Structural tax reform: what should be brought to the table?

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Abstract

This article canvasses what features of our current tax system should be brought to the table for consideration in the development of policies directed to structural tax reform. It does so against a background of political infection of the tax system over the last five years; the historical and current tax mix; the influence of global competitiveness on the corporate tax system; the confined income tax base for individuals including the current bias in favour of capital gains; and the base limitations of the GST vis–à–vis geographically close comparable jurisdictions. While the author puts forward his own views, he acknowledges the need for comprehensive discussion and understanding with a view to achieving some semblance of consensus. The author's conclusion is that the reform required must implement a broader base upon which our income tax can operate and so facilitate a reduction in marginal rates to provide an equitable foundation to broaden the base of the GST.

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1. Introduction

When I agreed to write this paper, I was hopeful, although not optimistic, that Treasury's long-awaited "white" or "green" paper — the colour really doesn't matter — canvassing the options for structural tax reform would have been released into the public domain. It is, after all, January 2015, nigh on 18 months into the government's term of office. My own view is that the government has no realistic prospect of formulating policies of structural tax reform, at least policies based on widespread involvement and debate by all interested stakeholders in the community, with a view to achieving some consensus — I accept that total consensus is a sheer impossibility — to take to the next election. I fear that time is now too short. Of course, politically, that may suit the government. Indeed, statements by the Treasurer that: "If you increase [the rate of] the GST, you need to compensate middle and low income Australians with significant tax cuts [and] [w]e haven't got the financial capacity to do that at the moment" (*The Australian*, 19 December 2014) might be a sign that structural tax reform, at least in the Treasurer's mind, is already on the "backburner". For my part, that would be disappointing; it would also be short sighted, as I will endeavour to make good.

It behoves all interested stakeholders to understand that the task of selling tax reform, particularly structural reform, can be tougher, and take longer, than finding consensus on the policies upon which the reform is predicated. So much is to be taken from two passages of the Taxation Review Committee's full report of 31 January 1975 (Asprey). In the last paragraph of the preface, the committee said:

> "In conclusion, the Committee would like to make it clear that, in undertaking a task of such magnitude, set by its terms of reference, it has always had a full realisation that it was entering upon a field in which controversy will never cease and that, upon the issues of taxation and economic policies which are inextricably interwoven in all questions of the reform of a taxation structure in any country, opinions as to the true and best path to follow will invariably differ. The history of every committee of inquiry into a taxation system is proof enough of that fact. Accordingly, this Committee expresses the hope that, out of the discussions which appear and the recommendations which are contained in this report and from the disputation which will inevitably follow upon its publication, a fairer, simpler and more efficient taxation system will eventually emerge than the one which presently produces the revenue for the Australian Government."

And at [1.12] the committee said:

> "Moreover, and above all, when a tax system becomes somewhat ossified and somewhat incoherent as has the Australian, and when rather sweeping reforms are under consideration, much public discussion and understanding

> are essential before large changes can be attempted. Structural reforms will inevitably take some years to implement, rate changes have to be made gradually as the circumstances of the day permit, and transitional problems of much intricacy have to be solved at every point. A proper appreciation of the ultimate aims of what is being proposed requires a presentation that in the first place is in terms of general principles rather than legal or quantitative detail. Strategy comes before tactics."

These observations are as apposite today as they were 40 years ago.

With perhaps one or two exceptions, politicians are not interested in tax reform. They say they are, but they only embrace tax change in the name of reform where it will sustain an increase in tax revenue going forward so as to enable them to spend more, or reduce a deficit caused by prior profligate spending, in either case, in their own political interest. Despite the introduction of the GST, which extended the taxation of the supply of goods to services, no consideration has been given to the tax mix in this country in decades. The reliance on income tax, both personal and corporate, relative to indirect taxes, even after the introduction of the GST and the reduction of personal and corporate tax rates over the last 30 years, has not changed.

This is borne out in a paper delivered to a forum in September last year by the recently retired Secretary to the Treasury, Dr Martin Parkinson (*Enhancing our living standards through tax reform*, 11 September 2014). After referring to a chart showing the respective contributions to revenue made by personal income tax, company tax and indirect tax in 1950–51, 2014–15 and as projected in 2024–25, Dr Parkinson said:

> "There are two things that are striking about the chart. The first is that the balance of taxes has remained reasonably constant over this entire period. This is despite the introduction of the GST and reduction in corporate and personal tax rates over the last decades.
>
> The second is that under current policy settings our reliance on income taxes – both personal and corporate – will continue to increase."

