What is tax reform for and what can it do?
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This paper is based on a Library Lecture given by Professor Stewart on 21 October 2015.

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ABSTRACT:

What is the purpose of tax reform? And what, realistically, can tax reform achieve? This paper considers the contemporary tax reform debate from a democratic, economic and social perspective. Professor Stewart takes a long term view of today’s tax reform proposals, and discusses the policy goals of sustainable revenues, economic prosperity, fairness and resilience in Australia's tax system at federal and state level.

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What is tax reform for and what can it do?

An era of reform?
In the last few weeks, I have spoken to a range of audiences about tax reform. They included Queensland and Victorian tax specialists; State Departments of Treasury and Finance; students of Global Finance; and the Prosper Society, formerly known as the Henry George Society, who in the 19th century were known as the ‘single taxers’—land tax being the single tax. Admittedly, most audiences have been tax specialists—or tax enthusiasts—of one form or another.

I am not the only one speaking about tax reform. Sometimes it seems that we talk of nothing else. The questions are, ‘what are we seeking to achieve?’ and ‘what can we achieve?’ under this label of ‘reform’.

I should say just a little bit about where I have come from. I’ve been an academic for many years. I have previously worked in private practice advising large corporations including mining companies and also in the Australian Government working on business tax policy and legislation. At the moment I am the Director of a fairly new research policy institute at the Crawford School at ANU called The Tax & Transfer Policy Institute.

In this role, I’ve been thinking quite a lot about the system as a whole; if you like, trying to think systemically.

I was invited, and very honoured to be so, to the National Reform Summit that was held recently. Reform is like sport. I love sport but I hate sports interviews, and I recall a cartoon whose author escapes me, of a sports interview. The team captain says, ‘Well, we sportsed very well out there that time, but unfortunately we didn’t sports well enough. The other team sportsed better. So we’re going to go away and do some training and we’ll be back to sports better next week’. We’ve been reforming very hard. We haven’t reformed hard enough. If we go away and regroup we might reform better next week.

There is a big challenge for governments to communicate why they want to ‘reform’ and what it is. After the Summit, I listened to 3SER Community Radio in Sydney, which is a young people’s community radio, and they had their morning breakfast show where they talked about ‘What happened yesterday?’ Well, it was the National Reform Summit, and they said, ‘Yeah, so a whole lot of important people got together to talk about reform. They thought there were a lot of things that needed reforming’—but they did not understand what, why, or where the costs and benefits might arise.

One of the reasons the National Reform Summit was held, was because there was a sense among a range of groups that government itself was not pursuing reform. That may still be the case, although there is now a little more momentum, I suggest, at the political level including state and federal governments together, for some kind of a tax ‘reform’.

What is the purpose of taxes?
Before we think about the purpose and expected effects of tax reform, what is the purpose of taxes?

Taxes are like plumbing. They are not an end in themselves. Rather, they are a means to fund government, resourcing joint, or public, action for the common good—rather than individualised, private or market action. It is precisely because of social and political organisation for the common good that we have taxation.

Adam Smith, writing 250 years ago, asked why do we have taxes at all? Adam Smith is well-known as the father of economics. It is less well known that he argued that government should be funded by taxation. He said only taxes could provide ‘That sure, steady, and permanent revenue which can alone give security and dignity to government … for a great nation’. Thus, taxes are needed for:

> defraying the necessary expence of any great and civilized state ... this expence must, the greater part of it, be defrayed by taxes of one kind or another; the people contributing a part of their own private revenue in order to make up a public revenue to the sovereign or commonwealth.¹

Indeed, Adam Smith defined political economy itself as being concerned with private and public revenue or wealth:

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Political economy, considered as a branch of the science of a statesman or legislator, proposes two distinct objects: first, to provide a plentiful revenue or subsistence for the people, or more properly to enable them to provide such a revenue or subsistence for themselves; and secondly, to supply the state or commonwealth with a revenue sufficient for the public services. It proposes to enrich both the people and the sovereign.²

Adam Smith had a vision for funding government that was ahead of his time. In this context, he also articulated a concept of ‘public goods’ which need to be funded with taxation. The concept can probably be traced further back, certainly the general conception of taxing to fund the benefit of government. However, Adam Smith observed that there are public goods ‘in the highest degree advantageous to a great society’ but which would not pay for any one individual to invest enough and which should be provided for all.³ For example, he included education for children in this category: he considered that government should pay for children’s education for the common good. This was inextricably linked to his vision of a market economy, which would be viable in the longer term.

