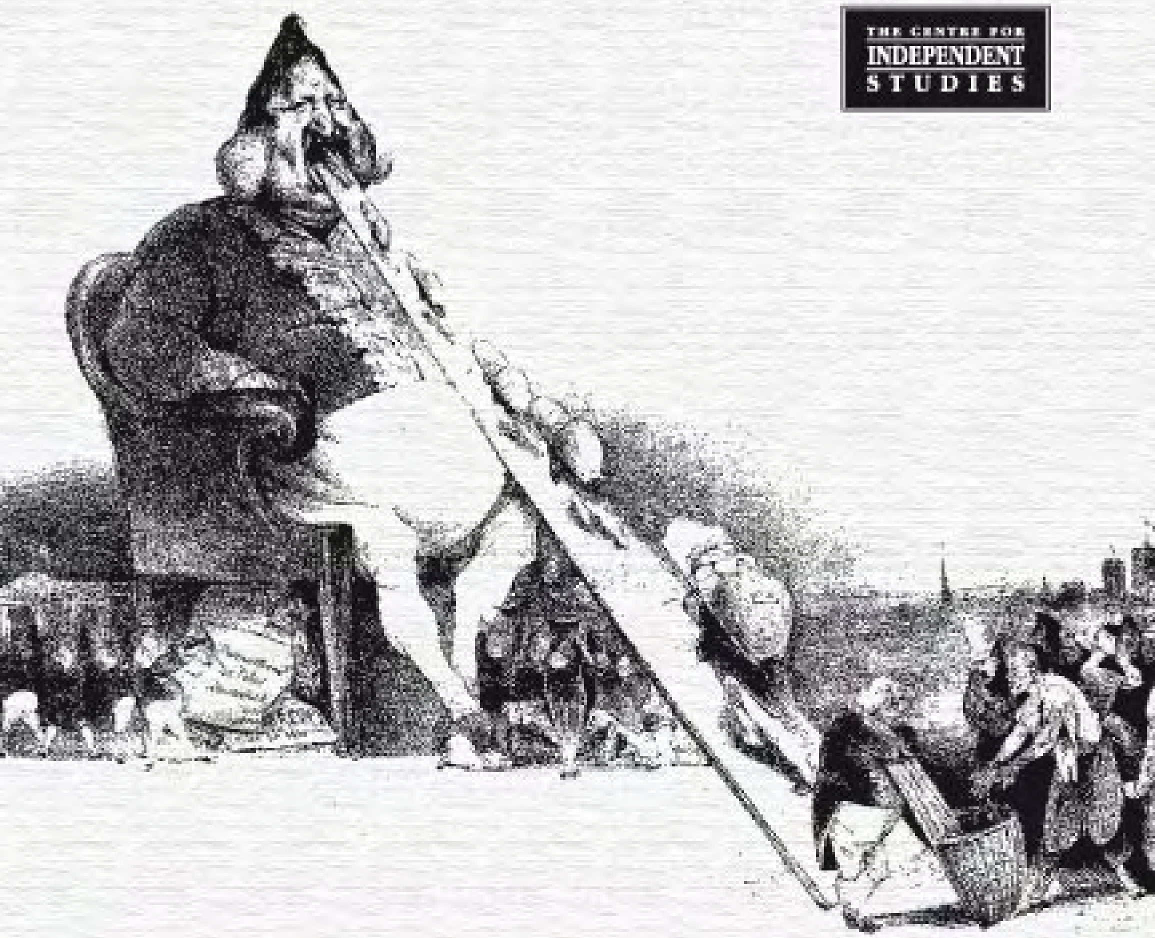

Taxploitation II

Tax Reform for Incentive, Productivity and Economic Growth

Edited by Robert Carling

THE CENTRE FOR INDEPENDENT STUDIES

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Tax Reform for
Incentive, Productivity
and Economic Growth

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2011

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Chapter 1

Introduction and Overview

Robert Carling

Tax reform is once again in the spotlight. The review of Australia's Future Tax System (AFTS), known colloquially as the Henry review, was completed at the end of 2009 and its report to the government was released in May 2010. It was one of the most comprehensive reviews of the tax and transfer payments system ever undertaken in Australia. The Rudd government made some decisions on the recommendations in May, but left the rest for future consideration or to be forgotten. The outcome of the 2010 federal election forced the government to reopen the discussion on tax reform options. At the behest of the independent MPs, whose support was necessary to the existence of the minority Labor government, there is now to be a tax forum in October 2011 to consider all of the AFTS review recommendations. In the wider community there is a strong and vocal constituency in favour of tax reform, although there is also a range of different objectives.

This publication (*Taxploitation II*) brings together eight monographs published by the CIS over the past five years in its *Perspectives on Tax Reform* series and follows *Taxploitation—The Case for Income Tax Reform* (2006), a collection of CIS monographs that made the case for personal income tax reform from various perspectives. Since then, the Howard and Rudd governments have made changes to personal income tax, but these fall well short of the wholesale reforms advocated in *Taxploitation*. A large reform agenda therefore remains. This volume not only revisits the agenda for personal income tax reform but also comments on a broader range of taxes. It is intended as a contribution to the tax reform debate from a perspective that emphasises smaller government, individual liberty, and economic freedom. As such, it does not always come up with the same solutions as the AFTS review, but there are striking similarities in some areas.

The ideas for tax reform outlined in the following chapters are not intended to form a coherent or comprehensive reform package. While many of the proposals could complement one another in such a package, others would not. To the extent there are inconsistencies, however, they reflect different views as to the best means rather than different basic objectives. What draws the chapters together, above all else, is a belief in the primacy of individual liberty and enterprise ahead of the state.

The monographs in this volume have generally not been revised from their original publication, except for updating some data.

Tax reform, revenue and the size of government

Tax reform is linked to the size of the general government sector because the tax system determines how much tax revenue governments will raise, and therefore, how much they will have available to spend or to hoard for future spending. The total impact of government on the economy is broader, because it also depends on the regulatory activities of governments and the extent of direct participation in economic activity through government trading enterprises such as public utilities. This does not alter the fact that tax revenue is the most important single gauge of government intervention.

Tax reform is often equated in the public mind to tax reduction, but reform can also be structured to have no net effect on revenue (revenue neutral) or even to increase revenue. In fact, according to its terms of reference, the AFTS review was not to presume a smaller general government sector or explicitly rule out a larger general government sector. While the review report flagged the likelihood of government expansion in the long term, for now it has settled for a set of recommendations that add up to broad revenue neutrality, with some measures adding to revenue and others subtracting.

Large-scale and beneficial reform is possible with revenue neutrality, but why stop there? Telling the review not to presume smaller government curtailed its scope even before it had started. The revenue neutrality constraint is too limiting. The approach to reform taken in this volume does not accept such a constraint and presumes that a smaller general government sector would be desirable. This is not to say that all options would require the general government sector to shrink, but the more ambitious ones would in the sense that over time, tax revenue and government spending would fall as a proportion of GDP. Note that this does not necessarily mean that absolute government spending in real terms would have to decline, because the fall as a percentage of GDP could be the result of real spending growing more slowly than the economy.

Reform is likely to be politically more achievable if it involves net tax reduction. But the more compelling reason to relax the revenue neutrality constraint is that smaller government and a lighter overall tax burden would be better for productivity and economic growth. There is abundant theoretical and empirical support for that proposition. Up to 2007–08, tax revenue in Australia hovered around 30% of GDP, which was the highest level on record. This proportion has since declined as a result of the global financial crisis, while the proportion of government spending has risen. The fall in the tax proportion is likely to be temporary, and it will be close to 30% again within a few years. It is cold comfort that this figure is below the average for all advanced economies—an average that is skewed upwards by the extremely heavy tax burdens of some European countries.

What should tax reform aim to achieve?

The usual criteria of a good tax system are that it should aim for economic efficiency, equity and simplicity. Economic efficiency is a term that embraces the effects of the tax system on the levels and growth rates of productivity and GDP. Taxes inevitably impose an economic cost, but they should be designed to minimise that cost. Equity has both horizontal (comparative treatment of taxpayers with similar capacity to pay) and vertical (comparative treatment of taxpayers with different capacities to pay) dimensions. Simplicity refers to the transparency, user-friendliness, and the operating costs of the tax system.

Applying these criteria is not straightforward because they do not always lead to the same conclusions for tax design; in other words, there are trade-offs among them. One of the most contentious issues is the extent to which the tax system should be designed to reduce inequality (vertical equity), because such redistribution blunts incentives and comes at a steep cost to economic efficiency. The priorities for tax reform in 2011 should depend on the greatest failings of the tax system based on the criteria of efficiency, equity and simplicity. Some politicians and commentators believe that the tax system should be more redistributive, but the Australian tax/transfer system is already one of the most redistributive in the world because transfers are highly targeted and tax is progressive. Considering the economic efficiency cost of high and progressive tax, the tax part of the equation is already excessively redistributive. This suggests that reform should focus on reducing the high economic efficiency cost and complexity of the tax system.

The AFTS review is not explicit about its view of the relative importance of objectives that are to some extent inconsistent, but it clearly attaches high importance to economic efficiency and simplification.

> Most of all we need a tax and transfer system that is oriented to supporting strong and sustainable growth [and] policies that not only redistribute income but also promote the growth of incomes at all levels ... (p xvi)

The review paints a vision for a twenty-first century tax and transfer system that 'would support per capita income growth rates at the upper end of developed country experience' (p xvii). It sees higher workforce participation, a more efficient pattern of saving, stronger investment in human and physical capital, and therefore, higher productivity growth as keys to the objective of high per capita income growth. The review acknowledges evidence put to it that Australia's combined tax/transfer system is Scandinavian in its pursuit of redistribution. The review seems to be in search of lower economic efficiency costs and greater simplicity more than greater redistribution, but we cannot be sure because neither the review nor the government was explicit about its priorities.

The unfinished business of personal income tax reform

The last paper in the *Taxploitation* volume was written by John Humphreys ('Reform 30/30: Rebuilding Australia's Tax and Welfare Systems') in November 2005, prior to the personal income tax cuts of recent years. In 'The Unfinished Business of Australian Income Tax Reform,' Robert Carling analyses those cuts and compares them with the goals spelled out in *Taxploitation.* He argues that although the personal income tax system has been reshaped and the overall burden somewhat lightened, some of the major failings of the personal income tax system identified in *Taxploitation* remain and should be the focus of reform in the wake of the AFTS review. Tax thresholds have been increased substantially, but high marginal rates have only been trimmed. The system has become even more complex with more deductions, offsets and concessions. Carling argues that marginal rates should be slashed; thresholds indexed to inflation; and many deductions, offsets and concessions removed.

Several contributors to *Taxploitation* made the case for a flat income tax. Carling endorses it in principle, while acknowledging that if a flat tax is unattainable for the foreseeable future, then a lower and flatter marginal rate scale would still be a worthwhile reform. Specifically, Carling suggests a new tax scale with the tax-free threshold increased from $6,000 to $16,000; much lower marginal rates of 15%, 27% and 35%; removal of many tax offsets and deductions; and abolishing the Medicare levy. He also suggests a dual income tax system whereby the above scale applies to labour income, while income from capital and savings (including capital gains, interest and rent) is subject to a low, flat rate similar to the corporate tax rate but pitched at a much lower level than the current 30% corporate rate. This treatment of income from savings and capital would be a boost for economic efficiency and a big step towards simplification. The case for differential treatment of labour and capital income comes from the theory of optimal taxation, which repudiates the view once popular with tax experts that all income should be taxed at the same rates, and posits that differentiation is necessary if revenue is to be raised at the least economic cost.

The AFTS review recommendations contain similarities and contrasts. The review does not put numbers on its recommended scale but outlines an 'indicative' scale consistent with its conceptual view of the ideal personal income tax system. The indicative scale also features a higher tax-free threshold to replace tax offsets, but it is at an even higher level of $25,000. While there are benefits to that, the cost is that marginal rates above $25,000 in the indicative scale are generally no lower than they are now, and at some income levels, even higher at 35% and 45%. Full-time workers at the adult minimum wage would face a marginal rate of 35% on extra earnings from overtime, promotion and their own efforts to acquire skills. The AFTS policy choice reflects a sanguine and, in Carling's view, mistaken view of the disincentive effects of marginal rates and a commitment to a more steeply graduated ('progressive') marginal rate scale. The AFTS review accepts in principle the case for differential taxation of labour and capital income, but applies this in the form of a 40% discount for capital income like the existing 50% capital gains discount instead of a lower flat rate for capital income. Again, this preference is driven by a desire to preserve 'progressivity,' but the recommendation that the highest effective marginal rate on capital income should be 27% represents a major breakthrough to those who have long argued for much lower marginal rates. The argument now shifts to labour income, where the AFTS review is suggesting excessive marginal rates.

There is no doubt that *both* substantially increasing the tax-free threshold *and* slashing marginal rates would be very costly to government revenue but could bring huge benefits if phased in over a few years and if the revenue neutrality constraint were to be relaxed.

Ending the tax/welfare churn

John Humphreys in 'Ending the Churn: A Tax/Welfare Swap' exposes one of the reasons the tax bill is as high as it is—not only is the welfare state massively expensive but many of the recipients of welfare benefits also pay the taxes that support those same benefits. This is the phenomenon of 'churn.' The problem of 'cash churn'—whereby people both pay tax and receive cash from the government—is well known. Humphreys, however, also applies the concept of churn to government-funded or -subsidised health and education services that are paid for and used by middle- and high-income earners.

The costs of churn are both economic (administration, compliance and economic efficiency costs) and non-economic (lower self-esteem and individual responsibility, political rent-seeking, and lack of transparency). There is also a dynamic cost, as the welfare system is expected to expand much further in line with demographic and other trends in the decades ahead. These trends will require government to increase tax, cut services, or reform the system. Humphreys suggests reforming the system by taking cash welfare recipients entirely out of the system by increasing the tax-free threshold to the point at which people stop receiving cash benefits. The much bigger issue of services churn can be dealt with by means-testing access to public health and education benefits and cutting middle-class and upper income taxes commensurately. This would lead to much higher tax-free thresholds than by eliminating just the cash churn. Middle- and high-income families would be compelled to buy their own health and education services (either from government or private providers) but the tax cuts would give them the extra disposable income to do so.

The AFTS review generally takes the same approach as Humphreys in greatly increasing the tax-free threshold, which would also exempt all government income support and supplementary payments from tax. These measures would go a long way towards eliminating cash churn by keeping welfare recipients out of the tax system and taxpayers out of the welfare system. The motivation, however, appears to be primarily the simplification and reduction of effective marginal rates in the welfare-to-work transition rather than reducing cash churn as such, which the review regards as being a relatively minor problem in Australia given the tight targeting of welfare benefits. The review does not consider services churn at all.

Reforming capital gains tax

In just 15 years, Australia went from not taxing capital gains at all to taxing them like ordinary income at full rates, subject to inflation indexation and averaging provisions (from 1985), and then to taxing them at full rates subject to a 50% discount for assets held longer than one year (from 1999). This chopping and changing, such as we have seen with superannuation tax, suggests that the right answer is unclear, but in 'Reforming Capital Gains Tax: The Myths and Reality Behind Australia's Most Misunderstood Tax,' Stephen Kirchner argues we were closest to having it right before 1985. He points out that the economic case for taxing capital gains is weak; capital gains tax (CGT) raises little revenue but comes at a heavy cost in lost economic welfare. The case for a CGT rests almost entirely on equity arguments, which say that a dollar of income is as useful whether it comes from wages or from an increase in the market value of an asset, and that most capital gains accrue to the wealthy anyway. But Kirchner points out that the advocates of the equity of a CGT may be surprised by how its burden is distributed in the long run. CGT is likely to lower productivity growth, and since productivity growth is the main determinant of sustainable real wage growth, the incidence of CGT falls on labour as well as capital.

Equity arguments, whether technically valid or not, hold sway with those who say capital gains should be taxed like ordinary income without the 50% discount. That is an extreme position. At the other end of the spectrum is the view that if economic efficiency arguments were allowed to prevail, there would be no CGT at all, as was the case until 1985. Some countries, including New Zealand and Singapore, still have no CGT, while all others apply various forms of concessions relative to full tax on ordinary income. In the United States, for example, the highest rate of federal CGT is 20%, which is much lower than the top rate on ordinary income. Focusing on Australia, Kirchner exposes the myth that the 1999 reforms halved the effective marginal rate on capital gains, pointing out that replacing inflation indexation with the 50% discount actually raised the effective marginal rate when capital gains are less than twice the rate of inflation, and reduced the effective marginal rate by less than 50% in other instances.

Despite all the chopping and changing of the past 25 years, there is a compelling case for further reform of CGT—not to increase the effective rate but to lower it, if not eliminate it altogether. This would produce substantial gains in economic efficiency. Over time, there would be more revenue, not less as holders of assets become more willing to realise gains and trigger a (lighter) CGT liability. Kirchner offers several reform proposals: a low, flat rate for all capital gains; abolishing the minimum holding period of 12 months before qualifying for concessional treatment; and reinstating the inflation indexation that applied from 1985 to 1999.

The AFTS review rejected the 'comprehensive income' view of the tax base and accepted the proposition of optimal tax theory (how to raise revenue at the lowest economic cost) that capital income should be taxed at lower rates than labour income. This should be the last nail in the coffin for the idea that capital gains should be taxed as ordinary income. Disappointingly, however, the review recommends that the 50% discount be cut to 40%, bringing it in line with the new discount recommended for other personal capital income such as interest. It is not clear where the 40% figure came from other than pragmatic revenue considerations, but it would be a backward step.

Corporate income tax

Although the major parties competed in the 2010 federal election campaign with promises to trim corporate income tax, more often the corporate tax debate is overshadowed by the personal income tax debate. Arguments by big business for corporate tax cuts are usually dismissed as self-interested sectional pleading. In 'The Faulty Arguments Behind Australia's Corporate Income Tax,' Sinclair Davidson presents a sound case for cutting the corporate income tax rate. For as long as this tax has existed, economists have dared to ask whether there is any case for it at all, given that corporations are not people and ultimately pass their income tax on to their employees (in lower wages), customers (in higher prices), and investors (in lower shareholder returns). Davidson canvasses the arguments and finds that the justification for corporate income tax is indeed weak. The main arguments for it are that it is a backstop to personal income tax and that governments find it a convenient source of revenue—it is politically popular, its true incidence is obscure, and corporations do not vote—but these are weak arguments. At the same time, there is a consensus among economists that the corporate income tax does a lot of harm. There is international evidence that its deadweight cost is high and it retards economic growth, possibly more than any other tax, through its effects on investment.

Davidson shows that Australian corporate tax revenue (relative to GDP) is high by OECD standards, and was increasing during the 1990s and 2000s even though the tax rate was cut to 30% in 2000—still high by international standards. He sees a clear case for lowering the rate further, although he doesn't put a figure on it. On its own, this move would widen the gap between the corporate and upper personal tax rates, but the latter should be cut at the same time.

One of the more welcome aspects of the AFTS review is that it accepts the case for reducing the corporate income tax rate. It recommends a sizeable cut from 30% to 25%, and unlike other recommendations, not in the long term but in the 'short to medium term.' So far, government has promised only to cut it to 29% from 2013 and only in conjunction with the mining resource rent tax.

State taxation

Carling's review of the need for state tax reform in 'State Tax Reform: A Review of Progress and Prospects' starts with a reminder that the states are responsible for some $50 billion of taxes per year. Although this represents only 15% of all taxation, leaving the Commonwealth responsible for the lion's share, state taxes account for more than 15% of what ails the national tax system. The costs that they impose on the economy are even higher, per dollar of revenue raised, than those of Commonwealth taxes. State taxes are generally narrow and highly selective, have complex structures, apply to transactions rather than value added, and add to business costs.

Carling concedes that the situation has improved from 10 years ago, when a phased program of state tax reform linked to the GST was started under an agreement between the Commonwealth and the states. Although some states are still dragging their feet in finishing that program, it has largely been completed. As a result, the financial taxes on deposits and withdrawals, mortgages, and share transactions, which were long a feature of the system, have disappeared. The potential scope for reform is, however, much larger. Contrary to popular understanding, payroll tax, land tax, stamp duty on real estate transfers, insurance taxes, and stamp duty on motor vehicle registrations were not part of the GST agreement. Although most states have trimmed their payroll and land taxes in recent years, these and other remaining state taxes are ripe for reform. Carling calls for a new Council of Australian Governments (COAG) agreement to define and implement such reforms. This agreement should include:

- abolishing stamp duties on insurance and motor vehicles, and in the states that still impose fire services levies on insurance, replacing them with property based charges as in the other states
- preferably abolishing, but at least halving, stamp duty rates on real estate transfers
- lowering rates of payroll tax and broadening the base by lowering the point at which payroll tax becomes payable, and
- lowering rates of land tax and broadening the base.

Broadening the bases of payroll and land taxes would help finance the other tax cuts, but there would still be a large funding gap. This could be filled through expenditure restraint and wider use of road user charges. Ideally, the states would be allowed to impose their own sales taxes, but this raises constitutional issues. An increase in the Commonwealth GST on the states' behalf as a trade-off for far-reaching state tax reform should be considered only as a last resort.

State taxation cannot be separated from the broader issue of how the states are funded, and in particular, their already heavy dependence on Commonwealth grants. The resulting 'vertical fiscal imbalance,' whereby the states' expenditure responsibilities far exceed their revenue raising powers, is inconsistent with the clear accountability within a federal system of government. Carling suggests that if there are insurmountable constitutional barriers to handing over broad-based consumption tax powers to the states, then the Commonwealth should devolve some personal income tax power to the states while reducing its own income tax (and grants to the states) to make room.

Some of the recommendations of the AFTS review are similar to those summarised above. The review recommends abolishing the remaining stamp duties and broadening the land tax. The main difference is that it also recommends replacing payroll tax with a Commonwealth broad-based business cash flow tax similar to a GST in its economic effects. The review acknowledges the problem of vertical fiscal imbalance and that its recommendations would worsen it. While it canvasses at length the option of devolving some personal income tax power to the states as a remedy for the imbalance, the review stops short of recommending it. But it does not rule it out either.

Taxation as fiscal illusion

Rather than focusing on any particular tax or level of government, in 'Fiscal Illusion: How Big Government Makes Tax Look Small,' Davidson canvasses an issue that cuts across all taxes and all levels of government: fiscal illusion and how it contributes to the growth of the state. Fiscal illusion is the political art of crafting tax and expenditure policies in ways that make taxpayers think government costs them less than it actually does relative to the benefits they receive from government spending. This illusion increases the politically sustainable size of the tax burden, and with it, the level of government spending.

Davidson identifies many of the techniques that governments use to promote fiscal illusion, including opportunistic tax levies designed to take advantage of community sympathy for various causes. Another example is the fondness for business taxes, which are not transparent to households even though they are passed on in lower wages or higher prices to consumers. Complexity of the tax system is yet another example of how fiscal illusion can be promoted, because it creates uncertainty about the true tax burden. Recent Australian experience is mixed. Davidson welcomes some changes that have reduced fiscal illusion, such as the replacement of the hidden and highly selective wholesale sales tax and an assortment of hidden, narrowly based state taxes with the broader and more transparent GST. On the other hand, complexity remains and has increased in recent years.

The AFTS review does not discuss fiscal illusion as such, but it holds that the tax system has become too complex and that simplification should be a central objective of reform. A number of its recommendations are aimed at greater transparency, and the review is critical of tax earmarking in general—a topic taken up in more detail by Carling in the next paper.

Tax levies

In reviewing the case for and against tax levies for specific purposes in 'Tax Earmarking—Is It Good Practice?' Carling examines a category of taxes rather than any particular tax. The practice of tax earmarking or 'hypothecation,' which means increasing an existing tax or creating a new one for a specific purpose, gives rise to tax levies such as the Medicare levy. While such levies have been a feature of the tax system for a long time, they have become increasingly popular at all levels of government; there is to be a temporary 'flood levy' in 2011–12 and suggestions for the future include a Medicare type levy for dental health services and another for disability support services. Carling argues that while levies can be a sound policy in limited 'user-pays' situations, more generally they are politically opportunistic. Governments think they can use levies linked to popular causes to increase the tax burden with less taxpayer complaint than an increase in general taxation. In reality, levies are just tax increases by another name.

The Medicare levy, which started at 1% of taxable income in 1984 but has crept up to 1.5%, is an excellent example. Often income tax rates are quoted excluding the levy, but in reality the levy is nothing but an extension of the basic income tax, with the same disincentive effects. Moreover, it is misleading in that it finances only a small portion of the true cost of Medicare. Carling argues that:

- If a levy only partly funds a program, it deludes taxpayers as to the true cost of what they are paying for.
- 'Cherry-picking' the most popular programs for earmarking is a recipe for bigger government because it panders to the public popularity of selected services while leaving the less popular programs in place to be funded from general revenue.
- Earmarking a tax increase is a way for governments to avoid the arduous work of searching for savings in existing expenditures to make way for new priorities. It facilitates incremental budgeting.
- Mixing earmarking with general funding makes the earmarking meaningless because money is fungible.

Carling concludes that governments should generally refrain from using tax earmarking and suggests abolishing the Medicare levy.

The AFTS review considers earmarking in the case of environmental taxes and concludes there is no general case for it, although 'hypothecated user charges (as opposed to taxes) that reflect the true cost of providing a good or service can be an efficient means of funding environmental programs' (Part 2, p 356). In the context of personal income tax, the review recommends abolishing the Medicare levy as a simplification measure, with the forgone revenue collected from a new personal income tax scale. The review also notes that 'the levy may send a misleading message to taxpayers about the cost of health spending [which] may encourage inconsistent demands for more public funding of health care combined with an expectation that this can be absorbed without higher rates of tax'—in other words, a false sense of entitlement.

Tax competition

In 'Tax Competition: Much To Do About Very Little,' Davidson challenges the notion of 'harmful' international tax competition. He argues that as in other areas, competition in the sphere of taxation should be welcomed as a force for good, not stifled by international policy harmonisation. As globalisation and international capital mobility have increased, tax policymakers and revenue collectors—especially in the developed world—have become concerned about the revenue implications of tax competition among countries, and have pursued cooperation and harmonisation through the OECD. The need for international cooperation to counter tax evasion is well understood. Less clear, and under challenge from Davidson, is the notion that tax policy coordination is needed to counter a tendency for international competition to lead to tax rates that are in some sense 'too low.' Davidson argues that the OECD has based its economic argument for tax policy coordination on unsubstantiated assertions that tax competition produces negative externalities and depresses tax revenue. To the contrary, he cites evidence of international competition having forced tax *rates* down while tax *revenue* has remained buoyant.

In Davidson's view, the debate surrounding tax competition is in fact inseparable from the familiar and much larger debate about the appropriate size and role of government. Those favouring more limited and less redistributive government are likely to welcome international tax competition as a discipline on government. Those who favour larger and more redistributive government see international tax policy cooperation as necessary to their objectives, especially in a world of greater capital mobility. The thrust of Davidson's case is that if Australian policy, rather than demonising international tax competition and trying to 'manage' it with other countries through the OECD, were to accept and adjust to it, then the Australian economy would benefit. This is relevant to the Australian tax reform debate at a number of levels, particularly for personal and company income tax, where the tax base is more mobile internationally.

The global financial crisis and the consequent explosion of fiscal deficits in many countries has led to tax increases in some countries as they attempt to bring public debt down to more sustainable levels. However, Australia cannot expect to gain a competitive advantage from this just by doing nothing. Despite the fiscal pressures, no country has attempted to increase its corporate tax rate—not even Ireland, where the rate remains only 12.5% despite that country's dire fiscal predicament. Moreover, the problem is concentrated in Europe and the United States, while the more dynamic economies with which Australia must compete are not increasing their taxes.

Summary

		Taxploitation II Contributors	*AFTS Review*
Personal income tax	Tax-free threshold	Increase to at least $16,000	Increase to $25,000
	Rate scale	Ideally flat, but otherwise 15%/27%/35%	35/45%
	Offsets	Abolish most	Abolish most
	Deductions	Abolish most	Standard deductions as default option
	Medicare levy	Abolish	Abolish
	Capital income	Low, flat rate	40% discount
	CGT	Low, flat rate; inflation indexation	40% discount
Corporate income tax		Reduce	Reduce to 25%
GST		Leave as is	Leave as is
State tax	Stamp duties	Abolish	Abolish
	Land tax	Reduce rates; broaden base	Reduce rate; broaden base
	Payroll tax	Reduce rates; broaden base	Replace with business cash flow tax
	Vertical imbalance	State personal income tax	Consider state personal income tax

As is apparent from the above table, the proposals *in Taxploitation II* closely agree with those of the AFTS in areas such as corporate income tax, state taxation, and the Medicare levy. The proposals point in a similar direction but by different means or to different degrees in areas such as increasing the tax-free income tax threshold and reducing personal tax on capital income. There is disagreement in areas such as the personal income tax scale, capital gains tax, and state payroll tax. The differences reflect a different view of the desirable size of government, with the AFTS review aiming for revenue neutrality and *Taxploitation II* desiring a reduction in the tax revenue/GDP ratio. The differences also reflect different views of progressive taxation. The AFTS review strives to at least preserve the current degree of progressivity in personal income tax; this volume argues not only for lower but also flatter if not a flat personal income tax.

Chapter 2

The Unfinished Business of Australian Income Tax Reform

Robert Carling

Australia's personal income tax system has undergone sporadic change under all governments since the 1970s. Cumulatively, the effect has been to 'reform' the system in the true sense of that much overused word. But the reform job is unfinished. The current episode of change ended on 1 July 2010, when the final instalment of the tax cuts initiated by the Howard government in 2007, and mostly confirmed by the Rudd government, were implemented.[1] Further changes will depend on the recommendations of the major review of the tax/transfer system initiated by the Rudd government and the current and future governments' response to the recommendations. Past reforms have generally cut into future tax revenue streams, but in the current circumstances a revenue-neutral or revenue-positive package appears to be in favour with government and some commentators. This approach would seriously restrict the room to manoeuvre.

Serious flaws remain in the personal income tax system, and any attempt at tax reform will be incomplete if those flaws are left in place. For a start, personal income tax rates still remain high even after the current round of cuts is completed in 2010. Cuts in tax rates can make a substantial contribution to the economic reform effort needed to strengthen Australia's economic prospects. Cutting tax rates need not involve simply disgorging government revenue, as has been the case in recent years, because reform more broadly defined can also involve measures that add to revenue. However, policymakers should not be closed to some further overall loss of revenue in the years ahead as part of the drive for economic reform. In contrast to the macroeconomic demand management mindset, which has dominated the tax debate in recent times, changes to personal income tax (and related changes to transfer payments) should be thought of as a microeconomic reform aimed at strengthening the supply side through faster productivity growth.

The remaining problems in the personal income tax system are not confined to high marginal tax rates. Complexity and lack of transparency plague the system as much as ever. Tax breaks in all their forms have long been part of the system, but recent trends are for more and larger tax offsets of various kinds. These offsets have added to the complexity and require taxpayers to wade through many pages of the *Tax Pack* if they are to have any chance of understanding their tax obligations and entitlements to offsets and rebates. There is also the long-standing issue of how the tax system interacts with welfare payments to produce effective marginal tax rates, which vary greatly from the statutory rates. The same can now be said of the various tax offsets that are withdrawn as income increases.

These issues were canvassed in a collection of papers on the case for income tax reform published by The Centre for Independent Studies in 2006.[2] The problems highlighted by that volume have been remedied only partially or not at all by the subsequent changes to the system, and the case for reform remains intact.

The focus of this paper does not imply that personal income tax is the only part of the tax system in need of reform. To the contrary, there is a strong case for reform in other areas, mainly company income tax and state taxation.[3]

Purpose, principles, context

Purpose

People's ideas for tax reform can differ because of genuine disagreements about the changes needed to achieve given objectives. Such differences can be addressed, at least in principle, through empirical evidence. But often, differences between policy prescriptions reflect fundamental differences of view about what the tax system should be aiming to achieve and the principles that should guide its design. These differences may be reduced through a more informed debate, but value judgments are also involved. People will always have irreconcilable differences over value judgments, particularly about what constitutes 'fairness' in taxation.

I have explored these issues of principle elsewhere and put forward a values-based set of guiding principles for tax reform.[4] Building on that approach, this paper sees tax reform as an economic reform, aimed at lifting productivity growth and the efficient use of labour, capital and land-based resources. Australia's economic reform effort since the 1980s is often credited with having boosted productivity growth, economic growth, and living standards beyond what would otherwise have been achievable. Tax reform has been one part of the economic reform story, principally through the reforms implemented by the Hawke government in the mid-1980s and the Howard government since the late 1990s.

At the same time, it is now recognised that the reform effort has run out of steam and that productivity growth—which is the key to raising living standards and the capacity to satisfy community expectations—has sagged since the stellar performance of the 1990s.[5] The reform effort needs to be revived. Although there is much attention being paid to policies that support aggregate demand, the emphasis must shift to expanding the economy's productive capacity—or from boosting aggregate demand to boosting aggregate supply. As the Governor of the Reserve Bank recently commented, Australia is emerging from the recession with a narrower margin of excess capacity than from other recessions and will reach capacity relatively quickly.[6]

Tax policy is by no means the only instrument of economic reform capable of influencing productivity growth, but it is an important one. It has powerful effects on relative prices, resource allocation, and the reward for investment and work effort. This needs to be the theme of tax reform, and it is one that can sit very comfortably with the subsidiary objective of simplifying what has become a very complex tax system.

Former Prime Minister Kevin Rudd appeared to be in tune with the idea of re-focusing tax policy on economic reform, writing that restoring growth to its average level over the last cycle could be 'achieved only through a responsible agenda of future economic reform' and by 'laying the foundations for a stronger, more productive and more competitive Australia today.'[7] He went on to advocate reform 'consistent with achieving a modern tax system that is internationally competitive, provides maximum reward for effort, supports job creation and encourages productive investment.' In January 2010, Rudd spoke of the need to lift Australia's productivity growth rate to at least 2% per year.

Equity considerations

One of the main challenges to redesigning the tax system to maximise economic growth and productivity comes from those who demand greater equity or 'fairness.' There are two dimensions to equity: horizontal (concerning the comparative treatment of taxpayers with the same capacities to pay) and vertical (the treatment of those with different capacities to pay). Pursuing greater horizontal equity can be consistent with economic efficiency and simplification to the extent that it involves removing those concessions, anomalies and disparities in the tax system that distort private sector decisions. But any attempt to increase vertical equity—in other words, to reduce income inequality—through the tax system would clash with improving economic efficiency.

While 'fairness' will always be a matter of personal choice, and individuals can make rational choices in favour of more vertical equity at the expense of some economic growth, the following points are addressed at those who demand more income redistribution through the tax system.

First, the impact of public policy on equity depends on the whole tax/transfer system (and even other policies such as health and education), not just personal income tax. The sum of all policy interventions can be highly redistributive without any one part necessarily being redistributive. If there is a strong economic case for making personal income tax lower and flatter, that case can be taken up without necessarily frustrating distribution objectives. Other policy instruments, such as transfer payments, lend themselves better to redistribution without imposing the high economic cost that comes with a redistributive income tax.

Second, the Australian tax/transfer system is already highly redistributive by international standards, with only one or two Scandinavian countries being more redistributive.[8] Given this fact, do we really want more redistribution? Do we already have too much, in that policy is paying too much attention to re-slicing the economic pie at the expense of making it larger? If the degree of income inequality is still unacceptably high, the answer may well rest with policies that tackle pre-tax inequality—such as education and training policies—rather than making the tax system work even harder to correct for inequality.

Third, contrary to popular belief, the changes in personal income tax over the last 10 years have actually redistributed the tax burden in favour of lower income earners. Certainly, higher earners have gained more in dollar terms, but that is only because they pay much more tax in the first place. In percentage terms, which are the only sensible way to look at tax burdens at different income levels, the cuts have been largest at low incomes and then gradually decline as incomes rise.[9] The system was 'progressive' to begin with and has become more so. In 2007–08, the top 25% of income earners earned just over 50% of total income but paid 67% of total income tax (61% in 1997–98).[10]

The trade-off between equity and economic efficiency is a balancing act, and where society chooses to strike the balance is subject to change over time. There is a view that the global financial crisis of 2008–09 has tilted the balance towards greater equity. This is based on a questioning of pre-crisis assessments of the economic benefits of a lower tax environment, a drive for more government revenue in the context of measures to reduce unemployment and protect low income households, and even a sense of revenge towards the wealthy for allegedly having 'caused' the crisis. Such sentiments are more evident in the developed northern hemisphere countries, which have been most affected by the crisis, than in Australia; in fact, a number of those countries have increased top marginal tax rates.

Be that as it may, it is dubious in the extreme to argue that the crisis justifies more redistributive tax policies. What the countries most affected need is a strong economic recovery that will evolve into durable, long-term growth, a goal that higher tax rates would frustrate. Higher top tax rates will also do little to help reduce budget deficits because they raise relatively little revenue; as an instrument of 'revenge' against the alleged culprits in the crisis, they would be exceedingly blunt and poorly targeted.

Budgetary context

When the Review of Australia's Future Tax System (the Henry review) was launched in April 2008, the outlook for the federal budget was vastly different from what it is now. Sizeable surpluses were in prospect as far as the eye could see. Now, the budget is heavily in deficit and a surplus is not expected to reappear until 2013. So should tax reform aim to increase tax revenue, reduce it, or be neutral? More precisely, the benchmark for the effects of tax reform is a growing revenue yield in line with the economy; the question is whether tax reform should make it grow faster or slower. At issue is not only whether the budget should be restored more quickly to balance or surplus but whether taxes should be set to finance a slower or faster rate of growth in public expenditure.

The onset of the global financial and economic crisis and the associated dramatic downward revisions to projected Commonwealth budget revenue from 2008–09 onwards have led many commentators to predict that the 2010 tax cuts would be the last for many years as government will need to retain all its projected revenue (and then some) if it is to restore the budget to balance. Some of these same commentators went further and advocated cancelling the 2010 instalment, having previously proposed the same fate for the 2008 and 2009 instalments. In 2008, the argument was that tax cuts were inflationary; in 2009 and 2010, tax cuts were unaffordable.

Whether out of conviction or political calculation, the Labor government implemented the promised tax cuts up to 2010. Beyond that, however, its focus was on reducing the budget deficit, and to that end, it said that it will 'bank' the automatic growth in revenue as the economy recovers, at least until the budget returns to surplus. Although political considerations can easily give such commitments a short shelf-life, taken at face value the government's words are a prescription for unchanged tax rates and thresholds, and for reaping the proceeds of bracket creep, for many years beyond 2010. The government has quietly abandoned its so-called 'aspirational' tax scale, which featured a top marginal rate of 40%.

In a sense, the question as to how revenue considerations should constrain overall tax reform is not one that needs to be answered in this paper, which deals with only part of the tax system. A reduction in the overall personal income tax, which this paper advocates, could be funded from other parts of the tax system. In practice, however, it is difficult to see how that could be achieved and, therefore, the reforms advocated in this paper are likely to curb the growth of revenue over time. Even in the current circumstances of a large budget deficit, this should not be seen as an obstacle to reform.

Tax reform need not be approached from the perspective that it has to be revenue-neutral or positive. There is a strong case, as will be argued below, for the overall tax burden to be reduced and reconciled with the budget outlook. The case is not only economic but also political in that reform is more easily achieved and sustained if there is a net overall reduction in tax. The key to reconciling this with fiscal responsibility is to view tax reform from a dynamic rather than a static perspective. Clearly, implementing a revenue-reducing tax reform immediately would be fiscally irresponsible in the current circumstances, but doing so over a period of years is another matter. This long-term approach sits comfortably with the long-term aims of the government's tax review.

A net tax reduction is more easily accomplished over a period of years for two reasons. First, over such a period, the growth of government expenditure can be more easily reduced to match the diminished revenue flow. Second, the economic benefits of tax reform emerge over time as a growth dividend to reform so that the revenue cost is less than in a static framework. The latter proposition does not rest on extreme notions of tax cuts leading to increased revenue, which in the past have been ridiculed as ‘voodoo economics.’ Rather, some allowance should be made in the estimates for a growth dividend. This was in fact done in the GST reforms.

An arithmetic example may help illustrate these points. Suppose that trend growth in both revenue and expenditure is 5.5% per year in the absence of tax reform and, at this rate, would maintain their shares of GDP unchanged.[11] Now suppose that tax reform results in the growth of revenue falling to 4.5% per year. After 10 years, this would result in the tax revenue share of GDP falling from around 30% to 27%. Growth of government expenditure would also need to be reduced to 4.5% per year, but this would still represent a real growth rate of 2% per year; at current population growth rates, it would more than maintain real per capita government expenditure. If a growth dividend from tax reform were factored in, both revenue and expenditure could grow somewhat faster, but their shares of GDP would still decline.

A reduction of just 1 percentage point in the annual growth rate of tax revenue would result in revenue being $43 billion per year lower after 10 years ($34 billion lower in today’s prices, after allowance for inflation over the 10 years). In today’s terms, $34 billion per year would buy a lot of tax reform.

If revenue and expenditure were to grow at the same rates year in, year out, there would be no reduction in the deficit from the current level. However, the above example is based on *trend* growth rates. The elimination of the deficit will largely come from the winding down of stimulus spending and a period of *above-trend* revenue growth in the recovery years.

What has changed in 10 years (2000–10)

The personal income tax system changed little from 1987—when the Hawke government’s 1985 reform package was fully implemented—until the Howard government’s New Tax System in 2000, which centred on the Goods and Services Tax (GST). Pressure for reform grew over this period and it was answered with the GST, other indirect tax reforms, and personal income tax cuts effective 1 July 2000. Attention returned to the tax system—particularly personal income tax—in the mid-2000s as government coffers began to swell from the revenue generated from the economic boom conditions, and culminated in the multi-year cuts announced in the

2007 Budget and further promises by both government and opposition in the 2007 election campaign. These cuts were completed in 2010, with the exception of the cut in the top marginal rate from 46.5% to 43.5% that was promised by the Howard government but rejected by the Labor government.

Rather than focus on the component parts, it is instructive to stand back and take a 10-year view of all the changes since 2000 to see what has changed in the structure of marginal rates, thresholds, and tax offsets.

(a) Marginal tax rates

The personal income tax structure has been based on a tax-free threshold, four graduated marginal rates, and a flat Medicare levy since the 1980s. Prior to the New Tax System reforms in 2000, the tax-free threshold was $5,400 and the marginal rates above that were 20, 34, 43, and 47%. The Medicare levy was superimposed at the rate of 1.5% above a tax-free threshold, but the benefit of this threshold was withdrawn above a certain income level so that, in effect, most taxpayers paid 1.5% from the first dollar of income.

Since 2000, there have been two sets of changes to marginal rates. The first, as part of the package that introduced the GST, concentrated on the two lower rates, which were cut by 3 and 4 percentage points respectively to 17% and 30%. The only change to the two upper rates was a 1 percentage point cut to the 43% rate. This concentration on the lower rates was due to the focus at the time on compensating low- and middle-income earners for the increase in indirect tax, at the expense of attention to the incentive aspect of cutting income tax, which would have justified more across-the-board cuts.