If this latter prediction of Dr Parkinson is correct, and there is certainly no reason to doubt it, then the challenges we face in the decades ahead to undertake structural reform of direct taxation in Australia are far more difficult and ominous than those involved in broadening the base of the GST, increasing its rate or both; proposals which, in recent times, have attracted a chorus of voices in support and against, although those against are undoubtedly politically sourced.

The one area of our tax system where politics is not the only determinant of policy is the corporate tax system; here, the competitiveness of the system has been a fellow driver of change as can be discerned from the trend over recent years for countries to lower corporate tax rates to attract both local and foreign investment and activity. As Dr Parkinson said:

> "A globalised economy and global supply chains mean that companies have greater choice about where they locate their production and productive assets – including intellectual property. Along with the significant differences in after-tax outcomes that can result from such choices, this places pressure on our corporate tax system and in particular our high corporate rate and our heavy reliance on corporate income tax."

On the other hand, the trade-off for Australia's high tax-free threshold — $20,542 per annum when combined with the low income tax offset — and the steep increase in rates after the tax-free threshold is that our effective marginal tax rates are comparatively high vis-a-vis other countries with similar tax systems. Going forward, these high effective marginal tax rates are going to create their own pressure on the demand for reform. In the words of Parkinson:

> "I have mentioned before that fiscal drag is expected to pull someone on average full time earnings into the third tax bracket [$80,001], with a marginal rate of 37% (or 39% including the Medicare levy) from 2015–16. And over the decade ahead, the average tax rate paid by that individual is expected to rise from 23% to 28%, an increase of over 20%."

The recent chorus of voices advocating a broadening of the base upon which the GST operates — specifically to extend it into the areas of health, education and fresh food; and to refine its operation in relation to services which are presently input taxed, notably financial services — has, at least until very recently, met with a lack of political will from all sides of politics. Some writers have suggested that if Australia is to overcome its debt and deficit prognosis, it will be necessary to increase the rate of GST as well as broaden the base.

I do not propose to explore the reasons for the lack of political will on this issue. Some are self-evident such as the fact that the GST is not perceived as providing any assistance to the Commonwealth's present financial predicament because its revenues are pre-emptively mandated to the states. Others are, perhaps, less obvious, although the GST's character as a standalone regressive tax undoubtedly contributes to that lack of political will; that character facilitates political trepidation in any attempt to broaden the base or increase the rate by creating an apprehension of inequity, irrespective of the actuality.

No, the catalyst for this paper lies in the fact that, while there has been vociferous support for broadening the base of the GST into areas of health, education and fresh food, and refining it in relation to financial services, there has been a continuing deafening silence for base broadening of the other major source of revenue — the income tax.

What I am going to suggest to you is that to press for base broadening of the GST and/or increasing its rate, without base broadening of the income tax and reduction of its high marginal rates, is not only politically flawed and unlikely to succeed, but is inconsistent with the generally accepted criteria or design principles which should drive the structure of the tax system.

Before embarking on this course, I should state the premises from which my views have evolved, articulating what I mean by certain fundamental principles.

The premises

I suspect there could be little argument with the proposition that if equity, efficiency and simplicity were the only criteria driving the structure of the tax system in this country, we would have a very different system to the one we have today. These criteria or design principles are well understood by informed stakeholders, and I won't elaborate on them to this audience.

To these design principles, the *Report to the Treasurer on Australia's future tax system*, December 2009 (Henry), added two others: sustainability — the tax system should have the capacity to meet the changing revenue needs of government on an ongoing basis without recourse to inefficient taxes; and policy consistency — acknowledging that rules in one part of the system should not contradict those in another part of the system, while recognising that:

> "[T]he primary objectives of the tax and transfer system, to raise revenue and provide assistant to those in need, should not be compromised by other policy objectives."
>
> (Henry, *Designing a future tax and transfer system,* Part one, Overview, 2.1, p 17.)