**Tax and legitimate government**

After 250 years, we are still operating within that paradigm of the ‘tax state’, but legitimacy of government through democratic institutions rather than inheritance or divine right has become embedded. Political economic ideas about tax and politics (developed in Britain, Europe and in the US) circulated widely including in Australia and took hold early. The statement of the Eureka Stockade Rebellion in 1854 in Victoria, which was put to the mining inspectors about the licence fees they had to pay, said in its first paragraph:

> That it is the inalienable right of every citizen to have a voice in making the laws he is called upon to obey—that taxation without representation is tyranny.⁴

In Australia, it is a fundamental principle that the Parliament has supremacy in deciding the object, shape, and weight of taxation. The High Court ruled on the progressivity of the federal land tax in *Osborne v Cth*.⁵ The Court held that it is not for the Court to decide validity of a tax based on how oppressive or steep the tax is. Barton J said:

> Assuming that the taxation which it imposes is drastic, as it is alleged to be, still it is not the function of the Court to say that drastic taxation on landed interests will prevent residents from owning large areas, or prevent landholders from residing out of Australia, or prevent absentees from holding land within the Commonwealth. ... Even assuming that such designs existed, they would not alter the construction of an Act or make it less an exercise of the taxing power. They may be the motive or even the ultimate object. We have not to do with either of these things. ... Conceding, for example, that in some cases a heavy tax may when administered operate, by the pressure of its severity, to destroy an industry which a State alone has power to control, or to force holders of large landed estates to sell them, or to remain in this country when they would rather live elsewhere, these are questions of the policy or wisdom of the tax, and belong to the people, directly or through their representatives, and not to the Court. And this is true even if the tax is so heavy and so carefully adjusted as to appear intended to produce the results foreboded. Questions of the abuse of power are for the people and Parliament.

It’s important to remember, when we’re thinking about trying to reform the tax system, that it is part of a broader system of democratic government. If politics seems to get in the way, we’re forgetting that politics is part of the point. Politics is actually why we have taxes.

It is also important to remember that the Constitution grants the Commonwealth Parliament power to levy any kind of tax and that the Parliament has the capacity, through the grants and other powers in the Constitution, to shape tax policy for the national good. At the same time, our federal structure is

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² Ibid., Book IV.I.1.
³ Ibid., Book V.1.69.
⁵ [(1911) HCA 19; (1911) 12 CLR 321]
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embedded in the Constitution and it is important for us to ensure that state and territory governments are fully democratic, funded and accountable to their residents and taxpayers. The importance of this has been highlighted recently by Cheryl Saunders and Michael Crommelin; federation and tax reform should aim to strengthen our federal democracy.\(^6\)

**A century of income tax and democracy**

This year is the centenary of Australia’s Commonwealth income tax. It was introduced in 1915 by Billy Hughes, at that stage Attorney General under Prime Minister Fisher. The income tax was an element in a suite of federal taxes that were enacted immediately before and during World War I, including the land tax in 1912, estates duty in 1914 and entertainments tax in 1916. Only the income tax has survived and it is under scrutiny again in current tax policy debates, following the release in March 2015 by the Australian government of the *Re:Think Discussion Paper*, aimed at a ‘national conversation’ on tax reform.\(^7\)

When introduced, the income tax was described by Sir Josiah Stamp, who was a leading economist in Europe, in a somewhat ambiguous remark, as ‘A courageous effort by the Australian Legislature’. The income tax was passed with bipartisan support, albeit this was made easier because the Government, after a double dissolution, had a majority in both Houses. The Leader of the Opposition, Mr Joseph Cook (Parramatta), recognised how an ‘income tax’ is ‘peculiarly appropriate in time of war’. He was cautious about the longer term implications, observing that ‘we are, so to speak, blazing a track’ as the income tax ‘is, so far as the Commonwealth is concerned, entirely novel, and of far-reaching importance.’\(^8\)

However, all were not happy about it. Mr W Elliot Johnson MP (Lang) presciently observed that ‘unfortunately, there is all too much reason to believe that this taxation will not end with the war’ and continued:

> To me it seems only part of a policy of frightfulness in taxation for which the war is made the excuse by honourable members opposite.\(^9\)

I have not heard the phrase ‘frightfulness in taxation’ yet in our contemporary tax policy debate but before it comes to an end I hope we see it resuscitated.