The second set of changes since 2000 has occurred since 2005. In that year, the lowest rate was cut further to 15%, bringing to 5 percentage points or 25% the total reduction in the lowest rate since 2000. Apart from that change, all the attention since 2005 has been to the two upper rates. The 42% rate carried forward from the 2000 reforms is being cut in steps to 37% from July 2010, which will bring the total reduction in the second top rate since 2000 to 6 percentage points (14%). In contrast the top rate, which had stood unchanged at 47% since 1989, has been cut only by 2 percentage points (4%), much less than any of the other marginal rates.

In summary, the last 10 years have seen a significant cut in headline marginal rates, although much of it has been in the context of compensating for higher indirect tax. The cuts in the first three marginal rates have totalled 12% to 25%. In contrast, the top rate has been cut by much less, resulting in a more steeply graduated rate scale.

The Medicare levy has remained at 1.5%, so that each of the marginal rates referred to above is actually 1.5 percentage points higher.

The cumulative changes in marginal rates over 10 years are illustrated in Table 1.

Table 1: Headline marginal rates (with Medicare levy), 2000 and 2010

$	2000	2010
0–5,400	0%	0%
5,401–6,000	20%	0%
6,001–20,700	20%	15%
20,701–37,000	35.5%	16.5%
37,001–38,000	35.5%	31.5%
38,001–50,000	44.5%	31.5%
50,001–80,000	48.5%	31.5%
80,001–180,000	48.5%	38.5%
>180,000	48.5%	46.5%

(b) Thresholds

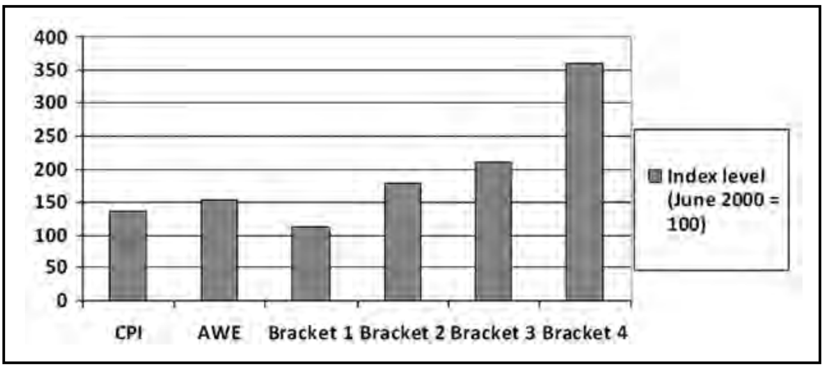
Much of what has been called 'tax cuts' over the last 10 years have been discretionary increases in the thresholds at which the different marginal rates cut in. It is important to remember that Australia—unlike several other developed countries—has not had automatic indexation of thresholds apart from a brief experiment by the Fraser government in the 1970s.[12] Measured by government revenue forgone, discretionary adjustments to thresholds have been at least as significant as cuts in marginal rates over the past 10 years, especially for the top rate threshold.

Chart 1 illustrates what has actually happened to the four thresholds since 2000 and what would have happened had they been automatically indexed to either the CPI or average weekly earnings.

With one exception, the increase in the threshold has exceeded the increase in consumer prices or average earnings. The thresholds for the second and third marginal rates have been approximately doubled, while that for the top marginal rate has been more than trebled. The increase in the lowest threshold (the tax-free threshold) was only 11%, but this is rendered meaningless by the Low Income Tax Offset (LITO), which has been increased from $150 in 2000 to $1,500 in 2010. This lifted the *effective* tax-free threshold to $16,000, representing a near trebling since 2000.

The large increases in thresholds for the upper marginal rates have substantially reduced the number of taxpayers subject to the upper rates and reduced the revenue cost of cutting those rates.

Chart 1: Increases in marginal rate thresholds compared with inflation, 2000–10



(c) Low Income Tax Offset (LITO) and other offsets

The above review of marginal tax rates and thresholds refers to the well-understood 'headline' rates and thresholds. In reality, and as recently spelled out by John Humphreys,[13] the simplicity and transparency of this structure have been seriously compromised by LITO and other selective offsets that are withdrawn above specified income levels.

It is important to understand the distinction between a tax deduction and a tax offset. A deduction, such as that for donations to charity, reduces taxable income to which statutory tax thresholds and rates apply. An offset is a rebate of tax payable, subject to a cap, and in the case of most offsets, phased out above a specified income level.

LITO, for example, is a maximum of $1,500 (from July 2010) but cannot exceed tax actually payable and begins to be phased out at a rate of 4 cents to the dollar of taxable incomes above $30,000. As discussed above, it results in a higher effective tax-free threshold than the commonly understood $6,000 threshold, but the phase-out mechanism also results in higher effective marginal rates in the phase-out range of income. LITO is essentially a higher tax-free threshold, the benefit of which is clawed back from income earners above $30,000 through an increase in marginal rates applying up to $67,500. It is a means-tested tax-free threshold.

Using July 2010 figures, this mechanism will raise the effective marginal rate over the income range from $30,000 to $37,000 from 16.5% to 20.5% (including Medicare levy in each case); from $37,000 to $67,500, the marginal rate will be 35.5%, not the 'headline' rate of 31.5%. The claw-back mechanism therefore increases the marginal rate for the majority of wage earners. Above $67,500, marginal rates are not affected, but average rates of tax are slightly higher because of the claw-back of the offset.

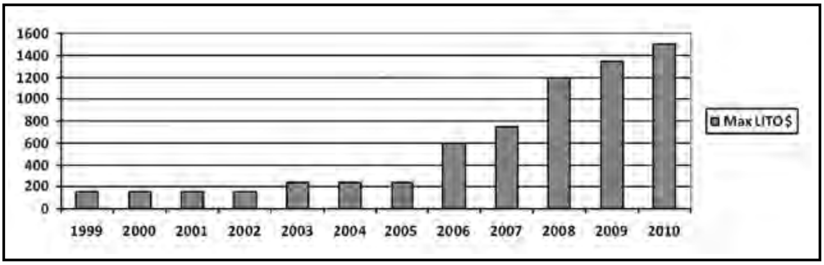
The purpose of LITO has been to increase the tax-free threshold while limiting the loss of revenue by clawing back the benefit above a specified income level. Whatever the wisdom or otherwise of that objective, the downside is that the claw-back mechanism adds 4 percentage points to marginal rates over the $37,500 withdrawal range. The resulting increase in the 31.5% rate, for example, negates all of the reduction in this rate implemented since 2000, when the GST was introduced.

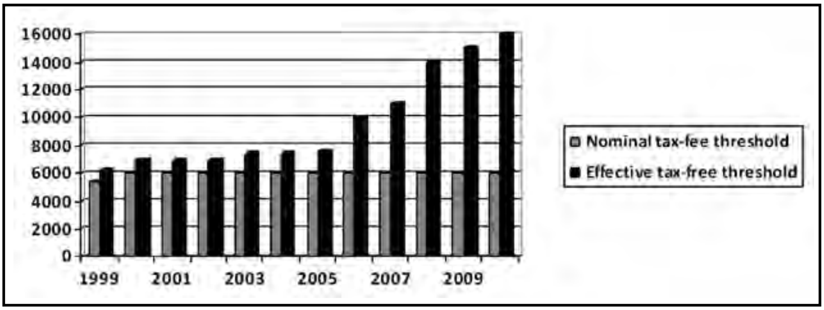
The LITO mechanism is not widely understood, adds to the complexity, and detracts from the transparency of the tax system. LITO is not mentioned in the basic tax return form. An ATO computer calculates whether each taxpayer qualifies for any LITO on the basis of the information supplied in the tax return, and it is reflected in the tax assessment issued.

As discussed below, although LITO is by far the biggest tax offset and has the widest relevance to taxpayers, there are numerous other offsets of relevance to selected groups of taxpayers, some of which are applied with the same claw-back mechanism. The seniors' offset and the mature workers' offset are examples. In fact, the selective offset seems to have become the favoured method of delivering a tax 'cut.' Under the proposed emissions trading scheme, households may be compensated in the form of a further increase in LITO.

Chart 2 shows how LITO has grown since 2000, and with it the effective tax-free threshold.

Chart 2: Growth of the Low Income Tax Offset since 2000





(d) The true marginal rate scale

Bringing together the statutory (or 'headline') marginal rates, the basic Medicare levy and LITO, the true marginal rate scale is shown in Table 2 and is contrasted with the headline scale. The true scale would be different again for those affected by the Medicare levy surcharge and other tax offsets such as the mature workers' and seniors' offsets, but Table 2 compiles the rates, levies and offsets that affect all taxpayers.

One of the striking things about Table 2 is that it shows that the true marginal rate scale has a fairly narrow range above $37,000, with true marginal rates falling in the range of 35.5% to 46.5% for all income levels except $67,500 to $80,000, where it is 31.5%. The great bulk of taxpayers above $37,000 face a marginal rate of either 35.5% or 38.5%. Moving from there to a flat rate above $37,000 would not be as great a leap as is often thought.

Table 2: Headline and true marginal rate scales from July 2010

Headline Scale		True Scale (with Medicare levy and LITO)	
$0–$6,000	0%	$0–$16,000	0.0%
$6,001–$37,000	15%	$16,001–$17,794	15.0%
		$17,795–$20,934	25.0%
		$20,935–$30,000	16.5%
		$30,001–$37,000	20.5%
$37,001–$80,000	30%	$37,001–$67,500	35.5%
		$67,501–$80,000	31.5%
$80,001–$180,000	37%	$80,001–$180,000	38.5%
>$180,000	45%	>$180,000	46.5%

The case for further reform

The above review of developments in the personal income tax scale over the 10 years since 2000 reveals that the thresholds for the various marginal tax rates have been increased very substantially, while most of the marginal rates have been trimmed. At the same time, the operation of LITO (among other tax offsets) and the Medicare levy creates a different and more complex effective rate scale than the headline scale.

Changes in the rate scale, and the associated large sum of budget revenue forgone, may suggest that the job of personal income tax reform has been finished or at least deserves lower priority now. Far from it, however, personal income tax reform should be a top priority for the next round of tax reforms. Marginal rates were high before the changes of the last 10 years, and they remain high. Increases in thresholds—large though they have been—are not a substitute for cuts in marginal rates; they only alter the income ranges over which the various marginal rates apply. In real terms, even this benefit will be eroded over time by inflation in the absence of automatic indexation of thresholds.

High marginal tax rates, erosion of the tax base, and complexity are intertwined. High marginal rates create pressure for selective tax relief in the form of deductions, offsets and concessions, which erode the tax base. Selective relief becomes entrenched and comes at a heavy cost in forgone revenue, which creates pressure to keep marginal rates high. At the same time, selective relief makes the system more complex and opaque.

The wedge between headline and effective marginal rates results partly from LITO and its phase-out arrangements, and from the interaction between the tax system and government cash benefits (transfer payments). Where transfer payments are means-tested, such as the age pension, the withdrawal rate adds to effective marginal rates over the withdrawal range. This effect has been partly ameliorated in recent years through increases in thresholds and reductions in marginal tax rates and benefit withdrawal rates, but high effective marginal rates remain a problem. Anne Harding and colleagues reviewed trends in effective marginal tax rates (EMTRs) over the 10 years to 2006–07 and found little change on average; income tax cuts had reduced EMTRs, but extensions of income-tested welfare payments and tax concessions worked in the opposite direction.[14] The percentage of working-age Australians facing EMTRs greater than 50% actually rose slightly, and that percentage was at or above 10% for the fourth, fifth, sixth and eighth deciles of disposable family income in 2006–07.

There is also the issue of 'churning,' whereby the same people are paying taxes and receiving government cash transfers, resulting in tax rates being higher than they would otherwise be.[15]

The solutions to high EMTRs are complex and beyond the scope of this paper. They cannot be found in tax reform alone, and are intrinsic to a system such as Australia's generous but tightly targeted welfare payments. Tax reform can however help by lowering marginal tax rates as much as possible, building in higher tax-free thresholds to replace some middle-class welfare payments, and avoiding claw-back mechanisms such as LITO, which add to effective marginal rates over wide income ranges. Variable tax-free thresholds could be used to reflect family circumstances (such as dependent spouse and children) in place of some cash benefits and tax offsets, as flagged by Peter Saunders and Barry Maley.[16]

In summary, the problems that remain in the personal income tax system include:

- high marginal rates
- bracket creep in the absence of indexation of thresholds
- erosion of the tax base through deductions, concessions, offsets, rebates, and the like
- complexity, which imposes costs and detracts from transparency

- high effective marginal rates resulting from the interaction between the tax system transfer payments and means-tested tax offsets.

The Labor government at different times has accepted a case for reform built on these grounds. Its 2007 election platform committed it to an 'aspirational' personal tax scale of three rates—15%, 30% and 40%. However, it long ago stopped talking about such a scale, and its current focus appears to be narrower, with an emphasis on simplification and greater 'fairness.' Simplification is certainly needed. 'Fairness' is subjective and therefore meaningless without definition by those advocating more of it. Too often, it is a beguiling cover for ulterior motives. If it means removing selective tax concessions that detract from horizontal equity, that is one thing; if it means making the personal income tax system more 'progressive' (redistributive), that is quite another.

Why should marginal rates be cut?

Income tax cuts are usually thought of as dollars-per-week benefits to the taxpayers' after-tax incomes at various income levels. This is the income effect, which is only part of the economic effect of tax cuts. In the economic case for lower income tax, the income effect is joined by the substitution effect, which is driven by marginal rates. The substitution effect arises because tax rates affect, at the margins, the relative attractiveness of different forms of economic activity, such as work versus leisure. It is possible to structure tax cuts to deliver an income effect with little or no substitution effect, but doing so would seriously limit the economic benefits because marginal rates have powerful effects on private sector economic behaviour.

The economic case for reducing marginal tax rates rests on the very high economic costs of high marginal rates, as explained by Alex Robson.[17] Those costs begin with administrative, enforcement and compliance costs. Although any income tax system involves such costs regardless of the rates of tax imposed, they are larger at higher tax rates because of the incentive that high rates create for tax avoidance and evasion. Administrative, enforcement and compliance costs will also be higher the more complex the tax system, and greater complexity tends to accompany higher tax rates.

But the biggest economic cost, and the one least well understood by non-economists, comes from the distortion of economic activity as individuals and businesses adjust their economic behaviour in response to the taxes imposed on them. This is called the 'excess burden' or 'deadweight loss' of taxation and comes from the fact that taxes, while raising revenue, tend to divert economic resources (labour, capital) from higher valued to lower valued economic uses. The only way to avoid these costs is to have no tax at all, but as that is impossible in a mixed economy of private and government activity, the challenge is to minimise the costs. That will depend partly on minimising the total tax burden and therefore the scope of government; for a tax burden of a given overall size, the economic costs depend on how the tax system is designed. This is partly a matter of avoiding heavy reliance on any one tax to produce revenue. Australia still relies relatively heavily on personal income tax. The deadweight loss can also be minimised by avoiding high tax rates, which have stronger effects on taxpayers' economic behaviour. A marginal rate of 20% imposes a much lower marginal deadweight loss than a rate of 40%, and so on. In fact, the deadweight cost of a 40% marginal rate is more than double that of a 20% marginal rate.

In the context of personal income tax, the source of the deadweight loss is best illustrated with examples. It can come from workers choosing to stay out of the workforce, reducing their hours of work, reducing the intensity of work in other ways, pursuing 'do it yourself' work, engaging in home production for barter, or switching to activities or occupations with significant non-pecuniary benefits. In the long term, deadweight loss can also come from people forgoing investments in human capital (deciding not to upgrade their skills) or devoting more of their income to consumption and less to saving and investment. The fact that not all of these opportunities are available to all individuals is irrelevant; it is sufficient that *some* individuals respond in *some* of these ways for there to be a deadweight loss.

These effects are said by some economists to be important for lower income earners, while high-income earners are unresponsive or less responsive and, therefore, high marginal tax rates on high incomes do not impose such a large deadweight loss. Yet high earners have the same incentives—and probably more opportunities—to adjust their behaviour in response to taxation as anybody else. As discussed below, lowering the top marginal rate of tax is an essential part of achieving the full potential benefits of tax reform, even though it seems to have gone out of fashion in policy circles.

Deadweight losses are difficult to measure in practice. In the past, most economists have argued that the elasticity of hours worked in relation to after-tax wages is low, and concluded that the deadweight cost could not therefore be high. However, these estimates take a narrow view of the effects of taxation and the sources of the deadweight loss, as discussed by Michael Keane in a paper for the Henry review.[18] Keane concludes that income tax is likely to have a much higher economic cost (by shrinking the pie) than in the old consensus view because that view has ignored how taxes alter incentives for investment in human capital. As reviewed by Alex Robson, comprehensive estimates of the deadweight cost of personal income tax in the United States show a cost of 20% to 40%; some estimates of the marginal deadweight cost are above 100%. Put another way, the cost to the economy exceeds the revenue raised by these percentages.

There are no estimates of the deadweight cost at different income levels, but another way of looking at behavioural responses to tax is to estimate the elasticity of taxable income with respect to changes in tax rates (the percentage change in taxable income when marginal tax rates change by 1%). Estimates based on US experience suggest that this elasticity is at least 0.4 (that is, taxable income falls by 0.4% for a 1% increase in tax rates), and that it is higher for taxpayers with higher incomes.[19]

Although personal income tax is most often thought of as a tax on wages and salaries, it is much more than that; it also includes individual income from saving and investment (interest, dividends, rent, capital gains) and from unincorporated businesses. It is therefore a tax on capital as well as on labour. Capital income, and the economic activities underlying it, is likely to be even more adversely affected by taxation than wage and salary income because capital is more mobile than labour.[20] This has been recognised by some countries that have adopted different (lower) tax rates on capital income, and the same approach is sometimes suggested for Australia. Regardless of tax reform takes us in that direction, the fact that saving, investment and entrepreneurial activity are more responsive to taxation than labour supply reinforces the case for lower marginal rates. Moreover, as capital income is more concentrated at higher income levels, the case for reductions in the higher marginal rates of income tax is also reinforced.

International competitiveness is often emphasised as a desirable principle of tax policy. In the current global context, there are some signs of a trend back to higher marginal tax rates in developed countries after a long period during which they drifted lower. Should such a trend be confirmed, some economists would doubtless argue that it weakens the case for lower taxes at home. The economic costs of taxation are certainly magnified in an open economy, as the potential for cross-border movements in the factors of production—particularly capital but also labour—provides greater opportunities for the kinds of behavioural responses discussed above. Even in a closed economy, there are many opportunities for the behavioural responses that result in deadweight costs. International trends do not, therefore, remove the case for reform at home.

The economic benefits of lower tax rates can be thought of as static (a one-shot lift in the *level* of national income) or dynamic (an increase in the *rate of growth*). In practice, both are likely to happen. The removal of inefficiencies in resource allocation is likely to produce a one-shot lift, although it may be spread over a number of years, thereby affecting the growth rate over a period of adjustment. Tax changes that increase saving, investment and entrepreneurial activity can also lift the growth rate permanently. As illustrated in Box 1, empirical studies have found evidence of the relationship between taxation and the level and rate of growth of GDP.

How should the tax scale be reformed?

The above discussion largely addressed issues of principle. It is time to consider the practical details of how the personal income tax scale should be changed based on those design principles.

(a) Lowering and flattening marginal rates

The economic arguments for lower marginal tax rates outlined above lead logically to the conclusion that the tax scale should be compressed into a single rate rather than the traditional graduated (or 'progressive') scale. If the economic behaviour of higher earners is at least as responsive to taxation as that of lower earners, and if the marginal rate is the same for higher and lower earners, then deadweight economic costs will be minimised. If there is no tax-free threshold, the single marginal rate is the same as a 'flat' or 'proportional' scale, where tax as a percentage of income is the same at all levels. In most tax systems, however, there is a tax-free threshold, and applying a single marginal rate above that threshold still results in a 'progressive' system in the sense that the *average* rate of tax rises with income.

Box 1: Taxation, GDP and growth—some empirical evidence*

Asa Johansson and colleagues (OECD, 2008) found corporate taxes to be the most harmful for growth, followed by personal income taxes.[21] They found evidence that 'flattening the tax schedule could be beneficial for GDP per capita, notably by favouring entrepreneurship' and that highly progressive income tax schedules have adverse effects on GDP per capita 'through both lower labour utilisation and lower productivity partly reflecting lesser incentives to invest in higher education.'

Christina and David Romer found large effects of tax changes on GDP in their analysis of post-World War II tax reforms in the United States. A tax increase equivalent to 1% of GDP lowered real GDP by 2% to 3% over time.[22]

Fabio Padovano and Emma Galli used data for 23 OECD countries and found that high marginal tax rates and graduated taxes tended to be negatively associated with long-term growth.[23] An increase of 10 percentage points in marginal rates decreased annual economic growth by 0.23 percentage points.

Eric Engen and Jonathan Skinner examined more than 20 studies of the link between tax rates and economic growth and concluded that 'a major tax reform reducing all marginal rates by 5 percentage points, and average rates by 2.5 percentage points, is predicted to increase long-term growth rates by between 0.2 and 0.3 percentage points.'[24]

Using data for 63 countries, Reinhard Koester and Roger Kormendi found that reducing progressivity in taxation while holding tax revenue constant led to higher levels of national income.[25]

**This summary draws from Milagros Palacios and Kumi Harischandra,* 'The Impact of Taxes on Economic Behavi*our,' Fraser Forum 02/08 (Fraser Institute, 2*008).

Although a flat or single rate system applies in a number of emerging market economies such as Russia, Latvia and Estonia, in most countries a graduated scale is the norm and is one of the mechanisms used to reduce pre-tax income inequality. Developed countries tend to have more steeply graduated scales than developing countries, but even in developed countries the income tax typically started as a single rate of tax and then evolved over many years into a graduated scale, notwithstanding the economic costs.

Fairness and equity, however, are in the eye of the beholder, and there are strong counter-arguments against imposing graduated scales on these grounds. As Sinclair Davidson points out, 'fairness' in a progressive tax system will always be a matter for arbitrary judgment; political economists and philosophers such as Adam Smith and John Stuart Mill have argued that fairness lies in proportionality.[26] Lachlan Chipman has argued the moral case for a flat, proportionate income tax.[27]

If starting with a clean slate, a flat rate set at a level that would produce only a modest deadweight economic cost would be best from both economic and 'fairness' perspectives. It is a matter of judgment what such a rate would need to be, but the consensus of those who think in these terms is that it should be no higher than about 30%.

Chipman, however, also acknowledges the formidable political obstacles in the path of a flat tax in Australia.[28] What are advocates of reform to do in these circumstances? The approach taken in this paper is to accept that the principle of a graduated scale has become too entrenched to overcome in the foreseeable future and to propose a revised graduated scale consistent with lower economic costs. The top rate (currently 46.5%) and the second top rate (38.5% from July 2010) need to be aligned at a level of no more than 35% so as to substantially reduce economic costs. The existing 35.5% and 31.5% marginal rates should also be reduced (to say 27%), particularly if reform is to remove some concessions and deductions (as discussed below). The existing 16.5% rate is largely a fiction. As Table 2 shows, over the entire income range from $6,000 to $37,000, to which this rate purportedly applies, the true marginal rates are zero, 15, 25, 16.5, and 20.5%. A sensible reform would collapse this part of the scale to just two rates—zero up to the current effective tax-free threshold of $16,000 and 15% from there to $37,000.

These changes would leave a scale of zero, 15%, 27% and 35%.

(b) A dual rate scale?

The above discussion assumes a comprehensive income tax system that, in principle, taxes all income at the same rates regardless of type. Australia, like many countries, uses the comprehensive approach as the starting point, but in practice, allows many departures from it through various forms of tax relief, as discussed in the next section. One of the departures is to tax selected forms of capital income more lightly.

An alternative and more systematic approach is a dual income tax system, as used in the Netherlands and Scandinavian countries.

The dual system applies a proportional (flat) tax to all capital income such as interest, dividends and rent, and a graduated scale to labour income, with the flat rate on capital income lower than the top rate on labour income. The AFTS review has seriously considered a dual system.[29]

The rationale for the dual system is that the economic costs of the income tax are higher for capital income than for labour income due to the higher mobility of capital. A flat rate capital income tax also offers opportunities for simplification because final tax can be withheld at source, eliminating or simplifying tax returns. There are additional advantages if the flat tax on personal capital income is aligned with the corporate income tax rate.

The concept of a dual tax system has its attractions and should be seriously considered, but not as a substitute for a reduction in tax on labour income as well. While it is true that economic costs are higher for a given rate of tax on capital income than on labour income, this does not negate the reality that current marginal tax rates on labour income also result in excessive deadweight economic costs. If the scale suggested above were to be adopted within the context of a dual system, then the graduated rates of zero, 15, 27, and 35% should apply to labour income and a flat rate of, say, 20% to capital income. It would also be desirable for corporate profits to be subject to the same tax rate as personal capital income.

A dual system would need to include robust safeguards against opportunities to disguise what is truly labour income as capital income to take advantage of the lower marginal tax on capital income.

(c) The Medicare levy

The Medicare levy has existed since 1984, starting at 1%, then being raised twice to its current level of 1.5%. In more recent years, a 1% surcharge was added to the basic levy for those above specified income thresholds who do not take out private health insurance. The levy raises around $7 billion per year but covers only a fraction of the true cost of Medicare. As such, it is misleading in that it neither determines nor constrains public spending on Medicare, but this does not stop it from encouraging a strong sense of entitlement to ‘free’ medical care. Spending on Medicare is determined independently of the levy. The levy is really just a second income tax and is more accepted by the public because of its link to a popular spending program.

There are arguments for and against such 'earmarked' or 'hypothecated' taxes; although they can serve a legitimate purpose in limited situations as 'user pays' taxes, levies such as the Medicare levy are an abuse of the concept and should not be part of the tax system.[30] Similar levies have been proposed for dental care and disability support, and the same arguments apply.

Both the basic Medicare levy and the surcharge add to complexity in the tax system, with 11 pages of the *Tax Pack* being devoted to them. On top of that, the phase-in of the levy between $17,794 and $20,934 distorts the marginal tax rate, effectively adding 10 percentage points over that range, bringing it to 25%.

There is a strong case on transparency grounds for abolishing the levy as part of tax reform and accommodating the cost of abolition within the setting of new marginal rates. Other levies of a similar kind should not be adopted. Abolition of the Medicare levy surcharge means that an alternative 'stick' would be needed to encourage take-up of private medical insurance, but the existing lifetime cover arrangement may be sufficient in itself.

(d) Thresholds

As discussed above, there have been large increases in thresholds in recent years. The priority now should be lowering marginal rates rather than further increasing thresholds. The one exception would be higher tax-free thresholds to recognise the family circumstances of taxpayers rather than spouse offsets and family payments. For example, the basic tax-free threshold of $16,000 could be boosted by, say, $8,000 if the taxpayer has a dependent spouse and by a certain amount for each dependent child. This idea is not explored further here because it would take the paper too far from its core proposition.

It is a matter for consideration whether the new top rate should cut in at the existing top threshold ($180,000), the second top threshold ($80,000), or somewhere in between.

(e) Indexation of thresholds

The final issue in the reform of the personal income tax scale is indexation of the thresholds. Australia briefly experimented with indexation in 1976, but it was quickly watered down and then completely abandoned because the government preferred to make adjustments to thresholds as well as marginal rates at its discretion. The experience of other countries has been different, and full, automatic indexation is still practised in countries such as the United States, the United Kingdom, and Canada.

There is a very powerful argument for full, automatic indexation. In its absence, average tax rates tend to increase as income inflation results in a larger proportion of incomes being subjected to higher marginal rates. In other words, average tax rates increase even if real incomes do not. This is convenient for governments because it super-charges revenue growth by stealth without legislative effort or transparency. The revenue dividend from this 'bracket creep' can be allowed to build up for a number of years, and then committed—at least in part—to tax 'cuts.' The discretionary threshold increases of recent years (as discussed above) went beyond compensation for bracket creep, but that does not alter the fact that in part, they merely handed back the proceeds of bracket creep to taxpayers, even though they were presented as tax 'cuts.'

Indexation would come at a cost to revenue growth in the future but is not a substitute for cuts in marginal rates. It is essential that a combination of marginal rates and thresholds that minimise economic costs is put in place first, followed by the indexation of thresholds. Indexation would then cement (in real terms) a desirable rate scale rather than the current one.

(f) The new rate scale

Table 3 illustrates the new rate scale (which would be indexed) and compares it with the current unindexed effective scale taken from Table 2.

Table 3: Current (effective) and proposed marginal rate scales

True Scale (current) (with Medicare levy and LITO)		**Proposed Scale**	
$0–$16,000	0%	$0–$16,000	0%
$16,001–$17,794	15%	$16,001–$37,000	15%
$17,795–$20,934	25%		
$20,935–$30,000	16.5%		
$30,001–$37,000	20.5%		
$37,001–$67,500	35.5%	$37,001–$80,000	27%
$67,501–$80,000	31.5%		
$80,001–$180,000	38.5%	>$80,000	35%
>$180,000	46.5%		

Reducing Complexity

(a) Removing tax relief (or 'broadening the base')

Certain reforms to the tax scale proposed above would simplify the personal income tax system, for example, converting LITO to a simple tax-free threshold. Simplification also, however, demands reform of the tax base, which requires a searching examination of tax deductions, offsets, rebates, exemptions, and concessional rates (termed here as 'tax relief' for simplicity). Such an examination also provides part of the solution to financing the proposed reform of the tax scale, and helps improve the horizontal equity of the system by promoting equal treatment of equals.

Different forms of tax relief affect tax paid in different ways and need to be defined. A *deduction* is an allowance for an expenditure incurred and is a reduction in income in the calculation of taxable income.The rationale for some deductions is that they recognise expenses directly incurred in earning taxable income, but some deductions are allowed for other reasons such as for donations to charities. Deductions are open-ended and provide a larger reduction in tax, the higher the taxpayer's marginal rate.

Tax *offsets, credits and rebates* are reductions in tax payable after a person's taxable income has been calculated and the tax rate scale has been applied. They are usually capped in dollar terms and cannot reduce tax payable below zero unless classified as 'refundable,' the main instance of which is franking credits on dividends. In some cases such as the LITO, the full offset is effectively means-tested as it applies only up to a certain income level and is then phased out as income increases.

Tax *concessions* take the form of exemptions or lower tax rates for certain types of income, such as the 15% tax on superannuation contributions and earnings and the 50% capital gains concession.

Over the years, the trend has been towards more tax relief in the personal income tax system, adding to complexity and making the incidence of personal income tax more variable in response to individual taxpayers' circumstances. This trend is a result of the tax system being used to pursue social objectives, the incorporation of concessions for some forms of capital income, or simply governments playing politics by using the tax system to reward favoured groups or causes. The same sacrifice of revenue by governments could have been made to lower marginal tax rates across the board. Reform that reduces selective relief and cuts marginal rates across the board is often referred to as 'broadening the base and lowering the rates.' The last major reform of this kind was undertaken in the late 1980s, when capital gains and fringe benefits were brought into the tax net and marginal rates were cut. Since then, tax relief has crept back into the system.

One indicator of complexity is the number of pages of *Tax Pack* devoted to explain the various types of tax relief: 12 pages on deductions for work-related expenses; eight pages on the spouse or housekeeper offset; six pages on the education tax refund; three pages on the senior's offset; and so on. Other indicators are the volume of tax legislation—with the core *Income Tax Act* now weighing in at around 9,000 pages—and the estimates of tax expenditure, which reveal revenue forgone from personal income tax and retirement income tax relief of $63.8 billion in 2007–08.[31]

Table 4 illustrates the extent of personal income tax relief, including where possible, the revenue forgone. It covers the types of income tax relief available up to 2007–08, but since then more have been added, such as the education tax rebate and the increased child care tax rebate.

Table 4: Personal income tax relief, 2007–08

Type of relief:	Amount deducted $ billion	Revenue forgone $ billion *
Deductions:		
• Rental deductions	32.7	11.6
• Work-related expenses	16.1	5.7
• Non-employer super contributions	7.4	1.5
• Interest and dividend deductions	4.	1.4
• Gifts and donations	2.3	0.8
• Cost of managing tax affairs	1.7	0.6
• Other	2.0	0.7
Total		22.3
Offsets and credits:		
• Dividend franking credits		11.4
• Low income tax offset		3.7
• Termination payments		0.8
• Super contribution, annuity and pension offset		0.6
• Senior Australians		1.2
• Mature age workers		0.5
• Pension or pensioner		0.5
• Spouse, housekeeper		0.6
• Medical expenses		0.5
• Zone/overseas forces		0.3
• Entrepreneurs		0.2
• Other		0.6
Total		20.9
Selected concessions:		
• Superannuation:		
o Fund earnings		14.5
o Employer contributions		13.0
• Capital gains discount		9.7
• Exemption, various government cash benefits		4.8
• Statutory formula to value car benefits		1.0
Total		43.0

Sources: *Tax Expenditures Statement 2009* (Australian Treasury, January 2010); *Taxation Statistics 2007–08* (Australian Taxation Office, January 2010).

* Assuming marginal tax rate of 35.5%.

These estimates are by no means beyond dispute. For example, the estimate for the capital gains concession simply applies full tax rates to the capital gains actually reported in a particular year. In reality, the volume of realised gains is highly sensitive to the tax rate, and the abolition of the concession would certainly not produce an extra $9.7 billion in annual revenue. In general, estimates of revenue forgone make no allowance for what the behavioural response of taxpayers would be to the removal of the deduction or concession. Moreover, the costing of the various superannuation benefits is strongly contested, and with different methodologies from those used by the government, it is possible to come up with much lower costs.

There is also a sound conceptual case for much of the tax relief built into the system. For example, there is a case for deductions for expenses incurred in deriving taxable income, for franking credits on dividends to avoid double taxation of dividends, for capital gains concessions, and for concessional taxation of superannuation and other forms of saving. Reflecting this reality, no income tax system in the world fails to allow for any tax relief at all.

The complete list, however, contains some that could be removed or the benefit of which could be delivered in another form without complicating the tax system. Even in the case of those for which there is a conceptual case, the simplification objective could justify their removal and replacement by lower marginal rates for all taxpayers. For example, the deduction for work-related expenses has a conceptual basis, but the principle is applied inconsistently and there is a lot of room for dispute at the margins as to what constitutes a valid work-related expense. Alternatives would be to allow a standard deduction from all wage and salary income or to apply the revenue saved from abolishing the deduction to lower marginal rates for all.

Notwithstanding the above qualifications, it would be surprising if an amount of $10 billion–$20 billion per year could not be saved from the complete catalogue of tax relief—an amount that could go a long way towards funding the reductions in marginal rates proposed above.

(b) Other ways to reduce complexity

One form of simplification often suggested is to do away with the need for annual tax returns for many taxpayers. This will only be possible, however, if the tax system itself is simplified, such as by eliminating or standardising deductions as discussed above.

Greater resort to withholding taxes would also help. The PAYE system for wage and salary earners is a withholding system, but often tax is over-withheld because taxpayers have deductions or other circumstances that prevent the employer from withholding the correct amount.

The concept of withholding at source could be extended to investment income, such as interest and dividends; this is already done (at the top marginal rate) where a taxpayer does not quote a tax file number. Again, under the current system, withholding agents cannot withhold correct amounts as taxpayers' actual marginal rates are unknown to them. This would be less of a problem if investment income were to be taxed at a single flat rate as under the dual tax system discussed above; even then, taxpayers' marginal rates would vary depending on the investment income deductions they are allowed and use.

Doing away with annual tax returns is not as easy as it sounds.

Conclusion

Australia's personal income tax system has undergone sporadic change and reform over many years, but there is still much unfinished business. Tax reform more broadly defined is once again squarely on the policy agenda, although it is not clear what the government has in mind for personal income tax. What is clear is that tax reform will be seriously lacking if it fails to address the unfinished business of personal income tax reform.

In the view of this paper, the main issues are high marginal rates of tax (both 'headline' and 'effective'); an excess of selective tax relief in the form of deductions, offsets, credits and concessions; and complexity. These are all closely inter-related. The main reason for tackling them is to reduce the high economic costs of the current system and to make it simpler and more transparent. The goal of reducing economic costs is very much in harmony with the Labor government's objective of lifting productivity growth.

Cutting marginal rates of tax as proposed here would come at a substantial cost to government revenue, but this can be managed by phasing in the changes over a long period, curbing the growth of government spending, and reducing selective tax relief (broadening the tax base). Australia last saw the base broadening/rate cutting approach to personal income tax reform in the 1980s. It is time to cut rates and broaden the base again.

Endnotes

1 The Labor opposition adopted the Howard government's personal income tax proposals in the 2007 election with the sole exception of the proposal to cut the top marginal rate from 46.5% to 43.5%.

2 Peter Saunders (ed.), *Taxploitation—The Case for Income Tax Reform*, Reading 11 (Sydney: The Centre for Independent Studies, 2006).

3 See, for example, Sinclair Davidson, *The Faulty Arguments Behind Australia's Corporate Income Tax*, Policy Monograph 87 (Sydney: The Centre for Independent Studies, 2008); and Robert Carling, *State Taxation and Fiscal Federalism—A Blueprint for Further Reform*, Policy Monograph 73 (Sydney: The Centre for Independent Studies, 2006).

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5 Productivity Commission, *Australia's Productivity Performance*, Submission to the House of Representatives Standing Committee on Economics (Commonwealth of Australia, 2009).

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8 Peter Whiteford, *Transfer Issues and Directions for Reform: Australian Transfer Policy in Comparative Perspective*, presented to the Conference on Australia's Future Tax System (Melbourne: 18–19 June 2009).

9 See *Mid-Year Economic and Fiscal Outlook, 2007–08* (Commonwealth of Australia, November 2007), chart 3, 8.

10 Australian Taxation Office, *Taxation Statistics 2006–07* (Commonwealth of Australia, 2009).

11 The assumed 5.5% trend growth comprises 3% real growth and 2.5% inflation.

12 Full indexation to a discounted CPI was applied in 1976 and 1977 before being cut to half indexation in 1978 and then being eliminated completely in 1979.

13 John Humphreys, 'Revealing Australia's Real Income Tax Rates,' *Policy* 25:2 (Sydney: The Centre for Independent Studies, 2009).

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25 Reinhard B. Koester and Roger Kormendi, 'Taxation, Aggregate Activity and Economic Growth: Cross-Country Evidence on Some Supply-Side Hypotheses,' *Economic Inquiry* 27:3 (1989).

26 Sinclair Davidson, 'Who's Not Paying Their Fair Share of Income Tax?' in *Taxploitation*, as above.

27 Lachlan Chipman, 'The Moral Case for a Flat Tax,' in *Taxploitation*, as above.

28 As above.

29 *Australia's Future Tax System*, as above, 67.

30 Robert Carling, *Tax Earmarking—Is It Good Practice?* Policy Monograph 75 (Sydney: The Centre for Independent Studies, 2007).

31 Treasury, *Tax Expenditures Statement 2008* (Commonwealth of Australia, 2009).

Chapter 3

Ending the Churn: A Tax/Welfare Swap

John Humphreys

Australia is a welfare state. The government provides relatively generous income support, family benefits, retirement income, health services, and education at a cost of more than $250 billion per year (over 23% of GDP). This welfare state retains significant support among the general population and politicians.

However, there is one element of the welfare state that produces absolutely no benefit.

In the financial year 2009–10, up to $140 billion was taken from Australian taxpayers and given back to the exact same taxpayers. This welfare 'churn' does not achieve any redistribution. The main cause is the so-called 'middle-class welfare'[1] where middle- (to high-) income earners both pay taxes and receive government welfare services.

Although reforming the welfare state is a notoriously difficult political exercise, the argument for addressing middle-class welfare churn is strong and deserves serious consideration.

The first section of this paper will look at the size of welfare churn in Australia and draw a distinction between the pointless 'cash churn' and the equally pointless but more costly 'services churn' (including government health and education).

The second section will explain in more detail the costs of middle-class welfare churn. Some economists argue that the direct economic costs of churn aren't high, while sociologists point to the important but unquantifiable social and political impacts. Both groups have a point. However, the biggest costs of churn are the dynamic effects, including long-term unsustainability and lower-quality services.

In contrast, the only benefit from middle-class welfare churn is for politicians—who are seen to be active and handing out benefits to voters.

The third section will look at how to address middle-class welfare churn. The simplest solution would be to remove the welfare state. However, this paper will limit itself to considering options that retain current levels of government redistribution.

The solution is to have a tax-welfare swap, where some people accept fewer government benefits in exchange for paying less tax. This can be achieved either with an 'opt-out' swap or a 'means-test' swap. While these two approaches have several similarities, there are also some key differences.

The fourth and final section will look at how a 'means-test' tax-welfare swap would work in practice. By removing some of the middle-class welfare churn, it will be possible to increase the tax-free threshold to more than $100,000 for some workers and offer up to $80 billion worth of income tax cuts, while leaving nobody worse off. This represents significant tax reform that is worth pursuing.

The tax-welfare churn

It is easy to get confused by Australia's tax and welfare system. We have 125 taxes, 40 cash transfer payments, and dozens of schemes for subsidised services, each with its own special rules and regulations. The complexity of the system allows anomalies to go unnoticed and unreformed (See Box 1).

Box 1: Example of tax system anomaly: regressive income tax[2]

Most people assume that our marginal income tax rates are progressive, with high-income earners paying a higher marginal tax rate. The reported marginal tax rates are 15, 30, 38 and 45%. However, the true marginal rates are actually much more complex and regressive in two places. The marginal tax rate is 25% for an annual income of $20,000 but 16.5% for $25,000; 35.5% for $60,000; and 31.5% for $70,000.

If the true tax rates were understood, there would be pressure to fix the system. But because the system is not well understood, there is little drive for reform.

Tax-welfare churn is perhaps the largest anomaly in the Australian tax system. The intention of the welfare state is to *redistribute* money from the relatively 'rich' to the relatively 'poor' so that everybody has a certain minimum standard of living.

In contrast, *churn* occurs when government both takes tax and gives welfare to the same person (or family), with no redistribution of income. It is unlikely that tax-welfare churn was an intended part of the welfare state, but the complexity of the system has made it difficult to reform.

How much churn?

It is difficult to measure exactly how much welfare is redistribution and how much is churn. In his 2007 book on tax-welfare churn, Peter Saunders estimated that about half of the welfare state was redistribution and half was churn.[3]

Table 1: Tax and benefits by private income quintile[4]

(%)	Lowest	2nd quintile	3rd quintile	4th quintile	Highest
Tax	5.6	9.0	15.4	23.3	46.7
Benefits	41.1	23.0	15.5	11.5	9.0

In its 2007 report *Government Benefits, Taxes and Household Income*, the Australian Bureau of Statistics (ABS) provided information on the taxes paid and benefits received by income quintile for 2003–04 (Table 1).

The ABS data do not cover all taxes and benefits. Of the taxes and benefits measured by the ABS, about 50% of welfare was redistribution from higher-income to lower-income families, while 50% was churn between people of roughly the same income. Applying the tax and welfare income distributions from Table 1 to all tax and benefits from the same year (2003–04) gives us similar results—about 45% of welfare was redistribution and about 55% was churn.

Taking the same proportions and applying them to the tax and benefits from the last year with full data (2007–08) shows that about 44% of welfare is distribution and about 56% churn.

