no effect on land use decisions. By contrast, the current land tax, with exemptions for owner occupied homes, but not other residential, and exemptions for primary production land, distorts land use. The progressive rate structure distorts ownership and operation by larger businesses, with losses of unrealised economies of scale and scope. Estimates of comparative efficiency costs of conveyance duty and a comprehensive base flat rate land tax indicate productive gains of the order of 70 cents per dollar of tax revenue switched.

The tax mix change package would bring large gains in simplicity with lower administration and compliance costs. Conveyance tax is removed, in effect the narrow base state land tax is removed, and the new tax piggy-backs on the existing local government rate system.

Replacing conveyance duty with land tax would provide a more stable and predictable revenue stream for state governments.

Assessing the redistribution or equity effects of the reform package involves consideration of effects on asset prices, cash flows and timing. If, as logic argues, the value of an asset, including land and property, reflects the discounted value of the expected future stream of after-tax economic rents, then property asset values will not change. On average, the approximate aggregate revenue neutral package replaces the existing conveyance duty and state land tax with a higher local government rate; and other taxes remain unchanged.

Rent income and capital gains on property are subject to the progressive income tax, and state and local taxes are deductions in assessing income. Then, an important progressive element of overall taxation on rent income and on property asset appreciation remains.

There will however be changes in the distribution of cash flows. Those who more frequently buy and sell, and who are disadvantaged by conveyance duty, will gain. By contrast, those who buy and sell infrequently will see themselves as losers from the reform. One can take different views on the desirability, or not, of this redistribution. The extended transition period with the ACT arrangements are designed to reduce the magnitude of these cash flow gains and losses.

(b) Comprehensive base on all labour remuneration, both a lower and simpler progressive income tax rate schedule, and automatic indexation of tax brackets

AFTS proposed a comprehensive tax base on all labour remuneration, simplification of the work related expenses deduction, and a simplified personal income tax rate schedule. In important senses, the reform package has similar attributes as the broader base and lower rates package of the mid-1980s successful income tax reform package. The broader base would fund lower income tax rates to generate the same aggregate revenue.

All labour remuneration in the form of wages and salaries, fringe benefits and employer contributed superannuation (SG and salary sacrifice) would be taxed at the relevant personal rate. In the case of removing concessions for fringe benefits for employees of non-profit businesses, some of the revenue may need to be recycled to the employers as a part of the package of general government policies to support education, health and charities. For the SG, employers would transfer after personal income tax funds to the superannuation funds, with the funds responsible only for taxation on earnings. The broader tax base would fund a reduction in tax rates.

The current ad hoc set of allowed work related expenses, other than government contributions for child care, could be replaced. Options include: either (a) a standard deduction of, say $500, with or without the option for a detailed claim on higher expenses, or (b) no deduction and a revenue neutral reduction of the tax rate schedule which is distributional neutral across broad categories of taxpayers by taxable income.

The Medicare Levy is not a hypothecated tax in any sense (revenue goes straight into consolidated revenue, is much less than health expenditure, does not influence health expenditure decisions). It and special exemptions such as LITO complicate the effective tax rate schedule, and over some income levels they add to often very high effective marginal tax rates (Chart 3.1). Transparency, simplicity and efficiency would be gained by their removal.

Automatic indexation of the tax brackets would end fiscal drag. Note that fiscal drag both (a) increases average tax rates for all taxpayers, but much more for those on lower incomes, and (b) increases marginal tax rates for some (Box 2.2).

This would be a commonwealth alone reform package.

Efficiency benefits of the package come in several ways. First, a comprehensive tax base on all forms of labour remuneration removes distortions to the mix of remuneration, and the mix of consumption provided by the remuneration. Second, the lower rates financed by a more comprehensive base will reduce the magnitude of distortions to labour decisions at both the extensive and intensive margins; and noting the current estimate of a marginal efficiency cost of a 25% flat labour income tax of about 30 cents per dollar of revenue (Chart 2.9). Third, a simplified rate schedule encompassing the Medicare Levy, LITO and other special offsets will remove some phases of relatively high effective marginal tax rates. Fourth, the gains in transparency and simplicity with removal of the ad hoc work deductions and fiscal drag are likely to be considerable.

The broader base and lower rate package to collect about the same revenue can be designed to maintain roughly the same vertical equity distribution across broad income categories. Within each broad income category, those who now draw remuneration as a larger share than the group average from the concessional fringe benefits and superannuation will lose, while those who draw a smaller share than the average will gain. This redistribution should be presented as a desirable improvement in horizontal equity.