The federal income tax funded the beginnings of the welfare state. By the 1950s, this welfare state was well-established. You can see this trajectory in this chart from the Australian Treasury of the last hundred years of tax in Australia from 1902 to 2013.

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\(^8\) Commonwealth Parliament, Hansard, House of Representatives, 31 August 1915, p. 6373.

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In this chart, you can also see how small Australia’s government (at State and federal levels combined) was at federation relative to the size of the economy: about 5 per cent of GDP. That is smaller than the governments of most developing countries today. The chart shows the expansion of government after World War II, from 1942 to the 1950s. When our former Treasurer Joe Hockey said we have a tax system that looks like the 1950s, as a matter of detailed law design this is inaccurate; but as a matter of overall tax level and tax mix, it is generally correct. Nonetheless, I have to wonder whether this is such a bad thing. In fact, we can see from the chart that taxes (and spending) reached their peak under Prime Minister John Howard during the 1990s, when revenues were pouring in regardless of what we did. Tax and spending reached a peak and then crashed at the financial crisis in 2009; are now on the way up again, but revenues have not recovered to pre-crisis levels yet.

The Australian federal individual and company income tax have come to provide the lion’s share of tax revenues in Australia. At federation, income taxes—levied by the states—raised only 6 per cent of Australian tax revenues. By 1939-40 this was 34 per cent, but three quarters was still raised by the states. Today, the income tax is by far our most important tax by revenue. Australia would look very different without it.

In 2013-14, the personal income tax, with the Fringe Benefits Tax and superannuation fund taxes, raised about $173.7 billion, while company income tax (including petroleum resource rent tax) raised $68.6 billion.10 The total of $242 billion comprises 70 per cent of federal tax revenues, and is nearly six times the revenues raised by the Goods and Services Tax. Income tax revenues are enough to fund our cash transfer (social security and welfare) system, defence and the federal government expenditure on health, in the current budget.

Commonwealth spending and the Budget now is about one third social security and welfare (the transfer system); one third health and education; and what’s called ‘other purposes’ is the grants to the states, which really basically funds health and education.

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10 Australian Government, Budget 2015-16, Paper No. 1, Statement 5 (Revenue), Table 7.
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The chart below shows the overall tax level as a percentage of GDP for several countries. For example, the Netherlands, UK, Spain, New Zealand, Canada and Japan, and the OECD average, are higher than Australia. So we have a substantial collection of tax but not massive. The chart also shows some of the different important taxes including, of course, income tax. The tax state—the government that we have constructed over the last century in Australia and in all these different countries in different ways—relies most heavily on direct income tax and consumption taxes.

Australia’s tax level and tax mix as % of GDP, comparative context; Source: TTPI Stocktake Report (2015), OECD revenue statistics.

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11 This chart excludes superannuation (as it is not treated as a tax).
In conclusion, the income tax has been very effective; with its growing revenue collection, together with increased revenues from some other taxes, we have seen the growth of the public sector in Australia. Nonetheless, this trajectory is visible across developed countries, as is clear from the above chart and other OECD statistics; although in some other countries the tax level is much higher than in Australia. There is a real question as to where you would end up if you do change this dynamic in Australia’s tax system.

**Is there a crisis of the tax state?**

At the very time that Australia’s federal income tax became operational during World War I, Joseph Schumpeter, the leading public economist from Austria (who then went to the US) articulated the idea of the ‘tax state’: that is, a state that is developed and funded dependent on taxation. It is interesting to consider Schumpeter’s views because he is also one of the leading economic thinkers of the 20th century on issues of entrepreneurship, innovation and the ‘creative destruction’ of markets; key concerns that have again reached the political and economic agenda in Australia.