These measures are imperfect. Some of the 'churn' will actually be redistribution between different people with the same income but different life situations.[5] Some of the 'redistribution' will occur within a family unit, and is churn for all intents and purposes. These two effects mean that the above statistics may over- or underestimate the true amount of churn. However, it is difficult to adjust for these effects, so this paper will use an estimate that about 50–56% of welfare is churn.

Given that the total government welfare spending (health, education and transfers) was $253.7 billion in 2007–08,[6] total churn is estimated to be $127 billion to $142 billion per year. This is about 12% of GDP every year that is pointlessly churned within the economy with no benefit.[7]

Some churn is inevitable. With some taxes, it will be difficult or even impossible to exempt low-income earners from paying. For example, it will be difficult to charge a different rate of GST for people dependent on their income (although Saunders offers some suggestions[8]). And it would be impossible to exempt low-income earners from the consequences of a company tax, which drives up prices and drives down incomes and profits.

Table 2: Income tax churn and net tax by income quintile in 2007–08[9]

($m)	Lowest	2nd quintile	3rd quintile	4th quintile	Highest	Total
Income tax	$426	$6,528	$18,875	$33,493	$82,597	$141,919
Churn	$426	$6,528	$18,875	$29,176	$22,833	$77,838 (55%)[10]
Net tax	-	-	-	$4,317	$59,764	$64,081 (45%)

However, while some tax-welfare churn may be inevitable, this is not true for income-based taxes. Table 2 shows the tax-welfare churn involved in income tax.

In 2007–08, the total individual income tax (including superannuation and fringe-benefits taxes) was $142 billion. Of this, about $78 billion (55% of income tax) was churned back to people from the same income group, while only about $64 billion (45% of income tax) went for redistribution or public goods.

While it may not be possible to eliminate churn, the above information suggests that we should be able to reduce it by up to $80 billion per year.

Cash churn vs services churn

Government welfare benefits can be split into two distinct categories. Either the government gives people cash to buy what they need or it subsidises certain industries that then provide their services for free or cheap.

'Cash churn' occurs when people pay tax and then receive cash back from the government. For example, a person earning $20,000 per year both pays income tax and is eligible to receive Newstart allowance (the 'dole').[11] More commonly, middle-income families with children often both pay tax and receive child-support payments. Cash payments are generally means-tested,[12] which means that as people earn more money through work, they receive fewer benefits from the government.

If cash payments go only to low-income earners (who pay little tax), then there should be relatively little churn. As Peter Whiteford shows, the Australian government's cash payments are mostly targeted at low-income families, and consequently, we have the lowest level of cash churn in the OECD.[13]

However, there is still a significant amount of cash churning for people on middle and high incomes, mostly as a result of family benefits. Whiteford explains that ‘in virtually all OECD countries, the middle 60% of households receive between 50% and 65% of all transfers, with Australia being placed at the lower end at 56%.’

Buddelmeyer, Herault and Kalb show that the top 50% of income earners in Australia still receive 10% of cash welfare benefits.[14] The average income tax paid by people in the fifth decile is $5,331, while the average of cash benefits for the same group is $6,805.[15] In total, about 13% of income tax ($18.4 billion) is given back as cash to the people who paid the tax.[16]

This indicates that there is still significant scope to reduce cash churn.

While most research is focused on cash churn, it is only part of the story. ‘Services churn’ occurs when people pay tax and then receive the money back as subsidised services.

The two most obvious examples of services churn in Australia are health and school benefits. In contrast to cash benefits, government service provision is generally not means-tested, which means it is also available to middle- and high-income earners. This makes up most of what is called ‘middle-class welfare.’

While cash churn is a problem, services churn is a bigger issue. About 42% of income tax ($59.6 billion) goes back as services churn to the same people who paid the tax.[17] This means services churn is actually three times as big as cash churn.

Box 2: Lifetime churning[18]

The above discussion has concentrated on money that goes from taxpayer to government and back to the same taxpayer in the same year (simultaneous churning).

Lifetime churning occurs when a person is a net taxpayer at some points in their life and a net welfare recipient at other points in their life. Some of the welfare identified above as ‘redistribution’ will actually fall into this category.

With lifetime churning, the government is effectively acting as a bank or an insurance company, managing inter-temporal transfers for people by taking their money in their high-income years and handing it back in their low-income years. Various reforms have been introduced to decrease lifetime tax-welfare churn, such as university HECS payments and compulsory superannuation. Peter Saunders has suggested various additional reforms that would further reduce lifetime churning.

While these issues are important, this paper examines only simultaneous churn.

The case for reform: Why churn is bad

At first glance, the tax-welfare churn may seem pointless but mostly harmless. After all, the benefits end up with the people who paid tax, so all is well that ends well.

Some economists claim that churn is mostly cosmetic and that the economic costs—such as administration, compliance and economic inefficiency—are quite low. In response, some sociologists suggest that the bigger costs are non-economic, including social, political and transparency costs.

Both groups are correct. The direct economic costs are real but relatively small. The non-economic costs may well be larger, but they are unquantifiable.

For services churn, there are additional dynamic costs that are potentially more important.

Unlike cash churn, services churn decreases individual control over how one's money is spent. This reduces competition between service providers and lowers the quality of services. Further, as the services are not means-tested, government spending continues to grow as society gets richer. Specifically, with an ageing population and ever-increasing demand for health care, it is not sustainable to continue providing government health services to high-income earners.

Direct economic costs

The direct economic costs of churn fall into two categories. By requiring money to pointlessly flow around the economy, churn increases administrative costs to the government and the compliance costs to citizens. In addition, by distorting behaviour the government creates 'efficiency' costs to the economy.

Economists such as Nicholas Gruen and Peter Whiteford have correctly pointed out that the direct economic costs of churn are not large.[19] However, this does not mean that these costs should be ignored. Rough estimates suggest that the direct economic costs could be several billion dollars per year.

Administration and compliance costs

Tax and welfare policies need to be administered by an ever-growing army of bureaucrats, and understood by an equally large horde of tax accountants and lawyers. Alex Robson estimated that the Australian 'tax army' (people working on tax administration and compliance) in

2001–02 exceeded 80,000, which was more than three times bigger than our real army.[20]

In addition, there are administration and compliance costs associated with welfare, health and education benefits. Centrelink alone employs about 25,000 people, in addition to thousands of extra bureaucrats in the Commonwealth and state departments of health, education and welfare, as well as outsourced welfare workers.[21]

The bureaucracy in the federal departments of health, education, welfare and tax costs $5.5 billion every year.[22] If we added other relevant agencies, state bureaucracies, and compliance costs, the total cost would exceed $10 billion.

Removing tax-welfare churn would not eliminate all these costs. We would still need a tax and welfare bureaucracy, and people would still face some compliance costs. However, if we could remove churn, then each person would only need to deal with the tax system *or* the welfare system but not *both*. By removing some people from the tax system and taking others out of the welfare system, each government agency would deal with fewer people and each person would deal with less bureaucracy.

It is impossible to know exactly how much administrative and compliance cost could be avoided if we removed churn, but even if costs could be reduced by only 10%, it would still add up to more than $1 billion per year.

Economic cost of higher taxes

Middle-class welfare-tax churn adds around $130 billion to Australia's annual tax bill, including about $80 billion in income tax. Given that each tax dollar creates about 20 to 40 cents of additional cost,[23] it seems that churn produces a significant cost to the Australian economy. However, this is a misleading picture. Surprisingly, the economic efficiency costs may be one of the least important costs from tax-welfare churn.

To understand why churn does not create a significant economic efficiency cost, it is necessary to differentiate between two important issues involved with the tax-transfer system. The first issue—and the focus of this paper—is that welfare can result in pointless churn when the welfare recipient is also paying tax.

The second issue is that when people earn more money, they both pay tax and lose welfare benefits, which results in high 'effective marginal tax rates' (EMTRs). For example, a person with an income of $20,000 per year must pay tax at a marginal rate of 25% and loses welfare benefits at a rate of 60%, resulting in an EMTR of 85%. If they earn an extra $100, they must give $85 to the government. High EMTRs create a disincentive against working, which in turn creates the economic efficiency cost.

Reducing churn while not changing the EMTRs would not improve economic efficiency. Conversely, reducing EMTRs but not reducing (or increasing) churn would improve economic efficiency. Because of this, some economists argue that churn is not a major problem.

This isn't quite correct. While economic efficiency costs are low, they are not zero.

It is possible for some churn to have an impact on incentives. While cash churn does not change disposable income, this is not necessarily true for services churn. If services churn supplies the same services that taxpayers would have voluntarily bought for the same price, there would be no change in their disposable income or their behaviour, and consequently, no economic efficiency cost.

However, if services churn forces people to spend too much on a particular service (or get the 'wrong' cover), it would leave them with less disposable income and a higher EMTR than they would have had without the tax-welfare churn. The distorted decision represents an economic efficiency cost.

It is very difficult to judge how much of the tax-welfare churn involves an economic distortion. If 20% of taxpayers spent 10% too much[24] on health or education, then only about $3 billion[25] of government spending creates a distortion, with an economic cost of perhaps $1 billion.

Although the efficiency costs are not high, this does not justify churn. As there are no clear benefits from tax-welfare churn, any efficiency cost is too high. And when we consider all the costs, the case for reform is strong.

There is another lesson to be drawn from the above discussion. While it is important to address tax-welfare churn, we must recognise the other problems associated with the welfare state that need to be addressed. The current system includes high EMTRs for some workers, which creates a 'poverty trap,' where people do not get much financial benefit from additional work. It is important to ensure that any tax-transfer reform does not exacerbate this problem.

Non-economic costs

When considering the costs of churn, sociologist Peter Saunders suggests that the 'sociological and psychological' costs are actually more important than the economic costs.[26] Unfortunately, these costs are difficult to quantify.

Non-economic costs of churn fall into three broad categories—social costs, political costs, and transparency costs.

Social costs of dependency

Tax-welfare churn results in people relying more on government for their income and services and taking less personal responsibility for their own life. This has a negative effect on the recipients (through lower self-esteem), encouraging worse behaviour (through learned helplessness and distorted time preference), and undermining social capital (by exacerbating social exclusion).

Self-esteem (and Maslow's loftier goal of self-actualisation)[27] is possible only when people are in control of their own lives. While it is comfortable for a child to have the protection of one's parents, to fully develop as an adult it is necessary to take responsibility for one's own life and attain the pride that comes with independently managing one's own affairs. Welfare (both the churn and the redistribution) reduces people's responsibility for the outcomes in their life and instead socialises them into a mentality of dependence and servitude. Put more dramatically, lack of individual responsibility takes away some of the meaning of life and weakens people's sense of controlling their own destiny.

Further, the weakening of individual responsibility leads to less responsible behaviour. In short: incentives matter. While it is true (as welfare advocates claim) that some people suffer for no fault of their own, it is also true that sometimes people make bad decisions. In public policy, it is generally understood that when you want more of something, you subsidise it and when you want less of something you tax it. Tax-welfare churn (as well as tax and welfare in general) subsidises bad decisions and taxes good decisions. It is not surprising then that the welfare state has led to some instances of 'learned helplessness,' where people become unable to make responsible decisions. Unfortunately, this irresponsibility meme can be just as hereditary as family genes, and can result in intergenerational dependency.

Another way to look at this issue is through the effect of changing time preference. As noted by Ben O'Neill,[28] any policy that reduces individual responsibility for future position will increase time preference, leading to a greater preference for immediate satisfaction and less concern for future consequences. An excessively high time preference can explain certain 'anti-social' behaviours such as drug addiction, abandoning family commitments, and crime.

A final social consequence of tax-welfare churn (and welfare in general) is the exact opposite to what was intended by the promoters of universal welfare. The claim that government welfare would enhance social harmony, social inclusion, and stability ('social capital') has been shown hollow, with the voluntary personal interactions of concerned citizens in civil society groups being replaced by impersonal bureaucratic departments.

Humans will always need to cooperate, both to achieve their own personal goals and to help their family, friends, neighbours and strangers to achieve theirs. This cooperation creates and uses social capital. Unfortunately, as the welfare state grows, the role for voluntary civil society such as Friendly Societies[29] decreases (known as 'crowding out'), which further isolates welfare recipients from the community and contributes to social exclusion and a loss of social capital. Other effects on civil society are considered in the following section.

The above arguments apply to all welfare. However, this does not necessarily mean there should be no government welfare. If a government provision provides a real benefit, then it may be appropriate despite the costs. But tax-welfare churn contributes to all these costs without providing any additional benefit.

Political costs

More welfare and more churn also impose political costs on the community. The bigger the government, the more is the opportunity for bad outcomes. Big government leads to wasteful rent-seeking, regulatory capture, politicisation of civil society, greater potential for cheating and abuse of political power, and the building of a political culture of dependence.

The most commonly cited political cost of government programs is that they encourage rent-seeking, where people divert resources from the real economy into lobbying the government for preferential treatment.

Public choice theory suggests that government programs will tend to be 'captured' by special interest groups, and the outcomes tend to maximise political benefits and not necessarily community benefits. Money spent on lobbying would be better spent in the marketplace or distributed as charity.

Another cost is that the direct impact of community groups is undermined, and civil society groups shift their resources increasingly towards political action. Saunders calls this the 'politicisation of civil society,' where community groups focus their attention on politicians instead of the community they are trying to help. As sociologist Frank Furedi says, modern civil society groups are increasingly 'professional institutions that are in the business of "Doing-For" instead of "Doing-With" people,' 'essentially lobbying groups' and 'predominantly media-focused organisations whose main objective is gaining publicity' instead of directly helping people.[30]

The cost here is not simply the resources wasted in rent-seeking and the loss of social capital but the loss of the valuable contribution made by civil society, which can be more efficient and effective at dealing with poverty.

Community groups sometimes have a better knowledge of the specific circumstances in their community, and have a strong motivation for finding innovative and effective strategies for efficiently helping their community. They are also valuable institutions for building social capital, both among donors, volunteers and the general community, as well as the clients. As civil society groups merge into political organisations, many of these benefits are lost.

Another political concern is the greater the role for government and the greater the scope for abuse of government power. The more responsibilities that we hand to government, the greater the possibility that people will benefit from corruption instead of competence and political connections instead of need.

More interaction with government provides more opportunities for people to 'game the system.' Each government program is subject to some level of abuse. As more people are exposed to more government agencies and programs, the amount of tax and welfare cheating will increase. This has a direct fiscal cost to government as well as a policing cost, which in turn can result in a further loss of privacy for taxpayers and welfare recipients.

Finally, there is the impact that big government has on political culture. With a universal welfare system supplied to everybody regardless of need, government encourages the view that it is the solution to all of life's problems. This contributes to a political culture where, instead of seeing a problem and working towards a solution, people simply complain and wait for government to fix the world. In other words, people change from 'problem-solvers' to 'whingers.'

An electorate that expects government to do everything, combined with politicians who promise they can do everything, leads people to build unrealistic expectations. When these can't be filled, it results in disillusionment with the political process and disempowerment. Furedi suggests that this leads to a 'heightened consciousness of isolation' and that such political dependence helps 'induce an exaggerated sense of weakness and a fatalistic outlook.'[31]

Lack of transparency ('Illusion effect')

A central feature of the tax-welfare churn is that it effectively hides who is a net taxpayer (paying more tax than receiving welfare benefits) and who is a net welfare recipient (receiving more benefits than tax paid). This is the 'illusion effect.'

Ironically, the lack of transparency is sometimes thought to be a virtue of churn. Advocates of both tax cuts and increased welfare spending suggest that the lack of transparency may trick the public into supporting their preferred policies.[32] While possible, this benefit is purely political and it is not even clear which side of the political debate will benefit from it.

It is possible that the lack of transparency may trick people into working hard despite their high (but difficult to determine) effective marginal tax rates.[33] However, it is questionable whether this sort of illusion will be effective in the long run as people adjust and learn over time.

The only clear beneficiaries from the illusion effect are politicians, who are able to take credit for more government handouts and subsidised services.

In contrast, the illusion effect does have some very real costs. The lack of transparency allows government to ignore policy anomalies such as high EMTRs or handouts to rich families. If it were easier to identify exactly what was happening, it would create pressure on policymakers to address problems instead of hiding them.

Dynamic costs from services churn

The direct economic and non-economic costs of churn provide a strong rationale for reforming the tax-welfare system. However, there are additional dynamic costs specifically related to services churn.

Unsustainable in the long run

Due to demographic changes, the nature of health spending, and the growth of long-term welfare dependence, the current welfare state is not fiscally sustainable without significant tax increases.

The purpose of the welfare state should be to help people who have insufficient income to help themselves. As we get richer, we expect the welfare state to shrink as more and more people become self-sufficient. Surprisingly, the exact opposite has happened.

In the mid-1960s, only 3% of working-age adults relied on welfare benefits for their income; before Medicare, nearly three-quarters of families had their own private health insurance. As economic growth over the following 40 years led to a doubling of average incomes, and ever more money going to charity, we could have expected government welfare to drop to near zero and private health cover to expand across most of the population. Instead, we have 16% of working-age adults relying on welfare benefits and the government funding almost three-quarters of health costs.[34]

There are several reasons for this unexpected outcome. First, once the government gets in the business of handing out money, it becomes a target for lobby groups who want more handouts, irrespective of whether they are needed. Second, the social costs of welfare can sometimes discourage work, reduce individual responsibility, and increase 'learned helplessness'—leading to a sustained demand for welfare.

However, the main reason that the welfare state can't shrink is that government does not target its health and schooling assistance to poor people but instead offers a universal health and schooling system. Such an approach makes it impossible for the welfare state to shrink, no matter how rich we become.

Further, universal government health services put upward pressure on the welfare budget. The reason for this is that as income increases, the demand for health services increases faster than the demand for other goods, which puts heavy pressure on the government to always spend more on health. This trend is exacerbated by the ageing population, where the elderly have greater demand for high cost health care.

By the middle of this century, the percentage of people aged over 65 will nearly double to 25%, and the percentage of people aged over 85 will triple to nearly 6%.

The fiscal consequence of an ageing population, and the growing demand for health care, is a major challenge for government. Already, over the past four decades, we have seen federal government health spending rise from 1.5% to nearly 4% of GDP.

Over the past 20 years, health spending has increased by an average of 4.8% per year (rising to 5.8% annual growth under the Howard government). Of this, about 1.8 percentage points were due to an ageing population.

According to the 2007 *Intergenerational Report* (IGR), this trend is set to continue, with Commonwealth health spending predicted to rise from 3.8% to 7.3% of GDP by 2046–47.[35] Even these estimates may be conservative.[36]

These increases are the equivalent of an extra $41.2 billion spending per year, which must be funded by an extra $41.2 billion per year in tax. To put that number in perspective, it is more than the federal government defence and education budgets combined, or nearly $2,000 per person in Australia. To raise this amount of money, government would have to significantly increase tax. Even if we doubled the GST to 20%, it would be unlikely to raise enough money to pay for our future Commonwealth health bill.

The actual fiscal problem facing Australia is more dramatic than this. The IGR estimates that federal spending on all areas will increase by about 5% of GDP half way through this century—which is the equivalent of nearly $60 billion of extra tax and spending every year. This excludes the growing costs to state and local governments. According to the NSW Auditor-General's report, health spending has been expanding rapidly over recent decades and at the current rate, 'funding for health will consume the entire State budget by 2033.'[37]

At the same time that the welfare state is expanding, the percentage of people in work is expected to decrease. While today we have five people of working age for each person over 65, by the middle of this century there will be fewer than 2.5.[38] The IGR estimates that the decrease in the workforce participation rate will drag the economy backwards by about 0.3% of GDP per year. At the same time, lobbying for health, welfare and other government spending will continue to grow.

Put simply, the current welfare state is not sustainable. At some stage during the next half century, government will either need to significantly increase tax or start cutting spending.

This is not to say that any welfare system is unsustainable. If welfare was provided only to people genuinely in need, then there would be no sustainability problem. Welfare costs would be relatively low, allowing lower taxes, leading to a virtuous cycle of higher incomes, more charity, greater capacity for self-reliance, and less need for government welfare.

Unfortunately, our current approach of tax-welfare churn means that the demand for government welfare will continue to grow. It is not welfare that is unsustainable but our current tax-welfare churn version of welfare.

Lower quality services

When government provides a subsidised (or free) service, it often does not have the correct incentives to provide efficient and high quality care. The reason for this is that a government monopoly service does not receive the benefits of market competition such as less waste and more choice, better service, better matching of supply to demand, more innovation, more opportunities for specialisation, better risk management, and better use of diverse and constantly changing knowledge. (See Box 3)

It is not necessary to privatise government health or education services to achieve the benefits from competition. However, to achieve better results and more choices at a lower cost, it is necessary to introduce the discipline of competition with private competitors.

Market competition can be severely handicapped if government continues to offer a subsidised (or free) service available to everybody. While these benefits may well be of value to low-income earners, government services provide no net benefit to people caught in tax-welfare churn, but they reduce competition.

By removing the middle-class welfare of services churn, government can still provide benefits to low-income earners while allowing people to choose their preferred service in a competitive market. This would lead to less waste and higher quality services by both government and non-government service providers.

Note that none of this is a threat to redistribution, government ownership, or government provision for poor people. It is possible to have all these and still introduce greater competition into the health and school systems.

Box 3: The benefits of competition

Nobel Laureate economist Milton Friedman drew an important contrast between the different ways that people deal with money. When you spend your own money to meet your own goals, then you are careful to get value for money and achieve your objectives. If you spend other people's money on your own goals, then you will tend to be less careful with money but still aim to effectively achieve your goals. If you spend your own money on other people's goals, then you will be careful about value for money but less concerned with the effectiveness of your spending. The worst scenario is when you are spending other people's money on other people's goals and have no incentive to be either efficient or effective. This is what happens with bureaucracy and government monopoly.

The solution to the problems of government-run businesses is to introduce competition. It is not necessary to privatise a government business to benefit from competition, though this is one option. Government businesses must be put in a competitive marketplace where they are forced to pay closer attention to the demands of their customers and the efficiency of their production.

Most people understand why competition leads to better outcomes. The threat of losing customers drives providers to offer better quality services and lower prices, while the lure of making profits drives providers to do things in the most efficient way possible and quickly adapt to new innovations. Without competition, there is little incentive for high quality, low cost, and efficient service. Comparisons of competitive markets with government monopolies have repeatedly shown the advantages of market competition.

In addition to the above standard economic defence of competition, there is also an evolutionary (or Austrian economics) reason to value competition. Information about preferences, technology and resources is spread among the wider population, and is always changing. In his famous essay on knowledge, Austrian economist Friedrich von Hayek showed how markets were better than bureaucrats at using all available information in society and adapting to new information.

Box 3: The benefits of competition (cont'd)

An important benefit from competition is that it provides a diversity of choices for consumers. Different people and organisations often have a particular set of skills and knowledge that allow them to specialise and provide some services better than others. Competition allows customers to match their personal preferences with the suppliers of their choice.

The above argument is the reason the Australian government does not run clothes shops, farms, hairdressers, grocery stores, bakeries, banks, or airlines. Countries that have experimented with monopoly government control of business have paid a high price in low efficiency, shortages, poor service, low productivity growth, and consequently, lower wages and higher prices. A comparison of East and West Germany, or North and South Korea, are just two of many historical case studies.

The solution: A tax-welfare swap

The case for removing tax-welfare churn is strong. It is not the only problem in our tax or welfare systems, but as churn has no clear benefit it is an obvious candidate for reform.

While some churn is unavoidable, churn between income tax and middle-class welfare can be removed by trading income tax cuts for less middle-class welfare.

For low-income earners, this will involve little change because low-income earners pay relatively little income tax. The bottom 40% of income earners pay only 4.9% of income tax, while the top 40% pay 86.8%.

At the same time, the top 40% receive 20.5% of government welfare benefits, mostly through health and schooling subsidies. By removing this middle-class welfare in exchange for income tax cuts, churn could be reduced by as much as $80 billion per year. That means an $80 billion cut to income tax and $80 billion less government spending on middle- and high-income earners, while redistribution remains unchanged.

There are two potential strategies for achieving the above tax-welfare swap and creating a more sustainable health and welfare system: the 'opt-out' swap or the 'means-test' swap.

Opts-out vs means test

The 'opt-out' approach is to create a parallel system for those who want to avoid the current tax-welfare system. In the parallel system, people would be responsible for all (or parts) of their own welfare, including unemployment insurance, health insurance, schooling costs, among others. In exchange, they would pay a lower level of tax and some tax towards public goods and redistribution to people who choose to remain in the welfare system. This approach has been advocated in Australia by Peter Saunders:[39]

> The basic idea is that people who agree to take more responsibility for themselves should be allowed to retain more of their taxable income so they can afford to buy replacement services, but that those who prefer to remain in the state system can stay as they are.

Under the Saunders system, people remain in the government system unless they decide to opt out, in which case they reduce their tax payments by an amount equal to the benefits they are receiving. If you do not pay enough tax to cover your welfare benefits, then you can stay in the government system and continue to receive the same welfare. People who do opt out are required by law to buy health care and schooling for their children.

The alternative is a means-test swap.[40] In this approach, government support is slowly removed from people as they earn more money. They are compensated for this loss through tax cuts, which exactly offset the lost government benefits. Once income exceeds a certain level, people would be fully responsible for their own welfare (including health insurance and their children's schooling) and be able to afford those payments through lower taxes. As with the 'opt-out' approach, there would be a mandatory minimum level of health insurance and schooling that people must buy.

While both 'opt-outs' and 'means-testing' allow people to 'swap' their middle-class welfare benefits for lower income tax, there are two differences.

Unlike Saunders' 'opt-out' approach, the 'means-test' approach would mean that all high-income earners eventually stop receiving government funding. Saunders prefers the opt-out system because some high-income earners may want to stay with a government system. However, that is still possible with the means-testing approach. Government can remain an owner and operator of health cover and schools and allow high-income earners the option of continuing to pay for those government services if they want. The difference between opt-outs and means-testing is that the latter guarantees lower churn for middle- and high-income earners while providing all the same options.

The second difference is that the 'means-testing' approach would reduce churn for people who are net welfare recipients but still pay some tax. Under Saunders' 'opt-out' approach, these people would continue to pay tax and receive full government benefits. Under the 'means-testing' approach, these people would pay no tax and receive slightly fewer benefits. Here, the means-test guarantees lower churn and increases choice for low-income earners while providing all the same options.

Saunders suggests that the 'opt-out' approach may be more politically feasible. However, this is open to dispute. The concept of opting out is a relatively new and untested policy option in Australia, and the stark differences between two parallel, co-existing systems may make the choice of opting-out seem dramatic and un-egalitarian. In contrast, the concept of means-testing is common, widely understood, and widely accepted.

Criticism of means-testing

In his report on middle-class welfare, Luke Buckmaster outlines a number of criticisms of means-testing:[41]

- high effective marginal tax rates (EMTRs) and a 'poverty trap'
- perverse incentives
- intrusive process
- possibility of low uptake of the programs, and
- administration costs.

Perhaps the most serious of these points is the point about EMTRs and the 'poverty trap,' which is linked to the issue of perverse incentives. As Saunders explains, means-testing can decrease the incentive to work because:[42]

> [A]s soon as people work harder and earn more, not only do they pay more tax, but they also start to lose their government benefits. This double-whammy creates very high rates of effective taxation' at the margin (that is, people retain relatively little of each new dollar they earn), and this depresses incentives.

> [I]ncreased use of means-testing (either for access to income support or for access to government services more generally) would make this problem even worse than it is already.

These criticisms do apply to a simple means-test and are a strong reason to reject that approach. But the means-test swap, where means-testing is linked to matching income tax cuts, does not face these problems.

By exchanging middle-class welfare for income tax cuts, the effective marginal tax rates would not increase. Indeed, as explained previously, the tax burden would actually decrease for some people, leading to improved incentives.

Similarly, the other concerns suggested by Buckmaster are not relevant for the means-test swap. Concerns about low uptake can be fixed by having compulsory uptake and automatic government coverage for low-income earners. And while there would still be some level of administration costs and intrusiveness, these problems would actually decrease by removing churn.

There is another potential concern with the means-test approach. The government services (health cover and schools) do not currently have a price. However, this could be calculated by the government and would create the additional benefit of providing greater transparency about government activity.

From theory to practice

Following the means-testing approach for a tax-welfare swap, it is possible to outline roughly how such a system would work in Australia.

As discussed earlier, only about one-quarter of tax-welfare churn comes from cash-churn, while the remainder comes from health and schooling subsidies going to middle- and high-income earners. Further, services churn has all of the costs of cash churn, plus the dynamic costs of unsustainability and lower quality services. This section focuses on services churn, but it is worth noting how cash churn could be addressed.

The best way to remove cash churn (and lower EMTRs) is to entirely take cash welfare recipients out of the tax system. This can be achieved by increasing the tax-free threshold to the point where people stop receiving cash welfare. While this would remove the costs of churn and improve work incentives, it would come at a significant fiscal cost to government in lost revenue.

A moderate approach to removing cash churn (but not changing the EMTRs) is to entirely take cash welfare recipients out of the tax system but increase the means-test on their cash welfare benefits. For example, paying 20% in tax and losing 50% of welfare benefits for every dollar earned could be replaced by paying zero percent in tax and losing 70% in welfare benefits.

Such a reform would not change the EMTRs or disposable income of the cash welfare recipients. While the changes would be relatively minor, they would still bring several benefits, including greater transparency, reduction in administration and compliance costs, fewer social and political problems associated with welfare and big government, and a greater sense of self-reliance.

Health spending churn

In 2006–07, government (Commonwealth, state and local) spent $64.5 billion on health goods and services,[43] which represented a health subsidy of nearly $3,000 per person per year. Properly costed government health care would cost about $3,000 per person. By removing churn, low-income earners would continue to receive the full subsidy of $3,000 so that complete health care was always available.

With this clearer understanding of the subsidy involved in government health cover, it is possible to means-test this subsidy for people with relatively higher incomes. The reduction in the health subsidy for middle- and high-income earners would be directly linked to an offsetting decrease in income tax via an increase in the tax-free threshold. For example, individuals previously facing a marginal income tax rate of 16.5% (the rate for people earning $25,000 per year) and receiving the full government health cover would instead pay zero percent income tax and have their health subsidy phased out at 16.5%: for every dollar they earn, their health subsidy would reduce by 16.5 cents.

A single person earning about $31,300 per year would no longer receive any government health subsidy but would ‘save’ $3,000 in taxes not paid. They would only start paying tax on the money earned above $31,300 per year. As it would be compulsory to have a minimum level of health cover (at least covering catastrophic health insurance), that person would be obliged either to continue to buy government health cover for $3,000 (and be in the same position as the current scheme) or purchase elements of health cover (perhaps hospital cover or GP insurance) from the private sector. While it would be illegal to purchase too little health cover, it would still be possible for people to purchase extra health cover if they chose.

Parents would have access to a $3,000 health subsidy for each of their children and be required to purchase health cover on their behalf. Like the original benefit, this would be means-tested, with the lost benefits exactly offset by lower taxes so that the family cannot be in a worse situation than they are under the current system.

This approach allows for government to continue offering health services, including hospitals, general health insurance (GPs and other Medicare benefits), ambulance cover, and pharmaceutical insurance. This ensures that people always have the option of continuing with their current health cover, and at the same price.

Box 4: The next step in health reform

It is an open question whether the government health subsidy should only be available to purchase government supplied health cover. If the subsidy was only available for government health care, most low-income people would remain in the 'free' government system, but they would be required to pay the full amount for private health cover. Alternatively, if the subsidy could be used for any health cover (government or private), then low-income earners would have the choice to use their $3,000 government subsidy to buy any range of government or private health options. This paper does not aim to resolve this debate.

It is likely that new private providers, both for-profit and non-profit, would emerge to compete with government in providing these services. It would be necessary to maintain a level of regulation over private health providers to ensure they do not unfairly discriminate or reject people on the basis of health risk. This could be achieved in a number of ways.[44]

School spending churn

In 2006–07, government (Commonwealth, state and local) spent $58.2 billion on schooling (both private and government schools).

This represented a school subsidy of about $12,000 per government student and about $6,300 per private student per year.[45] So if schools were properly costed, government schools would charge about $12,000 per year and private schools would cost on average $6,300 per year more than they do now.[46]

By removing churn, low-income earners would continue to receive the full amount of this subsidy so that government schools remained free and private schools remained subsidised.

Like the health subsidy, once there is a clearer understanding of the subsidy involved in government schooling, it would be possible to means-test this subsidy for people with relatively higher incomes. This means-test would be directly linked to an offsetting decrease in income tax via an increase in the tax-free threshold.

For example, someone paying a 35.5% income tax marginal rate (paid by somebody earning $40,000 currently) and receiving the full government schooling cover would instead pay zero percent income tax and have their schooling subsidy phased out at 35.5%. That is, for every dollar they earn, their schooling subsidy would reduce by 35.5 cents.

The split between funding for private and governments schools creates an added complexity when means testing a school subsidy. It is possible to argue that the higher subsidy should always go to the poorer families, irrespective of whether they go to a government or private school. However, while the author is sympathetic to such a reform, such a change goes beyond the scope of this paper, which focuses only on removing the tax-welfare churn. Consequently, the reform proposal in this paper will use the current approach to school funding, which has differential subsidies depending on whether a child attends a government or private school, with a bias towards government schools.

For example, a single person with one child in a government school and earning about $76,000 per year would no longer receive any government health subsidy or school subsidy, and would instead have 'saved' about $18,000 in taxes not paid. That money is available for them to pay for two lots of health cover ($3,000 each) and one lot of government schooling ($12,000).

In contrast, a single person with one child in a private school could earn about $59,000 before they no longer received any government health or school subsidy, and they would have 'saved' about $12,300 in taxes not paid. That money is available for them to pay for two lots of health cover ($3,000 each) and one lot of private schooling ($6,300).

Box 5: The next step in school reform

To ensure that nobody in the current system is disadvantaged, it may be necessary to take the above two-tier approach to the schools subsidy. However, this could be reformed in a number of ways so families with similar incomes receive similar benefits.

One option would be to offer an average subsidy of $10,000 to all people, irrespective of whether their child went to a government or private school. However, if there were no efficiency savings at government schools, this may require some families to pay a top-up to their government school of perhaps $500 per term. If this was considered unacceptable, then the extra $2,000 per year could be sourced from the general revenue, which would reduce the budget balance by about $500 million each year for 12 years as the new system was introduced.

Another option would be to offer the larger $12,000 subsidy to all parents of new students and have the phase-out rate increased slightly. This would provide a larger subsidy to poor families with a student at a private school, and reduce the subsidy to richer families with a student at a government school. Unfortunately, this would marginally increase the EMTR for families during the phase-out of the subsidy.

Equalising the schools subsidy (or equivalent tax cut) for all students would open up the benefits of greater competition in the school market.

Benefits from the reform

The above reforms mean that people who pay income tax would not receive government benefits, and people who receive government benefits would not pay income tax. This would increase the tax-free threshold. An individual's tax-free threshold would depend on how many children they have and whether they go to a private or public school. The specific tax-free thresholds for different taxpayers are outlined in Table 3. These rates only factor in the removal of services churn. For some people, the removal of cash churn may push these tax-free thresholds even higher.

People with an income under their tax-free threshold would receive government benefits. People earning an income above their tax-free threshold would no longer receive health or schooling benefits. They would be effectively independent of the welfare state.

Table 3: New tax-free thresholds and tax savings[47]

	Tax-free threshold	Tax saving
Individual	$31,500	$3,000
With one child (not at school)	$41,000	$6,000
With one child (private school)	$59,000	$12,000
With one child (government school)	$76,000	$18,000
With two children (private school)	$86,000	$21,500
With two children (government school)	$114,500	$32,500

The benefits of this system relate to unwinding the costs of churn, as outlined earlier in this paper:

- Administration and compliance costs would be reduced as each government agency has fewer clients and each person has to deal with only one agency.
- Fewer economic distortions and improved incentives.
- Lower social costs from welfare—allowing people to have higher self-esteem, giving people back a sense of responsibility, which leads to better decision-making, and building social capital.
- Lower political costs as greater self-reliance leads to less rent-seeking, fewer opportunities for corruption or cheating, less need to invade privacy, and less alienation from the political process.
- Greater transparency as each taxpayer and welfare recipient can more clearly understand government policy and their position in the tax-transfer system.
- A sustainable system that will be able to avoid the fiscal problems associated with universal health care and an ageing population. Instead of growing welfare resulting in $60 billion more tax each year, an increasingly prosperous society will have less need for welfare.
- Greater choice and competition, especially in health, will lead to less waste, more diversity, better service, more innovation, and better use of all available information in producing more effective and efficient services.

The most obvious impediment to this reform is that government can no longer take credit for pointlessly churning money within the economy. Politicians and people who prefer complexity would have to deal with the transparency of the new system. However, an inconvenience to politicians is a small price to pay for a better tax-welfare system.

These reforms would also require some adjustment to Commonwealth-state financial relations. The total impact on government would be neutral: income tax cuts would reduce Commonwealth revenue, while welfare reductions would be split between the Commonwealth and state governments. Governments can design new financial arrangements to reflect the changed responsibilities.

Conclusion

There are many areas of government policy that involve difficult trade-offs between competing goals. Political debates rage about whether we should sacrifice some freedom for security or trade some efficiency for greater equality. It is unlikely that any of these disagreements will be resolved soon.

In contrast, addressing tax-welfare churn does not involve any such difficult trade-off. Removing tax-welfare churn can be done, it will have benefits, and there are no real costs.

The Australian welfare state (including cash handouts, government health, and government schools) costs us about $250 billion per year. Approximately half of this is redistribution from rich to poor. But the other half is pointless churn between people on the same incomes. Not all of this churn can be addressed, but the $80 billion associated with income tax can be fixed.

The solution is to means-test government benefits and compensate people by offsetting income tax cuts. This approach means that anybody who needs government help will still get it. However, people on higher incomes will exchange their government subsidy for a tax cut that would allow them to personally pay for health and schooling.

It is true that this reform would not resolve many outstanding problems in the tax-welfare system, such as high effective marginal tax rates or the crowding out of civil society. However, there are important benefits that would flow from this reform, with lower administrative and compliance costs, greater economic efficiency, fewer social costs from welfare, fewer political costs from big government, greater transparency, a sustainable welfare system, and a more efficient and effective health and schooling system.

It is rare that a reform proposal can offer $80 billion worth of tax cuts while promising not to make anybody worse off, but that is exactly what this proposal does. It is an idea that can be supported by people from across the political spectrum. Tax-welfare churn can and should be addressed now.

Endnotes

1 The term 'middle-class welfare' is commonly used to refer to welfare that goes to people who aren't in poverty, which includes both the middle- and high-income earners.

2 John Humphreys, 'Revealing Australia's Real Income Tax Rates,' *Policy* 25:2 (Winter, 2009), 32–34.

3 Peter Saunders, *The Government Giveth and the Government Taketh Away* (Sydney: The Centre for Independent Studies, 2007).

4 Australian Bureau of Statistics, *2003/04 Government Benefits, Taxes and Household Income Australia*, Cat. No. 6537.0 (Canberra: ABS, 13 June 2007).

5 For example, people may be treated differently because they have a disability or because they are on the old-age pension.

6 In 2007–08, the Commonwealth government spent $18.6 billion on education, $44.5 billion on health, and $97.2 billion on social security and welfare. In the same year, state and local governments spent $39.6 billion on education, $41.5 billion on health, and $12.3 billion on social security and welfare. That comes to a total of $253.7 billion. This excludes $17.5 billion spent on housing by Commonwealth, state and local governments. Data available at ABS.

7 If churn is 50%, then it amounts to 11.3% of GDP. If churn is 56%, then it amounts to 12.6% of GDP.

8 Peter Saunders, *The Government Giveth and the Government Taketh Away*, as above, Appendix II, 125–127.

9 Taken from the ABS, Commonwealth Budget, and author's own calculations.

10 This measures the percentage of income tax that goes back to the same people in welfare. This is a different statistic to the churn estimate, which estimates how much of the welfare originally came from tax from the same people.

11 It is worth noting that a person with an income of about $20,000 per year can face an effective marginal tax rate of 85%, meaning if they earn an extra $100 they must give $85 to the government. This is because they face an income tax of 15%, Medicare levy of 10%, and their Newstart allowance is withdrawn at 60%.

12 Until recently, there were some notable exceptions to the means-testing of cash payments. However, in the 2008–09 and 2009–10 Commonwealth budgets, there were new means-tests placed on the Baby Bonus and the Family Tax Benefit.

13 Peter Whiteford, 'The Welfare Expenditure Debate: "Economic Myths of the Left and Right" Revisited,' *Economic and Labour Relations Review* 17:1 (2006). See also Peter Whiteford, *Transfer Issues and Directions for Reform: Australian Transfer Policy in Comparative Perspective* (2009).

14 Hielke Buddelmeyer, Nicolas Herault, and Guyonne Kalb*, 'Churn' within the Australian tax and transfer systems of 2003/04 to 2008/09: An Analysis Using the Melbourne Institute Tax and Transfer Simulator (MITTS)* (University of Melbourne: Melbourne Institute of Applied Economic and Social Research, September 2008). Buddelmeyer, Herault and Kalb looked at how much various income deciles paid in income tax and the Medicare levy, and how much they received in family payments, pensions and allowances.

15 For the same decile, the median annual tax was $3,297 while the median annual cash benefit was $5,639.

16 As with the estimates of total churn, this measure is imperfect. Some of the 'churn' will actually be redistribution between different people with the same income but different life situations. Some of the 'redistribution' will occur within a family unit and so is effectively churn.

17 As shown in Table 2, total churn from income tax is 55% of income tax. If 13% of that is given back as cash, that leaves 42% for services churn.

18 For more information about lifetime churn and how it may be addressed, see Peter Saunders, *The Government Giveth and the Government Taketh Away*, as above.

19 Quoted in Peter Saunders, as above, 39.

20 Alex Robson, 'How High Taxation Makes Us Poorer,' in Peter Saunders (ed.), *Taxploitation* (Sydney: The Centre for Independent Studies, 2006), 21–38.

21 Peter Saunders, *The Government Giveth and the Government Taketh Away*, as above, 42.

22 Data taken from Portfolio Budget Statements for the Australian Taxation Office ($3.2 billion); Department of Health and Ageing ($0.7 billion); Department of Education, Employment and Workplace Relations ($0.9 billion); and Department of Families, Housing, Community Services and Indigenous Affairs ($0.6 billion).

23 For a discussion of economic efficiency cost of taxation, see Alex Robson, 'Why Churning is Bad for You,' in Peter Saunders (ed.), *Taxploitation*, as above.

24 In economics, people spend 'too much' on something if they could have received greater benefit by spending their money in a different way. For example, if a person wants to spend $100 on health and $200 on education but is forced to spend $150 on each, then in economics they would be said to have spent '$50 too much' on health and '$50 too little' on education.

25 This is 1% of the total health and education spending of $145 billion.

26 Peter Saunders, *The Government Giveth and the Government Taketh Away*, as above, 40. Note that there are two British sociologists called Peter Saunders. The author quoted here is the Saunders who worked at The Centre for Independent Studies.

27 In 1943 Abraham Maslow proposed a 'hierarchy of needs' in order of importance. The five needs were (1) physiological; (2) safety and security; (3) love and belonging; (4) self-esteem; and (5) self-actualisation.