A second proposition with which, I suspect, it would be difficult to find argument is that changes to the taxation system are so riddled and infected by politics, changes amounting to real tax reform cannot even make it to the table for consideration and discussion, let alone be adopted as policy for implementation. Recent events in relation to the present government's budget proposals and the abolition of the carbon and mining taxes illustrate the state of infection. I have previously addressed this matter.

Indeed, some would say, with some justification, that there has been no structural tax reform in this country since the introduction of the GST at the beginning of this century. For fifteen years, we have seen only political infection of the tax system; and at this point in time, the prospects going forward, in the short to medium term, look far from disinfected.

The introduction of the GST provides a good example of the damage that political infection of a tax can perpetrate. In comparison to its New Zealand counterpart, the base of the tax was compromised from the outset, excluding health and education, while the exclusion of fresh food from other food by a series of carve-outs and exceptions to carve-outs has only exacerbated its inefficiency. The cost of collecting the tax per dollar of revenue raised is far higher than it should be, and far higher than it would be if the base was not politically infected by such compromise and carve-outs. And I leave out of the equation the additional compliance costs to the business community created by the complexity in such inefficient design.

The political infection of its introduction was carried over into the "handcuffs" that were placed on Henry's terms of reference:

> "The review will reflect the Government's policy not to increase the rate or broaden the base of the GST; preserve tax-free superannuation payments for the over 60s, and the announced aspirational personal income tax goals."
>
> (Henry, *Objectives and scope*, Part one, Overview, p viii, para 5.)

Indeed, those "handcuffs", and the ongoing reluctance of both sides of politics to allow a review of the design of the GST to be even brought to the table for informed consideration and discussion has greatly contributed to the current demand for GST base broadening and rate increase measures.

In my view, this political reluctance to bring a review of the GST to the table for consideration and discussion will not change until it forms part of a wider platform of reform, a platform which embraces a broadening of the concept of income to allow rates of income tax to be reduced at all levels, but in particular at levels above $37,000 (a modest annual amount even for a single working woman or man) when a 32.5% rate (plus 2% Medicare levy) cuts in. Only then will reform be embraced by both sides of politics, so as to make the votes of those in the political middle, as they should be on such important policy matters, totally irrelevant.

Base broadening: from Asprey to Henry

One does not have to be a rocket scientist to appreciate that the broader the base of a tax, the lower the rate that needs to be imposed to raise a given amount of revenue; the same logic inevitably leads to the conclusion that by broadening the base, the same amount of revenue can be raised even if the rate is reduced; and that if additional revenue is required, it can be achieved by base broadening without increasing the rate.

Recommendation (R) 1 of Henry was that "revenue raising should be concentrated on four robust and efficient broad based taxes" including "personal income, assessed on a more comprehensive basis". In R 2 through R 25, Henry made a number of recommendations for assessing personal income on a simpler and more transparent basis, but apart from recommending partial recovery of that part of the income tax base ceded to the fringe benefits tax back in 1986 (R 9), none of these recommendations are what I would describe as base broadening measures. The concept of what is "income" for the purposes of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) and the *Income Tax Assessment Act 1997* (Cth) (ITAA97) was not even mentioned.

In contrast, Asprey devoted a whole chapter (ch 7) of its full report of 31 January 1975 to the concept of "income" as the base of the income tax. Relevantly, it said:

> "7.3 The legal meaning of income is drawn very largely from judicial decisions – many of them borrowed from the United Kingdom – extended and refined by specific provisions. The primary characteristic of the tax law's approach has been to express what the word may be taken to mean in ordinary English usage. ...
>
> 7.4 For analysis in terms of economic principles in which theory comes first and practicalities are wrestled with later, economists have sought a primary definition of income in any period that is a measure of the flow of an individual's actual and potential satisfactions. One of the most thorough-going efforts to this end is that associated with the American economist Henry Simons whose Personal Income Taxation, published in 1938, has had great influence in academic debate. That formulation centres upon "increases in economic power" to command satisfactions.
>
> 7.5 The economists' definition would in general include in income all of the gains that the law includes: salary and wages; profits from a business or profession or business deal; interest, rent, dividends; compensation for income; and periodical receipts. But it also covers a great many gains that would probably not be reckoned as income in ordinary English usage, and have not been brought in, or have been brought in only to a very limited extent, by judicial and legislative extensions and refinements of that usage. The comprehensive tax base would include:
>
> (a) capital gains: gains from the realisation of property, when the realisation is not an aspect of the carrying on of a business or a profession, or the carrying out of a business deal;
> (b) bequests and gifts received;
> (c) lottery and casual gambling winnings;
> (d) retirement benefits and compensation for loss of office;
> (e) compensation for physical injury to person received in a lump sum or for injury to reputation; and
> (f) non-money income."