In 1917, Schumpeter was worried about whether governments were going to be viable in the future and in particular whether taxes were going to sustain them. He foresaw a fiscal crisis of the state.\(^1\)

What worried Schumpeter was that he didn’t think taxes could sustain social expenditure. It wasn’t war or debt that he was worried about, but funding what the people wanted the money to be spent on: the social welfare state. Yet, our democratic government succeeded—after many, slow and tortuous attempts especially through the Depression—in mobilising tax revenues to fund the public services, goods and redistribution that Australians wanted, as expressed through the democratic process.

In spite of the massive increase in the size of government over the last century, we still don’t like paying tax. We still have this extremely difficult politics of taxation. We celebrate in Australia the rebel who avoids, resents and even steals from the state at the same time as we celebrate our education health and welfare systems and the equal opportunity and fair go that Australia has to offer—at least, to most of its people, most of the time.

**Should tax reform fund the deficit?**

The federal government has a fiscal deficit, as indicated in the 2015-16 Budget. The Budget projects that we will recover a prudent stance of fiscal balance or a small surplus, without any legislative change but as a result of the effect of bracket creep in the personal income tax, by 2019-20.

Is this the right way to go? It has been suggested recently that we should move away from this supposedly ‘volatile’ income tax base which goes up and down with recessions. But that is, in fact, what the income tax is designed to do and one reason it is so resilient (I return to the concept of resilience later). Collections fall in times of recession and the government shares, to some extent, in the losses of businesses and collects less from individuals who are earning less. Collections go up in good times. And without indexation of income tax thresholds or brackets (which Australia has never done, unlike Canada or the United States), the progressive personal income tax grows with real wages and inflation, over time fixing the deficit, while still collecting more from those who have higher capacity to pay.

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What does this mean for tax reform? This may depend on your view about efficiency of taxation and a different goal of tax reform being to support economic prosperity.

We could ‘fix the deficit’ by leaving the income tax system, more or less, the way it is. Of course, even doing nothing has distributional consequences. All Australians would contribute to funding the deficit through bracket creep, but the effects may be felt more strongly at low and middle income levels. In any event, leaving the system the way it is will not deliver further revenues to fund apparently growing health and other public expenditures in future; the government still projects significant expenditure cuts being needed in the medium term.

We could—as has been suggested by many—aim to raise other taxes, such as land tax, or the Goods and Services Tax (GST) in order to increase tax revenues and fix the deficit. However, such a change is rarely suggested as a simple addition to the current system. Rather, it is usually argued that in making such a change, we should reduce other taxes.

A tax reform that actually raises taxes will require visible government benefits demanded by the people—and/or a visible lowering of other taxes—if it is to garner sufficient support. Any increase in some taxes and decrease in other taxes will also have distributional consequences.

What are principles of tax reform?

As taxes are a way to draw a share of the economic return into the public domain, we clearly should care first, about what is done with the funds—that the decision making about expenditures is done in a fair way and funds are utilised for the common good—and second, that taxes themselves are raised in the most efficient, fair and effective way possible.

The classic tax policy principles are equity (fairness), efficiency and simplicity. But probably most people would agree that just raising a tax is not ‘reform’. It has to be considered in light of the broader policy goals. On this basis, we have argued at TTPI that taxes should be designed to produce sustainable revenues, while supporting or helping deliver:

- economic prosperity
- fairness
- resilience.  


I’d like to read you a little bit from Billy Hughes’ second reading speech for the 1915 income tax in which the goals of fairness and prosperity are both discussed. To me it sounds like this speech could be repeated today. What Hughes said was:

The Commonwealth has hitherto not resorted to taxation of income but I have always regarded this form of direct taxation as particularly, peculiarly appropriate to the circumstances of a moderate community. Not only as an effective means for raising money for the conduct of government, but serving as an instrument of social reform.14

That is the ‘ability to pay’ element which is a strength of our progressive income tax in delivering widely recognised fairness to the tax system.15 I value fairness highly but in this lecture I want to focus on ideas of efficiency and resilience of the tax system.

A tax reform goal for efficiency: supporting economic prosperity?
While we have a need for revenue, when tax reforms have been done in Australia with the stated goal of increasing prosperity, they have usually been presented as a ‘revenue-neutral’ package, including substantial tax cuts and other compensation. That is more difficult when we have a fiscal deficit stretching into the future.