28 Ben O'Neill, 'Liberty, Time Preference and Decadence,' *Policy* 25:1 (Autumn, 2009), 45–48.

29 Before the 1911 pension laws were introduced in the United Kingdom, more than half of the population benefited from Friendly Societies, and three-fourths of the population were covered through private welfare programs. For more information, see David Green, *Reinventing Civil Society: The Rediscovery of Welfare without Politics* (London: IEA Health and Welfare Unit, 1993).

30 Frank Furedi, *Politics of Fear: Beyond Left and Right* (Continuum International Publishing Group, 2005), 111.

31 As above, 73.

32 For a tax-cutting perspective, see Adam Lerrick, *Obama and the Tax Tipping Point* (American Enterprise Institute for Public Policy Research, November 2008). For the welfare argument, see Luke Buckmaster, *Money for Nothing? Australia in the Global Middle Class Welfare Debate* (Parliamentary Library, 2009).

33 Andrew Leigh, *Why Tax Reformers Should Learn About Ignorance*, *Online Opinion* (28 April 2009). Note that Leigh is not necessarily arguing in favour of this approach. He is simply pointing out that the complexity may hide the true costs of the policy.

34 Peter Saunders, *The Government Giveth and the Government Taketh Away*, as above, 15.

35 Treasury, *International Report 2007* (Canberra: Commonwealth of Australia, 2007).

36 Jeremy Sammut, *The Coming Crisis of Medicare*, Policy Monograph 79 (Sydney: The Centre for Independent Studies, 2007).

37 Auditor-General's report, *Performance Audit: Delivering Health Care Out of Hospitals* (Sydney: NSW Department of Health, 2008), 2.

38 Treasury, *International Report 2007*, as above.

39 Peter Saunders, *The Government Giveth and the Government Taketh Away*, as above, 98.

40 John Humphreys, 'Declaring Independence,' in *Declaring Dependence, Declaring Independence: Three Essays on the Future of the Welfare State*, Occasional Paper 111 (Sydney: The Centre for Independent Studies, 2008). This approach is a variant on the reforms suggested by New Zealand politician Sir Roger Douglas. Details of the Douglas approach are available in Peter Saunders, *The Government Giveth and the Government Taketh Away*, as above, 82–86.

41 Luke Buckmaster, as above.

42 Peter Saunders, *The Government Giveth and the Government Taketh Away*, as above, 44.

43 Of this, $61.1 billion was spent on hospitals, pharmaceuticals, Medicare benefits, and associated health services. The remaining $3.5 billion was a subsidy for private health insurance (figures don't add due to rounding).

44 The most obvious method of avoiding unfair risk assessments is to not allow private health companies to discriminate on the basis of people's risk-rating. Another option is to allow companies to discriminate on the basis of risk-rating when somebody changes insurers but requires the old insurer to pay the risk premium to the new insurer. This will not disadvantage the old insurers as they would have also reduced their exposure to a high risk customer.

45 Note that this is the average cost. There is a large variance in government subsidies for different private schools. Adjusting for this would add a level of complexity to the arrangements but would not change the nature of the scheme.

46 With the higher fees, it would be necessary for schools to allow parents to pay over the course of the year so that the cost of schooling could be matched to the tax savings that parents would receive over the course of the year.

47 Numbers have been rounded to the nearest $500.

Chapter 4

The Faulty Arguments Behind Australia's Corporate Income Tax

Sinclair Davidson*

* I would like to thank Robert Carling and two anonymous referees for their comments on a previous version of this chapter. My research into Australian corporate income tax is supported by the Australian Research Council.

In Australia, the primary function of taxation is to finance government spending, and the secondary objectives relate to influencing social and economic outcomes, resource allocation, consumption patterns, the level and direction of savings, and the relative welfare of different groups.[1] Non-distortionary taxation is not necessarily an objective of the Australian system.

Australia's corporate income tax is said to be very successful, raising substantial revenue, and there has been little debate about it over the past few years. While public debate has concentrated on personal income tax, there has been little demand for corporate income tax reform. Arguments by the Business Council of Australia (BCA), for example, that corporate income taxes are too high have been viewed as special pleading by lobby groups. This paper investigates Australian corporate income tax and highlights a number of issues that deserve greater public awareness.

For example, both the Australian corporate income tax rate and the corporate income tax take are high by world and OECD standards. Contrary to widespread opinion that large corporations pay very little (or even no) corporate income tax, Australian Taxation Office (ATO) data show that large corporations, which make up about 0.5% of all firms, pay over 76% of corporate income tax. The legal incidence of the corporate income tax burden is uncertain. The rationale for levying a corporate income tax relies on weak arguments, while the deadweight costs are likely to be very high—research undertaken for the Henry review indicated that corporate income tax deadweight losses could be as high as 40 cents in the dollar.[2] Consistent with the BCA's argument, the effective corporate income tax rate in Australia has probably been rising over time. The international evidence suggests that high corporate income tax rates retard economic growth.

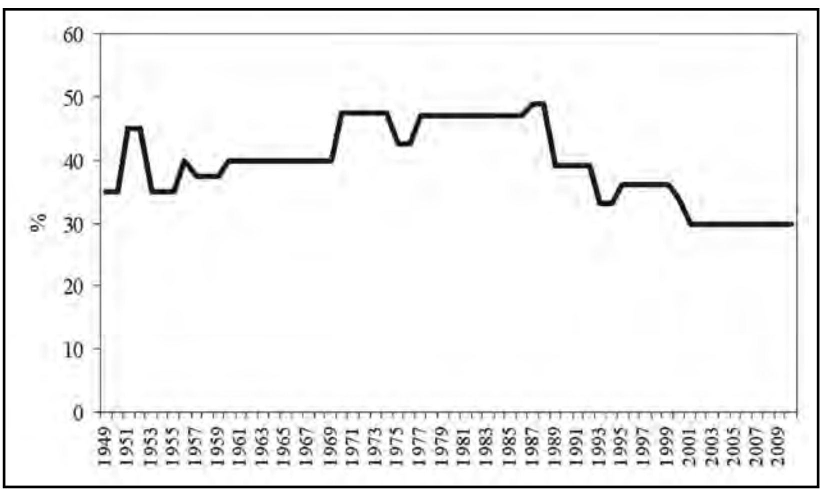
Overall, this chapter presents arguments that suggest the case for corporate income taxes is uneasy. Corporate income tax itself is a good revenue-raiser, but its true costs are uncertain. Consequently, it makes sense to take a cautious approach to this form of taxation; corporate income tax rates should certainly be lower, not higher. Reform in this sector is long overdue.

Corporate income taxation in Australia

Corporate income is taxed at a flat rate of 30% in Australia. There is no tax-free income threshold. Australia operates a partially integrated personal and corporate income tax system, where corporate income tax constitutes a withholding tax on personal income. Individual taxpayers pay tax on dividend income at their marginal tax rate. Taxpayers with a high marginal rate pay in the difference between their rate and the corporate income tax rate. Taxpayers with a low marginal rate can offset other income against the withholding tax (called an imputation credit) or receive a refund for the difference.

The corporate income tax rate has been on a rollercoaster ride over the past 93 years since its introduction in 1915 when the Commonwealth brought in a tax on undistributed company profits; dividends were taxed as personal income. The corporate income tax rate was 6.25%.[3] In 1922, the corporate income tax rate on undistributed profits was increased to 12%, but reduced the next year to 5% of net profit. Figure 1 shows the evolution of the corporate income tax rate since 1949.[4] In that time, there have been a large number of changes in the rate itself, and also in the treatment of private and public companies. Since 1973, however, private and public companies have been taxed at the same rates and the corporate income tax became a flat tax.

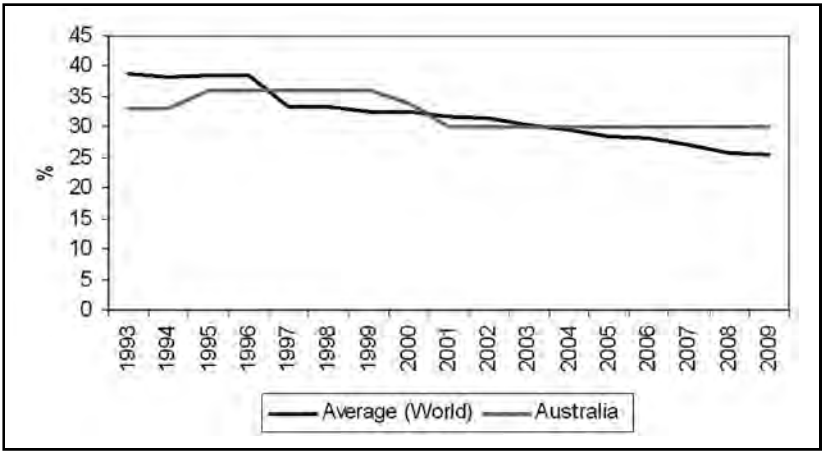
Figure 1: Australian corporate income tax rates



Source: Historical data from Julie Smith.[5]

KPMG has made international comparison data available starting from 1993. Using that data, I have captured world average rates (across 65 economies) (Figure 2). Both the average world corporate income tax rate and the Australian corporate income tax rate have declined over time. Since 2003, the Australian corporate income tax rate has been higher than the (unweighted) average corporate income tax rates for the world.

Figure 2: Comparative corporate income tax rates (unweighted)



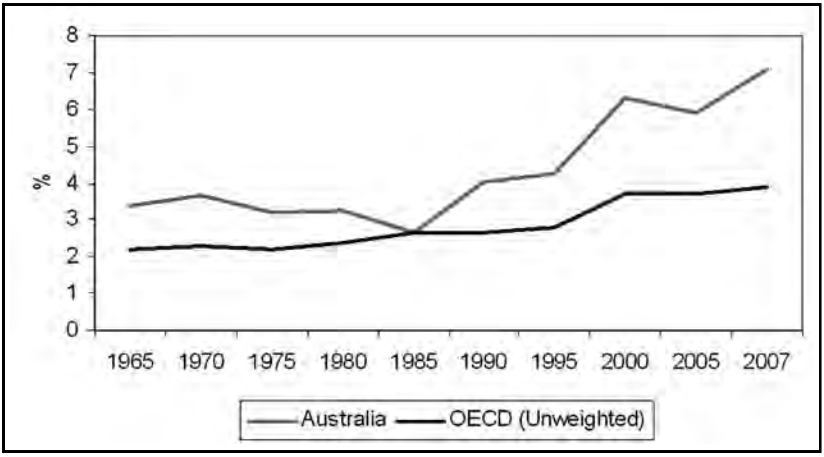
Source: Australian Treasury and KPMG International.[6]

The headline corporate income tax rates are only one part of the issue. A far more important aspect of the tax burden is how much revenue the tax system raises. In 2010–11, the corporate income tax is expected to raise \$66.5 billion (or 32% of income tax revenue). That overstates the amount of revenue the Treasury will get to keep, as corporate income tax is, in principle, prepayment of personal income tax. Neville Hathaway and Bob Officer of Capital Research have undertaken a careful analysis of the creation and usage of imputation credits. Their argument is that about 35% of corporate income tax revenue is redeemed at the personal level as a prepayment of personal tax. That would imply, everything else being equal, that Treasury can expect to net about \$43.2 billion from corporate income tax.

Figure 3 shows the ratio of corporate income tax revenue to GDP for Australia and unweighted corporate income tax revenue to

GDP ratios for the OECD. Not only is Australian corporate income tax *revenue* higher by OECD standards, it has also increased dramatically since 1985 even though the corporate income tax *rate* has declined in the same period. So, in an environment where the corporate income tax *rate* has declined, the corporate income tax *take* has increased. This has been observed in many economies, not just Australia, and is partly a result of cuts in headline tax rates being accompanied by base-broadening. In short, there is no evidence that international tax competition is reducing corporate income tax revenues, as is sometimes argued.

Figure 3: Comparative corporate income tax revenue (as % of GDP)



Source: OECD revenue statistics.

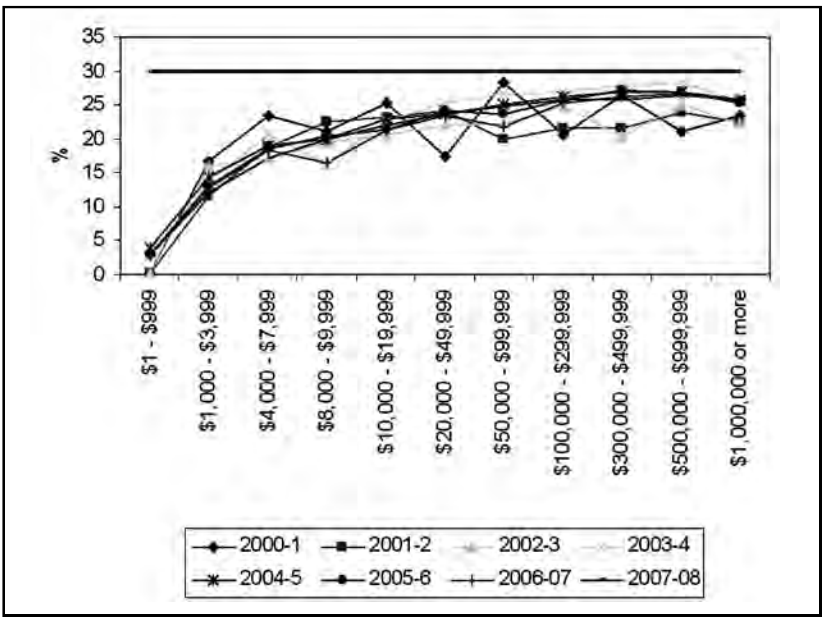
Who pays corporate income tax?

The mechanics of corporate income tax

The mechanics of corporate income tax are simple: all companies face a flat rate of 30% of assessable income. Unlike the United States, Australia does not levy a progressive corporate income tax, and unlike the pre-1974–75 situation, public and private companies pay the same nominal rate. If the effective tax rate of firms were plotted against their taxable income, we would observe a flat line at the corporate income tax rate (30%).[7] When I actually undertake that exercise (shown in Figure 4), though, something very different emerges.

The effective corporate income tax rate follows the same pattern that a progressive tax system would.[8] Firms with very low taxable incomes appear to pay lower effective rates than firms with higher taxable incomes. The difference between the effective tax rate and the statutory tax rate is explained by the existence of tax offsets, foreign tax credits, the franking deficit tax offset, and 'other refundable credits.'[9] Smaller firms face a consistently lower effective tax rate than larger firms. This could be explained by smaller firms having a precarious existence and highly variable profitability. Unfortunately, the data are too aggregated to explore the idea any further. In addition, the difference between the effective tax rate and the statutory tax rate is highly variable—although in the last two years it was much less volatile. The important issue here is that the corporate income tax does not function as a flat tax would.

Figure 4: Effective and statutory corporate income tax rates by taxable income



Source: Author's calculations and ATO tax statistics (various).

It is not just the effective tax rates that are distorted: a very small number of the firms subject to corporate income tax are responsible for paying the majority of the corporate income tax revenue (see Table 1). Firms with more than $1 million in taxable income make up about 0.5% of the total number of firms, yet in 2007–08 they paid 76.26% of net corporate income tax. To provide a starker statistic, 92 respondents to a BCA survey paid $18.1 billion in corporate income tax—nearly 37% of the total corporate income tax revenue paid in 2005–06.[10] Tax Commissioner Michael D'Ascenzo recently indicated that 'large corporates with a turnover of $250 million or more contributed 65% of company tax in 2006–07. And of this, the top 50 contributed 71%, and the top 100 companies contributed 82%.'[11] The Australian corporate income tax burden is highly concentrated on a relatively small number of firms.

It could well be argued that those firms earn the vast majority of profits in Australia, so it is unsurprising that they should pay much more in corporate income tax. I tested that argument by calculating their share of the total income and taxable income of all entities that pay Australian corporate income tax, and comparing that with their net tax share. In 2007–08, these firms earned 57.8% of total income and 72.5% of taxable income while paying 76.26% of net corporate income tax. The corporate income tax is not as distorted as the personal income tax, where the top 1% of taxpayers earned 10.1% of taxable income and paid 18.5% of net personal income tax. John Braithwaite says 'both Australia's and America's wealthiest corporations do not pay their fair share of tax.'[12] The data do not support this argument.

Table 1: Distribution of firms and net corporate income tax

	Proportion of firms (%)	Proportion of net corporate income tax (%)	Effective tax rate (%)
1996–97	0.30	64.45	24.81
1997–98	0.32	67.45	23.60
1998–99	0.34	65.95	23.86
1999–00	0.38	66.87	23.28
2000–01	0.33	70.99	23.32
2001–02	0.35	69.79	22.41
2002–03	0.37	70.54	22.27
2003–04	0.39	70.20	25.54
2004–05	0.38	72.59	25.68
2005–06	0.44	75.60	25.36
2006-07	0.52	77.80	25.57
2007-08	0.53	76.26	24.56

Source: ATO tax statistics and author's calculations.

Corporate income tax incidence

The above analysis shows who directly pays the corporate net income tax—corporations. Many economists, though, would be dissatisfied with this type of analysis. Tax incidence studies investigate who bears the economic tax burden, as opposed to who actually pays the tax. These types of studies differentiate between the legal incidence of taxation (what I have shown above) and the economic incidence of the taxation. The legal incidence refers to the distribution of tax payments based on who has the legal obligation to remit the tax to the government. The economic incidence is based on the economic impact a tax has on behaviour, and partly on economic welfare.

Economists routinely assume that legal incidence and economic incidence are different, and they are unsure as to who bears the burden of corporate income taxation. There are three groups that could bear the economic incidence of corporate income tax. First, consumers could pay the tax (as higher prices). Second, workers could pay the tax (as lower wages). Finally, investors could pay the tax (as lower returns). There is a large body of literature that attempts to untangle the incidence of corporate income tax.[13] Economists agree that investors bear the short-run tax burden, but they are less certain on who bears the long-run burden. A 2006 paper by the US Congressional Budget Office (CBO) suggests that in the United States, over 70% of the corporate income tax burden is borne by workers in the form of lower wages, and only 30% by investors.[14] The study found that the effect on consumers was very small. The argument is that in an open and competitive economy, it is unlikely that the tax burden could be passed forward to consumers. This is most likely the case for the tradable sector, but consumers will bear a small component of the corporate income tax in the non-tradable sector.[15] That implies the corporate income tax burden is largely shared by investors and workers.

Why have corporate income tax at all?

For those in government who want to create fiscal illusion—where the tax burden is made to look smaller than it really is—the corporate income tax is ideal. Voters and taxpayers are uncertain where the incidence of the tax falls, and even how much net revenue the tax raises. There are clear reasons in political economy to impose a corporate income tax, even if it seems somewhat cynical to focus on them. But what of the purely economic aspects of corporate income tax?

General principles

Three reasons can be given for imposing corporate income tax: its *desirability*, its *necessity*, and its *convenience*.[16] While all three reasons are plausible, they are not necessarily convincing. The *desirability* of corporate income tax arises primarily from the ability to tax foreigners. It is entirely plausible to argue this is desirable, but the motive of taxing foreigners needs be tempered by an awareness of the cost that this form of taxation imposes on the domestic economy, and also by the desire to attract foreign investment. The issue of desirability also raises the possibility of Pigovian taxes, which are used to overcome so-called market failures in the form of externalities. For example, if we believe that excessive car use contributes to greenhouse gas emissions, we could impose a tax on petrol to reduce demand and consequently reduce greenhouse gases in the atmosphere. This example is quite clear-cut, and petrol is subject to very high taxes in most countries. In the case of corporate income tax, the question is one of what externalities the corporate form imposes on society, and how the corporate income tax resolves that market failure. Since there is no clear answer to the questions, the function of corporate income tax as a Pigovian tax should be downplayed.

The second argument in favour of the corporate income tax is based on its *necessity*. This argument holds that the corporate income tax serves as a 'backstop' to the personal tax system, and generally serves to avoid distortions in the overall tax system. The logic underlying this argument is that the solution to economic distortions due to a high personal tax rate is to have a high corporate income tax rate. There are two interrelated arguments here. The first is that corporate income tax is necessary to prevent individuals from organising their personal affairs through the corporate form to avoid personal income tax. It is not clear how big a problem this is. For example, Nicholas Gruen suggests, 'The ease with which a taxpayer can reduce their effective personal tax rate through incorporation is frequently overstated.'[17] Gruen makes the argument that incorporation at best defers personal tax payments, but does not allow individuals to avoid personal taxation. In apparent contrast to Gruen, Braithwaite writes, 'the wealthy can *greatly* reduce their [tax] contribution by legally classifying themselves as a company instead of as an individual.'[18] He seems to contradict himself, however, when he goes on to argue that legal efforts to prevent this sort of activity introduced in the 1990s 'appear to have been successful.' In effect, he argues that the increase in corporate income taxation in Australia 'simply highlights the "fiscal termites" elsewhere.'[19] Consistent with Gruen, this suggests Australians are not actually able to convert large amounts of personal income into corporate income.

Braithwaite's and Gruen's arguments indicate that the personal tax system has few leakages. Consequently, the personal tax system may not need a backstop. Yet the adage 'a tax delayed is a tax not paid' still applies. Individuals who allow income to accumulate in corporate vehicles control the timing of their personal income tax liability, and likely will be able to reduce their effective personal tax rate. In the interim, they pay the corporate income tax rate. This tax avoidance strategy, while legal, will result in efficiency costs.

The second argument on the necessity of corporate income tax is closely related, yet less plausible. This argument recognises that taxation distorts the economy. To minimise these distortions, it is necessary to tax everything. Joel Slemrod calls this a 'folk theorem.'[20] Further, he describes it as 'the most informal argument of all' supporting corporate income tax.[21] He concedes that a lot of formal economic theory on taxation (known as optimal tax theory) seems to suggest something like the folk theorem. But formal theory does not support corporate income tax in small, open economies. In his empirical analysis, Slemrod finds no evidence supporting the folk theorem, but suggests his evidence is consistent with the backstop theory.

The *convenience* argument for corporate income tax is largely self-explanatory. Corporate income taxation is a source of easy revenue for government. The costs of corporate income tax to government are low, it is politically popular, its incidence is uncertain, and corporations themselves do not vote (though many of their stakeholders do). The fiscal illusion and lack of democratic accountability associated with corporate income taxation make it convenient to impose. Joseph Pechman goes further by arguing that 'A special tax on the corporate form of doing business is considered appropriate because corporations enjoy special privileges and benefits.'[22] Such a special tax was introduced in the United States to avoid a constitutional challenge to the corporate income tax. Pechman recognises the weakness of the argument, but ultimately justifies the corporate income tax on the basis of the backstop theory.

The arguments in favour of corporate income tax need to be weighed against the costs of imposing it. The excess burden (or deadweight cost) of corporate income tax is that it causes resources to be misallocated. There are three separate sources of inefficiency.

First, corporate income taxation leads to a misallocation of resources across the corporate and non-corporate sectors of the economy.[23] Jane Gravelle argues that this distortion has received most attention in academic studies.[24] A large body of literature in the United States addresses the extent of this type of deadweight loss from corporate income tax. Unfortunately, the empirical estimates of corporate income tax's deadweight costs vary from 5% to over 100% of revenue raised.[25]

Second, corporate income tax reduces economic efficiency, productivity and growth over time. Ireland demonstrated this point very well when it dramatically lowered corporate income tax rates, resulting in increased investment flows and economic growth.[26] Ireland is not a special case. Young Lee and Roger Gordon investigated the relationship between corporate income taxation and economic growth using a cross-section of 70 economies, including Australia, from 1970 to 1997.[27] They found a consistently negative relationship between statutory corporate income tax rates and economic growth—everything else being equal, a 10% decrease in the corporate income tax rate can be expected to increase subsequent economic growth by between 1% and 2%. Interestingly, they find personal tax rates have no relationship with economic growth.[28] Simeon Djankov and his co-authors in a 2008 draft paper studied a new World Bank corporate income tax database to investigate the impact of effective corporate income tax rates on aggregate investment, foreign direct investment, and entrepreneurial activity in 85 economies, including Australia.[29] They report that corporate income taxation has a huge impact on the economy. Higher corporate income taxes increase the size of the informal economy and reduce aggregate investment, foreign direct investment, and entrepreneurial activity.[30]

Finally, corporate income tax distorts the debt-equity financing choices of corporations and the dividend decision. In principle, the dividend imputation system in Australia should reduce the debt-equity distortion (at the expense of having high dividend payout ratios) and reduce the double taxation of corporate income.[31]

As indicated, estimates of the corporate income tax excess burden vary dramatically. At a 2006 American Enterprise Institute (AEI) conference, Kenneth Judd made this point.[32]

> Economists have argued that the corporate income tax reduces economic efficiency by more than alternative tax instruments. These arguments typically assume perfectly competitive markets, ignore risk, and do not consider economic growth through innovation, even though these elements are key features of any modern economy. The true economic cost of the corporate income tax is much greater than conventionally believed when we consider how it interacts with investment and growth in a modern, technologically advanced economy.

Unfortunately, Judd is unable to provide an estimate of the excess burden, apart from arguing that it is higher than otherwise thought. This is somewhat problematic. The magnitude of the corporate income tax burden is largely unknown.

The Treasury view

The (unofficial) Treasury view of Australian corporate income tax is set out in a 2004 paper by James Kelly and Robert Graziani.[33] They argue the role of company income tax[34] is to tax the income of Australian residents and to act as a withholding tax on Australian-sourced income for foreign investors:[35]

> Company income tax helps to ensure that residents are appropriately taxed on their income. Without company income tax, a resident could accumulate income tax-free in a company. Tax would be deferred until the resident sells the shares in the company or receives a dividend.

As if there was something wrong with that! This is a combination of the folklore theorem and the argument that corporate income tax is a backstop to the personal tax system. This is a weak justification for corporate income tax, yet Kelly and Graziani write as if these arguments were beyond question. Indeed, they present them as being self-evident.

Kelly and Graziani suggest that choosing a corporate income tax rate is a balancing act between taxing Australian residents and taxing foreign investors. Further, they imply that the balance is currently tilted towards foreign investors by having a lower tax rate for corporations than for individuals. When discussing the possibility of lowering the Australian corporate income tax rate, they argue that the primary cost for Australia would be 'the reduced revenue collections from foreigners due to the lower company tax rate.'[36] They raise three additional considerations. First, lowering the corporate income tax rate would constitute a wealth transfer from Australians to foreign investors. Second, increased foreign direct investment could lead to diminished domestic competition. Third, it would have the effect of '*further compromising* the effectiveness of company income tax in its role of taxing residents.'[37]

There are many difficulties with these arguments. In the first instance, Kelly and Graziani assume that any decrease in the corporate income tax rate will reduce tax revenue. Yet they show how over a 20-year period (1984–2004), OECD corporate income tax rates fell while revenues increased.[38] They suggest that increased revenue is due to a broader tax base and increased profitability. The arguments about wealth transfers and reduced competition are difficult to evaluate in isolation from a more generalised discussion about foreign investment, competition policy, and taxation. Their final point is telling. They take the view that the corporate income tax system is *already* compromised in taxing Australians. In other words, for the corporate income tax system to meet the folk theorem and backstop requirements, the corporate income tax rate would need to be as high as the personal tax rate—presumably the top marginal rate. Given their implicit revenue-neutrality assumption, they do not envisage lowering the top personal rate. Rather, it is the corporate rate that is too low.

Is the corporate income tax burden increasing?

The BCA has noted Australia's very high corporate income tax burden and attempted to explain the increase over time.[39] In particular, it investigated the notion that profit share for corporations has increased dramatically since 1984.[40] While it does find that profit share has grown since 1984, this cannot explain the increase in the corporate income tax burden, which doubled from 1984 to 2006.

In the 2007–08 budget papers, Treasury responded with an analysis titled, 'Measuring the Effective Company Tax Rate,' arguing that commonly used techniques of estimating effective tax rates are biased.[41] By removing such sources of bias and creating a new measure called 'economic profit,' Treasury estimates the effective tax rate and argues it has declined in line with reductions in the nominal corporate income tax rate. Treasury concludes that 'company tax has been growing in line with economic profit' and that corporations are paying more tax because they are earning more profits, which is how the system was designed to operate.[42]

Unfortunately, Treasury does not provide specific details of its analysis. Nor does it provide the data for further analysis and comparison. Their 'economic profit' measure and the subsequent effective corporate income tax rate cannot be replicated.

To provide greater insight into the growth of the Australian corporate income tax burden, I decompose the ratio of corporate income tax revenue to GDP as follows:[43]

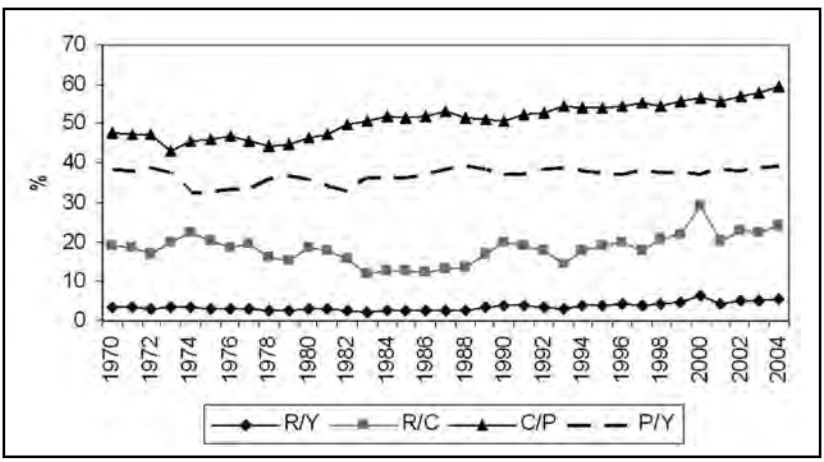
$$\frac{R}{Y} = \frac{R}{C} \bullet \frac{C}{P} \bullet \frac{P}{Y}$$

where R = corporate income tax revenue, Y = GDP, C = total corporate profit (operating surplus), and P = total profit in economy.

Then $\frac{R}{C}$ = effective corporate income tax rate, $\frac{C}{P}$ = share of corporate profitability, and $\frac{P}{Y}$ = profit share of economy.

Created using data from the OECD national accounts, Figure 5 shows the results of this decomposition. In principle, the measure of effective tax rates is biased in the manner Treasury describes.

Figure 5: Corporate income tax revenue to GDP decomposition



Source: Author's calculations and OECD national accounts.

The results are consistent with the BCA analysis. Profit share in the economy has increased since the early 1980s, but has been fairly stable over a long period. The corporate profitability share has increased, though, as has the effective corporate income tax rate. In other words, the corporate income tax base has become more comprehensive. As the economy has evolved, so has the corporate form become more attractive, but this has exposed more economic activity to the corporate income tax, which itself has become more comprehensive. So while the corporate income tax rate itself may have fallen, the corporate income tax base has expanded at a greater rate. All this leads to an increase in the overall corporate income tax burden.

Given the paucity of Treasury data, it is not possible to compare this analysis with the Treasury analysis. To prove its analysis, Treasury would need to show that its measure, 'economic profit,' has grown faster than the corporate profitability share measure (Treasury's measure of the effective tax rate is falling, while the overall corporate income tax take is rising).[44] That may well be the case, yet in their analysis of the Australian corporate income tax, Kelly and Graziani make no mention of increases in corporate profitability share driving increases in corporate income tax revenue. Rather, they speak of broadening the tax base ('a significant policy influence') while reducing nominal tax rates as being the cause of increases in corporate income tax revenue.[45] Their argument is consistent with the notion that the effective tax rate has increased.

To sum up, increases in corporate profit share are not enough to explain the massive increase in corporate income tax revenue.

Corporate profitability itself has also increased over time—we keep reading of record profits—and some of the increase in corporate income tax revenue can probably be explained by this increase. Treasury argues the increase in corporate income tax revenue effectively explains this increase. At the same time, the effective corporate income tax rates have also increased—though Treasury denies this—contributing to the increase in the corporate income tax burden.

Conclusion

John Braithwaite argues that 'Compared to individual workers, clearly [Australia's] wealthiest corporations do not pay their fair share of tax.'[46] The ATO data analysed in this paper do not support that view. It is quite clear that Australian corporate income taxation is highly concentrated, with many corporates not paying any tax at all or paying very low rates of tax, while a small number pay a high level of tax. The corporate income tax debate in Australia, to the extent it exists at all, has been overshadowed by the personal tax debate. This might not matter if corporate income taxation were simply a prepayment of personal tax. Despite the claims that this is how the corporate income tax system works, it is clear that a lot of corporate income tax is *not* simply a prepayment of personal income tax. It is likely that corporate income tax is having a large negative impact on the economy.

The Australian corporate income tax rate is high by international standards, as is the amount of revenue it raises. High corporate income tax rates have been shown to have deleterious effects on the economy. This chapter's analysis makes it clear that corporate income taxation is in need of reform, and the corporate rate of 30% should be lowered.

Government also needs to carefully consider the tax base and the distortions in effective corporate income tax rates at lower levels of taxable income. It is quite possible that the potential benefits of having a flat corporate income tax rate are not being realised. Of course, increasing the gap between personal and corporate income tax rates may invite further aggressive tax planning. But that is not an argument for doing nothing. Rather, government should consider a 'whole of tax system' approach to tax reform, and reduce personal and corporate income tax rates alike.

Endnotes

1 Commonwealth of Australia, 'Treasury Submission to the Senate Economics References Committee Inquiry into the Structure and Distributive Effects of the Australian Tax System,' *Economic Roundup* (Spring 2003).

2 KPMG Econtech, 'CGE Analysis of the Current Australian Tax System' (2010), 3.

3 Julie P. Smith, *Taxing Popularity: The Story of Taxation in Australia* (Canberra: Australian National University, 1993), 152.

4 The figure shows data from 1949 for two reasons. First, before 1942, states also collected corporate income tax, but I was unable to track down comprehensive data on the state corporate income tax rates, and I cannot be sure that my source (Julie P. Smith, *Taxing Popularity*, as above) is comprehensive prior to 1949.

5 Julie P. Smith, *Taxing Popularity*, as above.

6 Treasury, various budget papers; KPMG International, *KPMG's corporate*

income tax rate survey: An international analysis of corporate income tax rates from 1993 to 2006 and *KPMG's Corporate and Indirect Tax Rate Survey 2009* (Amsterdam: KPMG International).

7 Accounting income and taxable income are slightly different concepts. Certain items, such as depreciation, are treated differently for accounting and tax purposes. The ATO reports taxable income and I use those figures in the calculation, not the accounting figures.

8 The referees for this chapter provided a number of alternative explanations for the discrepancy. One explanation revolved around the issue of taxable income and accounting income. I have used the taxable income figure provided by the ATO, which already takes account of depreciation and the like. Another explanation is that changes in the definition of taxable income are driving the result. It is true that the definition of taxable income can and does change over time, but should not affect the result here—I am reversing out a percentage from two numbers where 'by definition,' one number should be 0.3 times the other number.

9 The ATO does provide data on these offsets and so on. In principle, it should be possible to add these figures back to the net tax figure and arrive at the theoretical tax paid (0.3 × taxable income), but that exercise does not yield the expected answer either. Either the data are too aggregated to be useful or some other distortion remains in the tax system.

10 BCA (Business Council of Australia), CTA (Corporate Income Tax Association), and PricewaterhouseCoopers, *Tax Nation: Business Taxes and the Federal-State Divide* (Melbourne: BCA, 2007). The calculation is based on the 2005–06 corporate income tax revenue reported in the relevant budget papers.

11 Michael D'Ascenzo, 'A New Dimension,' speech to the Corporate Income Tax Association Convention (Sydney: 12 May 2008).

12 John Braithwaite, *Markets in Vice, Markets in Virtue* (Sydney: The Federation Press, 2005), 30.

13 See Jane G. Gravelle, 'Income Tax, Corporate, Federal,' in Joseph J. Cordes, Robert D. Ebel, and Jane G. Gravelle (eds.), *The Encyclopaedia of Taxation and Tax Policy* (Washington, DC: The Urban Institute Press, 2005), 190–193.

14 William C. Randolph, *International Burdens of the Corporate Income Tax*, Congressional Budget Office Working Paper 2006–09 (Washington, DC: CBO, 2006).

15 As above, Table 2, 56.

16 See Richard M. Bird, *Why Tax Corporations?* International Centre for Tax Studies Working Paper 96:2 (Toronto: University of Toronto, 1996).

17 Nicholas Gruen, *Tax Cuts to Compete: The Influence of Corporate Income Taxation on Australia's Economic Growth*, Committee for Economic Development of Australia Information Paper 85 (Melbourne: CEDA, 2006), 18.

18 John Braithwaite, *Markets in Vice, Markets in Virtue*, as above, 30, emphasis added.

19 As above, 29.

20 Joel Slemrod, 'Are Corporate Income Tax Rates, or Countries, Converging?' *Journal of Public Economics* 88 (2004), 1169–1186.

21 As above, 1170.

22 Joseph A. Pechman, *Federal Tax Policy*, revised edition (Washington, DC: The Brookings Institution, 1971), 105.

23 It is important to remember that the top marginal US corporate income tax rate is high relative to the personal tax rate. This would lead to under-incorporation. See Austan Goolsbee, 'Taxes, Organizational Form, and the Deadweight Loss of the Corporate Income Tax,' *Journal of Public Economics* 69 (1998), 143–152, for a discussion of the US situation. In Australia the situation is different: the (flat) corporate income tax rate is low compared to personal tax rates. This might encourage over-incorporation.

24 Jane G. Gravelle, *The Economic Effects of Taxing Capital Income* (Cambridge: MIT Press, 1994), 77.

25 See Austan Goolsbee, 'Taxes, Organizational Form, and the Deadweight Loss of the Corporate Income Tax,' as above; Jane G. Gravelle and Laurence J. Kotikoff, 'The Incidence and Efficiency Costs of Corporate Income Taxation When Corporate and Noncorporate Firms Produce the Same Good,' *Journal of Political Economy* 97 (1989), 749–780.

26 See Geoffrey Kingston, 'Our Treasurer Should Cultivate an Irish Lilt,' *Policy* 22:4 (Summer 2006–07), 3–7.

27 Young Lee and Roger Gordon, 'Tax Structure and Economic Growth,' *Journal of Public Economics* 89 (2005), 1027–1043.

28 This result is not consistent with previous empirical research. On this issue, see Alex Robson, *The Costs of Taxation*, Policy Monograph 64 (Sydney: The Centre for Independent Studies, 2005), 10–12.

29 Simeon Djankov, Tim Ganser, Caralee McLiesh, Rita Ramalho, and Andrei Shleifer, 'The Effect of Corporate Income Taxes on Investment and Entrepreneurship,' draft paper (January 2008). The World Bank database is a joint project of the World Bank and PricewaterhouseCoopers. PricewaterhouseCoopers and the World Bank, *Paying Taxes 2008: The Global Picture* (2007) forms part of the World Bank's 'Doing Business' project.

30 Simeon Djankov, et al. generally find that a 10% increase in the effective corporate income tax rate leads to an approximate 2% decrease in investment, foreign direct investment, and business density, with a 2% increase in the informal economy. This figure is consistent with the corporate income tax elasticity of -0.2 reported by Jonathan Gruber and Joshua Rauth, 'How elastic is the corporate income tax base?' in Alan Auerbach, James Hines, Jr., and Joel Slemrod (eds.), *Taxing Corporate Income in the 21st Century* (Cambridge: Cambridge University Press, 2007), 140–163.

31 A further potential distortion of the dividend imputation system is the share buyback wave that Australia is experiencing. The structure of the transaction allows previously unused dividend imputation credits to be streamed to those shareholders who participate in the buyback. For further discussion of the imputation system, see Sinclair Davidson, *The Facts of Australian Corporate Income Taxation* (Sydney: Association of Certified Chartered Accountants, 2007).

32 Kenneth L. Judd, 'Corporate Income Taxation in a Modern Economy,' paper presented to the American Enterprise Institute conference, 'Corporate Income Taxation and the Economy' (10 May 2006).

33 James Kelly and Robert Graziani, 'International Trends in Company Tax Rates—Implications for Australia's Company Income Tax,' *Economic Roundup* (Spring 2004). Strictly speaking, the paper is the views of the authors 'and not necessarily those of the Australian Treasury.'

34 By this they mean the corporate income tax.

35 As above, 33.

36 As above, 36.

37 As above, 38, emphasis added.

38 As above, 27.

39 BCA (Business Council of Australia), *Corporate Income Taxation: An International Comparison* (Melbourne: BCA, 2005), 13.

40 Profit share is defined as profits as a share of total factor income.

41 Treasury, *2007–08 Budget Paper No. 1*, 5-13–5-15 (Commonwealth of Australia).

42 As above, 5–15.

43 This follows the analysis by Peter Birch Sorensen, 'Can Capital Income Taxes Survive? And Should They?' keynote paper presented at the Venice Summer Institute workshop, 'The Future of Capital Income Taxation' (San Servolo: Venice International University, 17–18 July 2006).

44 It is quite possible that the corporate form has become more valuable because economic profit has increased over time. In the short run, it is also possible that economic profit has grown faster than the corporate profit share of the economy. In the long run, though, (excess) economic profit should be competed away as more firms enter the market and the corporate profit share increases.

45 James Kelly and Robert Graziani, 'International Trends in Company Tax Rates,' as above, 27.

46 John Braithwaite, *Markets in Vice, Markets in Virtue*, as above, 30.

Chapter 5

Reforming Capital Gains Tax: The Myths and Reality Behind Australia's Most Misunderstood Tax

Stephen Kirchner

The crucial issue about the capital gains tax is not its revenue-raising capacity. I think it is a very poor tax for that purpose. Indeed, its major impact is to impede entrepreneurial activity and capital formation. While all taxes impede economic growth to one extent or another, the capital gains tax is at the far end of the scale. I argued that the appropriate capital gains tax rate was zero.

— *Alan Greenspan, testimony before the US Senate Banking Committee, 25 February 1997*[1]

Capital gains tax (CGT) has been a feature of the Australian tax system since 1985. While there is still widespread support for a CGT as a part of this system, there is also persistent dissatisfaction with the tax. The reforms instituted by the Ralph Business Taxation Review in 1999 sought to alleviate one of the world's highest capital gains tax burdens that resulted from Australia's then internationally anomalous taxation of capital gains at the same rates as ordinary income. The Ralph review recognised that an improved capital gains tax regime was needed to support saving, investment and economic growth.[2]

However, the revenue-neutrality constraint under which the Ralph reforms were implemented traded off the former averaging and inflation indexation provisions for the introduction of CGT discounts for individuals and funds, among other changes. The Ralph reforms left an ambiguous legacy in terms of the overall tax burden on capital gains. While the 50% CGT discount for individuals is widely thought to have halved the effective marginal tax rate on capital gains, it has been less widely acknowledged that the abolition of inflation indexation *raises* the marginal tax rate when capital gains are less than twice the rate of inflation. The implications of the Ralph CGT reforms vary widely depending on the type of taxpayer, asset class, and inflation environment.