Asprey went on to comment on each of these, recommending some, such as capital gains, and rejecting others, such as lottery and casual gambling winnings, due to difficulties of enforcement and administrative problems in determining what deductions should be allowed. Interestingly, it only rejected the possible extension of the income tax base to include all bequests and gifts because it favoured the continued taxation of property the subject of bequests and gifts on a separate basis. Of course, such separate taxation no longer exists having been abandoned a couple of years after Asprey reported. In my view, there is a strong case for bequests and gifts to be brought into the concept of "income" as the base of the income tax. It is a matter which should be brought to the table for discussion. If and how it is to be done would depend on the outcome of that discussion.

I very much doubt that consensus could be found among readers of this paper, let alone in the wider community, as to what accretions to one's economic power should properly be brought within the concept of "income" as the base of the income tax. Views will differ but that should be no impediment to an item being brought to the table for consideration and discussion. Some of the more likely candidates include the following.

(1) Fringe benefits

Henry recommended (R 9) that those fringe benefits that are readily valued and attributable to individual employees should be taxed in the hands of employees through the PAYG system; other fringe benefits, including those incidental to an individual's employment, should remain taxed to employers at the top marginal rate (and non-reportable for employees). There then followed a number of simplification and rationalisation recommendations. Having regard to what was said by a Full Court of the Federal Court in *FCT v Indooroopilly Children's Services (Qld) Pty Ltd* ((2007) 158 FCR 325) concerning the nexus required between a benefit and an individual for the benefit to be a fringe benefit taxable as such, I am not sure where Henry's recommendation draws the line in the sand between benefits attributable to individual employees which would be taxable in their hands and benefits incidental to an individual's employment which would remain taxed to employers.

Moreover, while experience under the old regime was that benefits that did not have a market value created difficulties and disputation for taxpayers and administrators alike under s 26(e) (repealed) ITAA36, which measured tax value by references to the words "value to the taxpayer", these difficulties were largely overcome under the *Fringe Benefits Tax Assessment Act 1986* (Cth) by statutory methodologies and formulae for measurement of the tax value. I entirely agree with Henry that there is room for improvement in these methodologies and formulae, including simplifying their application, but disagree that if a benefit does not have a ready market value, so that its tax value has to be calculated by recourse to statute, there remains a case for maintaining the FBT arrangements so that such benefits are taxed to the employer. In my view, a strong case exists for the total abolition of this creature we imported from across the Tasman Sea and its replacement by taxing all such benefits in the hands of employees.

Whether the FBT is ultimately abolished; whether it is restructured along the lines recommended by Henry or whether, ultimately, nothing is done, it should be brought to the table for consideration and discussion in the context of broadening the income tax base.

2. The CGT discount

Prior to the introduction of Pt IIIA into ITAA36, effective with respect to the acquisition of assets on or after 20 September 1985, the tax base excluded all gains made from the sale of assets, other than:

1. sales made in the ordinary course of a taxpayer's business;
2. sales made in the course of a taxpayer's business where the asset was acquired for the purpose of profit making by the means giving rise to the profit; and
3. sales made which triggered one or more specific provisions of ITAA36, such as, without being exhaustive, ss 25A or 26AAA.

Part IIIA introduced a modicum of balance to the tax base that had hitherto been absent. Subject to the grandfathering for pre-20 September 1985 assets; the exemption for certain assets, notably the main or principal residence; the averaging concession said to reduce the bunching effect of an accumulated capital gain (Sch 7 of the *Income Tax Rates Act 1986* (Cth)); and indexation of the cost base, the gains on sale would form part of the tax base.