It is interesting to note that while supporting income tax as an instrument of social reform, Hughes was aware in 1915 of the potential disincentives for economic activity of the income tax. He continued:

It’s necessary to consider however not merely the requirements of the revenue, but also the incidence of the tax so that the economic equilibrium may be disturbed as little as possible. Australia is a very rich country, her production per capita being very great, perhaps the greatest in the world. A country’s productivity is the measure of its labour force, its energy and its resources. The productivity of labour depends mainly on two things, the amount of capital available and the manner in which it is being used, and the efficiency of the labour. At this juncture it is of the utmost importance that we shall do nothing to discourage enterprise.

Many are familiar with the concept that tax ‘gets in the way’ of enterprise or productive market activity and that efficiency requires a neutral and lowest possible tax. This is the basic model that economists use about efficiency of a tax. You impose a tax on a good (this is your pre-tax world); in the post-tax world, the supply goes down and the price goes up. Some of the tax goes to government; that’s the wedge. So taxes impose a wedge between demand and supply. Vendors get less, buyers pay more, the difference is the tax, and that triangle in the middle is what is called the deadweight loss because the quantity produced overall declines.

One of the key elements of economic thinking is that it aims to optimise supply using price in the market: to come to the single most efficient method for doing something, the optimal allocation of resources.

15 Ibid.
The Treasury argues that the economic costs of the tax system (the ‘marginal excess burden’) are higher than they need to be and that many features of the existing system make it less attractive to invest in Australia and limit job growth, affect work incentives or add significant complexity across the system. For particular taxes, Treasury estimates that stamp duty on transactions and insurance are the least efficient followed by company income tax; that a broad based land tax (and council rates) on land value are the most efficient; and that a broad based flat rate GST and flat rate income tax have equivalent efficiency.

The Treasury explains carefully the many assumptions in its modelling. The model depends on assumptions about responsiveness of work, investment and savings to taxation, of rational behaviour with full information and few if any market constraints; however, those assumptions may not reflect actual behaviour and it is important to consider empirical evidence. The model also assumes households act as a single unit and does not identify individual earners in a family and their incentives or responses to tax systems. Individuals may also respond to taxes in ways that seek to reduce their tax bill—through tax planning—without changing their underlying economic behaviour.

Yet even acknowledging these limitations, it would be wrong to ignore the potential behavioural effects of taxes and broader economic costs of those responses, as empirical evidence does show that statistically, individuals do respond in various ways to features of the tax system and that tax rates—and concessions or loopholes in the system—can have real effects on economic behaviour.
Resilience

We can think about the tax system as a system that connects public and private revenues across the economy (in Adam Smith’s language)—or connects government to individuals and businesses and creates relationships between individuals through collective decision making about resource allocation. I’m interested in a resilient tax system because I’m interested in a stable democratic government.

In applying a concept of resilience to our tax and transfer system, I adapt the approach developed by scientist Brian Walker for consideration of sociological and ecological systems. The concept of resilience has also come to the fore in a financial context after the global financial crisis, regarding ‘resilience’ of the financial and banking system globally and of national markets such as housing markets.

System resilience. Source: www.stockholmresilience.org/21/research/what-is-resilience.html

Systems theory suggests that resilience is about the capacity of a system to recover its equilibrium. As illustrated by the figure above, systems theorists use the metaphor of a ball in the bowl; that the world changes, there are shocks and crises and so on, but unless you hit that threshold you’ll bounce back, the system will more or less recover to its equilibrium. However, once over the threshold, the system is destroyed and a new equilibrium may be established.

In the ecological context, systems resilience is used to talk about ecosystems that are pushed over a threshold and can never recover their previous state. Salinity in the soil is an example: you get to a certain threshold of salinity in the soil, it gets to within two metres of the surface, and then it changes the ecosystem and there’s no return. So this idea of being able to recover, or, alternatively, to transition safely to a new equilibrium is central.

In contrast to the economic goal of optimisation, resilience may require some diversity or redundancy of methods or approaches in the system. A key element of resilience thinking is to observe that fully optimising a system may make it less resilient. We should expect, therefore, that we may not be able to fully optimise the system, in part because we cannot predict which elements of the system may collapse or fail, so retaining a variety of elements in the system is important.

If we think about tax system resilience, what might be some of the features we want our system to have? We want it to be resistant to planning, we want it to have low costs for sustainable revenues, and we want it to be adaptable to future challenges. That also means the system must be politically legitimate and sustainable.