The 2009 review of the tax system by Treasury Secretary Ken Henry (the Henry review), identified Australia's relatively high tax burden on capital as a priority for further reform. The review rejected the comprehensive income view of taxation in favour of an expenditure tax benchmark that seeks to exempt saving from taxation. The review recommended a 40% tax discount on capital gains for individuals as part of a broader savings income tax discount that would also apply to net interest income, net residential rental income, and interest expenses related to listed shares. The review favoured a discount over a flat tax rate for savings income, despite noting that 'both alternatives have the potential to represent a good fit for Australia's future tax system.' The review claimed that the discount approach 'assists in upholding the current progressivity of the income tax system.'[3] Neither side of politics has yet to fully embrace the Henry review's recommendations in relation to the savings income discount. While the proposal has some merit, it would be preferable to move to a low flat rate of tax for income derived from saving, including capital gains, consistent with the expenditure tax benchmark that informed the Henry review's recommendations. Equity objectives are better served through the expenditure side of the budget rather than through the tax system.

This paper argues that further reform of capital gains tax should be a priority for the tax reform process. The paper begins by considering the rationale for taxing capital gains. The economic case for taxing capital gains is widely acknowledged to be weak, even by supporters. CGT raises little revenue but comes at a substantial cost in terms of economic welfare. The case for taxing capital gains rests almost entirely on equity considerations. In particular, it is commonly assumed that the absence of capital gains tax affords opportunities for tax avoidance by converting income into capital gains, particularly on the part of wealthy taxpayers. However, this problem is asserted far more frequently than it is demonstrated. Moreover, it ignores the fact that CGT is itself readily avoided in a manner that is harmful to economic efficiency. The preoccupation with preventing avoidance ignores the significant costs arising from CGT that ultimately harm the ability of the tax and transfer system to satisfy equity objectives.

The second section examines some of the data on capital gains tax in Australia. The pre- and post-Ralph CGT regimes are compared to the tax treatment of capital gains in other countries. Capital gains are added to ordinary income on a realisation basis and then taxed at marginal rates after concessions and discounts. Since taxpayers can chose the timing of the realisation, the effective marginal tax rate on capital gains in Australia is to some extent a matter of choice (technically, the effective marginal tax rate is endogenously determined). This makes it very difficult to isolate and estimate the effects of the Ralph reforms on CGT realisations and revenue. However, growth in CGT realisations and revenue from individuals and funds after 1999 and prior to the onset of the financial crisis in 2008 outstripped that from companies, which did not benefit from a discount under the Ralph reforms. Individuals received a larger discount than funds (50% versus 33%), yet CGT revenue collected from the former has exceeded growth in the latter. The CGT share of Commonwealth tax revenue has increased from 2.9% to 6% since the Ralph reforms. The data suggest that the Ralph reforms have seen more CGT revenue being collected, not less. This is consistent with international evidence on the responsiveness of capital gains realisations and tax revenue to changes in the CGT rate and predictions made a decade ago by those who advocated reform of Australia's CGT regime.

The third section considers the relationship between capital gains tax and investment in housing. In conjunction with negative gearing of investment property, the principal residence exemption from CGT and the Ralph capital gains tax discount are widely seen as skewing saving and investment decisions in favour of housing and putting upward pressure on house prices. Critics of capital gains tax concessions have focused on the short-term demand-side implications of this tax treatment while ignoring the implications for housing supply. Looking through the cyclical fluctuations in housing activity, the dwelling investment share of real GDP has been little changed on average over the post-War period under three different CGT regimes (pre-September 1985, post-September 1985, and post-September 1999). However, dwelling investment as a share of *nominal* GDP has been rising, suggesting that housing investment expenditure is increasingly manifesting as higher prices rather than more dwelling units. Dwelling investment in Australia is yielding fewer new dwelling units per person than at any time since the 1960s due to increasing constraints on the supply of new housing. The result has been upward pressure on house prices and rents and reduced housing affordability. The solution to this housing affordability problem is not to impose new taxes on housing but to alleviate the supply-side impediments to the construction of new homes.

In addition to equity considerations, much of the support for CGT is based on hostility to speculation and speculative gain, which is often portrayed as being somehow 'undeserved' rather than the hard-earned return to saving and investment. The fourth section argues that all saving and investment is inherently speculative. Speculation is essential to the efficient allocation of capital, and the tax system should reward rather than penalise the entrepreneurial search for capital gain. There is thus no reason for the tax system to favour longer-term investments over shorter-term 'speculative gains.' There is no economic basis for minimal holding periods before qualifying for concessional CGT treatment.

The fifth section argues for further reform of capital gains tax, building on the approach taken by the Ralph reforms a decade ago. Reform options include a flat tax rate for capital gains, the abolition of minimum holding periods for concessional tax treatment, and the reinstatement of the indexation of capital gains for inflation.

Why tax capital gains?

The literature on optimal taxation (how to raise revenue at the lowest economic cost) argues that capital income should not be taxed because it distorts the choice between current and future consumption, reducing saving and investment. The burden of capital taxation in a small, open economy like Australia's generally falls on saving rather than investment, with foreign capital inflows taking the place of any reduction in domestic saving, leaving domestic investment unchanged.[4] Even where the optimal tax literature identifies potential departures from the general case against capital taxation, there is no basis for concluding that labour income and capital income should be taxed at the same rates.[5]

The excess burden of a tax is the economic activity lost as a result of the tax and increases in proportion to the square of the tax rate. As tax rates increase, the excess burden will rise faster than revenue raised. The full economic burden of a tax needs to take account of these efficiency costs, which may exceed the amount of revenue raised.[6] The greater mobility of capital compared to labour results in a larger dead-weight loss (or excess burden) from taxes on capital than labour. Before the Ralph reforms were introduced in 1999, Diewert and Lawrence estimated the dead-weight loss of capital taxation in Australia as being as high as 48 cents for every dollar of revenue raised. These efficiency losses point to the scope for dynamic revenue gains from reductions in capital taxation that would offset static revenue losses through an expansion of the economy and the tax base. The dead-weight losses from capital taxation can also be thought of as the economy-wide rate of return that could be expected from a reduction in government spending that in turn funded a reduction in capital taxation.[7]

Capital gains are taxed on a realisation basis, giving an incentive for the owners of taxable assets to hold on to them to avoid paying the tax rather than selling them to those who value them more highly. This 'lock-in' effect results in a less efficient allocation of the capital stock, reducing productivity and economic growth. Reducing or eliminating capital gains tax unlocks these unrealised capital gains. In principle, it would be possible to tax capital gains on an accrual rather than a realisation basis, alleviating the lock-in effect. In practice, taxing capital gains on an accrual basis is likely to add to the complexity of CGT so that the net welfare gains from moving to an accrual-based system for CGT are ambiguous. As even its advocates concede, there is no international consensus on what capital gains are or how they should be taxed, making for unavoidable complexity in the administration of the tax. The relevant provisions of the pre-1998 Australian legislation were described as an 'incoherent mess.' Even following its rewrite in the late 1990s, the current legislation defines 53 separate capital gains tax events. A redraft of the legislation by the Board of Taxation in 2000 reduced the current 126 pages of CGT law to 28 pages, but the re-draft still awaits implementation.[8] The Henry review proposed a further simplification of the legislation, including the exclusion of low revenue-generating assets. The inherent complexity of capital gains taxation is one of the reasons it is particularly inefficient at raising revenue.

Estimating the responsiveness (or elasticity) of capital gains tax realisations and revenue to the tax rate on capital gains is fraught with difficulty. The empirical literature on this question has accordingly produced very mixed results.[9] However, experience with CGT abroad suggests that higher capital gains taxes are self-defeating as a revenue raiser and that lowering tax rates on capital gains can be positive for CGT revenue and the broader tax base.[10] In the case of the United States, Moore and Kerpen note that 'over the past 30 years, a consistent pattern has emerged: every time the capital gains tax has been cut, capital gains tax revenues have risen. Every time the capital gains tax has been raised, capital gains tax revenues have fallen.'[11] As we shall see, the Ralph reforms in Australia also point to revenue gains from lowering the effective tax rate on capital gains.

The rationale for taxing capital gains is based on the Haig-Simons view that the tax base should incorporate the broadest possible definition of income, including additions to real net worth.[12] The Haig-Simons view is based on notions of equity rather than efficiency and has its basis in legal rather than economic reasoning. The Haig-Simons conception of the tax base is motivated by considerations of both horizontal and vertical equity. Horizontal equity maintains that all income, including additions to net worth, should receive much the same tax treatment, regardless of how it is derived (or more simplistically, that 'a buck is a buck'). However, as Treasury Secretary Ken Henry has noted, 'the logic of income from all sources … being subject to a common progressive tax schedule is now widely accepted to be flawed.'[13] The comprehensive income view ignores the fact that saving and investment take place out of after-tax income. Taxing capital gains arising from saving and investment amounts to double-taxation. Since an asset's capital value is the discounted value of its future income stream, the returns to the asset are taxed twice. CGT is applied to the disposal of an asset, while the yield of an asset is also taxed as ordinary income. This double-taxation not only discourages saving but rewards the accumulation of debt because debt reduces the additions to net worth, which the Haig-Simons concept of income seeks to tax.

The returns to human capital (wages and salaries), by contrast, are taxed only once. As Grubel suggests, one could adapt the argument often made against capital gains tax concessions to make a case that the relatively favourable tax treatment of ordinary income encourages overinvestment in human capital at the expense of financial and other capital.[14] Investments in human capital seem to enjoy much better public relations, so the relatively favourable tax treatment extended to the returns to human capital compared to financial and other capital is seldom questioned.

The Australian tax system provides relief from double taxation in the form of dividend imputation credits for company tax, but this principle has not been recognised in the case of CGT. Retained corporate earnings are also taxed twice by Australia's tax system: first as company profits and then as capital gains in the hands of shareholders. Capital losses are not treated symmetrically with capital gains, with the latter added to ordinary income for tax purposes, while the former can only be offset against other capital gains. While this is designed to prevent some forms of tax arbitrage, this is one of the ways in which capital gains are treated differently to ordinary income, contrary to the notion of horizontal equity that is supposed to underpin the Haig-Simons view of income. Few developed countries tax capital gains at the same rate as ordinary income, an anomaly in Australia's tax system the Ralph review sought to remedy. Even the pre-Ralph regime CGT was concessional in taxing only real capital gains and in its use of averaging provisions.

CGT is also motivated by considerations of vertical equity, the view that the wealthy should pay proportionally more tax. There is a widespread belief that the failure to tax capital gains would provide wealthy taxpayers with the opportunity to convert ordinary income into capital gains and thereby avoid tax. As even the advocates of CGT readily concede, 'the essential role of the CGT is not therefore to raise revenue. It is to act as a "backstop" to the income tax system—to act as an integrity measure.'[15] The 1985 Draft White Paper on the

Reform of the Australian Tax System (RATS), which paved the way for the introduction of CGT, argued that the absence of a CGT was 'at the core of many avoidance arrangements.'[16] Yet no estimates have ever been made of the additional revenue this anti-avoidance measure is supposed to have captured.[17]

The incentive to convert income into capital gains does not necessarily translate into the ability to do so, and the opportunity for avoidance via this mechanism is asserted far more often than it is demonstrated. As economist Jude Wanniski recounted, 'Alan Greenspan … told me he had spent decades trying to figure out how to convert ordinary income to capital gains and couldn't figure out how to do it.'[18] CGT is itself a largely voluntary tax that is easily avoided by not realising the gain. Reductions in capital gains tax generally yield increases in tax revenue because of an increase in realisations—in other words, a reduction in tax avoidance. To the extent that lower rates of CGT induce increased realisations that would otherwise go untaxed, this results in more revenue being collected from wealthy taxpayers, not less. Reductions in CGT are also likely to lead to an expansion in the tax base. Tax avoidance schemes are the result of high marginal tax rates that make such schemes economic, such as the punitive 60% top marginal rate that prevailed in 1985 for incomes above $35,000 (around $82,000 in today's dollars). The best way to render tax avoidance schemes uneconomic is to lower existing tax rates rather than erecting a wider tax net.

Capital gains tax concessions are often condemned as 'subsidies' to the rich. Just as high-income earners benefit more in absolute terms from reductions in income tax, it should not come as a surprise that those who do the most saving and investing will benefit more in absolute terms from capital gains concessions. It is widely recognised that the labour supply decisions of taxpayers are influenced by income tax rates, but this is also true of saving and investment behaviour. The size and distribution of so-called 'tax expenditures' on capital gains tax concessions are not independent of the tax rates that are applied to saving and investment. Reductions in these 'tax expenditures' are likely to come at the expense of saving and investment, and ultimately harm the ability of the tax and expenditure system to serve equity objectives.

CGT harms equity in other ways. To the extent that CGT hinders capital formation, it may lower Australia's capital-labour ratio and reduce long-run productivity growth. Since productivity growth is the main determinant of sustainable real wages growth, the incidence of CGT falls on both labour as well as capital. The final economic incidence of the tax is likely to be very different from its first-round statutory incidence.

Capital gains tax in Australia

Australia has the highest reliance on capital taxation in the OECD, with around 33% of all tax revenue derived from taxes on capital income, including CGT. The overall tax burden on capital is around 11% of GDP, the fourth highest in the OECD. By contrast, the tax burden on labour is 12% of GDP, the fourth lowest in the OECD.[19] In 2006–07, before the 2008 financial crisis, CGT raised $15.8 billion, a modest 6% share of total Commonwealth tax revenue. However, this is a significant increase on the $3.9 billion in CGT raised in 1998–99, the year before the Ralph reforms, when CGT amounted to only 2.9% of Commonwealth tax revenue.

The pre-Ralph CGT regime imposed one of the highest effective tax rates on the disposal of shares among developed countries.[20] Australia was one of the few countries in the world to tax capital gains at the same rate as ordinary income. The post-Ralph regime resulted in an improvement in international competitiveness but still left Australia with a relatively high tax burden on capital gains, particularly compared to those countries without a general capital gains tax.[21] Figures 1 and 2 are based on a representative CGT event, namely the acquisition and disposal of shares, under assumptions specified by Wyatt, Phillips and de Lange.[22] They show average tax rates for high- and low-income earners in a range of countries, including Australia under the pre- and post-Ralph regimes.

A number of countries, including New Zealand, Singapore and Hong Kong, have no general capital gains tax regime and so are shown with a zero average tax rate. Concessional tax treatment also yields a zero tax rate for some countries (for example, Germany) under the assumptions used by the authors. The Ralph reforms improved the international competitiveness of Australia's CGT regime but still left us with a relatively high tax burden on capital gains. This was partly a function of high marginal income tax rates, which have been reduced since 2003.

However, the implications of the Ralph reforms for the CGT tax burden vary across different taxpayers, asset classes, and inflation environments. CGT is not paid by foreign portfolio investors. Changes to the tax law in 2006 sought to alleviate the burden of CGT on some, but by no means all, categories of foreign direct investment (FDI). The Henry tax review has noted the very high responsiveness (or elasticity) of FDI to the tax burden in a world of highly mobile capital.[23] Australia's relatively high tax burden on capital gains, together with its relatively restrictive regulatory regime for FDI, helps explain Australia's chronic underperformance in attracting FDI and its over-reliance on potentially volatile short-term portfolio flows to finance the shortfall between domestic investment and saving

Figure 1: Average tax rate on capital gains (low income): selected countries

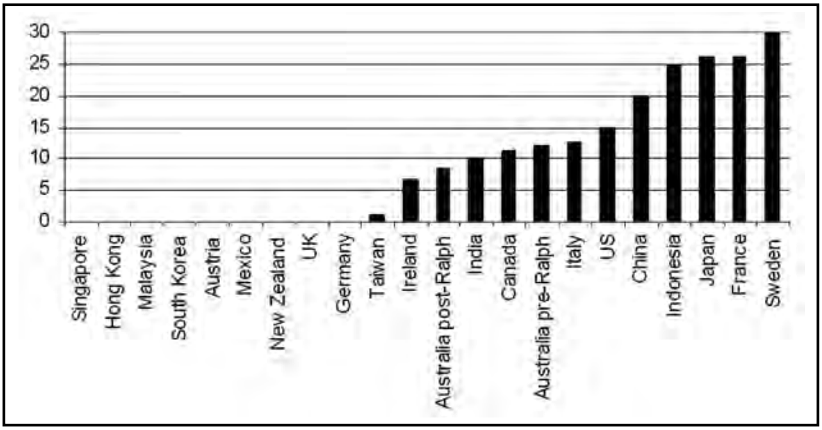
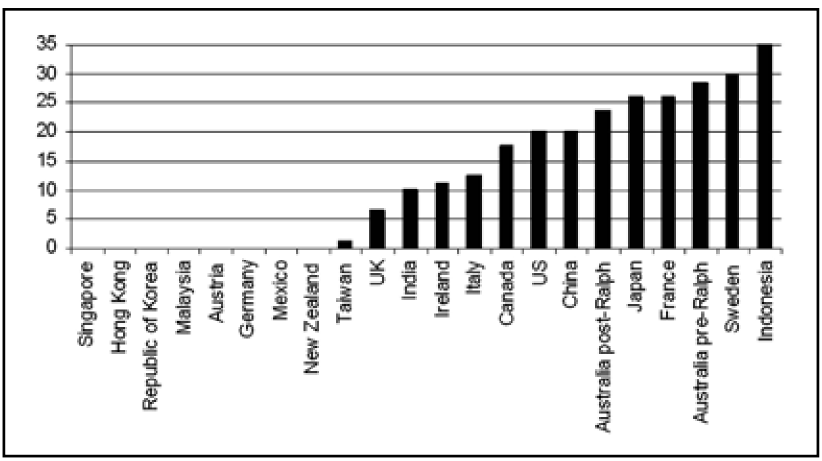


Figure 2: Average tax rate on capital gains (high income): selected countries



Source: Wyatt, Phillips and de Lange (2003).

(the current account deficit).[24] The recent financial crisis points to some of the risks associated with an over-reliance on short-term portfolio inflows to fund domestic investment.

The Ralph reforms traded off the former averaging and inflation indexation provisions for a 50% CGT discount for individuals and 33% for funds, but not for companies. While these discounts are widely thought to have reduced by half the effective marginal tax rate on capital gains for individuals, it has been less widely acknowledged that the abolition of indexation raised the marginal tax rate when capital gains are less than twice the rate of inflation.

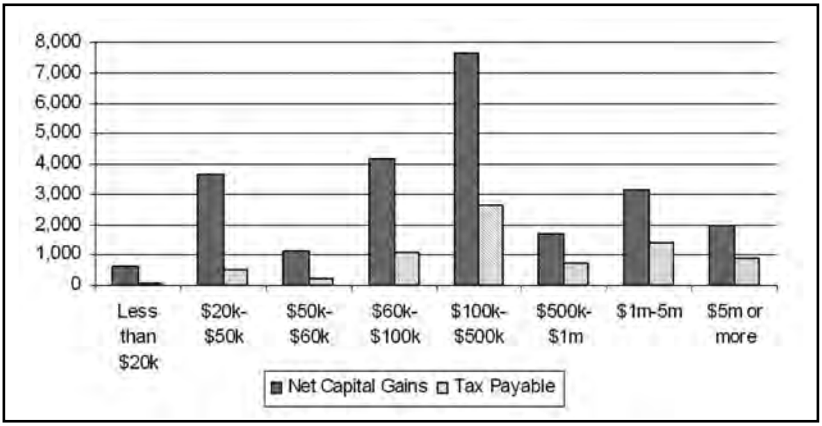
Capital gains in Australia are taxed on a realisation basis and added to ordinary income to be taxed at marginal tax rates after the application of concessions and discounts. The marginal tax rate on taxable capital gains is notionally the taxpayer's top marginal income tax rate, but because taxpayers can choose the timing of any realisation, they can also choose their effective tax rate (technically speaking, the effective marginal tax rate faced by taxpayers is endogenously determined). As already noted, taxpayers can defer realisation until income is temporarily lower. Together with frequent changes in statutory income tax rates on overall income, this makes it difficult to isolate the effects of exogenous changes in tax rates on realisations and revenue from the behavioural responses of taxpayers.

Net capital gains and CGT paid by individuals in different income brackets are shown in Figure 3 for the 2006–07 tax year.

CGT revenue from individuals seemingly mirrors the progressivity of the income tax, with those earning more than $100,000 paying 75% of CGT, despite being responsible for only 57% of net capital gains, based on the 2006–07 tax year. However, one-off CGT realisations can temporarily place low-income earners in higher-income tax brackets, so these data understate the tax burden on low-income taxpayers (this 'bunching' problem was less pronounced under the pre-Ralph averaging provisions). By the same token, wealthier taxpayers are likely to defer realisations to the years in which income is temporarily low or until retirement. The distribution of capital gains and tax paid across income brackets can thus be misleading as to the progressivity of CGT. The fact that one-off realisations can place individuals in higher tax brackets is one source of the so-called 'lock-in' effect. This effect could be reduced by applying a flat tax rate to capital gains. Like stamp duty, the application of CGT on a realisation basis acts as a transactions tax that reduces both economic efficiency and revenue collected. The 'tax clientele' effect refers to the diversion of the stock of taxable assets into the hands of those with lower tax rates, such as those with temporarily lower incomes and super funds.[25] The CGT promotes rather than prevents tax avoidance through this 'tax clientele' effect.

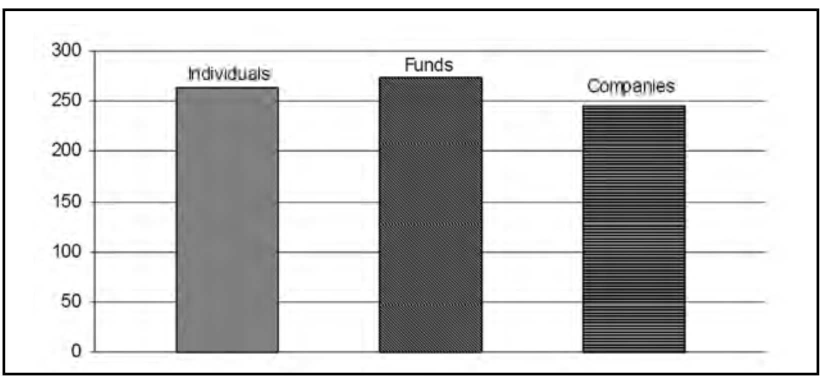
Since the 1999 Ralph reforms, growth in net capital gains for individuals and funds has outstripped growth in net capital gains

Figure 3: Net capital gains and tax paid ($m): Individuals by income 2006–07



Source: Australian Taxation Office, *Taxation Statistics, 2006–07.*

Figure 4: Growth in net capital gains (%) 1998–99 to 2006–07

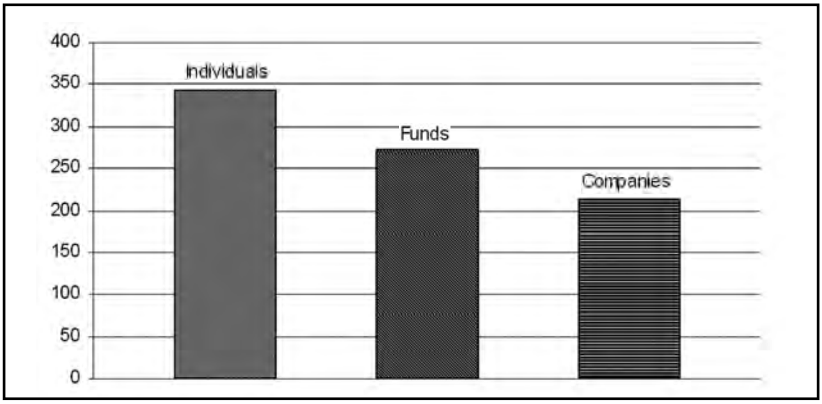


Source: Australian Taxation Office, *Taxation Statistics, 2006–07.*

reported by companies, which were not discounted as a result of the reforms (Figure 4).

The growth in realisations flowing from the post-1999 CGT discounts is reflected in the change in CGT payable by the three classes of taxpayers in the years since 1999. Growth in CGT revenue from individuals and funds outstripped that paid by companies, at least up until the 2008 financial crisis, which weighed on fund returns (Figure 5).

Figure 5: Growth in CGT payable (%) 1998–99 to 2006–07



Source: Australian Taxation Office, *Taxation Statistics, 2006–07*.

It is noteworthy that individuals enjoyed a larger discount under the Ralph reforms than superannuation funds (50% versus 33%), yet yielded a larger increase in CGT payable. The reforms also saw a change in the relative importance of individuals and companies in overall CGT revenue. In 1998–99, individuals accounted for 43% of CGT paid, while companies accounted for 39%. By 2006–07, the share of CGT paid by individuals rose to 50%, while the share paid by companies fell to 33%. The Ralph review expected its CGT measures to generate an additional $350 million in revenue between 2000–01 and 2004–05.[26] While it is not possible to reliably estimate the contribution of the Ralph reforms compared to the counter-factual of no reform, it is worth noting that CGT payable increased by just over $3 billion in this period. The 2001–03 bear market in equities, which followed the introduction of the Ralph reforms in 1999, lowered CGT payable in the early part of this decade, and was often misused by some media commentators to claim that the Ralph CGT reforms had cost the government revenue.[27] A longer run of data across these asset price cycles makes clear this was not the case.

The Commonwealth Treasury's annual Tax Expenditures Statements under the Charter of Budget Honesty are frequently misreported as a measure of the budget revenue forgone as a result of various CGT concessions, including the Ralph capital gains discounts. For example, journalist George Megalogenis has falsely claimed that 'The latest calculations from Treasury say the concession will cost taxpayers $6.87 billion in revenue forgone in 2007–08.'[28] As the Treasury makes clear, its approach measures the benefit to taxpayers, not the cost to the budget. The methodology makes no allowance for changes in behaviour on the part of taxpayers in response to CGT or other tax concessions. To avoid double-counting, the Treasury includes the value of other CGT concessions in its estimates of the tax expenditures on the post-Ralph CGT discounts. This overstates the value of tax expenditures on the Ralph CGT discounts, while understating the value of other CGT concessions.[29]

The data point to a positive impact on CGT revenue from the Ralph reforms, consistent with overseas experience and some of the larger estimates of the elasticity of capital gains tax realisations and revenue with respect to the tax rate. Before the Ralph reforms were enacted, supply-side economist Alan Reynolds predicted that lowering CGT rates would 'raise much more revenue than current law, quite possibly twice as much in the long run.'[30] In the event, CGT revenue rose from $3.9 billion to $15.8 billion from 1998–99 and 2006–07, while the CGT share of Commonwealth tax revenue rose from 2.9% to 6%. Australia's pre-Ralph CGT regime would most likely have yielded less revenue had it remained in operation. However, the long-term implications of the Ralph reforms may vary under future asset return and inflation environments.

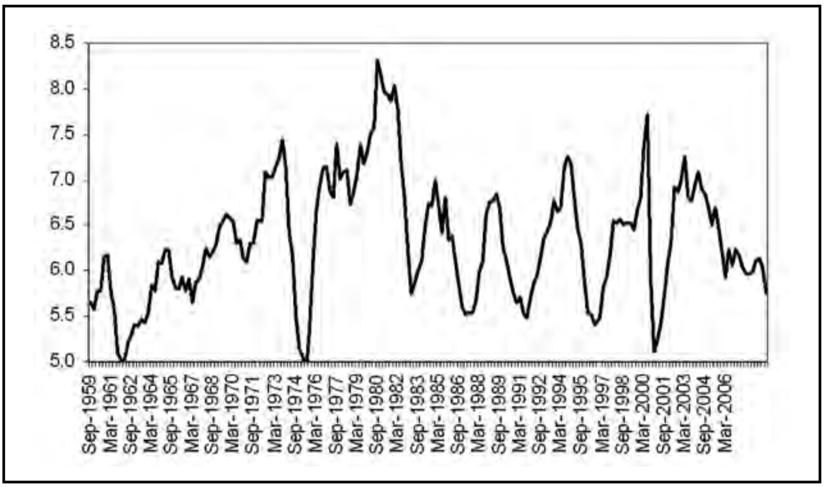
Capital gains tax and housing

The Henry review recommended that saving via owner-occupied housing remain tax exempt, based on the expenditure tax benchmark that informed the overall review. Capital gains and net rental income would be subject to a 40% savings income discount, which would bring the tax treatment of rental property more into line with that afforded by other types of saving.

The principal residence exemption from CGT has been blamed for skewing saving and investment decisions in favour of housing. It has long been suggested that Australia ‘overinvests’ in housing, although the rate of homeownership in Australia is not significantly above the OECD average. It has also been suggested that the exemption is responsible for house price appreciation and reduced housing affordability.[31] While the value of the principal residence exemption and other CGT concessions is capitalised into the value of the housing stock (as with other taxable assets that benefit from concessional treatment), this is a one-off effect that does not explain ongoing price appreciation.

Continued house price inflation cannot co-exist with ‘over-investment’ in housing unless constraints on new housing supply prevent this investment expenditure from translating into additional dwelling units. The dwelling investment share of real GDP has cycled around a mean of around 6.3% for most of the post-War period. Neither the introduction of CGT in 1985 nor the Ralph reforms in 1999 has led to a fundamental change in the dwelling investment share of GDP (see Figure 6).

Figure 6: Dwelling investment (% of real GDP)



Source: Australian Bureau of Statistics.

By contrast, the dwelling investment share of nominal GDP has increased steadily, indicating that investment expenditure has increasingly translated into higher prices rather than additional dwelling units. The combination of high population growth and inadequate construction of new houses means that Australia is producing fewer dwelling units per person than at any time since the 1960s.[32]

Australia faces a growing shortage of dwelling stock due to what Reserve Bank Governor Glenn Stevens has called 'serious supply-side impediments' to building new homes.[33] It is these supply-side constraints that are putting upward pressure on house prices and inflation, not the concessional CGT treatment of housing. Increasing the CGT burden on housing by abolishing the principal residence exemption would only add to the supply-side constraints that have put upward pressures on house prices and rents. As a tax on transactions, CGT on owner-occupied housing would further reduce turnover in the housing stock and lead to a less efficient allocation of that stock. Analysis of the welfare consequences of capital gains tax concessions often ignores these supply-side effects. As John Freebairn has noted, the benefits of capital gains tax concessions 'fall primarily on the supply-side' of the housing market.[34] Yet he focuses only on the demand-side when analysing the welfare consequences of CGT concessions.

The Henry review's recommendations in relation to the tax treatment of residential property were subject to the major proviso that supply-side constraints in the housing market need to be tackled first, and that phase-in arrangements should apply to minimise disruption to the housing market. The final report notes:

> Changing the taxation of investment properties could have an adverse impact in the short to medium term on the housing market … Reducing net rental losses and capital gains tax concessions may in the short-term reduce residential property investment. In a market facing supply constraints, these reforms could place further pressure on the availability of affordable rental accommodation.[35]

The review thus acknowledges that the current concessional tax treatment of residential property benefits supply as well as demand. The review also notes that 'the tax system is not the appropriate tool for addressing the impact of other policies on housing affordability.'[36]

Abolition of the principal residence exemption or the taxation of imputed rent would establish the tax deductibility of mortgage interest payments on the principal residence, encouraging Australians to borrow more heavily to invest in housing to offset the tax burden on ordinary income. In principle, deductibility could be limited or quarantined from other income, but this would be inconsistent with the approach taken to deductibility in relation to other assets. Currently, the absence of deductibility for mortgage interest on owner-occupied housing means that reducing mortgage debt dominates the after-tax return on other forms of saving, giving households a strong incentive to reduce debt. The increased leverage that would result from the deductibility of mortgage interest payments would add to the demand for housing, while the removal of the principal residence exemption would weigh on supply, making housing less affordable. The deductibility of mortgage interest would also offset any extra CGT revenue collected from the abolition of the principal residence exemption, making it a poor revenue raiser. As the Productivity Commission inquiry into First Home Ownership noted, 'reducing the application of CGT in other areas could conceivably deliver better outcomes for the community than imposing it on owner-occupied housing.'[37]

In conjunction with negative gearing arrangements that have been in place since 1987, the 50% capital gains tax discount for individuals is also widely seen as skewing saving and investment decisions in favour of housing. The housing boom in Australia around 2002 and 2003 was widely blamed on the introduction of the Ralph CGT discounts in 1999. In reality, as Reserve Bank research has found, the boom was attributable to the inability of housing supply to respond flexibly to the increased debt servicing capacity of households that emerged in a low inflation and low interest rate environment.[38] It should also be noted that the boom in house prices at the beginning of the decade occurred in the context of a bear market in equities between 2001 and 2003. It is hardly surprising that the demand for housing should increase at a time when prices of a major competing asset class are declining. Pronounced house price inflation was also a global phenomenon at this time, which favours the view that global factors, rather than country-specific factors such as the Ralph reforms, were the main cause. The weakness in equity markets between 2001 and 2003 also accounts for the weakness in overall CGT revenue in these years, which was wrongly attributed to the Ralph reforms by many in the media.[39]

The Productivity Commission inquiry into First Home Ownership noted that 'changes to the capital gains tax regime, coupled with long standing negative gearing arrangements, *were seen* to have contributed to higher prices through encouraging greater levels of investment in housing [emphasis added],' although the commission itself did not actually model the effects of the tax changes.[40] Increased investment in housing could only lead to higher house prices if supply-side constraints were reducing the number of new dwelling units per dollar invested. If increased demand for dwelling investment puts upward pressure on prices, this is an argument for easing these supply-side constraints, not for further discouraging housing investment with higher taxes, particularly a CGT that would compound lock-in effects already created by other transaction taxes such as stamp duty. Basing tax policy on structural impediments to new housing supply would be to compound one set of bad public policies with another.

Housing is not the only asset class that qualifies for negative gearing and the concessional treatment of capital gains. The supposed distortion arising from these concessions cannot explain why housing would be favoured by investors over other asset classes such as equities, particularly given the much higher transaction costs associated with real estate. The share of individual taxpayers claiming a net rental loss in 2006–07 was 9%, only a small increase on the 6% negatively gearing property in 1995–96.[41] This does not suggest a rush of taxpayers seeking to take advantage of what many suppose to be a tax giveaway, and also undermines the notion that taxpayers can readily convert ordinary income into concessionally taxed capital gains. The choice to invest in housing must be driven by broader factors other than CGT concessions. Moreover, one effect of the Ralph 50% CGT discount for individuals was to *reduce* the percentage value of the principal residence exemption, easing any distortion from the exemption. Those who complain about a distortion arising from the principal residence exemption cannot also logically complain about the introduction of a CGT discount as part of the Ralph reforms.

The failure to comprehend the supply-side as opposed to the demand-side implications of capital gains tax for dwelling investment and housing affordability is exemplified by journalist George Megalogenis, who has variously described the CGT concession as a 'rort'[42] and 'the greatest generational heist of the decade,'[43] and has absurdly suggested that housing affordability could be improved 'by making property less attractive than other investments, such as shares or superannuation.'[44] Similarly, John Garnaut has described the concessional treatment of capital gains as a 'boon to speculators … gouging billions from tax revenues with the benefits going overwhelmingly to the rich.'[45] We have already seen that this is a misreading of the Treasury's Tax Expenditures Statement. Following the Henry review, Megalogenis wrote that 'the Henry review was being cheeky in playing down what previous decisions did to housing affordability.' He went on to describe the 1999 Ralph reforms to capital gains tax 'as the worst revenue decision of the Howard government.'[46] Megalogenis and many other media commentators may well find the Henry review cheeky because it repudiates most of their commentary on the subject of capital gains tax, negative gearing, and housing affordability over the last decade. The real cheek is that these commentators have not changed their tired old tune in light of the Henry review.

The outraged language often used to describe the CGT treatment of housing is indicative of the depth of hostility to both housing as an investment and the idea of speculation and speculative gain (see next section). Dwelling investment is widely characterised in the media as 'unproductive,' yet housing investment produces an essential service, namely shelter. The growing national shortage of dwelling stock and the upward pressure this puts on house prices and rents has its most adverse impact on those with low incomes.[47] Only the already well-housed could be so callous as to think of housing as 'unproductive' or conclude that Australia 'overinvests' in housing. The outrage over CGT and other tax concessions for housing is fundamentally misplaced and should be directed against the structural impediments to new housing supply. Taxing capital gains on owner-occupied housing could even give policymakers a perverse incentive to restrict housing supply to reap more CGT revenue from higher house prices.

Why the tax system should reward, not punish, speculation

The hostility to the concessional CGT treatment of housing is often extended to saving and investment via other asset classes as well, reflecting deep-seated societal suspicion towards 'speculation' and speculative gain. Capital gains are commonly viewed as somehow easy and therefore undeserved. For example, a report for the Brotherhood of St Laurence referred to capital gains on housing as 'effectively unearned' as part of its argument for the abolition of the principal residence exemption on 'high value' homes above \$500,000.[48] This will come as news to those who have worked and saved hard to buy their own home. The notion of capital gains as the return to unproductive or speculative activity drives the view that taxing these gains will not have adverse economic consequences and may even direct people into what are deemed to be more 'productive' activities. The owners and managers of assets are also frequently accused of having a bias in favour of short-term profits at the expense of longer-run gains. These views are a large part of the motivation behind the minimum 12-month holding period for assets before qualifying for concessional CGT treatment under the Ralph reforms. Minimum holding periods and tapered tax rates are a common feature of concessional CGT regimes internationally.

The decision to save and invest rather than consume is inherently speculative, since there is no guarantee these saving and investment decisions will deliver the desired rates of return that will compensate for forgone consumption in the present. Few people invest with the intention of making a capital loss. Speculation is fundamental to the operation of a market economy. Capital markets need entrepreneurs to direct capital into more highly valued uses. This process is subject to considerable uncertainty and is often risky. As part of the overall division of labour in an economy, entrepreneurs specialise in bearing these risks and uncertainties.[49] Capital gains are the pay-off to this specialisation, while the price of entrepreneurial error is capital loss. Speculation is inseparable from the experimentation and innovation that drives capital allocation, new business formation, technological change, long-run economic growth, and growth in real wages. Seen in this light, entrepreneurial speculation is potentially highly productive and should be rewarded by the tax system, not penalised.

The idea that investors suffer from a short-term bias implies there are unexploited profit opportunities in longer-term investments. As Reynolds has noted, markets do not value stocks or other assets based on the motivation of those who own the assets or the time-frame of their investment. The owners and managers of firms and other assets are influenced by the market value of the assets. There is no reason to believe that short-term investment strategies necessarily induce short-term business strategies.[50] Minimum holding periods encourage investment in assets with longer maturities (including housing) at the expense of those with shorter maturities, which may yield higher before-tax returns. They lock investors into assets that have performed well in the past but may not perform as well in the future, denying capital to emerging opportunities that may earn higher rates of return. This reduces the dynamism of the economy. Imposing higher tax rates on short-term capital gains may even promote short-termism by encouraging investors to realise capital losses early when the tax benefits are greatest.

Reforming capital gains tax

The Henry tax review has conceded that the 'comprehensive income' view of the tax base, which originally motivated the introduction of the CGT in Australia, is flawed.[51] It has highlighted the need to alleviate Australia's relatively high tax burden on capital, and suggested moving to a broad 40% savings income discount, including capital gains. While this would improve the current taxation treatment of some forms of saving, it would represent an increase in the tax burden on capital gains relative to the current 50% discount, and would have a negative impact on those with unrealised capital gains. If the discounting approach to the taxation of saving is to be adopted, there is a strong case for increasing the discount to at least 50% to match the existing concessional tax treatment of capital gains. This would also be more consistent with the Henry review's overall expenditure tax benchmark, which in principle seeks to exempt the returns to saving from taxation.

The Henry review notes that there is an equally strong case for a low flat rate of taxation to be applied to income derived from saving, including capital gains. The discounting approach aims to uphold the progressivity of the current system, but this is to fall into the trap of viewing the tax system as a vehicle for meeting equity objectives rather than raising revenue efficiently. Equity objectives are best met through the expenditure side of the budget rather than the tax side. A low flat rate of tax on capital gains would alleviate the lock-in effect that arises from one-off realisations placing taxpayers in higher income and tax brackets. It would also work against the 'tax clientele' effect, whereby the stock of taxable assets is diverted into the hands of taxpayers with lower tax rates, such as super funds, and the realisation of gains by those with temporarily lower incomes. It is noteworthy that Germany moved to a flat 25% tax rate for capital gains from the beginning of 2009 as part of a broader tax reform effort.[52]

The current minimum holding period of 12 months before qualifying for concessional tax treatment should be abolished. This would encourage increased turnover of assets and reduce lock-in effects, increasing the ability of investors to capitalise on emerging opportunities and quickly shift capital to more highly valued uses. This will bring forward realisations that would have ultimately been taxed at concessional rates anyway.

Indexation for inflation should be a fundamental principle guiding tax reform, including reform of CGT. Capital gains tax should be applied to real rather than nominal gains to avoid an increase in the effective tax rate due to inflation. As noted earlier, the abolition of indexation as part of the Ralph reforms has increased the CGT burden for individuals where the rate of inflation is more than twice the rate of return on the asset. This could be expected to increase the CGT burden in a low asset return/high inflation environment. This also potentially creates perverse incentives for government due to the interaction between inflation and CGT revenue. As Alan Greenspan has noted:

> It's really wrong to tax a part of a gain in assets which are attributable to a decline in the purchasing power of the currency, which is attributable to poor governmental economic policy. So, for the government to tax peoples' assets which rise as a consequence of inferior actions on the part of government strikes me as most inappropriate.'[53]

The Henry review maintained that its proposed 40% savings income discount was a more realistic inflation adjustment than the Ralph review's 50% discount, given the RBA's 2% to 3% inflation target. This somewhat misses the point behind inflation indexation, and does not address the future potential for unwelcome interactions between monetary and fiscal policy.

Conclusion

The taxation of capital gains raises little revenue but inflicts significant costs on the Australian economy. Even among supporters, there is little argument that CGT is a poor revenue-raiser. At best, CGT is seen as an anti-avoidance measure. Yet CGT is itself readily avoided through the deferred realisation of capital gains. This lock-in effect immobilises the capital stock, denying capital to emerging uses with potentially higher rates of return. The excess burden of the tax weighs on economic activity more generally. Despite being motivated by a comprehensive view of the income tax base, CGT actually violates principles of horizontal equity by imposing an additional tax burden on saving out of after-tax income. Taxing the capital gain on the disposal of an asset adds to the taxes already applied to the yield on that asset.

Despite failing all the criteria of a good tax, there is nonetheless considerable hostility among many commentators to the existing concessional treatment of capital gains on the part of individuals and funds. There is also support among some commentators for extending the capital gains tax to the family home, which they regard as good economics but bad politics. In reality, it is bad economics too, as the Henry review has made clear. The opposition to the concessional treatment of capital gains is rooted in the economics of the 1920s and 1930s, not modern tax theory and practice. Australia's pre-Ralph CGT was internationally anomalous in seeking to tax capital gains at the same rate as ordinary income. The optimal tax literature generally rejects the idea that capital should be taxed, but even where a case for taxing capital can be made, there is no support for the notion that income derived from capital should be taxed at the same rate as income derived from labour.

The support among many commentators for extending the CGT sits uneasily with the widespread support for alleviating the tax burden on saving, including the concessional tax treatment of superannuation. This largely stems from the failure to recognise capital gains as a genuine form of saving. Much is made of the distortions arising from the different tax treatment extended to different forms of saving in Australia. The focus for reducing these distortions should be to ease the tax burden on other forms of saving rather than to increase the tax burden on capital gains. It is no accident that the preferred saving vehicle for many Australians is one of the few assets protected from CGT and other taxes—the family home. The magnitude of so-called 'tax expenditures' on housing is an induced behavioural response to the structure of the tax system more generally. It highlights the need to lower taxes on saving more generally, not to increase the tax burden on housing.