What happened? In 1998, a committee comprising three businessmen, Messrs John Ralph, Rick Allert and Bob Joss (the Ralph committee), was established by the Howard Government to make recommendations on reforms to the Australian tax system. Having regard to its recommendations, the writer can only conclude that what one person calls "reform", or what he perceives as a matter "calling for reform", are very much in the eye of the beholder; the design principles referred to above seem to be irrelevant. The Ralph committee recommended, and the government of the day embraced, the abolition of averaging; the freezing of indexation as at 30 September 1999, and the introduction of a discount (50% in the case of an individual or trust; 33.5% in the case of a complying superannuation entity) for gains resulting from a CGT event happening on or after 21 September 1999 for assets held for 12 months or more before the CGT event where the cost base is calculated without recourse to indexation. The reform of 1985 was effectively blown away. The tax base pendulum was again in full swing, this time swinging against income from personal exertion in favour of realisation of gain by those who could afford to buy and sell what might be called "non-essential" or "investment" assets.

The rationale for the introduction of this concession at the time and, indeed, the case that it made out for its retention today, is that employment and economic growth will be promoted by offering investors in start-up companies, particularly in high risk enterprises, such discounts. There is no empirical evidence to support this proposition but, even if there were, there would be no difficulty in confining the concession to such situations. What is fair or equitable about an individual who, by the sweat of his brow, derives a salary income of $200,000 per year and includes the whole of that amount in his assessable income, as against the individual who lives across the road and only includes $100,000 in his assessable income of the $200,000 gain made from the sale of shares in a listed company or real property. It is difficult to see how those latter investments make any contribution to employment or economic growth.

What is not realised by most people, including, I suspect, the government of the day, is that this change, the CGT discount, removed from the tax base as it existed prior to the introduction of Pt IIIA 50% of the gain made on the sale of an asset acquired for the purpose of profit-making by sale and held for more than 12 months: following the introduction of Pt IIIA, s 25A ITAA36 was amended so as not to apply to property acquired on or after 20 September 1985 (s 25A(1A)) on the assumption that it would be caught by Pt IIIA.

Writers who have evaluated the CGT discount and related reforms against the tax policy criteria or design principles referred to earlier (in particular, see P Kenny, "Australia's capital gains tax discount: more certain, equitable and durable?", (2005) 1(2) *Journal of the Australasian Tax Teachers' Association* 38–109) have concluded that while the reforms that abolished CGT averaging and froze CGT indexation were to be welcomed because both concessions failed all four tax policy criteria of fiscal adequacy, equity, economic efficiency and simplicity, the CGT discount had had a great and negative impact on fiscal adequacy, breached horizontal and vertical equity since it was only available to asset holders, added to complexity given the numerous requirements and anti-avoidance provisions totalling 22 pages of legislation, while economic efficiency did not appear to be greatly assisted.

Surprisingly, Henry did not recommend the removal of the CGT discount; indeed, Henry did not even consider its merit by reference to the tax policy criteria it advocated for the structural design of the tax system. In fact, as part of R 14, it recommenced its retention albeit reducing the discount from 50% to 40%. Henry wrote:

> "A 40 per cent discount represents a more realistic inflation adjustment than the 50 per cent discount currently provided for certain capital gains given the recent history of real risk-free returns and the Reserve Bank of Australia's objective of medium term price stability – with the goal of

> keeping consumer price inflation between 2 and 3 per cent, on average, over the cycle. Moving to a 40 per cent discount on capital gains would also reduce the arbitrage opportunities currently available while limiting the transitional costs involved with the abolition of the existing capital gains discount."

With great respect, the transitional costs associated with its abolition would be de minimis compared to the additional revenue it would generate. Australian Treasury's estimate of the tax expenditure from the CGT discount in the 2005–06 year was $2.03b. Notwithstanding the transition through the intervening GFC, it could be three times as much today.

In my view, it is important that the abolition of the existing CGT discount be brought to the table for consideration and informed discussion, even if any recommendation for abolition is not ultimately adopted. The same applies to Henry's recommendation for the abolition of grandfathering for pre-capital gains tax assets and for pre-1999 indexation arrangements, which were part of R 17. On this issue, it is difficult to disagree with Henry's argument.