For example, integrity rules in tax systems are necessary to ensure resilience although they frequently introduce complexity and cost. We may aim for simplicity and efficiency in taxation by moving to reliance on only one or a few ‘ideal’ taxes. But having several different taxes applying to different bases in the system—but not too many—may lead to a more resilient system in the long term, even if the different taxes do not themselves raise much revenue.

Some kinds of change in our tax system may be difficult to reverse or modify in future, and this could undermine efficiency, fairness and resilience. A historical example in our tax system of a shift over a threshold to a new equilibrium may be the abolition of inheritance taxes by all states and by the federal government in the late 1970s up to 1981. In spite of increased attention being paid to wealth taxes today as a useful policy instrument and efficient tax, moving (back, or forward) towards higher wealth taxation

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is extremely challenging politically. We seem to be in a stable state in which we under-tax wealth and assets, in an era when there is increasing concern both about inequality and about efficiency of taxation.

There are other reasons why our tax system may be becoming less resilient, especially regarding mobility of capital; increasing digital or intangible value creation; and changes in the way in which we all work.

**A tax mix ‘switch’ from income to consumption?**

One efficiency argument commonly made is that Australia needs a tax mix ‘switch’ away from income tax and towards consumption. A cut in less efficient taxes could be funded by an increase in other taxes—or by base broadening of more efficient taxes. The idea of a tax mix ‘switch’ away from personal income tax towards the GST is commonly floated. Premier Mike Baird of NSW recently proposed an increased GST although most of the revenue would be distributed to the states, on his proposal, rather than being used up in personal income tax cuts.\(^\text{17}\)

Such a tax mix ‘switch’ could be achievable politically because both GST and personal income tax are in the federal tax base, so that both tax and compensation could be delivered by the same government—even though by agreement, we allocate all GST revenues to the states.

However, the narrative that this would generate a large efficiency gain is misguided if the focus for the ‘switch’ is on individual income tax.

The Treasury modelling set out above shows that at a flat rate, efficiency of personal income tax and (broad based) GST is basically the same. The model assumes the GST in such a comparison is broad-based, which our GST is not, as it applies to less than half of the potential consumption base.

The model also assumes, as mentioned, that a household acts as a single unit, when in fact it is critical to observe that households have two earners who work and invest in different ways—who operate as different taxpayers. This assumption is often made because it is easier to collect data on a household basis; and in particular, it is difficult to unpack consumption within a household.

Measures of efficiency that take women’s workforce participation seriously and use an individual base—and this is a key element of our workforce that is underutilised and a key platform in a prosperity agenda—indicate that a *progressive* personal income tax is most efficient.\(^\text{18}\) It taxes lower waged and more responsive workers (whose choice to work is more ‘elastic’) at a lower rate, and those with higher wages—who have, empirically, lower ‘elasticity’ of work response—at a higher rate. That is consistent with goals of economic efficiency and women’s workforce participation.

Consequently, a straightforward tax mix ‘switch’ between GST and personal income tax may not have a substantial positive effect on the economy. It could even be counter-productive. It will not address those taxes where the economic argument has the most weight—which are state land tax and payroll tax.\(^\text{19}\) It may also reduce resilience of our tax system in the longer term, on the basis of fairness and legitimacy of the tax.

Such a tax mix ‘switch’ may also fail to address other weaknesses in our tax system. For example, in the state tax bases, we have local government taxes, stamp duties and land tax (among others). Professor John Freebairn and I have recently done a report that reiterates the economic arguments for doing a switch between land tax and stamp duty, pushing that land tax share of the burden up and taking it off transactions and appreciated property values.\(^\text{20}\) Australia has a relatively low reliance on property taxes overall in our whole tax mix—lower than in comparable countries and we could improve that.


\(^{20}\) Ibid.
What is tax reform for and what can it do?