There is a widespread belief that the principal residence exemption and the concessional treatment of capital gains adds to demand for housing and puts upward pressure on house prices. Yet the supply-side implications of CGT for housing are almost always ignored in public debate. The notion that Australia overinvests in housing is belied by a growing national shortage of housing stock that is placing upward pressure on house prices and rents. The idea that investment in housing is somehow 'unproductive' should be condemned as offensive to the many Australians who increasingly struggle to find affordable accommodation. Removal of the principal residence exemption and the concessional treatment of capital gains would have adverse consequences for housing supply. Like stamp duty, CGT serves as a transactions tax that would lower turnover in the housing stock and result in a less efficient allocation of that stock. Abolition of the principal residence exemption would establish the tax deductibility of mortgage interest payments, giving Australians an incentive to increase their borrowings to offset taxes on ordinary income. This increased leverage would increase the demand for housing, adding to upward pressure on house prices and rents. Deductibility of mortgage interest would also offset the revenue raised by a CGT on owner-occupied housing.

The opposition to the concessional treatment of capital gains on the part of many commentators reflects hostility to what is perceived to be 'easy' or 'unearned' gain through speculation. This stems from the failure to recognise the critical role that speculation plays in the efficient allocation of capital and new business formation, which in turn drive long-run productivity growth and growth in real wages. Capital gains are the return to entrepreneurial risk-taking, just as capital losses are the price paid for entrepreneurial error. The tax system should reward rather than penalise entrepreneurship and risk-taking, with a view to expanding the tax base and reaping more revenue than is ever likely to be collected by taxing capital gains at the same rate as ordinary income.

Reform of capital gains needs to be reconciled with demands for reform of the tax system more generally. Yet the evidence suggests that easing the burden of CGT would come at little static cost to the revenue, but has the potential for substantial dynamic revenue gains from the alleviation of lock-in effects, dead-weight losses, and the compliance and collection costs that CGT imposes on the economy.

The much stronger growth in CGT payable on the part of individuals and funds compared to companies between the introduction of the Ralph reforms and 2006–07 highlights the potential dynamic revenue gains. Rather than winding back the Ralph reforms, the focus should be on extending the current concessional treatment of capital gains in conjunction with broader reforms aimed at easing the overall tax burden on capital. A low flat rate of tax on capital gains would reduce lock-in and tax clientele effects, which reduce revenue collected as well as being harmful to economic efficiency. Minimum holding periods for qualifying for concessional tax treatment should be abolished to increase capital agility. Inflation indexation should also be reinstated to ensure that the Ralph reforms continue to provide relief from CGT in a low return/high inflation environment.

The Henry review is commendable for rejecting the comprehensive income view of taxation and embracing an expenditure tax benchmark that would seek to exempt the returns to saving from taxation, including capital gains. However, the proposed broad 40% savings income discount represents an increase in the tax burden on capital gains relative to the current 50% discount implemented under the Ralph reforms. If the discounting approach is to be pursued, then a 50% discount would be more appropriate. However, as the Henry review demonstrates, there would also be advantages in pursuing a low flat rate of tax for saving, including capital gains.

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Chapter 6

State Tax Reform: A Review of Progress and Prospects

Robert Carling

Interest in federal-state financial relations was kindled by the election of the Labor federal government in 2007, with reform of federalism as one of its top priorities. At the same time, the government wanted to expand the economy's productive capacity and cut red tape for business. State tax reform would further each of these objectives. Although the government has not identified state tax reform as one of its priorities, it *is* a high priority for some in the community, including peak business groups. While their motive is at least partly self-interest, there are also strong public interest reasons for adding state taxation to the reform agenda pursued by the Council of Australian Governments (COAG).

State taxes, although sometimes described as 'nuisance' taxes, are much more than that. They raised $51 billion in 2008–09 and have significant effects on the economy and on the everyday lives and activities of households and businesses. Although state taxation plays a secondary role to Commonwealth taxation, the ongoing tax reform debate should include it.

The flawed condition of state taxes was one reason for the A New Tax System (ANTS) reforms that ushered in the Goods and Services Tax (GST) in July 2000. Ten years later, the GST has replaced various inefficient state taxes, which had raised more than $4 billion a year before it commenced, and the states say they will abolish another $1 billion worth of taxes (in 2008–09 dollars) over the next three years.

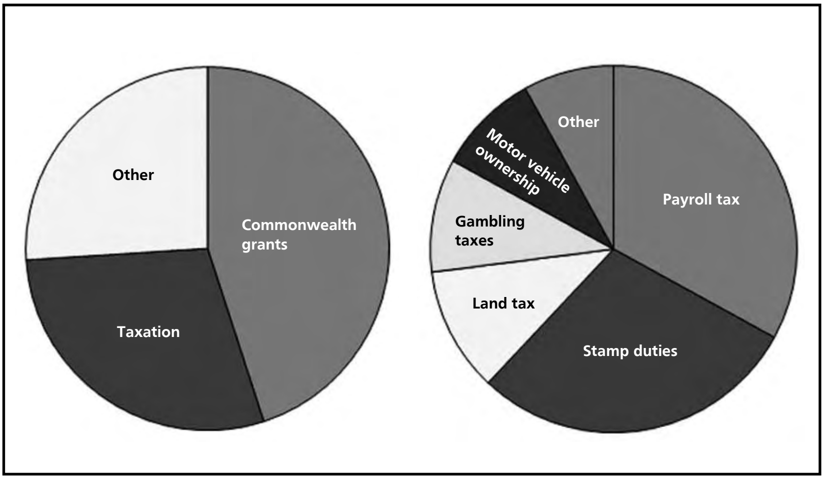
These are significant reforms, but there is much more to be done to improve the way the states are funded. If we designed a state tax system from scratch today, it is unlikely that anyone would come up with what we now have. In this paper, I review the ANTS reforms of state finances and look at ways to further improve the system of state taxation.

State tax revenue in context

National tax revenue at all levels of government was $340 billion in 2008–09, of which state taxes accounted for $51 billion (15%). States' own tax revenue accounts for around 29% of their total revenue. As shown in Figure 1, the rest comes from Commonwealth grants (45%) and an assortment of other sources (26%) such as sales of goods and services and distributions from government business enterprises. These proportions vary from state to state, but that is another story.

Consistent with the Australian Bureau of Statistics (ABS) treatment, this presentation classifies GST revenue as Commonwealth tax revenue that is transferred to the states as general purpose grants.[1]

Figure 1: Composition of state revenue, 2008–09



Source: Australian Bureau of Statistics (ABS).[2]

Given the ABS treatment of GST revenue, the tax slice of the state revenue pie comprises five major components: payroll tax (33%); stamp duties on various transactions (29%), especially property; land tax (11%); gambling taxes (10%); and motor vehicle ownership and operation fees (9%).

State taxation before the GST

Taxes are unpopular, but state taxes are probably more unpopular than others. This dissatisfaction has its roots in the Commonwealth's wartime takeover of income tax, which until 1941 was primarily a state tax. The effective banishment of states from the income tax field since then, together with the constitutional restriction on state indirect taxation (such as excise, sales and consumption taxes) has resulted in the states relying on a diet of Commonwealth grants and an assortment of narrowly based taxes.[3] In 1971, they acquired payroll tax from the Commonwealth. In the 1980s, they ventured into financial transactions taxes, such as those on deposits and withdrawals, and business franchise fees on tobacco, alcohol, and petrol. At the same time, stamp duties kept growing in importance, as gambling taxation did with the spread of gaming machines in clubs, hotels and casinos.

In August 1997, the High Court ruled that business franchise fees were invalid under the Constitution, as they amounted to excises.[4] This blew a $5 billion hole in state budgets overnight, and was a catalyst for the national tax review announced by Prime Minister Howard a few days later. But dissatisfaction with state taxation was much more broadly based—the High Court judgment merely provided the trigger. The core economic reason for the dissatisfaction was the belief that some state taxes—stamp duties in particular—imposed high deadweight economic costs by distorting economic activity. They had narrow bases, were levied on turnover, and became embedded in the business cost structure. While deadweight costs are by their nature difficult to measure, attempts at doing so have placed stamp duties high on the scale of economic efficiency costs.[5]

Other issues with state taxation before the GST included:

- the heavy dependence of the states on Commonwealth grants to finance their expenditures (the so-called vertical fiscal imbalance)
- the low buoyancy of state tax revenue (failure to generate automatic revenue growth in line with the economy)
- the volatility of some tax bases
- regressive or arbitrary effects on income distribution
- complexity, especially for companies with interstate operations having to deal with different state tax systems.

The structure of state tax revenue in 1999–2000, the last pre-GST year, is shown in Table 1. Payroll tax was the largest single revenue source, but the various stamp duties in total generated more revenue. Most important among the stamp duties were those on conveyances (property transfers), financial transactions, and insurance. Gambling taxes and land tax were also important sources. Franchise taxes, although classified by the ABS as state taxes, were by then collected by the Commonwealth on behalf of the states as a result of the 1997 High Court judgment against their constitutional validity.

Table 1: State tax revenue before and after the GST ($ billion)

	1999–2000	2008–09	2013–14 (IGA reforms completed)
Payroll tax	9.0	16.9	16.9
Land tax	1.9	5.6	5.6
Stamp duties:			
FID and Debits	2.2	–	–
Marketable securities	0.7	0.1	–
Loan securities	0.8	0.3	–
Leases, hiring, rental	0.3	-	–
Conveyances (property transfers)	5.5	9.5	9.0
Insurance	1.4	3.1	3.1
Motor vehicles	1.4	2.0	2.0
Other	0.1	0	0
Gambling taxes	4.4	5.0	5.0
Motor vehicle usage taxes	2.5	4.4	4.4
Franchise taxes	5.8	–	–
Other taxes	1.9	3.7	3.7
Total	37.9	50.6	49.7

Source: Australian Bureau of Statistics.[6]

GST-related reforms

The popular impression was that once the GST was introduced, most or all state taxes would disappear. This is one of the enduring myths surrounding the GST and the ANTS reforms, based more on what the promoters of that myth would like to see happen than on what was intended to happen. In fact, while ANTS provided for a number of state taxes to be abolished, they accounted for only around 10% of total state tax revenue. The best known of the state taxes—such as payroll tax, land tax, and stamp duties on housing, insurance and motor vehicles—were not among them. Furthermore, while the agreement ultimately struck between the Commonwealth and the states set specific dates for some of the taxes to be removed, the timing of others was left open, leaving threadbare the charge that the states have been slow to act on their ANTS obligations.

The state tax reforms accompanying the GST were embodied in the June 1999 Intergovernmental Agreement on the Reform of Commonwealth-state Financial Relations (IGA). These reforms were less ambitious than the original ANTS proposals, as a result of amendments negotiated to achieve Senate passage of the GST legislation. Even so, as a result of the IGA, the following taxes have been abolished by all states at various times over the 10 years since the GST commenced: financial institutions duty, debits tax, marketable securities duty on listed securities, most duties on loan securities, and hotel bed tax where it applied (in NSW and the Northern Territory). The abolished taxes accounted for around \$3.5 billion of revenue (around 25% of stamp duty revenue and 10% of total state tax revenue) in 1999–2000.

The IGA provided for the following taxes to be phased out (but left the timing to be determined after a review in 2005): stamp duty on mortgages; duties on leases, hiring and rentals; duty on business conveyances; and duty on unlisted marketable securities.[7] Following the 2005 review, the Commonwealth reached agreements with each state for phasing out of most of these taxes according to state-specific schedules. These schedules were, however, renegotiated with the new federal government in 2008. As a result, while some states have completed their abolition, NSW and South Australia will not do so until July 2012 and Queensland and Western Australia not until July 2013. Even then, no state will abolish stamp duty on real property transfers by businesses, which was a point of dispute between the states and the Howard government. The states only agreed with the Rudd government to abolish duty on non-real business transfers.

Table 1 also shows how the structure of state taxation will look once the reforms are complete (in 2013–14). Contrary to popular belief, the GST agreement did not provide for the abolition of all stamp duties, with those on residential real property transfers, insurance, and motor vehicles remaining.

The replacement of the abolished taxes by the GST represents an unambiguous improvement in the national tax system's economic efficiency. It will significantly reduce the tax system's complexity and marginal deadweight cost. It will also have dynamic benefits over time, in that the additional state revenue flowing from the GST will make the states less likely to increase their remaining inefficient taxes or adopt new types of inefficient taxes.

Yet this does not mean there are no reforms left worth pursuing, only that the ANTS package tackled the highest-priority reforms within its limited scope. The remaining state taxes may have been lower reform priorities, but that does not mean they are ones state governments would impose in an ideal world or their existing structure is ideal.

What should we expect of state taxation?

The community's distaste for state taxes may account for the widely held view that even if the states are here to stay, we would be better off with the Commonwealth doing all the taxing and passing some of the proceeds to the states to finance their responsibilities. The GST has taken Australia in the direction of this model. By agreement between the Commonwealth and the states, the GST is imposed under Commonwealth statute, but all the proceeds are handed over to the states. It is administered by the Australian Taxation Office (ATO) under a service agreement with the states, which reimburse the Commonwealth for the costs of administration.

There is some support for the centralised approach in tax principles. It is administratively simpler, and avoids the economic efficiency costs that can be one result of decentralised taxation.[8] The problem is that centralised taxation is at odds with the federal system of government. If federalism is to produce the benefits expected of it—better local policy responsiveness, accountability, diversity, and competition—the states need to be responsible for raising their own revenue. Therefore, states must have some tax policy instruments under their control so they can make different fiscal choices if appropriate. There is a trade-off between the advantages of tax centralisation and the advantages of federalism. The challenge is to design state tax systems that give states the necessary autonomy and flexibility while minimising the economic efficiency costs of decentralisation.

The conventional prescription for tax design applies to states as much as to other levels of government. Taxes should be broadly based and as neutral as possible in their effects on resource allocation; they should pay regard to taxpayers' capacity to pay, and be simple to administer and comply with. But tax assignment in a federation also needs to recognise that the different features of state (and local) government make some taxes and tax policies more suitable for the states than others. As V.W. FitzGerald wrote in 1998, 'Principles for good tax assignment within a Federation are not a matter of mystery, but follow straightforwardly from broad economic, equity and public sector management considerations, together with the very basic principle of democratic accountability to electorates.'[9] FitzGerald went on to list principles for federal tax assignment, including the following:

1. Sub-national governments should tax relatively immobile bases to avoid distorting the location of economic activity.
2. Progressive taxation for re-distributional purposes should be national.
3. Benefit taxes and user charges (or taxes with that character) are best assigned to the specific jurisdiction providing the benefit or service.
4. Each level of government should be responsible for raising taxes covering a substantial proportion of what it spends on the grounds of basic democratic accountability.

The first principle is a special case of the economic efficiency criterion of taxation: taxes should not unduly distort resource allocation. This tends to favour sales taxes, personal income taxes, and property taxes for states, and rules out taxes such as company income tax and financial transactions taxes for which the base can be easily relocated.

The second principle suggests not that states should disregard the 'capacity to pay' criterion in tax design, but that they should avoid trying to reshape the income distribution and aim instead for a broadly neutral overall distributional impact of their tax systems (like a proportional income tax).

The final principle is a cornerstone of fiscal federalism, but in practice, no federation in the world achieves complete fiscal autonomy for its sub-national governments. The tendency for taxes to be more centralised than government spending, leaving a 'vertical fiscal imbalance,' follows from the superior economic and administrative efficiency of centralisation in many forms of taxation. This reality, however, does not negate the principle that each level of government should self-finance a *substantial proportion* of its expenditure, and should have the fiscal instruments at its disposal to make choices about the size and structure of its revenue and expenditure.

Post-GST state tax reform issues

The GST reforms leave two major state tax reform issues outstanding: deficiencies in the state taxes that will remain if and when the current reform program is completed; and the states' continuing heavy dependence on Commonwealth grants, albeit in the different guise of GST revenue grants. While these two issues cannot be kept completely separate, this paper focuses on the state taxation issues.

Some $50 billion in state taxes (in 2008–09 terms) will remain in place once the currently scheduled reform plans are completed. Table 1 shows what they will be: mainly payroll tax; land tax; stamp duties on real property transfers, insurance and motor vehicles; gambling taxes; and various motor vehicle usage taxes such as annual registration charges.

The case for further reform is based on the economic efficiency costs of the remaining taxes, their narrow bases, their high rates and graduated rate structures that serve no sensible purpose, and their complexity. In general, state taxes have been excessively engineered to serve policy objectives unrelated to efficient revenue-raising to fund service delivery. Current state tax policies offer several examples of this:

- Payroll tax exempts around half of its potential base by value, and land tax well in excess of half.
- Queensland has two different land tax scales, with different thresholds and rates. What you pay depends not only on the value of your land holdings but on whether you are a resident of that state and whether you are an individual, a company or a trust.
- To varying degrees, all states offer firm-specific payroll tax concessions under interventionist policies calculated to attract business. NSW offers a payroll tax rebate for employers who go above the tax-free threshold for the first time, provided they are located in regions of the state that have unemployment rates above the state average.
- All states levy conveyance (property transfer) stamp duty under progressive rate scales whose thresholds have not been adjusted for many years, resulting in massive bracket creep. Queensland imposes different rates depending on whether the property is being purchased as a principal place of residence, and if it is, whether it is a first home.

- All states impose stamp duty on insurance premiums at multiple rates, depending on the type of risk insured. In addition, NSW and Victoria partly finance their fire brigades through a fire services levy on insurance; the combined stamp duty and levy can be as high as 50% or more, and is in addition to the GST on insurance.

If these taxes are worth having, it is valid to ask why they are so complex, narrowly defined, and curtailed by exemptions and concessions, and why the resulting rates on the non-exempt bases are so much higher than they could otherwise be.

Bearing in mind what we should expect of state taxation, as discussed in the previous section, the problem is that the current array of state taxes—and the way they are applied—pays scant regard to the criteria for good state tax assignment and design. These taxes *do* distort resource allocation, they are *not* neutral with respect to income distribution, they *do not* give states sufficient fiscal autonomy, and they *are* complex in many cases. It is true that such state tax policies are partly the result of Commonwealth tax imperialism. Since assuming all income taxing power in 1941, the Commonwealth has never welcomed the states back to broad-based taxation. Even the Fraser government's 'new federalism' policy in 1976, while notionally allowing for a state income tax, provided no extra room for it by reducing Commonwealth income tax. But the states are not simply innocent victims. For example, they have chosen to apply payroll tax and land tax narrowly, and increasingly so over the years, by exempting large slabs of the potential base.

In what follows, we consider the major state taxes—payroll tax, land tax and the remaining stamp duties, which account for 75% of the $50 billion of 2008–09 revenue identified above—on their merits.

Payroll tax

Abolishing payroll tax was a key objective of the business lobby during the tax reform review of 1997–98. In the event, this did not form part of the ANTS reforms. Given the limited funds available from the GST and other reforms, there were higher priorities for state tax reform than the removal of payroll tax, which would have been very costly. This outcome has not stopped business groups from campaigning against payroll tax, and in some cases even asserting that GST was supposed to lead to its abolition.

Business despises payroll tax, but economists defend it as the best revenue source the states have under their own control. Businesses see payroll tax as another cost. Worse still, as an add-on to labour costs, it is seen as a 'tax on jobs.' Economists look through the legal incidence on employers to the underlying economic incidence, and see payroll tax being shifted to consumers (through higher selling prices) or employees (through lower wages). Thus, in the economic view, payroll tax is like the GST or personal income tax; if states cannot gain control of either of those broad-based taxes, then payroll tax is the best available substitute as an instrument for them to control their own finances.

The economists' view is closest to the mark, but payroll tax is by no means a perfect substitute for a GST or an income tax. To the extent that it works like an income tax, it is confined to labour income. Unlike the GST, it is not subject to input tax crediting and feeds into the cost of exports. Even though most of the economic incidence of payroll tax may not fall on employers, the illusion that it does may be so strong that it actually influences business behaviour. For these reasons, the opposition to payroll tax has some economic respectability.

An alternative to abolishing payroll tax and finding a replacement is to retain it and restructure it as the more efficient and less distorting tax that it could be. The most important defect of payroll tax is that the states have emasculated its base since taking the tax over from the Commonwealth in 1971. The payroll tax we see today falls far short of its potential, suffering from a severely shrunken base and relatively high rates. When payroll tax was last a Commonwealth tax in 1971, it was imposed at a rate of 2.5%, subject to a tax-free threshold of $20,800 per firm's annual payroll. As a state tax today, the rates range from 4.75% to 6.85%, and the tax-free thresholds from $550,000 to $1.5 million. Inflation accounts for part of the increase in thresholds, but even if indexed to average weekly earnings, the 1971 threshold would only have risen to around $250,000 today.

States have exempted an increasing proportion of the employer base from payroll tax in the mistaken belief that they are assisting 'small business.' In the process, they have created a regime that combines a high rate with a narrow base—the antithesis of tax efficiency. Some state governments now boast about how few businesses pay payroll tax, while burdening those that do pay with a heavier load than would be possible under a broad-based approach. In 1998, the Productivity Commission estimated that in 1993–94 only 8% of private sector enterprises paid payroll tax, and since then some states have lifted their tax-free thresholds very substantially, further reducing the proportion of enterprises within the base.[10]

The Productivity Commission estimated the average effective payroll tax rate in the mid-1990s at close to 3%.[11] This is an indication of the rate that could raise the same amount of revenue without a tax-free threshold and without exemptions. In practice, there is a case for a small tax-free threshold, because the cost of administering the tax on very small firms would exceed the revenue collected. However, even with a low tax-free threshold, a rate of 3.5% to 4.0% could raise as much revenue as the current statutory rates ranging as high as 6.85%. Lower statutory rates on a broader base would impose lower economic efficiency costs than the current tax.

High tax-free thresholds cannot be justified as small business assistance. Why is small business more deserving of assistance by virtue of its size? The case for exempting small business from payroll tax is no stronger than that for an income tax exemption, yet there is no tax-free threshold for company tax and only a $6,000 threshold where individual income tax applies to business income. Small business is not exempt from paying the 9% superannuation guarantee to employees. In any case, the 'assistance' provided by the payroll tax threshold is largely illusory, given that small business would shift the economic incidence of the tax backwards or forwards if they had to pay it.

Is payroll tax worth keeping in its far from perfect condition? At times, the tax reform debate has contemplated replacing payroll tax with a higher GST rate. The coalition proposed this as part of its 'Fightback' package in the 1993 federal election. In contemporary terms, abolishing payroll tax would require lifting the GST rate from 10% to about 13%. Purely as an exercise in tax efficiency, this would be a welcome change, but it would also leave the states with even less fiscal autonomy than they have, creating more vertical fiscal imbalance. A payroll tax (albeit an imperfect one) that each state is free to vary and use as a tool of interstate competition—would be replaced by a uniform GST over which no state has individual control. Payroll tax is one of the few instruments of tax flexibility currently available to the states.

On balance, payroll tax is worth keeping, but it should be substantially restructured as a low-rate, broad-based tax. Given the strength of opposition to base broadening, reform is best pursued not as a stand-alone exercise but as part of a larger reform of state taxation or even of business taxation more broadly defined to include Commonwealth business taxation. This way, the losers from payroll tax reform can see gains from other changes.

Whether reform in the direction of a broad base and low rate is achievable, states should at least stop further white-anting the payroll tax base by increasing tax-free thresholds and granting firm-specific concessions.[12] Constructive competition should focus on tax rates. The states could also simplify payroll tax administration.

Definitions of the payroll tax base, and methods of collection, already vary between the states. These differences serve no competitive purpose, but add to complexity and compliance costs for the many firms that pay payroll tax in more than one state. State governments have recognised this and have begun to harmonise their definitions, exemptions and collection practices.[13] They should also explore whether payroll tax could be administered through the ATO's Business Activity Statement (BAS) system.[14]

Land tax

Land tax is similar to payroll tax in the sense that both are theoretically economically efficient taxes but whose reality falls far short of the ideal. The contrast between land tax's potential and reality is even greater than in the case of payroll tax. Land tax is well-suited to be a revenue-collection instrument for sub-national governments because of the immobility of the base. Moreover, a broad-based property tax imposes low economic efficiency costs because of the limited economic 'wriggle room' available to the taxpayer. In Australia, while local government property rates are broad-based, the state land tax is very narrow.

Rates, which in part are a form of land tax, are the main revenue source for local government, and are subject to few exemptions and no tax-free threshold. The Australia-wide average effective rate in 1995–96 was 0.8%, comprising significant fixed charges and very low marginal rates on unimproved land values. In this form, local government property tax is relatively free of controversy and is accepted as well as any tax can be.

In contrast, state land tax—also levied on unimproved values—is subject to major exemptions and high tax-free thresholds for those who do pay. The major exemptions are for owner-occupied housing and agricultural land. The average effective land tax rate across all states in 1995–96 was just 0.2%, compared with much higher statutory marginal rates.[15] Thus, land tax applies to a small fraction of its potential base.

Another feature of state land tax is the imposition of graduated rate scales. Graduated scales represent an attempt by states to play a redistributive role that, to the extent it is warranted, is more effectively carried out by the central government. In any case, the distributional effects of a graduated land tax scale may not be what the policy aims to achieve. Most high value commercial properties are nowadays owned by property trusts and superannuation funds on behalf of small investors and fund members. It is not obvious that high land values are a good indicator of these ultimate owners' capacity to pay.

Ideally, the exemptions, thresholds and multiple rate scales would be swept away and replaced by a single low rate (which may vary between the states) and administered jointly with local government rates for maximum simplicity. The Productivity Commission estimates of average effective land tax rates suggest that a uniform rate of 0.2% would be required to raise the same revenue as the current arrangements. A second-best option would be to have a two-tier system, with a very low rate (say, 0.1%) for all residential land and something like the existing rates for non-residential land. This would be administratively more complex because of the need to distinguish between residential and non-residential uses of land and to impose different rates on mixed-use land.

As with payroll tax, however, there is strong opposition to base broadening. Unlike most other taxes that households pay, which are either deducted at source or embedded in prices paid or transaction costs, land tax requires paying cash—often substantial amounts—directly to the tax collection agency. It is based on valuations that, however much they are held at arm's length from political influence, taxpayers hold to be biased upward for the government's benefit.

NSW has served as something of a laboratory for land tax policy changes in recent years. The NSW government imposed land tax on some owner-occupied properties in 1997, but scrapped it in 2004 after it proved to be highly controversial. A similar measure in Western Australia several years ago was aborted in the face of strong community opposition. Also, NSW removed the tax-free threshold for all land tax payers in 2004, only to reinstate it under community pressure 12 months later.

The relevance of these episodes to a comprehensive, low-rate land tax is open to debate. A selective tax such as the existing land tax, which exempts most of the potential payers, is bound to arouse more passionate resistance from the few who do have to pay, and at a much higher rate than they otherwise would. The NSW experiment with owner-occupied land was grossly discriminatory, being confined by statute to the top 0.2% of owner-occupied properties in the state. It was the ultimate envy tax, raising little revenue but imposing large tax bills on a select few at a rate of 1.7% of value above $2 million.[16]

The Australian attitude to land tax appears even more idiosyncratic when contrasted with other countries, which rely much more heavily on similar taxes. For example, local governments in the United States impose quite hefty property taxes, on improved values, as the main source of funding for schools and policing. It may be that the closer connection to distinctive local services makes property tax more acceptable in that situation, just as local government rates are reasonably well-accepted in Australia. Or it could be that the use of improved rather than unimproved values makes the tax more acceptable because improved values are more readily observed in the market place. Nevertheless, the NSW experiments have reinforced all governments' distaste for a broad-based land tax.

The best possibility of land tax reform would be a package that combined land tax base broadening with the removal of property transfer duty, to which we now turn.

Stamp duties

> Popular with taxmen, stamp duty puzzles economists. All governments must claim a share of the fruits of an economy to finance what they do for their citizens. But a stamp duty taxes exchange, not production or value added. It is like children at a birthday party, stripping a layer from the parcel every time it is passed from hand to hand.
>
> —*The Economist*[17]

One effect of excluding the states from income tax and broad-based indirect taxation was to make them more reliant on stamp duties on 'an abnormally broad range of dutiable transactions and at high rates relative to most countries.'[18] Stamp duties are a significant feature of tax systems in some developing countries, but play a much more limited role in other developed countries than has been the case in Australia. Stamp duties were first applied in England in 1694 as a means of verifying the authenticity of documents, which were stamped upon payment of the duty. Governments found they could raise significant amounts of revenue this way, as people had little option but to have their documents stamped if they wanted to complete transactions. The only way to avoid the duty was by not transacting in the first place.

As indicated by the quotation above from *The Economist*, there is little economic logic to the use of stamp duties for revenue-raising purposes. Transfers of the same asset can be taxed over and over again even if they add no value, and without regard to the transacting parties' capacity to pay. Because of stamp duties' effect on transaction costs, taxpayers will try to minimise transactions or restructure them to minimise duty. This creates economic costs—'deadweight' costs—well in excess of the revenue raised by the duties. The payment of duties by businesses becomes embedded in their costs and cascades through the cost structure.

It was for these reasons that stamp duties were a high-priority target of the ANTS reforms, as a result of which the stamp duties on share transactions and deposits with financial institutions have been abolished, while those on mortgages, leases and hiring are being phased out. But the largest stamp duty of all—that on property transfers—remains, as do those on motor vehicle registrations and insurance.

Property transfer duty

Property transfer duty is the second-largest tax revenue earner for state governments and the fastest-growing on average over a long period, but it is also the most volatile.[19] Unlike land tax, which is a relatively low annual impost on the assessed unimproved value of a small proportion of land, transfer duty is imposed at a relatively high rate on the total value of property turnover, with few exceptions.[20] The rapid long-term growth of revenue comes from the growth of property values, while the short-term volatility comes from the volatility of prices, and more importantly, the volume of transactions. This volatility works against stable budget management, given the importance of transfer duty revenue to state budgets. Governments tend to lock the proceeds of property booms into their expenditure base, creating problems in the 'bust' phase of the property cycle.

Transfer duty is set at steeply graduated rates that have served the growth of government well over the long term by delivering a massive 'bracket creep' effect on revenue. Leaving the personal income tax thresholds unchanged for 20 years or longer, as prices and incomes grew, would be unthinkable. But this is exactly what happened in the case of property transfer duty, resulting in large increases in effective tax rates. For example, the duty payable on a median-priced Sydney house in 1986 was 2%, but in 2007 it stood at 3.7%—an increase of 85% in the effective tax burden with no legislative effort.

The review of international tax comparisons by Dick Warburton and Peter Hendy for the Commonwealth government in 2006 found Australia's abnormally high reliance on property *transfer* taxation was one of the outstanding contrasts with overseas experience.[21] The rates of such taxes in Australia were among the highest of the countries surveyed. In contrast, Australian reliance on property *value* taxation (like land tax) is relatively low.

The original policy purpose of graduated scales is lost in the mists of time, but state governments presumably had some redistributive objective in mind. This is as misguided as it is in the case of land tax. Apart from redistribution being an unsuitable role for sub-national governments, in the case of transfer duty, its distributional effects have as much to do with the frequency of property transactions by different income groups as with the rate scale. A low-income household may transact, and incur stamp duty, more frequently than a high-income household. Businesses paying duty at higher rates because of larger transaction values may pass on the costs to low-income consumers. The distributional effects are therefore unpredictable and arbitrary, notwithstanding graduated rate scales.

As a turnover tax, transfer duty imposes high deadweight economic costs. It distorts choices between buying and renting and between moving house and staying put or renovating. It tends to lock households into sub-optimal housing and militates against resource mobility. Marginal deadweight costs have increased over the years as a rising proportion of transactions have become subject to the upper levels of the graduated scales.

It is sometimes argued that transfer duty fills a void, such as the absence of capital gains tax or income tax on imputed rent of owner-occupied dwellings, left by income tax concessions on property. Whatever policy view one takes of those concessions, transfer duty is a poor substitute for higher income tax or capital gains tax on housing because it is a turnover tax that has higher economic efficiency costs and pays no regard to taxpayers' broadly defined capacity to pay. In addition, it is not the states' role to correct alleged deficiencies in the federal tax system.

Compliance with transfer duty is fairly simple in the case of most housing transactions, but can be complex for business and trust transactions. The states have introduced complex provisions to prevent land-rich companies and trusts from escaping transfer duty. Something of a cottage industry of specialist tax law has grown up to keep abreast—or ahead—of these complexities and to keep a lookout for loopholes and avoidance opportunities on clients' behalf.

There is a good case for abolishing transfer duty—or at least reducing it to a single low rate that would be less distorting—if a replacement revenue source can be found. The comprehensive land tax discussed above would provide such an opportunity to replace a tax on property *transactions* with an annual tax on assessed property *values*. This approach was discussed further in the section on post-GST state tax reform issues.

An alternative would be to lower, rather than abolish, the rates of property transfer duty. Even a bad tax can be made less bad by lowering the rate. If significant, such a reform would reduce the marginal deadweight cost of this tax. On average, across the states, halving the rates would bring top duty rates down to around 3% and rates on median-priced homes down to around 2%. This would cost the states around $5 billion in 2008–09 terms. In addition, the thresholds should be indexed to average property values to avoid the enormous bracket creep experienced over recent decades. A flat rate of around 1.5% would be better still, eliminating the possibility of future bracket creep.

In the current context, any consideration of lowering or removing stamp duty inevitably leads to the issue of housing affordability. One argument is that a cut in stamp duty would merely increase pre-duty house prices, resulting in no net change. Implied in the argument is that currently, the economic incidence of stamp duty falls on the seller, not the buyer, even though the buyer bears the legal incidence. While there may be some truth in this, the economic incidence is most likely shared between buyer and seller. However the economic incidence is distributed, the economic distortion imposed by stamp duty remains.

Stamp duties on motor vehicles and insurance

Among the remaining stamp duties, those on motor vehicles and insurance come closest to being selective consumption taxes. Unlike the GST, however, they become embedded in the business cost structure. To households, they are in a sense a double tax, as motor vehicles and insurance are also subject to the GST. There is no good reason to single out these items to carry an additional tax burden over and above the GST. These duties also suffer the defects of other stamp duties on turnover, as discussed above.

Motor vehicle stamp duty might be thought of as an environmental tax that helps internalise the external costs of motor vehicle usage. However, the duty falls on *turnover* in motor vehicles rather than on *usage*. If states want to mitigate the environmental impact of vehicles, they could do so more effectively through road tolls.

As well as the stamp duty on insurance, NSW and Victoria impose fire services levies on selected types of insurance to help fund their fire brigades. These levies are very high in some cases, and can take the combined weight of stamp duty and levies to 50% or more. Other states have moved to more appropriate property-based levies. NSW and Victoria should follow suit.[22]

Other taxes

The other main taxes are those on motor vehicle ownership and operation, such as registration charges, and the various forms of gambling. These are less controversial from an economic standpoint, although state dependence on gambling tax revenue is often criticised from a social policy perspective. The omission of these areas from the reform program outlined in this paper does not mean that they raise no issues, but simply that within the inevitably limited scope for state tax reform there are higher priorities.

There is also a raft of minor state taxes that the states have imposed over the years for various opportunistic reasons. They raise relatively little revenue for the effort expended in administering and complying with them, most of the burden of which falls on business. The following list of such taxes should be taken as illustrative rather than comprehensive:

- parking space levies (NSW and Victoria)
- health insurance levy (NSW)
- insurance protection tax (NSW)

- metropolitan parks levy (Victoria)
- community ambulance cover (Queensland)
- metropolitan improvement levy (WA)
- Save the River Murray levy (SA)
- environment, waste and landfill levies (all states).

The imposition of such 'nuisance' taxes was more the result of budgetary stress in particular states at particular times in the past than it was of a strong tax policy justification for them. All of the above taxes combined in all states raise less than $1 billion, or less than 1% of aggregate state revenue. Such taxes could be phased out over time with little impact on state budgets.

Financing state tax reform

While some reforms could be made revenue neutral, those that remove any of the major remaining state taxes would come at a substantial annual revenue cost. The remaining stamp duties generate revenue of $14 billion per annum, payroll tax $17 billion, and land tax $6 billion. It is necessary to explain how any of this could be financed. There are five basic options.

1. Revenue-reducing options

Revenue-reducing options involve all or part of the budgetary cost of tax reductions being borne by goverment budgets, whether they are state or Commonwealth budgets. If matched by a reduction in government expenditure, these options combine two objectives: tax reform and smaller government, involving a sustainable reduction in the overall tax take. Although analytically these are best kept separate, in practice tax reform is more likely to be 'saleable' if it involves a net tax reduction, and the economic benefits are likely to be greater as a result of the elimination of some inefficient government spending.

(i) State-financed tax reform

It is open to the states individually or jointly to pursue their own tax reforms independently of any national reform exercise. In recent years, NSW, Victoria and Western Australia have undertaken major tax reviews. Such reviews have sometimes produced far-reaching reform recommendations, but these have not been accepted by government.

States regularly tinker with their tax policies: for example, in recent years states flush with revenue from the real estate and resource booms have tended to lower payroll tax and land tax rates and lift tax-free thresholds. Yet these actions do not amount to reform, and they have left the fundamental problems in place. For genuine reform, states would need to take a bolder, more strategic approach backed by stronger expenditure discipline.

(ii) Future growth of GST revenue

The stamp duties already abolished or scheduled to be abolished in the future are essentially being financed out of the growth of GST revenue as the GST base grows. This growth is delivering to the states net revenue gains against the hypothetical benchmark set by the pre-2000 funding arrangements. The cost of abolishing stamp duties is absorbing part of those gains.

Some or all of the remaining net revenue gains could be earmarked for abolishing other stamp duties not currently scheduled for removal. This is essentially a special case of state-financed tax reform, as described above. The difficulty with this approach is that the states will point out that the IGA promised them a net improvement in their revenue position after the effects of tax reform were taken into account. There is scope for argument about how much of an improvement is needed to meet the IGA commitment, but even on the current projections, aggregate state revenue will struggle to keep up with nominal GDP growth. In any case, at least for the next five years or so, the net gains will not be large enough in aggregate to contribute much to abolishing the remaining state taxes.

(iii) Personal income tax sharing

The cost of abolishing state taxes could in effect be shifted to the Commonwealth's budget if the Commonwealth granted a portion of its existing personal income tax to the states to finance their reforms. This could take the form of revenue sharing, with the Commonwealth retaining full control of taxation of the personal income base, or base sharing, where the Commonwealth would hand the states a portion of the revenue and policy control of the corresponding portion of the tax base. Simple revenue sharing in exchange for removing some existing state taxes would worsen vertical fiscal imbalance, but tax base sharing would not have that disadvantage. For example, the Commonwealth could allocate 2 percentage points of the existing personal income tax rate scale to the states in exchange for the latter agreeing to abolish some taxes permanently. The basis for this kind of trade-off would be that the Commonwealth is in a stronger fiscal position than the states to bear the burden of removing state taxes.

The reality is that the Commonwealth is always likely to want to retain surplus revenues for its own use, and to fund either tax cuts or increased expenditure. A transfer of personal income tax to the states could, however, stand a better chance of being considered in the context of Commonwealth-state negotiations surrounding the national economic reform agenda. The National Competition Policy (NCP), adopted in the mid-1990s, involved a stream of payments from the Commonwealth to the states to share the fiscal dividend from the NCP reforms. A similar approach could take the form of a transfer of part of personal income tax revenue or the personal income tax base to the states. In return, the states would agree to use this dividend to abolish or reduce some existing state taxes.

2. Revenue-neutral options

(i) Increase the GST rate

The current GST rate of 10% would need to increase to 13.5% to cover the full cost of abolishing remaining stamp duties, to 13% to finance abolition of payroll tax, or 11.5% to cover land tax. To abolish all three taxes, the GST rate would need to rise to 18%, which would give Australia a European-sized value added tax (VAT).

A European-sized VAT/GST is too high a price to pay for state tax reform in Australia. Although the GST is a relatively efficient tax, taken too far it would become a problematic tax. The higher the rate of any tax, the higher are the marginal deadweight economic costs. Moreover, increasing the GST rate would cause a further increase in vertical fiscal imbalance, as a set of taxes that the states do control (stamp duties and so on) would be replaced with additional revenue from one they don't.

There is also a 'thin end of the wedge' argument that the GST is *too* efficient as a revenue-raising tool, and that any increase, no matter what the trade-offs, should be resisted because it would set in train a ratcheting up of the GST and of the overall tax burden. On this view, the existing 10% rate is a line in the sand that should never be crossed. International experience supports this pessimistic view, as most other countries that have adopted a GST or VAT have increased it several times from its initial level.

Nevertheless, a modest increase in the GST could represent an improvement in the tax system's economic efficiency (reduction in deadweight costs). Also, administration and compliance costs would be reduced, as increasing the GST rate on the existing base would be simple and costless, and would lower the costs associated with state tax administration and compliance. Maintaining the 'line in the sand' for the GST rate means continuing to bear the higher economic efficiency costs of the taxes that the GST could replace. Moreover, the inefficiency of existing state taxes is likely in the long run to place the marginal burden of revenue-raising increasingly on more efficient Commonwealth tax instruments. State budgets would be supported by increased Commonwealth grants back to the states, such as specific purpose payments for health and education. In that event, the increased resort to more efficient tax instruments would still take place, but in a form other than an increase in the GST.

The Howard government, which introduced the GST, was firmly opposed to any increase in the rate or base, and this position has been maintained by government and opposition since.[23] While it is understandable that they would oppose it as a net tax increase, it is not clear why it should be ruled out as a revenue-neutral substitute for other, less efficient state taxes. Yet any such substitution should be made conditional on its never being reversed—if any state were to reintroduce an abolished tax, its share of GST revenue should be reduced.

(ii) Reform and increase efficient state taxes

The review of payroll and land taxes in the above section on what we should expect of state taxation canvassed the possibility of broadening these tax bases to finance the removal of less efficient taxes. For purposes of illustration, working with national data, a tax of 0.25% on *all* unimproved land values, additional to the existing land tax, would raise about $6 billion, which would be enough to replace more than half the stamp duty on property transfers. Replacing a property turnover tax with a tax on land values has a strong economic logic, as discussed above.

Each additional 1% tax on payrolls, with no tax-free threshold, would raise around $4 billion, enough to finance abolition of insurance and motor vehicle stamp duties. Again, there is a strong economic case for such a switch.

These options could be finessed in all manner of ways, and are offered only as illustrations. The more important point is whether any such trade-offs would be politically feasible, given the reality of fierce resistance to payroll and land tax base broadening. The key would be to package base broadening with other state (and Commonwealth) tax reforms that would at least partly offset the costs to the losers from base broadening. For example, broader land tax and payroll tax could be offset by removal of stamp duties.

(iii) New state taxes

The option of creating new state taxes is raised in this context, not with the objective of increasing the overall tax burden but of replacing deficient taxes with better ones in a revenue-neutral package. The possibilities that conform to likely constitutional restrictions include income tax, wealth taxes, estate and gift duties, environmental taxes of various kinds, and user-pays-type taxes such as road user charges. The standout example among these is personal (not company) income tax.