3. The main or principal residence exemption

Now found in Subdiv 118-B of Pt 3–1 ITAA97, this exemption has existed since Pt IIIA was inserted in ITAA36. Its existence found support in Asprey, where it was observed:

> "23.57 The taxpayer's principal residence should be considered in a different light to his other assets, particularly in a society such as ours where home ownership is so highly valued and encouraged. A home is regarded as more than simply an investment and it must be remembered that any capital gain on a home will usually be in a sense illusory since the taxpayer will normally have to use all the proceeds of sale to purchase another house of comparable size, comfort and location. To tax the gain would have serious effects on the mobility of the work force. A person might be unwilling to accept a job in another city if the gain on the sale of his house is to be taxed, thus reducing the amount available for purchase of a new house and forcing him to accept a house of a lower standard than the one he has left. In addition, the administrative problems of levying tax upon the gains on the taxpayer's principal residence would be unacceptable. Apart from the task of valuing all houses on the date of commencement of the tax, there would be a continuing problem of determining the cost-base of the house. All expenditures on repairs, alterations and extensions would need to be accounted for and dissected into those that enhanced the value of the property (and would thus be taken into account in determining the cost-base and hence the gain) and those that were related only to the use or enjoyment of the property. In

> addition, homes are commonly owned for very long periods, and records of expenditure on the taxpayer's home are likely to be scanty or non-existence.
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> 23.58 The Committee accepts that it would be possible to adopt provisions giving a 'roll-over' (explained in paragraph 23.69) instead of an exemption or confining the proposed exemption to houses below a certain value. If either alternative were adopted, the tendency for resources to be diverted into overlarge houses would be corrected. The former alternative would, if anything, increase the administrative problems. Under the second alternative the administrative problems would be less: only a small number of houses need be outside the exemption. The administrative difficulties would nonetheless still be considerable.
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> 23.59 Accordingly, the Committee recommends that capital gains on the taxpayer's principal residence should in general be exempt from tax. But there is a need to ensure that this exemption is not abused and the Committee favours limiting the exemption to the house together with a reasonable amount of the land on which it is situated. It is recommended that the amount of land qualifying for exemption should be such amount as is reasonably necessary for the enjoyment of the house having regard to its location."

Clearly, Asprey's conclusion to recommend exemption from tax on the gain from the main or principal residence rather than some other relief, such as, for example, lifetime roll-overs, was an on-balance one after weighing the relevant advantages and disadvantages of exemption against other forms of relief. However, a lot has changed in the last 40 years. As foreseen by Asprey, the existence of the exemption over that period has led to a serious misallocation of resources into main resident investment and an over-capitalisation of many properties in the knowledge that any enhancement of value over cost will be tax free. This has undoubtedly contributed to price increases over the period and it is difficult to see any utility or benefit in this going forward, save for those who have the wherewithal to splurge on such indulgences, as well as lining the pockets of the realtors whose commission income rides on the "coat-tails" of increased prices.

It is my view that there must be a better method of providing relief to the large bulk of the taxpaying community without recourse to exemption and the attendant tax-free mega profits enjoyed by those wealthy enough to buy, develop and sell prime real estate constituting, for the period of their ownership, their main residence, without the administrative problems that so concerned Asprey. If only for this reason, the main residence exemption should be brought to the table even if a solution is not ultimately found and adopted.

The vast majority of the house-owning members of the community (averaging around two-thirds of the total community over the last couple of decades) have had to borrow substantial sums of money to get a start on the home-owning ladder and generally continue to borrow when they step up the ladder as their net worth increases. If the main residence exemption was abolished, while the interest on such borrowings would not be deductible, it would form part of the cost base of the home as would, generally speaking, all other non-deductible costs of owning it: s 110–25(4) ITAA97. Similarly, non-deductible capital expenditure to increase or preserve its value — the cost of improvements and refurbishment expenditure would form part of the cost base: s 110–25(5). In many cases, the gain on sale over a period of years may be quite modest and within some exempted threshold calculated by reference to the product of a per annum percentage of the ultimate cost base and the number of years in the period of ownership. To the extent that it exceeded any threshold exemption, roll-over relief would be available on a life-time basis. The tax, if any, need not be triggered until death although it would be if roll-over relief was not exercised, or could not be exercised due to downsizing; in both cases, cash would be released to pay the tax.