(c) Payroll Tax

Roughly similar arguments for a broad based labour remuneration tax made in the previous section can be made for a comprehensive payroll tax base. In particular, this means removing the exemption for small business, which in aggregate exempts about a half of employees and the payroll. Simplicity could be gained by using the state workers' compensation tax base or the commonwealth PAYG base. States would retain the right to choose the flat tax rate.

There are no cogent arguments of market failure between small and large businesses, however defined, to justify a general small business exemption for efficiency. Also, note the very wide and arbitrary definition of a "small business" for exemption for payroll tax from one state to another. Again, there is no solid data to support an assertion that small business is the driver of the economy. Both small and large businesses introduce new technology and products, both sectors generate employment, and there are instances of failed businesses and investments across different firm sizes.

In the long run, and taxation is a quasi-constitutional policy with infrequent substantive changes, most payroll tax is passed back to employees as lower market wages than otherwise, much as PAYG tax on labour income is passed back to employees. Payroll is a tax on the buyer or demand curve for labour, and PAYG is a tax on the seller or supply curve for labour. With labour demand considered to be more elastic than labour supply, most of the economic incidence of PAYG and payroll taxes is on the employee.

Further, in the case of the current payroll tax with its exemption of small businesses, the current payroll tax on large businesses induces some employees to shift from the taxed large business to the non-taxed small business. As a result, some of the payroll tax on employees in large firms is offset by a higher market wage, and some is passed down to employees of untaxed small firms as a lower market wage than otherwise.

A revenue neutral comprehensive base payroll tax and lower rate package would leave most employees with about the same after-tax market wage. At the same time, distortions to the choice of business organisation and size are removed, with efficiency gains.

(d) ANTS Mark II

Taxation reform of the GST involving a comprehensive tax base and/or a higher rate must be considered as part of a broader reform package to replace more distorting indirect taxes and as part of a higher consumption tax-lower income tax mix change package, as illustrated by the ANTS package of 2000. These reform packages offer large gains in national productivity by replacing high marginal efficiency cost taxes with a much lower efficiency cost tax, the GST. Maintenance of approximately the current progressive distribution of the total tax system requires that much of the revenue gain of a larger GST be carefully recycled as a one-off increase of social security rates and as a more progressive, and still lower, income tax rate schedule.

Some issues to consider in the ANTS Mark II package are as follows. A comprehensive GST tax base, NZ style, would about double the current one, with advantages of efficiency (savings of about two cents per dollar revenue (Treasury Working Paper 2015-01) and of simplicity. Questions have been raised about extending the GST to include education and health. Adding GST to education and health would further increase the cost differential between private supply and public supply; leading to distortion costs as well as equity effects. An acceptable package with a broader base GST may require some revenue recycling via higher subsidy rates than those now provided to private suppliers of health and education.

Significant improvements in simplicity and lower operating costs would be gained by replacing Australia's cumbersome legislation for the GST with the NZ alternative.

The indirect tax reform component of an ANTS Mark II package would include replacing stamp duties on insurance (in preference to alternatives), perhaps a part of a package replacing conveyance duty funded in part with a larger comprehensive base land tax and in part with a larger GST to replace duty on some of the buildings and other capital works share. Rather than replace stamp duties on the transfer of motor vehicles with a larger GST, their removal as part of a different reform package for motor vehicles as proposed by AFTS is argued in the next section. Taking a longer term view, and an average of broad income and demographic categories, it is likely that detailed modelling will show limited net redistribution effects for a larger GST to replace more distorting indirect taxes package, on the plausible assumption that the different indirect taxes are passed forward to households as higher prices.

The case to replace some of the revenue collected from income tax with a larger GST is an efficiency argument. Both taxes cause similar distortions to labour decisions. A consumption tax for income tax swap reduces distortions to the aggregate quantities of investment and saving, and especially distortions to the composition of investment and saving associated with the hybrid mess of different tax systems and different tax rates on different saving and investment choice options. The GST is regressive in its tax incidence because those on higher incomes on average have higher propensities to save. At the same time, exemptions for so called necessities from the GST are a very blunt instrument for redistribution when compared with the better targeted income tax and social security systems; and there is no logic to exempt food but not clothing, or water but not electricity. In order to maintain roughly the status quo overall tax distribution, much of the revenue increase of a GST for income tax mix change has to be recycled as a one-off increase in social security rates for the average CPI increase, and as proportional reductions in income tax which are larger at the bottom end than the top. No doubt there will be claims also for compensation for self-funded retirees whose real savings will be eroded; however, given their access to many tax concessions over their lifetime (including zero tax on owner occupied home, concessional tax on other property and on superannuation), the claim could be debated.