The problem with a state income tax is that the Australian tax system already relies relatively heavily on personal income tax. Most reform proposals rightly envisage reducing rates of personal income tax, not adding to them, which would be the effect of a state personal income tax without an offsetting reduction in Commonwealth rates. Trading off state stamp duties for a higher personal income tax burden would replace one set of problems with another. A better role for a state personal income tax, as discussed above, would be in reducing vertical fiscal imbalance by substituting for a slice of the existing Commonwealth personal income tax.

The reference above to likely constitutional restrictions is an acknowledgement of the history of High Court rulings against the imposition of sales, consumption, and like taxes by the states, under section 90 of the Constitution.[24] However, such rulings have been made in contexts where there was no Commonwealth support for the state taxes in question. While plans to amend the Constitution to allow the states to impose such taxes would be unrealistic, it is intriguing to consider what the outcome might be if the Commonwealth were to support a state sales-type tax in any proceedings before the High Court.[25] If such a tax were to prove sustainable under those circumstances, it would open up the possibility of the GST being converted to what it is not now—a bona fide state tax.

(iv) A combination of the above

Obviously none of these options are mutually exclusive. A combination of some increase in the GST rate (say, to 12.5%), some further commitment by the states to use their net GST gains to substitute revenue from existing state taxes, and some payroll and land tax base broadening would also serve the purpose. Such a package could raise the revenue needed to replace all stamp duties.

Limited reform options

Sweeping reform of state taxation would require one or more of a higher GST, broader bases for payroll tax and land tax, and devolution of some income taxing power from the Commonwealth to the states. Given that there are high obstacles to all of these options, it is worth considering what kinds of state tax reforms could be pursued without them.

One approach would be for states to continue acting unilaterally to gradually lower key tax rates such as payroll tax and land tax. However, this does not constitute 'reform,' some states do not currently take part, and state governments' willingness to continue along this path is only likely to last as long as the strength of their revenue flows.

Other approaches include:

- interstate harmonisation of state tax legislation and administrative provisions other than tax rates and thresholds, on which states should continue to compete (this approach has already begun with payroll tax).
- rationalisation of antiquated tax rate scales, and adoption of automatic threshold indexation to prevent further bracket creep (this is especially relevant to stamp duty on property transfers).
- phasing out nuisance taxes—as discussed in the above section on other taxes—which raise little revenue relative to the compliance burden they impose.

Bringing together the elements of a better state tax system

Bringing together the elements of reform developed above—in the sections on payroll tax, land tax, stamp duties, other taxes, and financing state tax reform—provides a blueprint for a better state tax system. This should be implemented as a package so that the losers from some of the changes can see their offsetting benefits. The reforms should be pursued through COAG because of its link to federalism and other COAG-initiated reforms, and because all governments will need to be involved even though the precise details of the changes may vary from state to state.

COAG should begin by reaffirming the state tax reforms specified in the 1999 IGA and the commitments by the states to abolish various stamp duties according to the timetables negotiated with the Commonwealth Treasurer. This reaffirmation is needed because of the risk of more backsliding by the states.

Going beyond the IGA reforms, a modest but useful first step would be for the states to agree to a set of reforms that essentially serve COAG's business deregulation objective:

- harmonise tax bases and administrative practices across the states, particularly in relation to payroll tax, to reduce compliance costs
- simplify complicated tax rate scales, moving as much as possible to single rate structures, and
- phase out the long list of nuisance taxes that raise little revenue relative to the costs of compliance.

The more ambitious post-IGA reforms should focus on eliminating or substantially reducing the remaining stamp duties, and restructuring payroll tax and land tax:

- abolish stamp duties on insurance and motor vehicles, and, in the states that still impose fire service levies on insurance, replace them with property-based charges as in the other states
- at least halve the rates of stamp duty on real property transfers, and index thresholds if multiple rates of duty remain
- lower rates of payroll tax, and broaden the base by lowering the tax-free threshold, and
- lower rates of land tax, and broaden the base by lowering the tax-free thresholds for non-residential land and taxing all residential (owner-occupied and other) land at a very low, flat rate.

The abolition and reduction of taxes in this package are likely to cost state governments in the order of $15 billion per year when fully implemented. The broadening of payroll tax and land tax would partly offset this, but a large financing gap would remain—say, $10 billion. State and Commonwealth budgets could partly absorb this gap over a period of years. The Commonwealth contribution should not take the form of a grant, which would exacerbate vertical fiscal imbalance. The Commonwealth should instead share personal income taxing power with the states. The remaining gap would require the states to develop new sources of revenue, such as by making wider use of road user charges and a state-specific sales tax. The latter would be subject to challenge on constitutional grounds. Only after these possibilities are exhausted should an increase in the GST, or a base broadening, be considered.

These reforms would involve a net reduction in overall tax. They would leave the states with several major tax revenue sources under their own control, which would be relatively efficient and buoyant. The suggestion that payroll and land taxes should have broader coverage will be unwelcome, but if governments and the community are unwilling to face up to the trade-offs between higher revenue from these sources and the lowering and abolition of inferior taxes, the scope for reform will be greatly diminished. In that situation, reforms would still be possible, but would be incremental and confined to the more modest measures listed above, such as interstate harmonisation of tax bases and the phasing out of nuisance taxes.

Endnotes

1 Up to 2007, the Commonwealth budget classified the GST as a state tax—on the grounds that all the revenue is received by the states—and excluded it from the Commonwealth accounts. The Rudd government, however, stated that it would align the Commonwealth budget with the ABS treatment that sees GST revenue as Commonwealth tax revenue.

2 Australian Bureau of Statistics (ABS), *Government Finance Statistics, Australia, 2005–06*, Cat. No. 5512.0 (Canberra: ABS, 2007).

3 Section 90 bars the states from imposing 'duties of customs and of excise.'

4 *Ha v New South Wales* [1997] HCA 34; (1997) 189 CLR 465; (1997) 146 ALR 355; (1997) 71 ALJR 1080 (5 August 1997).

5 For examples, see Owen Gabbitas and Damien Eldridge, *Directions for State Tax Reform,* Productivity Commission staff research paper (Canberra: Ausinfo, 1998); V.W. FitzGerald, 'A Review of State Tax Reform Options,' in Neil Warren (ed.), *State Taxation: Repeal, Reform or Resignation*, Australian Tax Research Foundation Conference Series 21 (Sydney: Australian Tax Research Foundation, 1999); and John Freebairn, 'Opportunities to Reform State Taxes,' *The Australian Economic Review* 35:4 (December 2002).

6 Australian Bureau of Statistics (ABS), *Taxation Revenue, 2005–06*, Cat. No. 5506.0 (Canberra: ABS, 2007).

7 States disputed the Commonwealth view that the agreement obliged them to abolish—as distinct from merely 'reviewing'—these taxes, but that dispute does not require comment here.

8 For example, see Boadway's discussion of the efficiency costs of destructive tax competition and tax exporting, distortion of cross-border transactions, and differential impact on the fiscal capacities of sub-national governments. Robin Boadway, 'Grants in a Federal Economy: A Conceptual Perspective,' in Robin Boadway and Anwar Shah (eds.), *Intergovernmental Fiscal Transfers—Principles and Practice* (Washington, DC: World Bank, 2007).

9 V.W. FitzGerald, 'A Review of State Tax Reform Options,' as above, 38.

10 Owen Gabbitas and Damien Eldridge, *Directions for State Tax Reform*, as above, 84.

11 This is defined as revenue as a percentage of the potential tax base with no tax-free threshold.

12 For an excellent statement of the case against firm-specific concessions, see Wolfgang Kasper, *Competitive Federalism Revisited: Bidding Wars, or Getting the Fundamentals Right?* Issues Paper 5 (Melbourne: Institute of Public Affairs, 1996).

13 At its July 2006 meeting, COAG agreed to pursue harmonisation of the payroll tax base and administrative arrangements as a deregulatory measure. As a first step, NSW and Victoria harmonised their legislation, exemptions, and administrative arrangements from 1 July 2007, but each state continued to set its own tax rates and tax-free thresholds independently. Queensland and Tasmania are to join this arrangement from 1 July 2008.

14 Issues here would be the legality of the ATO collecting a tax imposed under state statute and the feasibility of using BAS to identify within-state tax liabilities.

15 Currently, marginal rates range from a single 1.6% in NSW to a top rate of 3.7% in South Australia.

16 The threshold began at $1 million in 1997, but through indexation it had risen to $2 million by 2004.

17 'Licking the Stamp Duty,' *The Economist* (2–8 September 2006).

18 Phil Anderson, 'Stamp Duties: The Case for Reform,' in Neil Warren (ed.), *State Taxation*, as above.

19 Over the 10 years to 2005–06, revenue from stamp duty on property transfers grew at an annual average rate of 13%. Although this period included an exceptional residential real estate boom, the long-term average growth rate of this category of state revenue has typically been in double digits.

20 Marginal rates are as high as 7% in NSW. The main exception is purchases by first home buyers, which are exempt up to value levels that vary by state.

21 Dick Warburton and Peter Hendy, *International Comparison of Australia's Taxes* (Canberra: Commonwealth of Australia, 2006).

22 Both states have reviewed the case for replacing insurance-based fire service levies with property-based levies in recent years, and decided to continue with the insurance-based levies.

23 The then leader of the opposition, Kevin Rudd, went so far as to say on 27 August 2007 that the GST would be increased 'over his dead body.'

24 A discussion of this history is provided in Cheryl Saunders, 'The High Court, Section 90 and the Australian Federation,' in Neil Warren (ed.), *Reshaping Fiscal Federalism in Australia*, Australian Tax Research Foundation Conference Series 20 (Sydney: Australian Tax Research Foundation, 1997).

25 For this suggestion, I am indebted to John Stone, former secretary to the Commonwealth Treasury, and currently a board member of the Samuel Griffith Society and editor and publisher of its proceedings.

Chapter 7

Fiscal Illusion: How Big Government Makes Tax Look Small

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In his 1990 John Bonython lecture, James Buchanan pointed to the death of socialism, but argued that 'Leviathan lives on.'[1] In that lecture, Buchanan indicated a lack of an agreed principle as to how the economy should be organised. Leviathan, which can be characterised as a 'special-interest, rent-seeking, churning state,' finds fertile ground for growth in this type of environment.[2] In the two decades since then, Leviathan has not just survived but thrived. There are a number of possible explanations for the growth in government. In the first instance, it may well be that voters are demanding big government, and politicians are simply responding to that demand. It is possible, but unlikely, that Leviathan is surviving without any electoral support; that politicians are willing to supply big government and are able to do so despite no voter demand for it. But the second explanation is not plausible over more than one electoral cycle. Government that systematically ignores voter demands will suffer electoral damage.

A third explanation, which this paper will explore, relates to fiscal illusion. Leviathan promotes itself by creating an illusion on the demand side. Voters are unsure about what big government costs, so they demand more government than they otherwise would. Further, Leviathan is aided and abetted by those institutions of society that benefit from large government. In previous works, I have referred to these as the *revenue lobby* (while Peter Saunders has written of the *welfare lobby*). The revenue lobby consists of those elements within the ATO, the Treasury, and public service departments—and their allies in politics, academia, and the media—who continually argue for higher levels of taxation and welfare expenditure.

The consequences of taxation and fiscal illusion

Jean-Baptiste Colbert famously articulated fiscal illusion with this cynical observation:

> The art of taxation consists in so plucking the goose as to obtain the largest possible amount of feathers with the least possible amount of hissing.

In modern terms, we would describe the 'hissing' as being a behavioural response to taxation. It is well-known that individuals respond to taxation. For example, some individuals may substitute leisure for labour when tax rates rise, or invest less and consume more, and so on.[3] Ideally, taxes would excite no behavioural response but nonetheless raise revenue. The hypothetical tax that achieved this would be called a 'neutral tax'; it would require that a (living) goose be plucked with no hissing. Of course, this is impossible. All forms of taxation give rise to behavioural responses, and the stronger those responses, the greater the social cost of taxation.[4] Even poll taxes, often described by economists as being behaviourally neutral, cause hissing—albeit not of the type economists usually consider.[5] As George Stigler argued, taxes should 'not imperil the political support for the regime' but 'must yield revenue.'[6]

Joel Slemrod writes that 'a progressive tax distribution requires higher marginal tax rates, which dampen the incentive to work and do anything else that engenders financial success, and encourages privately rewarding but socially inefficient activities that reduce taxable income.'[7] The same principle applies to all taxation. The diversion of economic activity as a consequence of taxation incurs costs. These not only include the work-leisure trade-off but also all the costs associated with raising tax revenue, including value-reducing activities such as tax avoidance and tax evasion. In technical terms, the behavioural response to taxation is called the elasticity of taxable income.[8] What is important is the extent of behavioural response. If it is small, then high taxes have smaller social costs, while a higher behavioural response implies higher social costs from taxation.

Of course, the question of what is 'big' or 'small' is a value judgment. Slemrod recognises this, and argues that 'the benefits of a more equal distribution of well-being' are 'a value judgement.'[9] To provide some context, however, if the (Australian) response elasticity were greater than 1.22, a decrease in the top marginal personal income tax rate would lead to an increase in personal income tax revenue.[10] The equivalent figure for the United States is 1.86 (assuming a top marginal tax rate of 35%). Empirical estimates for the US elasticity of taxable income vary greatly. Martin Feldstein, for example, has estimated a figure in the range 1.1–3.05, while Jonathan Gruber and Emmanuel Saez find a figure of 0.4.[11] The important point, however, is that even if the (Australian) behavioural response were less than 1.22, determining whether it is too big or too small is still a value judgment. We should not assume that maximising tax revenue is a legitimate function of government.

Slemrod argues that tax authorities have some control over the social costs of taxation through their ability to influence the behavioural response to taxation. When introducing a new tax or modifying an existing tax, the authorities have to choose a suite of policies. They also have to justify the tax, and introduce (or modify) anti-avoidance and anti-evasion policies and the like. By making tax bases as broad and comprehensive as possible, tax authorities aim for a lower behavioural response, which allows them to easily increase rates in future. Geoffrey Brennan and Buchanan recognise this in *The Power to Tax*, arguing that citizens would ideally constrain government in the choice of tax base. Otherwise, 'all persons would be totally vulnerable to the fiscal authority, with all potential economic value subject to overt confiscation in the taxing process.'[12]

The tax authorities therefore have an incentive to minimise the behavioural response to taxation, subject to some cost constraint: political, financial or legal.[13] The behavioural response is determined by individual choice, which is outside direct government control, and also by the authorities' anti-avoidance technology and the amount of 'tax coordination and harmonization.'[14] Australia has been an active participant in efforts to harmonise and coordinate international tax information sharing and anti-avoidance activity.

Another mechanism for reducing tax response behaviour is to engage in behaviour that fosters fiscal illusion. The Italian economist Amilcare Puviani has developed the tax illusion literature in detail, but unfortunately, his work has not been translated into English, so the Anglophone world has to rely on secondary sources to understand this phenomenon.[15] Puviani considers how a tax system would be designed if the political authorities wished to minimise taxpayer resistance to any given level of tax revenue. As Buchanan indicates, 'political agents find it in their interest to modify the fiscal consciousness of citizens.'[16] In particular, '[t]ax impositions will be made to seem less onerous than might otherwise be the case.'[17] Fiscal illusion is said to occur when economic decision-makers incorrectly perceive the opportunities and costs they face. Within their understanding, these decision-makers' behaviour may be rational but can still be at odds with reality.

It is possible to create a fiscal illusion on the revenue and expenditure sides of fiscal policy. For example, on the revenue side, government attempts to dampen perceptions of high taxation while on the expenditure side, it wants to enhance perceptions of the value of taxation. In general, the literature on fiscal illusion has concentrated on the tax burden. If Leviathan can create the illusion that the tax burden is lower than it actually is, the state can grow beyond the size that voters want it to. Buchanan describes a series of mechanisms, based on Puviani's writings, that can be employed to create fiscal illusion.

In the first instance, complexity in the tax system is a source of fiscal illusion. The graduated progressive income tax fits exactly into this category. Adding exemptions, deductions, and mild (if not severe) inflation completes the illusion. Indirect taxes such as excise, levies and the GST also contribute to fiscal illusion. The burden of public debt, and its relationship to the present and future tax burden, also fits into the first category.

The second form of fiscal illusion can be described as 'taxing winners' or at least so-called windfalls. For example, taxes on inheritances, transfers and gifts are (often) willingly paid. Australia has few such taxes—the ill-fated Resource Super Profit Tax (RSPT) was said to be a tax on windfall profits. The third form of fiscal illusion is fees and charges on memorable and significant events such as getting wedding licences, driving licences, pet licences, fishing licences, and gambling taxes. These two categories are very similar, and taxpayers get to share their good fortune (and their financial fortune) with the tax collector.

A fourth form of fiscal illusion can be described as opportunistic taxation. Here, Leviathan takes advantage of changes in community attitude to levying a tax. For example, the Ansett, sugar, milk, super surcharge, gun buy-back, and Timor levies were all opportunistically imposed to cater to a specific attitude in the community. The Timor levy was not collected when it turned out that community attitudes did not support it. Such levies are often introduced quickly on a narrow base with a specific objective, yet remain in place for long periods of time.

The fifth form of fiscal illusion can be described as a 'dread consequence' tax. Without such taxes, the consequences for social life would be disastrous. For example, without the Medicare levy people might die in the gutter. Of course, there is little evidence of wholesale death in Australian gutters prior to the imposition of the Medicare levy, yet it is impossible to argue against it. This is a particularly good example of fiscal illusion. Community attitudes towards it are very positive, yet it also disguises the total cost of public health care. The levy itself does not generate sufficient revenue to sustain the Medicare program. Approximately 75% of Medicare funding comes from general revenue. At present, global warming is providing a similar rationale for a massively expanded state. In the first instance, there is a campaign to increase petrol taxes to benefit the environment and reduce traffic congestion.[18] Finally, imposing taxes with unknown or uncertain economic incidence adds to fiscal illusion. The company income tax is a classic example of this.

It is clear that many mechanisms exist to create fiscal illusion. This is even before taking into account the campaign of misinformation—including arguments that the 'rich' don't pay their fair share and the like—that sustains Leviathan.

Voter ignorance

Andrew Norton has undertaken an extensive analysis of public attitudes towards taxation, arguing that individuals may support higher taxes in the belief that they themselves will not actually pay the tax.[19] Many voters are woefully ignorant about how the Australian tax system works. In the 2004 Australian Election Survey,[20] only 43% of respondents knew that low-income earners pay a smaller proportion of their income in tax than higher earners do.[21] Of the remainder, 30% thought low-income earners pay a greater proportion of their income in tax, and 8% thought they pay the same proportion.[22] Remarkably, the majority of Australians have no understanding of the graduated progressive income.[23]

Table 1: Ignorance of the tax system

Response	Respondents (%)
A bigger proportion of their earnings	30.3
The same proportion	7.9
A smaller proportion	43.4
Don't know	18.4

Source: Australian Election Survey 2004.[24]

G.20. Obviously, a person on a low income will pay less total money in income tax than someone on a high income. But do you think that a person on a low income pays:

(1) A bigger proportion of their earnings in income tax than someone on a high income;
(2) The same proportion;
(3) A smaller proportion of their earnings in income tax; or
(4) Don't know.

Voters' level of knowledge or ignorance did not appear to dictate their attitudes towards the tax-cut/welfare-cut trade-off. Nor did it dictate whether they thought tax policy was important at the 2004 election. People who thought low-income earners pay more in income tax, however, were more likely to identify with Labor,[25] more likely to think taxes had risen a lot since 2001, and more likely to strongly favour spending on social services. They tended to describe themselves as 'working class,' and had lower incomes.

Of course, the whole notion of fiscal illusion relies, to some extent, on voters being rationally ignorant.[26] This does not mean, however, that voters make irrational choices. Arthur Lupia and Mathew McCubbins have explained how 'the democratic dilemma' is resolved so that rationally ignorant voters do make rational decisions.[27] This suggests a limit to Leviathan's ability to engage in activities that create fiscal illusion. Leviathan needs to continually reinforce the arguments and perceptions that sustain the illusion. Some voters will seek out and publicise objective information that contradicts it, and this in turn will raise the costs of maintaining it. Sustaining the illusion incurs information costs, search costs, and communication costs. These are not trivial—while information about taxation is readily available, the communication costs are very high.

It is not just voters who can be rationally ignorant. Mike Moore, the former prime minister of New Zealand, made a remarkable confession in the *Australian Financial Review*: he had been advised, apparently repeatedly, to leave New Zealand as a tax refugee:[28]

> I once talked to some senior NZ politicians about this and their eyes glazed over, as mine did when I was in politics, thinking, 'stop complaining, you must be earning it to pay [the top tax rate].'

Tax system complexity

Having a complex tax system is the first step towards fiscal illusion. The complexity of the Australian tax code is such that, in 2005, it totalled an estimated 8,800 pages.[29] In 2006, the federal government announced that it hoped to eliminate 2,135 pages of 'inoperable' material from the *Income Tax Act*. The Act was 126 pages long in 1936 and 3,500 pages by 1996. [30] Since 1996, the tax code has more than doubled in size. Chairman of the Productivity Commission Gary Banks estimates that at that rate of growth:

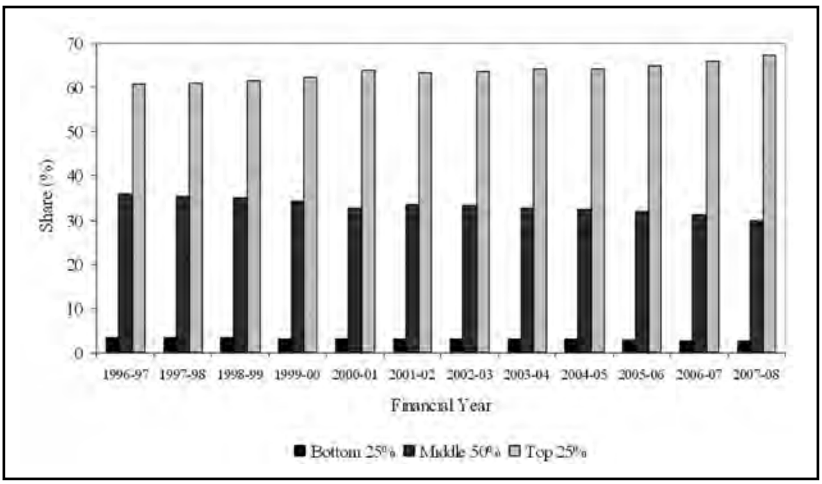
> By the end of this century the paper version of the Tax Act would amount to 830 million pages. It would take over 3 million years of continuous reading to assimilate and weigh the equivalent of around 20 aircraft carriers.[31]

Adam Smith's second maxim of taxation is that tax 'ought to be certain, and not arbitrary.'[32] Smith took the view that certainty is an important consideration; in fact, 'a very considerable degree of inequality … is not near so great an evil as a very small degree of uncertainty.' In Smith's view, uncertainty of taxation 'encourages the insolence and favours the corruption of an order of men [tax collectors] who are naturally unpopular, even where they are neither insolent nor corrupt.' Not only should taxation be certain for the individual taxpayer, it should be certain for all observers too. In other words, we should all be aware of how much tax we pay, and how much tax others pay. One of the problems of the Australian tax system is that there is a lack of trust in it—many people seem to take the view that everybody else is not paying their 'fair share' of tax.

The notion that some people are not paying their 'fair share' of income tax is, of course, entirely true. Figure 1 shows the relative net income tax shares of the bottom 25%, the middle 50%, and the top 25% of taxpayers.

As can be seen, the net income tax share of the top 25% of taxpayers has increased from 60.8% in 1996–97 to 67.4% in 2007–08. At the

Figure 1: Who pays personal income tax?



Source: Derived from ATO tax statistics.

same time, the net income tax share of the bottom 25% has fallen from 3.4% to 2.5%, while the net income tax share of the middle 50% has fallen from 36% to 29.8%. According to the 2004 Australian Election Survey, 57.8% of respondents thought that the personal tax rate had increased between the 2001 and 2004 elections. This figure had fallen to 41.7% by the 2007 election. Where income tax is concerned, the statement that personal taxes had increased was only true for the top 25% of taxpayers—even then, the tax rate had not increased, merely the tax paid as a share of total income tax paid.

The company tax burden is even more unevenly distributed. Table 2 shows the proportion of firms with a tax liability of greater than $1 million and the proportion of net corporate tax those firms pay. In 2007–08, 0.53% of firms paid 76.26% of all net corporate income tax. There is a lot of cynicism surrounding company tax, with some individuals claiming that large companies avoid paying their 'fair share' of tax. Yet that is not the case: smaller companies tend to pay less corporate tax, while larger companies shoulder (almost) the entire burden.

Table 2: Who pays net corporate income tax?

	Proportion of firms (%)	Proportion of net corporate tax paid (%)
1996–97	0.30	64.45
1997–98	0.32	67.45
1998–99	0.34	65.95
1999–00	0.38	66.87
2000–01	0.33	70.99
2001–02	0.35	69.79
2002–03	0.37	70.54
2003–04	0.39	70.20
2004–05	0.38	72.59
2005–6	0.44	75.60
2006–07	0.52	77.80
2007–08	0.53	76.26

Source: Derived from ATO tax statistics.

The curious case of Australia

Australia has a big government and it relies on fiscal illusion, much as many other economies. There was, however, a curious anomaly when the Howard government reduced the use of some forms of fiscal illusion while increasing others. For example, it eliminated federal public net debt and replaced the highly complex wholesale sales tax with the much less complex and more transparent Goods and Services Tax (GST). It also attempted to eliminate or reduce many state taxes, levies and charges that create fiscal illusion.

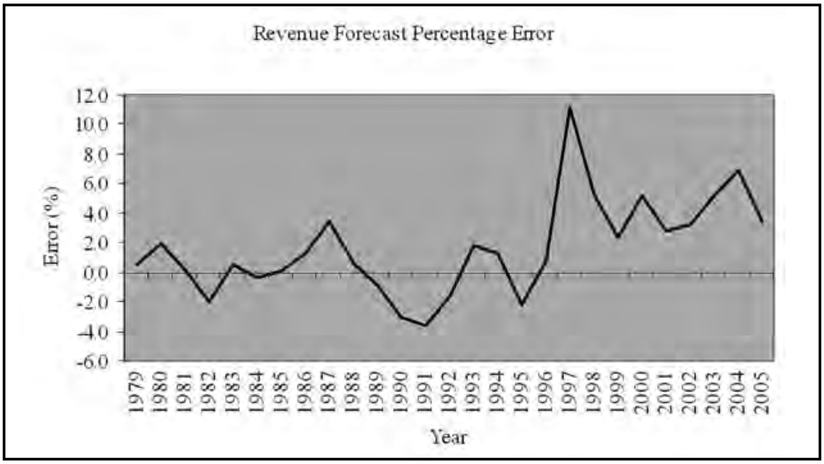
Yet the same government employed opportunistic taxation with gusto, refused to cut spending, and ran a budget surplus. In contrast to Ronald Reagan's argument that government will always spend all the money it can, the Howard government was strongly committed to running a surplus and did *not* spend all it could. It also did not reduce taxes as much as it could have; instead, it established the Future Fund and the Higher Education Endowment Fund to 'park' budget surpluses.[33] There was, however, no suggestion that these funds would reduce future tax burdens. Rather, they were created to subsidise future government spending. Most of the economic literature in this area predicts that Leviathan will grow as much as it can and will likely run budget deficits. The public choice literature on budget surpluses is under-developed. That same literature suggests that budget surpluses occur when rent-seekers reduce their lobbying behaviour.[34] It is not clear that this argument is appropriate in the Australian environment.

In his 2007 Budget speech, then-Treasurer Peter Costello made the following comment:[35]

> Our tax system exists to fund the decent services in health, education, aged care, and other services that Australians legitimately expect and are entitled to receive. If after we provide for those services, invest for the future, and balance our Budget, we can reduce the tax burden, we should do so.

Costello often made this or similar comments, and they seem to express a sensible and responsible fiscal policy. Robert Carling has described the Howard government's fiscal strategy as keeping the budget in balance, on average, and the forward estimates in surplus.[36] As Costello's comment indicates, cutting taxes followed from the primary strategy. Alex Robson has argued that an important part of the Australian fiscal illusion is 'unexpected' revenue.[37] Australians have come to expect that budget surpluses will always turn out to be larger than initial estimates. Figure 2 calculates the revenue forecast error as a proportion of the original budget estimate of government revenue.

Figure 2: How big is the budget surplus?



Source: Commonwealth budget papers, relevant issues.

An unbiased forecast should, on average, be correct. Unexpected events always confound forecasts, but over time these errors should be random and not reveal a pattern. In the 10 years to 2007, however, the forecast errors were large and positive. Robson argues that this was all part of a deliberate strategy to avoid tax cuts.[38] Former Secretary of the Australian Treasury John Stone has been scathing in his comments, referring to the forecast errors as a 'persistently woeful record' that 'can no longer be regarded as just bad luck.'[39] It seems that the Howard government deliberately ran larger surpluses than it announced each year. This strategy was facilitated by the Treasury underestimating government revenue. Yet the government did not spend all the money raised, nor did it cut taxes as much as it could have. Stone argues that had the government used the 'unexpected' surpluses to cut tax, the top marginal personal income tax rate could have been cut to 30% and the capital gains tax could have been abolished.[40]

While the Howard government ran budget surpluses, the Rudd-Gillard government was never able to achieve a budget surplus. Although the global financial crisis played a major part in that failure, government rhetoric was committed to returning the budget to surplus as quickly as possible.

Policy responses to fiscal illusion

The Inspector-General of Taxation (IGT) acts as an advisor to the federal government in the interests of taxpayers. This high-level position was created after a 2001 election campaign promise. The IGT can recommend improvements to the tax system but cannot review tax policy. The IGT has already expressed concern about the complexity and administration of Australia's tax laws.[41] Providing information that counters the effects of fiscal illusion would be within the IGT remit. A lot of information is placed in the public domain by the Australian Bureau of Statistics (ABS), the ATO, and the Commonwealth Treasury. A single, authoritative report into tax system complexity would substantially reduce fiscal illusion. In other words, part of the IGT's work should be to prepare a comprehensive strategy for taxpayer fiscal education.

The Charter of Budget Honesty requires the Treasurer to produce an economic and fiscal outlook report at each budget.[42] The charter is very prescriptive about what the report should include, and even sets out the principles of 'sound fiscal management.' These are, among other things, to 'pursue spending and taxing policies that are consistent with a reasonable degree of stability and predictability in the level of the tax burden.' There is nothing unusual about anything in the charter and it seems quite reasonable. What is missing is any requirement that the information in the report be accurate. In other words, there is no requirement that the budget itself be 'honest.' This is a major oversight. It is possible, but unlikely, that bad luck has confounded revenue estimation since the Howard government was elected. Stock market analysts with such a poor record of forecast accuracy would attract the attention of financial market regulators. It is clear that the Treasury revenue forecasting process needs to be audited, and quality control processes need to be adopted, but it is not clear who would undertake such an audit.

In addressing the issue of earmarked taxes, Carling argues that while taxpayers may choose to accept earmarked taxes, they should also have access to transparent information.[43] Each year, governments levying hypothecated/earmarked taxes should have to report and publicise the number of such levies, the revenue raised by those levies, and the total expenditure they support (for example, they should publicise that the Medicare levy only raises about 25% of the cost of Medicare).

Conclusion

Fiscal illusion sustains growth in government revenue and spending. The tax system is complex and unfair, with a small proportion of individuals and an even smaller proportion of companies paying the lion's share of both personal net income tax and net company tax. The federal government has done very little to reform and simplify the income tax system. At the same time, the federal government has undertaken steps to reduce fiscal illusion by reducing public debt and simplifying indirect taxes.

The Australian Leviathan is thriving, yet it is also attracting some criticism. Its arguments against reducing taxation are getting shriller each year. It is clearly becoming harder for government to find areas where it can spend money effectively. Rather than returning surplus funds to taxpayers, government is choosing to invest in equity portfolios on the stock market through special purpose funds. There are limits to how far this strategy can go.

Endnotes

1 James M. Buchanan, *Socialism is Dead but Leviathan Lives On*, Occasional Paper 30 (Sydney: The Centre for Independent Studies, 1990). Reproduced in *The Collected Works of James M. Buchanan*, Vol. 1 (Indianapolis: Liberty Fund, 1999).

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4 See Murray Rothbard, 'The Myth of Neutral Taxation,' *The Cato Journal* 1 (1981), 519–564.

5 Poll taxes and land taxes are said not to distort economic decision-making. This may well be true in a textbook setting, but introducing poll taxes has proven to be political suicide.

6 George Stigler, 'Smith's Travels on the Ship of State,' in *The Economist As Preacher, and Other Essays* (Chicago: University of Chicago Press, 1971), 142.

7 Joel Slemrod, 'My Beautiful Tax Reform,' in Alan Auerbach and Kevin Hassett (eds.), *Toward Fundamental Tax Reform* (Washington, DC: AEI Press, 2005), 138.

8 For an accessible review of the large literature in this area, see Joel Slemrod, 'The Consequences of Taxation,' in Ellen Paul, Fred Miller, and Jeffrey Paul (eds.), *Taxation, Economic Prosperity, and Distributive Justice* (Cambridge: Cambridge University Press, 2006).

9 As above.

10 In other words, elasticity corresponds to the turning point of the (Australian) Laffer Curve. See Sinclair Davidson, *Are There Any Good Arguments* for a discussion of the Laffer Curve and evidence supporting this theory. The turning point is calculated as $(1 - t)/t$, where t is the top marginal income tax rate in Australia (45%, excluding the Medicare levy). Also see Joel Slemrod, 'My Beautiful Tax Reform,' as above, 79.

11 Jonathan Gruber and Emmanuel Saez, 'The Elasticity of Taxable Income: Evidence and Implications,' *Journal of Public Economics* 84 (2002), 1–32, especially Table 1, 5.

12 Geoffrey Brennan and James M. Buchanan, *The Power to Tax: Analytical Foundations of a Fiscal Constitution*, in *The Collected Works of James M. Buchanan*, Vol. 2 (Indianapolis: Liberty Fund, 1999), 44–45.

13 There is, however, an exception to the rule. When governments are trying to collect revenue, they want to minimise the tax response, but when engaging in social engineering, they might want to maximise the response.

14 Joel Slemrod, 'My Beautiful Tax Reform,' as above, 87.

15 James M. Buchanan summarises Puviani in his 1967 book *Public Finance in Democratic Process*, in *The Collected Works of James M. Buchanan*, Vol. 4 (Liberty Fund: Indianapolis, 1999).

16 James M. Buchanan, 'Tax Reform as Political Choice,' in *Debt and Taxes*, in *The Collected Works of James M. Buchanan*, Vol. 14 (Liberty Fund: Indianapolis, 2001).

17 As above, 52.

18 See Robert Carling, *Tax Earmarking: Is it Good Practice?* Policy Monograph 75 (Sydney: The Centre for Independent Studies, 2007) for a discussion of tax hypothecation.

19 Andrew Norton, *Will You Still Vote for Me in the Morning? Why Politicians Aren't Rushing to Increase Taxes*, Policy Monograph 65 (Sydney: The Centre for Independent Studies, 2004).

20 The AES data (2004–05) is available from the Australian Social Science Data Archive. Those who carried out the original collection and analysis of the data bear no responsibility for my analysis and interpretation.

21 Unfortunately, the 2007 Australian Election Survey did not repeat the question.

22 Some within the revenue lobby do argue that the Australian tax system is proportional. This is incorrect: in Australia, income tax and the total tax burden are progressive. See Sinclair Davidson, 'Taxation with Misrepresentation: Australia's Revenue Lobby in Denial,' *Policy* 20:4 (Summer 2004–05), 31–37.

23 It is possible that some respondents were confused by the interaction of the tax system and the welfare system. Low-income earners do face high effective marginal tax rates.

24 AES data (2004–05), as above.

25 The converse was true too. Nearly 56% of voters favouring the Coalition on tax policy knew low-income earners pay a lower proportion of their income in income tax.

26 For a full discussion, see Roger D. Congleton, 'Rational Ignorance, Rational Voter Expectations, and Public Policy: A Discrete Informational Foundation for Fiscal Illusion,' *Public Choice* 107 (2001), 35–64.

27 Arthur Lupia and Mathew McCubbins, *The Democratic Dilemma: Can Citizens Learn What They Need to Know?* (Cambridge: Cambridge University Press, 1998). Bryan Caplan argues that four sources of voter bias lead to poor policy preferences. Bryan Caplan, *The Myth of the Rational Voter: Why Democracies Choose Bad Policies* (Princeton University Press, 2007).

28 Mike Moore, 'This cup does not runneth over,' *The Australian Financial Review* (24 May 2007), 63.

29 Fleur Anderson and Duncan Hughes, 'Costello overhauls tax laws,' *The Australian Financial Review* (25 November 2005), 1.

30 *The Australian*, 'Tinkering at the edges' (25 November 2005), 1.

31 Quoted in Fiona Buffini, 'Getting rid of clutter not easy in a minefield,' *The Australian Financial Review* (25 November 2005), 53.

32 Adam Smith had four maxims of taxation. See Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776; repr. Chicago: University of Chicago Press, 1976), 350–352.

33 See Stephen Kirchner, 'Future Fund or Future Eater: The Opportunity Cost of Commonwealth Revenue Hoarding,' *Policy* 22:3 (Spring 2006), 28–31.

34 Russell S. Sobel, 'Can Public Choice Theory Explain the U.S. Budget Surpluses of the 1990s?' *Journal of Public Finance and Public Choice* 23 (2004), 169–181.

35 Peter Costello, 'Budget Speech 2007–08' (8 May 2007).

36 Robert Carling, 'Put budget surplus to good use,' *The Australian Financial Review* (17 September 2007), 71.

37 Alex Robson, personal communication.

38 Alex Robson, 'Peanuts via Costello makes us all proper Charlies,' *The Canberra Times* (5 September 2007), 11.

39 John Stone, 'Mr Costello's Repeated Budget Failure,' *National Observer* 73 (Winter 2007), 13–24.

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41 John Garnaut, 'Tax watchdog has million-step plan to fix the system,' *The Sydney Morning Herald* (10 February 2004).

42 Commonwealth of Australia, *Charter of Budget Honesty Act 1998*, http://scaleplus.law.gov.au/html/pasteact/2/3115/top.htm.

43 Robert Carling, *Tax Earmarking*, as above.

Chapter 8

Tax Earmarking—Is It Good Practice?

Robert Carling

Earmarked taxes are an exception to the rule that governments rely mainly on general tax revenue to finance their expenditures. But Australian governments are using earmarking more. The Medicare levy on personal income tax has existed for many years, but more recently it has been joined by the gun buy-back levy, the Ansett levy, and the sugar levy, among others. These are all federal imposts, but state and local governments are also active in this field, with fire service levies on property or insurance premiums and 'environment' and 'infrastructure' levies on council rates, among others. It is quite possible that governments at all levels will venture further in this direction in the future, particularly if their budgets get tighter.

Although such taxes still represent a small proportion of total tax revenue, their expansion represents a new trend in Australian tax policy. Should we welcome this trend? Is it likely to lead to a higher or lower overall tax burden? Will it lead to an allocation of government resources that better reflects what the public wants? Will it forge a stronger link between spending and taxing decisions? Or is it just that governments have found a clever new way to increase the tax burden with less taxpayer complaint?

What is earmarking?

Tax earmarking—or what is sometimes called 'hypothecation'—means different things to different people. In its purest form it means that all revenue from a particular tax is kept separate from general revenue, it can only be used for a specific government expenditure program, and it fully funds that program.

Another version of pure earmarking sets aside a fixed portion of a particular tax for a specific expenditure program and fully funds that program. For example, 'x' percentage points of personal income tax could be earmarked to fully fund defence expenditure.

Pure earmarking imposes hard budget constraints on government because the earmarked revenue determines expenditure on the chosen program, which may be higher or lower than the government would determine under general funding. This constraint is less meaningful, however, to the extent that the earmarked tax can be easily adjusted to satisfy an expenditure target.

In a softer version of earmarking, the earmarked tax would fund only part of a specific expenditure program, with the remainder being funded from general revenue. This represents a major departure from pure earmarking because segregating the earmarked tax is meaningless when the revenue is mingled with general revenue to fund a program. As the allocation of general funding to the program is elastic at the discretion of government, the earmarked tax represents neither a floor nor a ceiling on the size of the program, and earmarking tells taxpayers nothing about the cost of the program being funded.

A variant of the soft approach to earmarking involves an entirely new tax or an increase in an existing tax being used to fund the expansion of an existing expenditure program.[1]

The soft forms of earmarking do not impose meaningful budget constraints. They run into the reality that money is fungible; a dollar allocated to a spending program from an earmarked tax is indistinguishable from a dollar allocated from general revenue.

The variations in the form of earmarking are not mere semantics. When it comes to finding a rigorous case for earmarking, it is easier to do so for pure earmarking than for the softer versions, which are more political opportunism than sound fiscal policy. In practice, most earmarking is of the soft kind.

Earmarking is sometimes thought of as being associated with fundamental changes in the way tax and spending are determined in the democratic system, such as subjecting each earmarked tax and its associated expenditure to a referendum. Earmarked taxes are sometimes introduced to meet a temporary expenditure, and therefore subject to a sunset clause. These are, however, variations on the basic idea rather than defining characteristics of earmarking.

In practice, earmarked taxes have often been called 'levies' or 'charges,' but these are just other names for what the Australian Bureau of Statistics (ABS) classifies as taxes under the internationally accepted methodology. (In some cases, the 'levy' label has been used to avoid the political opprobrium associated with a new or increased 'tax.')

Why earmark at all?

Tax earmarking in its pure form, with the revenue segregated for a specific purpose and determining the amount of expenditure on that purpose, is unpopular with governments because it imposes rigidities on their budgets. Earmarking favours particular categories of expenditure by giving them monopoly access to specific revenue sources and makes it more difficult to reallocate resources at the discretion of the executive. If revenue determines expenditure, then budgeting for deficits or surpluses is also more difficult. Opponents of earmarking also question why the level of expenditure on a particular program should be determined by the amount of revenue that the earmarked tax happens to yield each year, rather than by an evaluation of the benefits and costs of the program relative to all other programs that the government spends on.

But earmarking has supporters among ‘smaller government’ advocates because they believe that the link between specific taxes and specific expenditure programs drives home to taxpayers the true cost of the programs they are paying for and leads to more informed fiscal choices through the democratic process. On this view, earmarking helps overcome the problem of inconsistent voter demands for more public services and less taxation. The ‘smaller government’ advocates believe that earmarking would reconcile these inconsistencies in the direction of lower taxes. They also believe that through earmarking, the composition of government expenditure will more closely reflect taxpayer preferences. In short, advocates of smaller government—or at least some of them—see earmarking as a way of controlling the Leviathan.

Curiously, earmarking also enjoys support among those who favour *more* government expenditure. On this view, earmarking will lead to a higher overall level of taxation by exploiting what higher taxing groups believe to be the public’s willingness to pay more in taxes for the government programs they favour. The argument is that, if there was an identifiable tax for education, another one for health, another for law and order, another for roads, and so on, taxpayers would support a higher overall level of tax than if these programs were funded from general revenue and the link between taxes paid and benefits received was more obscure.

Some advocates of earmarking believe it will lead to a better allocation of resources without considering whether that will entail smaller or bigger government.