I have no doubt that better solutions could be developed but until the main residence exemption is brought to the table for consideration and discussion, there is no incentive to do so. It is too convenient to leave it on the "back burner" where it will simmer into oblivion. On the other hand, if the exemption issue is allowed to simmer on the back burner, the skewing of available resources, not only capital, but also labour, including technical skills, will continue to be poured into residential investment for homeowners to the detriment of residential investment for non-homeowners, as well as other far more productive forms of investment in terms of the engagement of both capital and labour.

4. Negative gearing

This is an issue which attracts spirited argument from both sides — those who support this particular feature of our tax system, and those who denigrate it, as symptomatic of the system's lack of equity. The former usually have a vested economic interest in its preservation.

It is not a new feature of the tax system even though Asprey had nothing to say about it. On the other hand, the federal government's draft white paper on the reform of the Australian tax system (June 1985) (the DWP) identified "negative gearing of rental property investments" as an abusive tax shelter and proposed measures to quarantine deductions for interest on moneys borrowed for such purposes, so that such deductions could only be claimed against rental income.

On 17 July 1985, the Treasurer announced that the government intended to proceed with such measures with respect to interest paid on moneys borrowed for rental property investments made after that day and these measures found legislative expression in the form of a new Subdiv G in Div 3 of Pt III ITAA36.

Rental property investment was not the only form of investment which the DWP identified as being open to the abuse of negative gearing; share investments were also identified, however, apart from the extension of the rental property quarantining measures to investments in companies which qualified as rental property companies, other share investments were not affected by the legislation.

The whole exercise was an unmitigated disaster. While the policy driving the legislation was relatively clear and certain, the means to give effect to it, the legislation, was overly complex and unwieldy — the proverbial sledgehammer to crack a peanut. The draftsman, presumably instructed by Treasury, sought to scope the legislation so that it purportedly applied to catch every rental property investment made after 17 July 1985, whether it be made by Westpac, from a pool of funds incapable of identification as to any component part but undoubtedly including borrowings, or by a natural person investing in the real estate market for the first time (outside his principal private residence) and borrowing for that specific purpose. The legislation was just not capable of dealing with both situations at opposite ends of the spectrum, nor with many situations that fell somewhere in the middle. The end result was that a little over 18 months after the legislation was enacted, it was rendered inoperative by the insertion in the operative provisions (s 82KZD) of a new subsection (1A) to the effect that "this section does not apply to the year of income commencing on 1 July 1987 or any later year of income".

In my view, notwithstanding this failed attempt to deal with the loss of revenue occasioned by recourse to negative gearing, the whole issue should be brought to the table again; this time with the benefit of the lessons learnt from the past. A starting point would be to deny deductibility for interest outgoings incurred by individuals, not otherwise carrying on a business, on borrowing to finance or re-finance the acquisition or holding of rental property in excess of the rental income derived from the property; with the excess interest going to increase the cost base of the property on its ultimate sale.

5. Superannuation

For nigh on eight years (since 1 July 2007), we have lived with a system of tax treatment of superannuation contributions, superannuation investment earnings and superannuation benefits that is totally skewed in favour of high income or high net worth individuals; not in any sense of statutory discrimination, but in the sense that the opportunities available for avoidance of the personal tax base can only be availed of by those sections of the community. One never ceases to be amazed at the apparent political consensus that accompanied the introduction of this system; that there was such consensus is manifest in the succeeding government's "handcuffs" placed on Henry, that his review was to "reflect the Government's policy **…** to … preserve tax-free superannuation payments for the over 60s …"

But it is the concessions other than the tax-free treatment of benefits for the 60s which is creating the demand for the system to be brought to the table for discussion and possible review. In particular, the income tax exemption for funds' earnings on assets attributable to the funding of current pension liabilities. The present government has confirmed that it will not proceed with the previous government's proposal to cap this tax exemption at $100,000 per annum per person from 1 July 2014.

I dare say that if the ordinary man in the street had any knowledgeable notion of what certain sections of the community were getting away with in this regard, any semblance of consensus would quickly disappear.

The whole system of the taxation of superannuation in this country needs to be brought back to the table.

