Possible New Taxes for Australia

Submission to Better Tax Review

Where is there a tax revenue problem?

In my view there are two key, related, problems with Australia’s tax system:

1. It’s over dependence on income tax revenue. As is well known, high marginal personal income tax rates are a disincentive to work and entrepreneurship. Corporate taxes lower the after tax return to equity capital as well as the internal funding available to business. These factors reduce business investment.
2. It’s cyclicality, particularly its dependence on global economic conditions. This reflects the nature of company profits and, especially, resource sector profits. [Budget cyclicality also reflects the automatic stabilisers linked to employment (income tax), and unemployment (the dole). Tax revenue will tend to decline at the same time that cyclical welfare spending is rising].

There are three major tax bases

1. Income
2. Consumption
3. Wealth

There are many other tax bases but these are limited in breadth, eg. imports, user-pays levies, luxury taxes, hotel rooms, asset purchases and “sin” taxes. Limited scope tax bases should generally be avoided as they will penalise and distort the markets for these activities.

This submission focuses on the 3 major tax bases. However, since Australia is already over dependant on income taxes, and the weaknesses of such have been noted above, it follows we have to pay more attention to consumption and wealth taxes. In addition to diversifying our sources of revenue it can be noted that these tax bases are comparatively stable, ie. non-cyclical. Revenue from taxes related to these bases will stabilise overall government revenue. This is a legitimate objective of public policy.

Specific recommendation related to consumption

At this time Australia has a GST which excludes various goods and services. The revenue from this GST accrues to the states. We should supplement this with a VAT of 2.5% on all goods and services and the revenue from which will accrue to the Federal Government. We could call it the Federal VAT.

Pro’s of a VAT.

* It is comparatively stable.
* It should grow over time in line with consumer spending.
* It is simple to understand and the infrastructure for its collection and administration already exists ie. it would use the existing structures for the GST. It should thus be easy and cheap to implement.
* It does not tax savings.
* It does not tax business inputs.
* It does not tax exports (excepting for hotel rooms).
* Since the net is very wide distortions are kept to a minimum.

Con’s of a VAT

* It is regressive. Pensioners, the unemployed and other low income citizens may need to be compensated.
* It will have a short term (1 year) impact on inflation. The RBA and most other parties will look through this.

Specific Recommendations related to taxing wealth

An issue to be borne in mind with any tax on wealth is that such taxes do not take into account an individual’s ability to pay in the absence of liquidating assets, ie. they ignore liquidity, income and cash flows. Such taxes should therefore be levied at very low rates in order to ensure that ability to pay issues are minimised.

1. Federal Government could add a levy onto the rates and taxes collected by local councils, the proceeds to accrue to the Federal or State budgets. It could be levied at a rate of 0.1% of the council’s assessed value of properties and collected quarterly with rates payments. Thus a house valued at $1 million would incur $1,000 of taxes annually, paid at the rate of $250 per quarter.

Pros of this levy

* The structure for collection of this levy already exists as do the asset valuations. It should therefore be cheap, easy and quick to implement.
* The tax collected will rise over time in line with rising property valuations.
* The incidence of the tax falls largely on the wealth of self occupied homeowners. It is therefore not regressive as the wealthy pay more than the less wealthy.
* The tax base is stable and the revenues resulting from this tax would also be stable.

Cons on this levy

* In the case of investors, while the levy is paid by investors they may be able to pass it on in part or in full to renters. The incidence is not clear cut.
* There is a class of retired home owners who are asset rich and cash flow poor. This levy may be difficult for them to meet. More on the issue of this class below.

1. Stamp duty on the purchase of real estate, levied by the States, could be replaced by an annual or quarterly levy. This levy would be based on the latest purchase price of a property and therefore be re-based every time the property is sold & bought. It could be set, for example, at 5% or 7% of current stamp duties.

Pros of this levy

* It relieves real estate purchasers of the need to find large sums of money up front at the same time as they pay for the property. Practically all purchasers have to add to their mortgage loans in order to finance stamp duties and thus end up paying, historically, 6% to 7% for up to 20 years on the addition to their mortgage loan to finance this tax. The proposed levy could actually save purchasers money while raising revenue for the states. The incidence would partly fall on the banks (via reduced mortgage lending).
* Stamp duties inhibit activity in the residential real estate market. Replacing stamp duties with a levy would therefore promote activity in this market and may even stimulate home building.
* The levy would grow over time in line with real estate values which, in the long term, have risen at a faster rate than CPI inflation.
* The base of the tax is clear and unambiguous. Collection should be easy.