Strengthening the GST

The GST raises only about one fifth of income tax revenues. It is reasonably effective, but the Australian Tax Office faces more problems with debt collection and the informal economy in the GST area than in most other areas of tax collection. The GST has the highest administrative cost of collection and also the highest compliance costs especially from small business.21

These are reasons to reform GST. There is a more general ‘resilience’ argument for why our indirect tax base (mostly the GST) needs to be strengthened, including, perhaps, broadening the base, as well as an efficiency argument. Australia’s indirect tax base is eroding. As a share of GDP and overall tax revenues, Commonwealth indirect taxes have actually declined since the mid-1980s.22

Broadening the GST base and—to a limited extent—raising the rate, can strengthen the indirect tax base. We should, to support resilience of the system, aim to increase our indirect tax base in particular through strengthening the GST base and perhaps by strengthening other indirect taxes—such as a carbon tax, fuel excise, or taxes on alcohol or specific goods (even, perhaps, sugar).

Strengthening the individual income tax

What about efficiency and resilience of the individual income tax? In our current system, we know that our income tax applies to people’s wages—although not as heavily as many countries—but it also applies very unevenly to the return to saving and investment.

I have discussed bracket creep above. The chart below from the Re:think Discussion Paper (updating the Murray Financial Systems Inquiry report of 2014) shows the effective income tax rates on different forms of investment or saving in our personal income tax. The chart shows effective tax rates for a person on the 32.5 per cent marginal rate. The bank account is taxed at their marginal rate. Their own home faces zero tax. Although we call it an income tax, we actually have a hybrid income/consumption tax that produces expenditure tax treatment of home ownership, a zero tax rate, or what we sometimes call a ‘pre-paid’ expenditure tax. Other real estate is taxed but not as heavily because of the capital gains tax (CGT) discount. The chart does not take account of negative gearing. Superannuation, overall is more generous even than expenditure tax treatment and that generosity goes to the top end. Australian and foreign shares are taxed differently at lower rates.


A key concern about resilience—and efficiency—of our personal income tax is this unevenness. This has been raised in policy documents for a long time. Associated with that, I do think that negative gearing of real estate is a problem. As shown in the chart below, ATO tax statistics show very large net rental losses (net rent is the red line, net of all deductible expenses). These large deductible losses in our income tax are undermining the wage tax base, and are actually operating as a tax shelter.

![Net rental losses chart](source: Australian Tax Office Statistics 2012-13)

The moderate income earner, for example, a hairdresser who buys a rental investment property with debt under $400,000, is not going to make a large capital gain (certainly not in the short term). So really what they’re doing is buying a tax shelter when they invest in rental real estate. From a tax reform perspective, one thing that we need to keep working on is this coherent treatment of taxation of savings. This would support efficiency and resilience of the system.

**Company tax, globalisation and entrepreneurship**

The company income tax is considered by the Australian Treasury as a less efficient tax: it is modelled as being nearly as inefficient as stamp duties, as indicated in the Chart above. At a 30 per cent rate since 2000 (now 28.5 per cent for small companies), Australia company tax is argued to be uncompetitive with other countries. Treasury modelling suggests that in a world of mobile capital, the tax rate should be lowered. The argument is that it discourages the marginal foreign investment that Australia needs.

Yet, our company tax is an effective revenue raiser. That the bulk of our $68 billion in company tax revenues are collected from the largest 20 companies, on the whole reflects that it is doing its job. Australia’s now almost unique dividend imputation system means that Australian resident companies with Australian shareholders (including superannuation funds) have a strong incentive to pay Australian tax. Imputation credits on franked dividends return nearly half of company tax revenues collected to shareholders. Some of the remaining company tax is on reinvested profits and some of it is effectively borne by non-resident investors, who do not pay dividend withholding tax but do not get the benefit of imputation credits either.

The company tax performs a multitude of functions. In our resource economy (unlike, for example, the United Kingdom), the company tax collects a lot of revenue from resource extraction. The company tax also acts as a ‘backstop’ for personal income tax, although because the company tax rate is a lot lower than the top marginal rate, tax planning incentives still exist and high wealth individuals have capacity to cap their tax rate at either the discount capital gains tax rate or the company tax rate.

The effective collection of resource revenues does make our company tax collections vulnerable to declining commodity prices. Company tax is also under challenge from economic globalisation. The OECD
What is tax reform for and what can it do?

have just released their final reports, to which countries agreed by consensus, of ways that the international tax regime can be cooperatively changed to address ‘base erosion and profit shifting’ (or BEPS).23 The G20 Finance Ministers endorsed these and we will likely see some action in coming years. Australia has already tightened our thin capitalisation debt rules and has introduced a ‘multinational anti-avoidance law’ which seeks to tax large businesses (such as Google) selling into Australia without having a taxable business presence. These processes will support the company income tax base.