Conclusion

The scenario we now find ourselves in is not new. For too long now, structural reform of many areas of the Commonwealth's legislative jurisdiction has been anaesthetised by the politics of those we elect as our representatives in the Commonwealth Parliament. Both sides, and those in the middle who profess to "keep the bastards honest", are equally to blame. At different times over the last 15 years, they have all pursued objectives driven by political expediency to the exclusion and detriment of the nation's best interests. In doing so, they have all displayed a lack of intellectual honesty, integrity and the courage necessary for strong political leadership. The most worrying aspect is not that this happened in the past, but there is every indication that it is going to continue into the future; and if it does, then the people of this country will never again enjoy the prosperity and consequential well-being that they, and their forebears, enjoyed in the past, and deserve to enjoy into the future: Europe here we come!

If you think I am exaggerating, I would suggest that you read Dr Parkinson's address to the Committee for Economic Development of Australia, delivered in Melbourne, on 27 November last year, where relevantly he said:

> "Tax and expenditure policies ultimately come down to the social welfare choices of Parliaments, but I would offer three points of guidance drawn from economics and experience.
>
> Firstly, from a growth perspective, focusing on reducing government spending is generally preferable to raising the overall tax burden.
>
> Obviously, changes within the mix of taxes that improve the efficiency of economic outcomes for any given amount of revenue are desirable, as is

focusing more on expenditures with long-term payoffs, like well-targeted investments in infrastructure and human capital.

Secondly, it's not feasible to materially reduce spending growth without looking at the largest spending categories. For the Commonwealth, this is health, welfare and higher education.

Whenever Parliament reverses, in part or in full, transfers provided to sections of the community by their predecessors, the savings inevitably come from those who were previously the recipients of those transfers.

While it is important that the public debate acknowledge that these sectors of the community are losing a benefit bestowed on them by a previous Parliament, it is also important to recognise the materiality of that loss, and to draw a distinction between reducing current transfers and reducing the future real growth in those transfers.

Third, it is important that we start the process of fiscal consolidation now.

Australia has recorded 23 years of consecutive growth and the budget projections are based on an assumption that this will continue for a further decade. Such an outcome – 33 years of uninterrupted growth – would be without precedent, domestically or globally.

Yet even on this assumption, we know the Budget is likely to remain in deficit in each and every one of the next 10 years unless we take action.

The implications for fiscal sustainability of failing to take action seem to have been lost in the public debate, as if this does not matter to Australia's future prosperity.

Moreover, fiscal drag, which helps improve fiscal outcomes in the pre-Budget line of this chart, is regressive yet gets little attention. As I have noted elsewhere, allowing fiscal drag to continue will result in someone on average full-time earnings moving into the second-highest tax bracket from 2015–16 and, over the decade ahead, experiencing a rise in their average tax rate of over 20 per cent.

In contrast to the focus of our public debate, comparator countries are lowering personal and corporate income taxes, and shifting the tax mix in favour of more efficient tax bases, in order to better compete globally. The consequence for Australia of maintaining a 1950s tax mix in the 21st century should be self-evident.

Conclusion

> …
>
> The decisions we take as a nation in the next few years will help determine whether we succeed or fail to ride the wave of opportunity open to us.
>
> The public needs to be engaged in this debate, and to appreciate the trade offs that result in success or failure.
>
> We know what failure looks like: declining growth in living standards, perhaps even falling living standards, lower wages, few opportunities for our young and, in all likelihood, declining public services and rising personal tax burdens as we struggle to maintain an outmoded industrial structure in an increasingly globalised world.
>
> But such an outcome is far from inevitable.
>
> Australia is in the fortunate position of having very sound institutions, a history of reform, and a willingness to continue adapting if we are persuaded by the need for change. So rather than being pessimistic about the future, we have strong grounds for optimism. Over the next few years, we have a unique confluence of opportunities to put Australia on a path to a more prosperous, sustainable future, to the benefit of all Australians."

It will be to the detriment of our "common wealth" if that "unique confluence of opportunities" is not grasped by structural reform of our tax system, reform which implements a broader base upon which our income tax can operate, so as to facilitate a reduction of marginal rates of income tax across the board, but particularly at lower levels, which will be required to provide an equitable foundation to broaden the base of the GST, and, if necessary, increase its rate, without doing violence to the underlying criteria that need to be satisfied for the achievement of true tax reform.