A larger GST likely augments the argument for a combined gift and estate tax, or a wealth tax. Here the arguments include equity and also efficiency on the premise that those holding wealth gain utility just as they do from taxed consumption.

Note that I consider the case for an ANTS Mark II on its own merits. There is no validity to the argument that because other OECD countries have a larger VAT or GST, then that alone is a valid argument for Australia to change.

(e) Special purpose indirect taxes on motor vehicles and alcohol

AFTS recommended logical reform packages for special taxes on motor vehicles and on alcohol. They continue to be valid. In both cases, approximate revenue neutral packages are good options.

Special taxation of the use of motor vehicles to improve national economic efficiency fall into three categories: (a) as a user charge for government provided road services to fund road construction and maintenance, policing and emergency services; (b) the external costs of congestion in the big cities during peak hours; and, (c) the external costs of pollution, and in particular from the combustion of fossil fuels, including greenhouse gas emissions. Special indirect taxes for each of (a), (b) and (c) to replace the fuel excise, state registration fees, stamp duties, parking levies and other state motor vehicle taxes would be the package.

A road user charge would be based on kilometres travelled per axle weight, with the rate to reflect road damage. Given population and economic growth expected in Australia, arguably a rate based on the long run marginal cost is appropriate on efficiency grounds. With an increasing cost function for road services, the user charge should also generate sufficient revenue to cover average costs. Ideally, an allowance for toll road payments would be a deduction.

A pollution tax to internalise the external costs of greenhouse gas emissions would be set at the marginal external cost and be integrated with a common economy wide tax on fossil fuels, and more broadly a price on greenhouse gas emissions. Simplicity would use a revised petroleum products excise tax, and with the rate indexed automatically.

Available technology, and in fact an extension of the technology now in place for toll roads, could be used to collect a charge for the difference between marginal social cost and average social cost (equal to private marginal cost) for congestion which varies by, say, half hour interval and by road to internalise the external costs of congestion.

Such a tax reform package for motor vehicle use will have redistribution effects. For example, those who travel above average kilometres, and those who travel more often during peak periods, will pay more. Conversely, those who travel relatively small distances and during off-peak periods will be winners. Given the importance of business use of motor transport, the final economic incidence through changes in relative product prices will require estimation for a complete equity assessment.

A more logical tax to internalise the external costs of alcohol consumption would be a common tax per unit of alcohol across all beverages. This would replace the current different tax systems on beer and spirits versus wine, and then different rates on draft versus bottle beer and on brandy versus other spirits. An aggregate revenue neutral package could be designed. Clearly this reform package will have redistribution effects, but primarily on different individuals given the plausible assumption that most to all of the special tax is passed forward to domestic consumers as higher prices. Consumers of the now relatively low taxed alcohol products will lose and consumers of the relatively high taxed products will gain. Arguably the net effect could be considered regressive; although this is an empirical question.

(f) Reform the hybrid taxation of different resident saving and investment options

The very different effective tax rates on owner occupied housing, other property, shares, financial deposits, superannuation and so forth documented in Re:think and AFTS involve substantial efficiency costs. To my knowledge there are no credible published estimates for Australia of the efficiency costs of tax distortions to the mix of different saving and investment options. On most evidence, the tax concessions are regressive in their incidence, and they result in significant horizontal inequity. The different tax systems and effective tax rates add to complexity, and they provide incentives and rewards for socially wasteful, though privately profitable, tax avoidance schemes.

I accept the Re:think arguments that some taxation of savings income is justified for reasons of efficiency and equity. However, while reform of the current effective consumption base tax treatment of the most important form of household saving in owner occupied housing is considered off limits, only a second best reform package to limit taxation distortions and breaks seems on the political-possible horizon. There are conceptual challenges to the design of a worthwhile reform package. Challenges include: allowing for the effects of inflation; interactions of Australian investment and saving decisions in the context of Australia as a net borrower in a much larger global capital market; and, the importance of market failures associated with inconsistent time preferences and effects of other government policies on decisions to save. One could take the view that reform of the hybrid tax treatment of different saving and investment options should be part of a comprehensive review of all policies which affect retirement incomes.

Extension of the AFTS recommendation for a 40% discount on the personal income tax rate to all income on all forms of resident saving, except owner occupied housing, and perhaps superannuation for reasons of administration, warrants consideration. In principle, the 40% discount rate reflects the effects of inflation so that only real income is taxed, and there is a common tax on the different saving options. Given that the relatively lower taxed saving options, including other property, are relatively more important shares of income for those with higher incomes, and the high taxed saving options, including financial deposits, are relatively more important components of saving for those on low incomes, the vertical distributional effects may be tolerable.

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