However, even these cooperative solutions will not address the potential for real economic investment to move in response to tax competition. In the longer term, this raises big questions about the future of the company tax in a global context. However, in the short term, while our company tax rate potentially could come down a little—at a revenue cost that would have to be made up elsewhere—I would not like to see us dramatically cut the company income tax rate without significant and careful consideration.

What of Prime Minister Turnbull’s agenda for innovation and entrepreneurship? This builds on the focus of the Government in the last couple of years which has emphasised tax as a barrier to small business and the role of taxation concessions in encouraging and supporting small business. As indicated by Hughes speech in 1915, concerns about the impact of income tax in deterring enterprise or investment have a long history.

Nonetheless, we should be cautious about enacting special rates, tax exemptions, credits or deductions targeted at particular kinds of investment. First, we need to be clear what the goal is. Small businesses play a very important role, but most of them do not grow or contribute in a significant way to economic growth. Some, but not most, new businesses, innovate and grow; many stay the same size, do not innovate much, while many fail. Second, businesses or investors may not respond to tax incentives (for example, Australia’s first attempt to encourage foreign pension funds to invest in venture capital in this country basically had no effect). Third, if businesses and investors do respond to tax incentives, the way in which they respond may be unpredictable and we can rarely identify if there is substantially increased real investment or gains on the margin. Fourth, we already provide a lower tax on capital gains—potentially too generous—through the CGT fifty per cent discount and through exemptions in venture capital funds vehicles.

We pay a significant price for creating ‘Swiss cheese’24 of our company income tax (and the personal income tax), through increased complexity, administrative costs and tax planning. Finally, it must be remembered that other economic and social drivers for innovation and entrepreneurship—for example, public expenditure on education or legal entity forms, wages and other taxes, may have more effect than income tax.

A tax system for the (medium term) future

The goals of tax reform depend largely on the time horizon. What should the tax system look like in two or five years’ time? What about in 10 years’ time? In 2055? (the 40 year time horizon for the Intergenerational Report25).

As we look to the future, we should be actively working on building a resilient tax system that is simple and transparent for taxpayers and low cost for administrators. Digital ‘disruption’ is not only a negative for the tax system. For example, we could aim, by 2025, for every individual to have a ‘single touch’ digital tax account that tracks their tax paid, expenses in real time and does away fully with the requirement for a tax return. Any reconciliation could be electronically calculated and refunds paid at year end. Employer Pay-As-You-Go wage tax withholding, and superannuation guarantee, would continue but would be updated and linked to this personal tax account—as we increasingly work more flexibly and with multiple employers and sources of income in future. A more uniform and broad based system would be simpler to administer through a single digital account.


What is tax reform for and what can it do?

We should be able to collect taxes for both federal and state governments from the same platform—payroll tax, for example, on the PAYG base and land tax on the council rates base. To address globalisation and mobility of investment, tax administrators need to be nationally and globally networked, while retaining confidence of taxpayers that privacy will be protected and the systems are procedurally fair. If we can build this capacity, then we can more easily move to harmonised tax bases on wages, consumption and land across governments for the national good.

In the longer term, there are many unpredictable elements because of technological change. For example, in two decades, some suggest that 40 per cent of existing jobs in Australia may have disappeared because of changes such as automated driving. What might this mean for tax reform? First, we don’t want taxation to get in the way of job creation—we do really need to manage economic change and find meaningful work and livelihoods for current and future workers. Second, we want a tax system that can continue to raise a fair share of revenues for government from the many, diverse, and flexible ways in which individuals derive economic return in future.

We’ve had a lot of change in our tax and welfare systems since the 1950s: globalisation of the economy; massive migration; urbanisation and development of our cities; the feminist revolution that brought women in massive numbers into our education, work and economic systems; and now a transition to longer lived but overall, ageing population and new technologies. The tax system has on the whole, through these dramatic changes, shown resilience and recovered to a stable state that is based at its core on an income tax. We have a dynamic political economy; as needs change, our tax and spending systems can change too. Tax reform is not a ‘once and for all’ process but an ongoing responsibility of the Parliament in legislating for the common good of all Australians.

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