Cons on this levy

* The levy would have to be phased in as it would not apply to houses on which stamp duty has already been paid. It could therefore take many years before it applied to all houses.
* In the initial phase it would raise less tax than an upfront stamp duty and it would take perhaps 5 or 10 years before it matched the revenue from stamp duties. However stamp duties are highly cyclical whereas the proposed levy would be stable.

Proposals (1) and (2) above are not the same. Proposal (1) applies to all houses, not just those recently transacted, and does not replace existing stamp duties. It would also be levied at a different rate. It is also envisaged that Proposal (2) levies would be collected directly by the state and not via local councils.

1. The value of a homeowners house should be taken into account when assessing their eligibility for means tested welfare payments. Many people find it outrageous that people who are actually wealthy should get a free ride on the back of taxpayers, many of whom may be much less wealthy than they are. Others again, who may have similar amounts of wealth in bank deposits or shares, do have this wealth taken into account when assessing their eligibility for means tested welfare payments. Apart from the inequity of the situation, it locks retired & elderly people into homes that are larger than their changed requirements. The traditional cry that these people lack the cash flow to pay for living expenses & taxes on their home is no longer valid. Home equity loans are now freely available and can be used to finance their cash flow needs. Such loans will typically be offset by appreciation in the value of the home.

Issues related to current company tax proposals

1) The proposed 1.5% levy on large corporations to finance increased childcare spending imposes a transfer of income from large to small corporations as well as from superannuation funds and self-funded retires to new mothers. These distributional affects are unfair and unwarranted. This levy should be replaced by one of the tax suggestions above.

2) Future policy action on corporate taxes should focus on reducing the cost of compliance in return for less abatements, deductions and inducements. Government should not be trying to “pick winners”, it should be focussed on creating a level playing field. From a corporate perspective the reduced cost of compliance would cover the increased revenue raised. Government is a net revenue winner from this.

3) I disagree strongly with the removal of dividend imputation and returning to the double taxation of dividends. I simply cannot see how this represents a step forward.

* Equity (risk) capital gets hit by company tax and then personal income tax while Loan capital gets treated as a tax shield while the debt holders are domiciled in a tax haven and do not pay income tax either.
* It also means that companies will cut their payout ratio making it even worse for shareholders looking for dividends.
* Companies will start raising their debt/equity ratios and their balance sheets will deteriorate. The financial health of the corporate sector will become more fragile.
* What about hybrid holders and issuers? How will they come out of this? People will return to putting their money in the banks – and opps - there will be a 0.05% tax on bank deposits also?
* The cost to companies of Hybrid finance will go up by about 41%. What will they turn to next?
* The argument that retained earnings (internal finance) is better than external finance is rubbish. You only have to investigate the appalling waste of badly invested capital in the US to appreciate the truth of this. Retained earnings leads to capital waste.
* It is entirely appropriate that a country with a chronic long term current account deficit, ie. whose domestic investment is funded by foreign capital inflows, should have a tax bias favouring equity investment in domestic businesses rather than businesses abroad.
* Since foreigners do not receive franking benefits from any other foreign nation anyway Australia is not disadvantaged by not providing such to foreign investors.
* Since the bulk of foreign equity investment in Aust is in the resources industry and resources cannot be easily replicated abroad, the flexibility of foreign capital to find alternative investments in other countries is exaggerated.
* Because dividend imputation results in a higher payout ratio in Australia foreign investors looking for dividends are well served by investing here rather than in countries like the US where dividends are actively discouraged by the tax system.

Apropos question 35:

“Should the tax system provide a more neutral treatment of different financing

arrangements (debt, equity and retained earnings), and if so, how?

Answer: The paper itself answers this question: Dividend imputation is probably the best measure that can be taken to even the field between debt and equity financing.

Issues related to Superannuation

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

Answer: A discount of 15 percentage points off a taxpayers marginal rate of tax rather than a flat rate contribution tax of 15%. A 15% discount would be a quite adequate inducement for people to place their money in superannuation funds while treating all tax payers more equally. It would also save the Government revenue.

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