Clearly, each of these opinions cannot be right at the same time.

The benefit principle of taxation

The practice of tax earmarking has gained some support from the benefit principle of taxation. Early writers on tax attempted to develop principles to guide the appropriate design of tax systems. One of the results of this work was the benefit principle:

> [P]eople should contribute to taxation according to the benefits they receive from government expenditure.[2]

The benefit principle emphasises efficient resource allocation and the establishment of a tight link between expenditure and revenue decisions in budget preparation. In some interpretations, it has been stretched to provide a basis for taxation based on 'capacity to pay' as well.[3] It is said, for example, that the better off stand to benefit more from the defence of the realm, containment of crime, and so on. However, this extension of the benefit principle seems capable of justifying almost any tax policy depending on the policymaker's value judgments. If the benefit principle is to be relevant, it would be as a principle that does *not* require making value judgments in the process of formulating tax policy.[4]

Tax earmarking is a logical application of the benefit principle. For it to work in practice, however, all the costs of a particular expenditure program should be fully funded, no more nor less, by the earmarked tax. If not, then taxpayers do not receive the correct 'price' signal to guide them to democratic choices consistent with efficient resource allocation. In practice, the benefit principle can be applied only in limited situations because:

- Unlike in Adam Smith's time, many of today's government programs have a social security or welfare purpose and it makes no sense to 'charge' the beneficiaries of these programs through the tax system.
- Even when the beneficiaries of a program are an identifiable sub-group of the population and it is appropriate on resource allocation grounds to charge them through the tax system, it is difficult in practice to determine the extent of the benefits, which may exceed or fall short of the financial costs of the program.
- It may be difficult to find a tax instrument that targets the beneficiary group.
- The 'capacity to pay' principle of taxation also has a place in the design of the tax system, but may well lead to different conclusions from the benefit principle.

For these reasons, the situations in which the benefit principle provides a clear case for tax earmarking are relatively few. The benefit principle is essentially a 'user pays' approach to taxation. User pays taxation has a place in the tax system where the beneficiary group can be clearly defined, the benefits can be well measured, an appropriately targeted tax instrument can be found, and the expenditure program is not intended to be redistributive. But given the restrictions on its suitability, it is unlikely to be at the core of the system.

Theories of fiscal choice

Public finance theorists have long grappled with the problem of explaining in abstract terms how government budgets are determined in a democratic system, given that the process is as much political as economic. This work has led to the development of theories of fiscal choice, which may be broadly described as 'voluntary exchange' and 'voting' models of budget determination. These approaches attempt to model how both the spending and revenue sides of the budget are determined and reconciled.

Voluntary exchange models do so by applying the price mechanism to public finance and viewing taxation as the price of public goods and services. Voting models analyse the determination of taxation and government expenditure in terms of individual participation through a democratic political process. These are different approaches, but they both attempt to explain how individual preferences for public goods and willingness to pay through taxation are aggregated, reconciled and expressed through the democratic political process—ultimately producing a budget.

Earmarked taxes are not an essential feature of these models but are included in them because of the link that earmarking establishes between the expenditure and revenue sides of the budget. Individuals may make more informed, rational choices if earmarking enables them to see this link more clearly.

James Buchanan has explored the implications of earmarking versus general financing within a voting model of fiscal choice.[5] The tentative conclusion from Buchanan's analysis is that institutional structures that favour general financing 'produce somewhat larger public expenditures in total.' At the risk of oversimplifying Buchanan's analysis, general financing tends to produce larger public expenditures because taxpayers will be willing to pay (vote for) a higher overall level of taxation to make sure policymakers allocate enough to the programs they value most highly. In other words, they are willing to pay more to make sure they get what they want (such as 'free' public hospitals) even if that means also getting what they don't value. Under general financing, they have to accept the 'bad' with the 'good' because policymakers determine the allocation. Under this system, it is easier for the minority (the vocal and politically active beneficiaries of narrowly targeted spending programs) to foist the cost of those programs onto others. Under a regime of earmarked taxes, taxpayers would vote down the taxes for what they don't want and vote up the taxes for what they want, resulting in lower overall taxation.

This is a powerful and attractive conclusion for the advocates of smaller government, but Buchanan notes that it requires 'a fiscal system characterised by substantially complete revenue segregation.' In other words, it doesn't hold where earmarking and general financing are mixed together. Indeed, that is likely to be the worst of both worlds, particularly if the earmarked taxes are used to finance the more widely popular expenditure programs and the general taxes finance everything else. Buchanan also qualifies his conclusions by noting that higher transaction costs under an earmarking regime could offset if not negate its superiority over general funding. Buchanan does *not* explicitly comment on the difference between 'hard' and 'soft' earmarking, but he surely had the hard form in mind, otherwise earmarking would fail to inform taxpayers of the true financial cost of particular programs.

Buchanan's analysis was based on a simple model containing two public goods—fire protection services and law enforcement—that benefit the broader population. While simplification does not necessarily invalidate the conclusions of economic models, in this case the relevance of the model to more welfare-oriented spending programs is open to question. By definition such programs are (or ought to be) narrowly targeted, but in this form they would be constrained by being tied to a tax that, also by definition, would have to be paid by someone other than the beneficiaries.

Modern criteria of tax design: efficiency, equity, simplicity

Tax design nowadays, at least in principle, is guided by the criteria of efficiency, equity and simplicity. These, at least, are the criteria that policymakers claim to apply, although in practice tax policy often fails to live up to them. While the modern approach contains elements of the benefit principle (allocative efficiency) and the capacity to pay principle (equity), it recognises that there are trade-offs among the criteria. It is a framework for analysis of taxation rather than an all-embracing theory.

This framework has led to an emphasis on broad-based taxes such as value-added (goods and services) tax, income tax, and property tax levied at low rates with a minimum of exemptions and concessions. (That, at least, is the theory; the practice is often quite different.) The objective of this approach is to minimise economic efficiency costs and maximise simplicity subject to equity considerations, which are taken into account through the setting of thresholds, design of rate structures, and so on.

The emphasis on broad-based taxation does not rule out more narrowly based taxes, but broad-based taxes are certainly expected to do most of the revenue-raising work in the modern system. In this scheme, narrowly based taxes are justified on allocative efficiency grounds and can include selective excises and user-pays type taxes.

This conventional approach to tax design has tended to confine tax earmarking to the peripheries of the tax system. Broad-based taxes generate too much revenue to be earmarked for a single expenditure program, even when defined broadly such as 'health,' 'education' and 'defence.'[6] There is, of course, no reason why a portion of a broad-based tax cannot not be earmarked for a particular program, although in practice such partial earmarking has been rare. It is more common for earmarking, where it exists, to be based on narrower taxes. To the extent that widespread earmarking required a plethora of smaller taxes, this would be fundamentally at odds with the broad-based approach. Fragmentation of the tax system would serve neither the economic efficiency nor simplicity objectives. The conventional dismissal of pure tax earmarking is, of course, reinforced by the executive's repugnance of the resulting budgetary rigidities, but the executive has been more willing to embrace soft earmarking where it suits its purpose.

Summary: Is there a role for tax earmarking?

There is a good case for earmarking on allocative efficiency grounds where the tax acts like a user charge, provided:

- the tax fully funds the service being delivered, or does so in conjunction with another price mechanism (that is, the service is only part tax-funded), and does not over-fund it (that is, generate a contribution to general revenue as well), and
- the tax is paid by the beneficiaries of the service.

If used in this way, earmarking would have a useful but peripheral role in government budgets. In the instances where it could be applied in this way, the service may be privatised anyway.

There is an in-principle wider role for earmarking in programs such as defence, law and order, education, and health, with the benefit of the size and composition of government expenditure being more in line with taxpayer preferences. However, the conditions for it to work on this broader scale are restrictive:

- The earmarking should be of the 'hard' form, with the tax fully funding the expenditure program, no more nor less.
- The coverage of earmarking would need to satisfy Buchanan's requirement of 'a fiscal system characterised by substantially complete revenue segregation.' In other words, governments should not 'cherry-pick' the most widely popular expenditure programs for earmarked financing and leave everything else to general funding.
- Sufficient suitable tax instruments would need to be available or broadly based taxes broken into earmarked components. The taxes should be ones that voter-taxpayers actually pay and not ones where the legal incidence falls on others only to be shifted (such as company income tax and the state payroll tax).
- Some way must be found to protect each expenditure program from the cyclical nature of earmarked taxes such as income tax. This would mean under-spending the tax proceeds in boom years and over-spending it in lean years. Under-spending would be politically difficult to sustain when the tax is understood by the public to be exclusively for the stated purpose, while over-spending represents a step towards undesirable 'soft' earmarking.
- It would have to be accepted that redistributive expenditure programs (targeted transfer payments to individuals) may well come under pressure to shrink because those paying the earmarked tax would be a different and broader sub-set of the population than those benefiting from the programs.
- Ideally, voters would have an opportunity to vote separately in referenda on each earmarked tax and its associated expenditure.
- In the Australian context there is another complication: the joint federal-state financing of areas such as health and education. Because some public expenditure on these programs is funded federally and some by the states, neither level of government can be held accountable (through an earmarked tax) for the totality of spending in those areas.

Pure earmarking requires a suitable constitutional basis. The Australian Constitution requires that all revenues be paid into a single consolidated revenue fund,[7] which is inconsistent with revenue segregation. Earmarking could still be applied by appropriating the proceeds of an earmarked tax from the consolidated fund for the specified purpose of the tax, but this approach rests on policy decisions of government rather than any constitutional principle.

These are serious obstacles to the proper use of earmarking on a wide scale. So what is wrong with soft earmarking—such as applying it selectively and mixing 'earmarked' and general revenue to fund particular programs? There are fundamental problems with soft earmarking:

- If the earmarked tax funds a program only partly, it deludes taxpayers as to the true cost of what they are paying for. The classic example of this in Australia is the Medicare levy, which funds only around one-quarter of the cost of Medicare.[8] Earmarking is supposed to strengthen the link between expenditure and revenue decisions and make them more consistent. Part-funding through earmarking goes in the opposite direction.
- 'Cherry-picking' the most widely popular public programs for earmarking while leaving the bulk of the programs to be funded from general revenue creates a bigger public sector. It panders to the public popularity of the earmarked services and the public's willingness to pay for them, while leaving unpopular programs in place and funded from general revenue. 'Cherry-picking' is a form of public sector self-promotion aimed at making government bigger.
- Increasing a tax or introducing a new tax and earmarking it to pay for the expansion of an existing program or for a new program are ways for government to avoid the hard work involved in looking for savings in other expenditure programs to make way for the new. Incrementalism is much easier than the hard work of reordering priorities.
- Earmarking is meaningless when earmarked funds are mixed with general funds because it neither constrains expenditure on the intended purpose nor puts a floor under it. The general funding component is elastic up or down at the discretion of government, which is why soft earmarking deludes rather than informs voters.

Table 1: Earmarked taxes and levies in Australia

Title of tax/levy	Level of government	Start date	Description and purpose	Comments
Medicare levy	Commonwealth	1984	Levy of 1.5% on personal taxable income to help fund Medicare. Originally 1%.	Funds only about 25% of the cost of Medicare.
Gun buy-back levy	Commonwealth	1996	Additional 0.2% on Medicare levy for one year to fund buy-back of guns from the public.	Temporary (in place for one year).
Aviation fuel excise	Commonwealth	1995	Aviation fuel excise is set at a level to cover costs of air services.	Revenue aims to fully fund the cost. User-pays type tax.
Passenger movement charge	Commonwealth	1978	Originally the departure tax. Levied on international passenger departures to fund border protection costs.	User-pays type, but over-funds the activity.
Aircraft noise levy	Commonwealth	1995	Fixed levy on air tickets through Sydney and Adelaide to fund sound-proofing of homes under flight paths.	Payers are the beneficiaries of conveniently located airports. Levy is temporary.
Ansett ticket levy	Commonwealth	2001	Levy of $10 on air tickets to guarantee employee entitlements following failure of Ansett.	Ended in 2003. Levy over-funded the activity. Payers were not beneficiaries.
Wool tax	Commonwealth	1964	Tax on wool growers to fund wool research and promotion.	Tax is set by ballot of wool growers. Currently 4%.

Title of tax/levy	Level of government	Start date	Description and purpose	Comments
Milk levy	Commonwealth	2000	Levy of 11 cents per litre on milk to fund dairy industry adjustment to deregulation.	Ended in 2010. Payers are not the beneficiaries.
Sugar levy	Commonwealth	2003	Levy of 3 cents per kg on sugar sales to fund sugar industry restructuring.	Ended in 2008. Payers are not the beneficiaries.
Fire services levies	State	Various	Levies on insurance (NSW, VIC & TAS) or property (others except NT) to fund fire brigades.	Payers are beneficiaries, but property is the better base. Only partly funds the fire services.
Parking space levies	State	NSW 1992 VIC 2006	Fixed levies on commercial parking spaces in inner city areas to combat congestion and help fund public transport initiatives.	An imprecise congestion tax. Revenue is a small contribution to public transport.
Health insurance levies	State	NSW 1983 ACT 1999	Fixed levies on private health insurance premiums to fund members' usage of ambulances.	Payers are only a sub-set of the beneficiary population.
Insurance Protection Tax	NSW	2003	Tax on insurance companies to fund NSW government costs in HIH collapse and to establish a fund for future similar events.	Similar to deposit insurance paid by banks in some countries.
Health Benefits funds Levy	VIC	2003	Levy on gaming machines.	Revenue of $130 million partly finances public hospitals.

Title of tax/levy	Level of government	Start date	Description and purpose	Comments
Community Ambulance Cover levy	QLD	2003	Fixed $ levy on electricity bills to help fund ambulance service.	All revenue to ambulance service, but only part funds the services.
Metropolitan Regional Improvements Tax	WA		Levy on Perth land other than owner-occupied housing to fund acquisition of land for regional purposes.	
Save the River Murray levy	SA	2003	Levy on SA Water customers water bills to fund SA government Murray River restoration costs.	User-pays to the extent that SA Water customers rely on Murray River water.
Environment and infrastructure levies	NSW local government	Various	Rate increases to fund environment and infrastructure works.	Only partly funds councils' environment and infrastructure works.

Earmarking in Australia

Some details of earmarked taxes imposed at the three levels of Australian government are set out in Table 1. No doubt the list is incomplete, but it includes the best known examples.

The Medicare levy was introduced in 1984 at a rate of 1%. It has since been increased three times to its current level of 1.5%; those with taxable incomes above a certain level and who choose not to have private health insurance are now charged an additional 1%. The levy applies from the first dollar of income (that is, there is no tax-free threshold), although low-income earners are exempt. Significantly, the increase in the Medicare levy rate since its introduction is the only increase in statutory personal income tax rates since the 1970s. The levy raised $8 billion in 2009–10 but covered only around 25% of the cost of Medicare (which includes the medical benefits scheme (MBS), the Pharmaceutical Benefits Scheme (PBS), and Commonwealth grants to the states for public hospitals).

The gun buy-back levy of 0.2% was superimposed on the Medicare levy for one year (1996–97) to cover the cost of the gun buy-back offer in the wake of the Port Arthur massacre. It was introduced in the context of the new government's drive to slash the budget deficit and its 'no new taxes' election pledge. The popularity of the buy-back made it easier for the government to cherry-pick this program for a tax increase. Arguably in easier budget conditions, the gun buy-back would have been funded without a levy.

In 1978, the Commonwealth introduced the international departure tax, the first of a stream of imposts on air travellers. It has since been converted to the Passenger Movement Charge (PMC), with the stated purpose of recovering the cost of border control (immigration control, customs, quarantine, and so on). In fact, the charge has over-recovered these costs and contributed to general revenue.[9] The PMC was followed by the aircraft noise levy in 1995 to fund the sound-proofing of homes near the Sydney and Adelaide airports. The noise levy has a 'beneficiary pays' justification and is being phased out as the work is completed. The Ansett levy (2001–03) was intended to fund the Commonwealth's commitment to guarantee selected employee entitlements following the failure of Ansett. Leaving aside whether this was an appropriate use of taxpayer money, the levy had no basis in tax principles and in fact raised more than the government needed for the stated purpose.

The Commonwealth sets aviation fuel excise at a level to fully fund the cost of air navigation services to airlines. The excise is adjusted each year to meet this target. This tax is a form of pure earmarking and can be justified as a 'user pays' tax.

Among a range of agricultural levies, the wool tax has existed since 1964 to fund wool industry research and promotion. It is a classic earmarked tax of the 'beneficiary pays' kind. The same cannot be said of the more recent milk and sugar levies, which were imposed for a finite period and intended to finance the restructuring of the dairy and sugar industries. In these cases, consumers are paying for benefits to producers.

In addition to the list in Table 1, it must not be forgotten that the Commonwealth government intended to impose a temporary 'Timor levy' on personal taxable incomes from 1 July 2000, ostensibly to prevent the costs of the Australian military intervention in East Timor from putting the budget into deficit. However, the levy was not implemented when it met with public opposition; revised budget estimates showed that a deficit could be avoided without it.

The states and territories impose a range of earmarked taxes, none of which are important in overall revenue terms but some are important to the funding of particular activities. One common theme is the funding of emergency services (fire brigade and ambulance services) through levies on insurance, property, private health insurance, or electricity bills.

NSW local governments in recent years have enthusiastically taken to imposing rate increases variously labelled as 'environment,' 'infrastructure,' and 'asset replacement' levies.[10] Some of these increases have been substantial and imposed on top of the government-imposed annual cap on standard rate increases.

Evaluation of Australian practice

Earmarked taxes in Australia, although they have increased in number, make a marginal contribution to revenue. Those listed in Table 1 account for only about 5% of total tax revenue. Thus, Australia comes nowhere near Buchanan's requirement of 'substantially complete revenue segregation' for earmarking to deliver the claimed benefits in terms of superior fiscal choice. In many cases, the revenue either partly funds or over-funds the purpose for which it is ostensibly raised. Few of the earmarked taxes come with a legislated restriction on the use of the revenue for a specific purpose. In practice, they contribute to general revenue.

Some of Australia's earmarked taxes can be defended as user-pays type taxes conducive to more efficient resource allocation—for example, aviation fuel excise, the passenger movement charge, fire service levies—though even in these cases there can be over-funding. More generally, Australian earmarking practice has been of the opportunistic cherry-picking kind that obscures the true cost of services and has been designed to facilitate the growth of government spending. The best examples of this are the Medicare levy, the gun buy-back levy, the mooted but aborted Timor levy, the Ansett levy, and the milk and sugar levies; at the local government level, we have the 'environment' and 'infrastructure' levies.

The Medicare levy pays for about 25% of the cost of Medicare but deludes the public into believing that they are paying in full for the program, which encourages an inflated sense of entitlement. In reality, the level and growth of spending on Medicare has little to do with the level and growth of revenue from the levy. Ultimately, the government determines the level of spending on Medicare through the amount of general revenue it allocates to it. The levy is virtually indistinguishable from general revenue. But due to the popularity of Medicare—no doubt in part because of the belief that it costs much less than it actually does—governments have been able to increase the levy in three steps since 1984 from 1% to the current 1.5% (or 2.5% for higher income earners who don't take out private insurance). This is the only increase in income tax *rates* that the government has dared to impose over the last 20 years or so, and it has been able to do so because of the 'Medicare' tag attached to the increase.

The same criticism could have been levelled at the aborted Timor levy in 1999, but that at least was to be temporary. The government thought the levy was politically sustainable because the Australian military involvement in East Timor was popular at home, and because the levy was structured to apply only on personal incomes above $50,000. If the Commonwealth budget were tighter today, would the government dare to propose an 'Afghanistan levy'? The obvious unreality of such an idea serves to illustrate the politically opportunistic nature of these levies.

It is quite possible that a future federal government operating in more difficult budgetary conditions will seek to increase the Medicare levy further or extend the principle to some other popular area of spending such as education or the environment. Worthy as the goals of the spending programs *might* be, it would be wrong to use soft earmarking for the same ill-conceived reasons as the Medicare levy.

The local government rate levies for 'infrastructure' and 'the environment' that have been used heavily, at least in New South Wales, in recent years are among the worst examples of earmarking. 'Infrastructure' can mean something as basic as street repairs and 'environment' can mean storm water drains, but the fancier labels seem designed to tap into current community interest in the environment and infrastructure. These levies are nothing but increases in rates to finance increments in the 'bread and butter' activities of local government. They are indistinguishable from general rate funding and can provide no guarantee to ratepayers that the funds raised will be used for the stated purpose because the larger general rate funding of 'infrastructure' and 'environment' works will ultimately determine the level of spending on them.

A case study—What to do with the Medicare levy

The Medicare levy, being the largest and best-known earmarked tax, is worth using as a case study in how to reform current earmarking practice. There are four basic options.

First, the levy could simply be abolished. This would provide a tax cut of 1.5 percentage points for all who pay the levy,[11] lowering the Commonwealth tax take by $8 billion per year. The problem with this option, apart from its affordability to government, is that although the levy is deficient as an indicator of the cost of Medicare, its existence in any form means that its removal would send the wrong signal to taxpayers about the cost of publicly funded health care.

Second, the levy could be greatly increased so that it covers the full cost of Medicare, offset by a reduction in marginal income tax rates to make the switch revenue neutral. The advantage of this option is that it makes the full cost of Medicare more transparent to taxpayers and therefore (perhaps) curbs demands for its enhancement. Provided successive governments resist any pressure to supplement levy proceeds from general revenue, the growth in the cost of Medicare over time would be capped at the growth of the personal income tax base, thereby exercising a useful discipline on health funding. However, it is unlikely that that proviso would be met. Also, it is not clear why Medicare is being singled out from all government programs and quarantined in this fashion.

Third, the levy could be abolished but folded in to statutory marginal income tax rates to make the change revenue neutral. The statutory marginal rates would become 16.5, 31.5, 38.5, and 46.5%.[12] Most people already know that these are the true marginal rates they pay, but formalising them would be more consistent with fiscal transparency. Actual funding of Medicare would be determined simultaneously with competing priorities, as is effectively the case now.

Fourth, abolition of the levy could be accompanied by an increase in the minimum superannuation contribution rate from 9% to 10.5%, with the increase to come directly out of employees' pockets as they benefit from the abolition of the levy. This would give superannuation contributors an enhanced capacity to self-fund their health costs in retirement and would fit in with the government's policy emphasis on preparing the ground for future rapid growth in health care costs as the population ages. One problem with this approach is that the population of taxpayers benefiting from the tax cut does not perfectly match the population of superannuation contributors. However, the main problem would be with the relatively few low-income superannuation contributors who would have to make higher superannuation contributions but are not currently paying the

Medicare levy. This problem could be addressed in the detailed design of the change.

The fourth option is the most appealing. It reduces the tax burden, eliminates the current misuse of the earmarking concept in Medicare funding, achieves some of the increase in superannuation contributions that are widely recognised as being needed, and introduces the principle of compulsory employee contributions.[13] It shares with the first and third options the drawback of sending the wrong signal to taxpayers about the cost of publicly funded health care, but the change can be explained as a way of increasing compulsory saving for individuals to meet more of their own health care costs in retirement.

Conclusion—Taxpayers beware!

There is a fairly narrow set of circumstances in which earmarked taxes are both workable and have a basis in taxation principles. Australian governments have made appropriate use of earmarking in some such circumstances, but have also abused the concept in other situations by applying it selectively to popular areas of government spending and mixing earmarked and general revenue together, which makes earmarking meaningless. Taxpayers should be alert to such practices and see them for what they are—increases in general taxation dressed up to appear as something more appealing. Taxpayers may still choose to accept a greater burden, but governments should enable them to make that choice on the basis of fully transparent information.

Endnotes

1 This classification of earmarking is similar to Margaret Wilkinson's 'strong' and 'weak' earmarking. Margaret Wilkinson, 'Paying for Public Spending: Is There a Role for Earmarked Taxes?' *Fiscal Studies* 15:4 (November 1994), 119–35.

2 Peter Groenewegen, *Public Finance in Australia—Theory and Practice* (Melbourne: Prentice-Hall of Australia, 1984), 99.

3 For example, Adam Smith has written, 'The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state.'

4 Sinclair Davidson points out that this proposition can be turned on its head, because it can be argued that the rich would be better able to protect themselves in the absence of law or government. Sinclair Davidson, 'Who's Not Paying Their Fair Share of Income Tax?' in *Taxploitation—The Case for Income Tax Reform*, Peter Saunders (ed.), (Sydney: The Centre for Independent Studies, 2006).

5 James Buchanan, *Public Finance in Democratic Process* (Chapel Hill: University of North Carolina Press, 1967), chapter 6.

6 There can be exceptions to this. For example, Samuel Brittan has advocated that the UK value added tax be earmarked for the National Health Service: *The Financial Times* (14 March 2002).

7 Section 81 states, 'All revenues or moneys raised or received by the Executive Government of the Commonwealth shall form one Consolidated Revenue Fund, to be appropriated for the purposes of the Commonwealth in the manner and subject to the charges and liabilities imposed by this Constitution.'

8 Medicare levy revenue is estimated at $7 billion in 2006–07 against a Medicare cost of $28 billion.

9 Australian National Audit Office, *Audit Report No 12* (Canberra: ANAO, 2000), 13.

10 Twenty-seven councils in 2005–06 and 23 in 2006–07. NSW Department of Local Government Annual Reports, 2004–05 and 2005–06. NSW legislation requires councils to obtain ministerial approval for rate increases above a cap set by the government each year.

11 Some taxpayers above certain income thresholds pay an additional 1% because they choose not to have private medical insurance. The government uses this mechanism to encourage take-up of private insurance. If the Medicare levy were to be removed, this policy 'stick' would be lost but it is not a major feature of the health system, and the government could no doubt develop other mechanisms to serve the same purpose.

12 The marginal rates would in fact need to be slightly higher than these for revenue neutrality because they apply with a tax-free threshold, whereas the Medicare levy does not.

13 Employees are in effect contributing already because the economic incidence of the 9% superannuation guarantee falls on them, but an explicit payment by employees would still help to enhance the value employees place on their superannuation savings efforts.

Chapter 9

Tax Competition: Much To Do About Very Little

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Tax competition has generated a huge, heated public policy debate.[1] Tax competition theory holds the possibility that competition for capital among countries will lead to 'inefficient' low taxes on capital (i.e. corporate income tax rates), 'inefficient' low levels of public expenditure, and the under-provision of public goods. John Whitney, tax partner at PricewaterhouseCoopers, has said, 'I believe that corporate tax is in near terminal decline. Over the next 10 years governments may have to deal with a lot less corporate revenue.'[2] In this view, tax competition is economically undesirable, and tax harmonisation (or coordination) is required to improve economic behaviour. Alternatively, tax competition could lead to lower taxes and appropriate levels of public intervention in the economy. In this latter view, tax competition leads to improved economic behaviour.

Overall, the basis for tax harmonisation relies on three foundations: a flawed vision of markets, false assumptions, and basic facts that do not support the arguments. This paper investigates the tax competition/harmonisation debate and highlights three important considerations. First, there is a conflict of visions, with differing perspectives on the value and role of markets and government, and differing expectations as to the role of fiscal policy. Second, the tax harmonisation arguments contain hidden assumptions that need further evaluation. The paper concludes with some basic facts that undermine the standard tax harmonisation arguments.

What is tax competition?

Richard Teather has defined tax competition as 'the use by governments of low effective tax rates to attract capital and business activity to their country.'[3] Daniel Mitchell defines a tax haven as 'any jurisdiction, anywhere in the world, that has preferential rules for foreign investors'—yet somehow the phrase has become a pejorative term.[4] Tax havens and tax competition are intimately related to each other. It is important to dispel stereotypical views about what constitutes a tax haven. That view may relate to some tropical island paradise with poor banking practices and allows money laundering and related criminal behaviour. To be sure, such places do exist—yet they are rarer than many think.[5] Switzerland—the most famous tax haven—has none of those features. Neither does the United Kingdom, a tax-haven for wealthy foreign domiciled UK residents. Hong Kong has very low tax rates, yet is seldom, if ever, criticised for being a 'tax haven.'

New Zealand can be described as a foreign trust tax haven; it does not tax the foreign income on new migrants for four years.[6] Ireland is a corporate tax haven. In his 2007 Budget Reply speech, Kevin Rudd, as leader of the opposition, proposed that Australia become a funds management tax haven by halving the 'withholding tax on distributions from Australian managed funds to non-residents from 30 percent to 15 percent.'[7] The Howard government hinted at a similar policy.[8] Australia already qualifies as an inheritance tax haven. In other words, tax competition is common among countries; at some level, many if not all countries qualify as tax havens.

As Teather describes, in the late 1990s a number of (European) high-tax economies began to fear that tax competition would undermine their own ability to raise tax revenue.[9] Wouter Bos, the Dutch Minister of Finance, argued that tax competition was 'not just a "race to the bottom" but a "race to public poverty," ... where total tax income of the countries becomes too low for governments to finance a sustainable and sufficient level of public services.'[10] These high-tax economies began a campaign against tax competition, with (some) tax havens using international oganisations such as the European Union, the OECD, and the United Nations. The Australian government has been a supporter of this campaign.

Tax competition, according to its critics, is a negative consequence of globalisation. Some countries deliberately establish their tax policies to erode the tax base of other countries, alter the tax structure of those countries, hamper the application of progressive tax regimes, and impede the redistribution of income or wealth. This decreases 'global welfare.' All these undesirable outcomes can be avoided 'through intensifying international co-operation'—in other words, by establishing a tax cartel. Taxpayers who take advantage of tax havens are free riders 'who benefit from public spending in their home country and yet avoid contributing to its financing.'[11] It is worth noting that this is not a legal argument but a moral argument masquerading as economics.[12]

The OECD promotes the view that tax competition has the potential to create harm by distorting investment flows, undermining the integrity and fairness of existing tax structures, discouraging tax compliance, changing the 'desired' mix and level of taxation and government spending, causing the tax burden to shift to less mobile tax bases and increasing the costs of tax administration and compliance burdens. Enrique Mendoza and Linda Tesar have summarised all these effects into three 'global externalities.'[13] The first externality is an old-fashioned 'beggar-thy-neighbour effect,' whereby governments reduce their taxes to attract investment from neighbouring countries. The second externality is a 'wealth-redistribution effect,' which is caused by inefficient tax-driven investment choices. Finally, there is a 'tax externality,' which is caused by the impact that tax competition has on tax revenue.

A 1998 OECD report, 'Harmful Tax Competition: An Emerging Global Issue,' made a series of claims regarding international taxation. The OECD had been commissioned by member states to 'develop measures to counter the distorting effects of harmful tax competition on investment and financing decisions and the consequences for national tax bases.'[14] The report is a wordy affair. It contains some discussion of the 'definition' of 'harmful tax competition' and also some criteria for identifying those economies that may engage in harmful tax competition. Two OECD members opposed the report but did not veto the project. Luxembourg argued that the report 'gives the impression that its purpose is not so much to counter harmful tax competition where it exists as to abolish bank secrecy,'[15] while the Swiss claimed that the report 'is partial and unbalanced.'[16] The dissenters, however, were hardly being principled. They could have vetoed further OECD work on tax harmonisation; instead, they refused to participate further.

The 1998 report doesn't provide a concise definition of harmful tax competition, but it does offer the following criterion: 'If the spillover effects of particular tax practices are so substantial that they are concluded to be poaching the tax bases of other countries, such practices would be doubtlessly labelled "harmful tax competition."'[17] So harmful tax competition is caused by 'spillovers.' This is a convenient definition. Spillovers—which economists usually refer to as 'externalities'—are often invoked as a justification for government regulation. This is the first of our hidden assumptions. It seems that any and every externality calls for government intervention. Worse, simply alleging externality is grounds for intervention.[18] A further quote from Bos highlights this point.[19]

> From an economic perspective, tax competition ... leads to efficient governments and the highest possible level of wealth for everybody.

> There is only one very important side condition for this last statement to be true, and that is that the global markets are perfect and there are no market failures whatsoever. This is, I am afraid, not the case in real life.
>
> When markets are imperfect, policy goals cannot be achieved by market forces alone. The same is true for competing in the field of tax policies. Any competition needs some form of regulation, so does this one.

It is true that externalities are, in theory, a form of market failure. It is much harder to make that type of argument in practice. Tibor Scitovsky, more than 50 years ago, said, 'Definitions of external economies are few and unsatisfactory.'[20] That comment is as valid today as it was then. Economists differentiate between types of externalities. Pecuniary externalities operate via the price mechanism, while technological externalities don't. Only technological externalities give rise to public policy responses. If they do exist, tax externalities are, at best, pecuniary externalities and wouldn't normally concern economists.

The tax-externality argument is the usual focus of popular discussion. The idea is that tax competition would trigger a 'race to public poverty' in which governments reduce tax on mobile bases (corporate income) and increase taxes on immobile tax bases to maintain government revenue. Alternatively, governments experience a loss of revenue and they reduce expenditure, increase government debt, or inflate the economy. Spillovers, and allegations of 'free riding,' have the advantage of being intuitively obvious to the layman but technically difficult to prove. In essence, this definition, based on spillovers, is an appeal to populism and empirically empty. Indeed, the OECD admits this point in the 1998 report: 'The available data do not permit a detailed comparative analysis of the economic and revenue costs involving low-tax jurisdictions,' and, further, 'A regime can be harmful even where it is difficult to quantify the adverse economic impact it poses.'[21] In other words, despite having no evidence to justify any policy intervention, the OECD decided that tax competition was undesirable.

Conflicts of vision[22]

Attitudes towards tax competition will inevitably be tempered by attitudes towards the legitimate role of governments and markets. These attitudes can be seen in views on capital mobility, and more generally, fiscal policy and the trade-off between markets and the state. In one sense, the tax competition debate is simply a continuation of the exchange rate regime literature: should exchange rates be fixed or floating? One of the defining characteristics of the Bretton Woods exchange rate regime was that capital was meant to be relatively immobile. Policymakers have since come to accept that mobile capital is preferable to immobile capital. This is, however, a grudging acceptance, and schemes to fix exchange rates and control capital flows have died a slow and painful death. Reuven Avi-Yonah makes this link quite explicit. 'Since the early 1980s, when exchange controls were relaxed, nominal tax rates have gone down sharply.'[23] The first vision is whether capital mobility can be considered to be 'good' or 'bad.' The second vision is the view of government. The Nirvana or 'standard model' views governments as being benign, benevolent social-welfare maximisers. In contrast, the Leviathan model of government suggests that politicians and bureaucrats are self-seeking agents and are less likely to be benign.[24]

		Capital Mobility	
		Good	*Bad*
Trust Politicians	Yes	• Tax Harmonisation	• Capital Controls • Fixed Exchange Rates
	No	• Tax Competition	• Dystopia

As policymakers came to the view that since capital mobility was preferable to immobility, the preference for capital controls would change to a preference for tax harmonisation. In that sense, tax harmonisation is simply a sophisticated form of capital control, implying that different countries should have similar, if not identical, tax rates. Daniel Mitchell says, 'Harmonized tax rates eliminate fiscal competition, much as a price-fixing agreement among gas stations destroys competition for gasoline.'[25] As Bos tells us, 'The OECD progress report describes standards and application notes with the aim of helping countries establish *a tax policy that is in line with the OECD standards*.'[26] (emphasis added) To be clear, no credible argument has been made for all countries to have identical tax rates. Indeed, the OECD argued, 'there are no particular reasons why any two countries should have the same level and structure of taxation,' but went on to say, 'Countries should remain free to design their own tax systems *as long as they abide by internationally accepted standards* in doing so.'[27] (emphasis added). This begs the question, 'What are the internationally accepted standards in setting domestic tax rates?' While Bos has answered this question, the OECD is silent on this issue. Yet it seems that as long as different tax rates do not cause a behavioural response, there will be no harmful tax competition. In other words, as long as the differences in taxes are too small to encourage a private sector response, taxes can be said to have been harmonised. The OECD describes two sources of tax differential. There may be a mismatch between two tax systems, which could be rectified by one or both countries changing their tax system, either by lowering or increasing the tax burden. The other source of tax differential is a deliberate decision by the government of one country to 'poach' economic activity from another—this is apparently harmful tax competition.

The Leviathan view is that government, not capital, should be controlled. Indeed, one of the greatest benefits of mobile capital is that it disciplines government. Even the OECD concedes that high-tax countries can reduce the impact of 'harmful' tax competition by modifying their own tax systems (that is, lowering their tax rates). Proponents of free markets should welcome tax competition, allegedly harmful or otherwise. Tax competition reduces the tax burden for everyone and increases economic activity for everyone. Indeed, Adam Smith recognised this in *The Wealth of Nations*:[28]

> The proprietor of land is necessarily a citizen of the particular country in which his estate lies. The proprietor of stock is properly a citizen of the world, and is not necessarily attached to any particular country. He would be apt to abandon the country in which he was exposed to a vexatious inquisition, in order to be assessed to a burdensome tax, and would remove his stock to some other country where he

> could, either carry on his business, or enjoy his fortune more at his ease. By removing his stock he would put an end to all the industry which it had maintained in the country which he left. Stock cultivates land; stock employs labour. A tax which tended to drive away stock from any particular country, would so far tend to dry up every source of revenue, both to the sovereign and to the society. Not only the profits of stock, but the rent of land and the wages of labour, would necessarily be more or less diminished by its removal.

In other words, governments have an incentive not to subject mobile capital to 'vexatious inquisition,' least that capital migrates. Leviathan is constrained in how much tax it raises. Teather argues that an upper limit on revenue forces the state to be more efficient in providing public services. These arguments are true, yet given the phenomenal growth in government size it is clear that these constraints are somewhat weak. The benefits of tax competition are more likely to be observed in the private sector. High levels of taxation are known to create deadweight losses, resulting in adverse economic effects. Alex Robson argues, 'There is little evidence to suggest that higher taxation increases GDP growth rates, and much evidence to suggest that the opposite is true.'[29] As Teather says, the motives of opponents of tax competition 'are the same as those of all who protest against true global free markets: a tendency to worry more about risks than opportunities, a desire for the status quo, and a distrust of economic freedom.'[30]

There is a second conflict of visions. The traditional theory of public finance has three functions for fiscal policy: to raise revenue, to redistribute wealth, and to maintain macroeconomic stability.[31] In particular, the tax harmonisation debate has concentrated on the second—the progressive aspects of income tax. John Kenneth Galbraith is worth quoting in this regard.

> The only effective design for diminishing the income inequality inherent in capitalism is the progressive income tax. Nothing in the age of contentment has contributed so strongly to income inequality as the reduction of taxes on the rich; nothing, as has been said, so contributes to social tranquillity as some screams of anguish from the very affluent.[32]

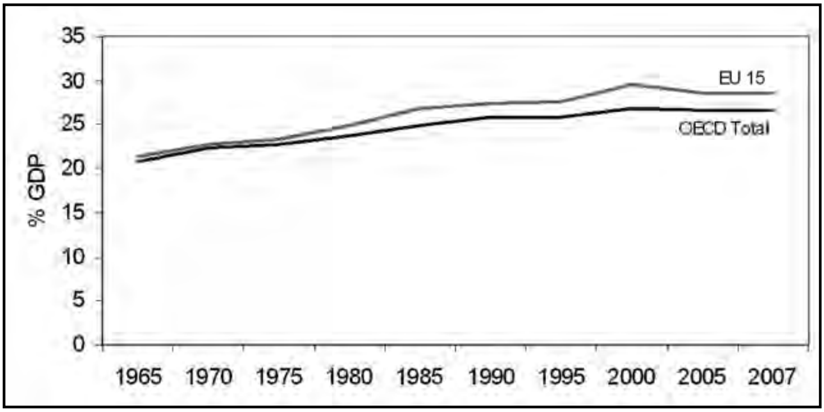
At best, fiscal policy can perform only one of these functions. It is not clear that fiscal policy is successful at redistributing wealth. Furthermore, arguments in favour of progressive taxation have been shown to be weak.[33] Nor has fiscal policy done very well in achieving macro-economic stability. These latter functions dovetail well when capital is immobile. Capital mobility is said to make macroeconomic stability harder to achieve and redistribution impossible. Revenue is apparently reduced. In essence, much of the tax harmonisation debate is an argument about the relative merits of the market versus the state and the goals of fiscal policy. Those who believe markets work better than government, that international capital mobility is a good thing, and that fiscal policy should have narrow goals are more likely to support tax competition, while those who prefer government action and expansive roles for fiscal policy prefer tax harmonisation.

Harm by assertion

Opponents of tax competition are quite specific about the adverse consequences of that competition. The tax burden on (mobile) capital will fall and shift to (immobile) labour. The social safety net will be cut and the welfare state will experience a fiscal crisis. The OECD prepared a long list of consequences of tax competition, but nowhere did it actually demonstrate that any of the potential harm had in fact occurred. The OECD, however, had good reason not to highlight the facts. This section reviews evidence that 'harmful tax competition' has actually occurred in the OECD and also the EU-15. Figure 1 plots the Total Tax Revenue to GDP ratio for both the OECD and also the EU-15 over the period 1965–2007. Unfortunately, the OECD data do not go beyond 2007, but Eurostat data for the European Union are available up to 2008. This should provide some perspective on the extent of the tax competition 'crisis' facing those economies. The European Union does face a fiscal crisis, but it is not clear whether this is due to tax competition as opposed to its own fiscal irresponsibility.

In 1965, total tax revenue (excluding social security) made up 20.9% of GDP. By 2000, this figure had increased to 26.9%. The EU-15 is in an even better position—tax to GDP (excluding social security) increased from 21.4% to 29.5%. Since that time, the tax to GDP figures have declined but on the basis of these data, it is difficult to argue the welfare state is experiencing a fiscal crisis

Figure 1: Total tax revenue to GDP



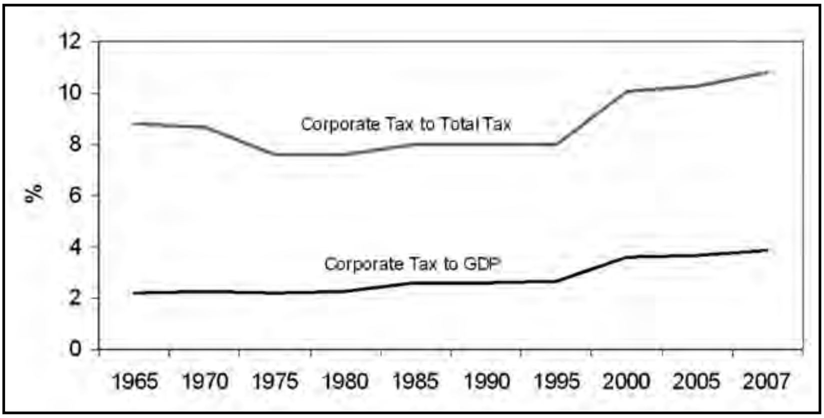
Source: OECD Revenue Statistics 1965–2007, Table 4. Data exclude social security.

resulting from tax competition. However, tax competition is said to have a huge impact on capital taxes and corporate tax, in particular. A *Financial Times* editorial argued, 'Corporation tax is a dying tax ...'[34] John Braithwaite blames corporate tax competition on the Thatcher government, which lowered the corporate rate from 46% to 34% in 1984. Ireland has lowered its corporate tax rate to 12.5%. Average corporate tax rates in Europe (and the world generally) have declined. So too, however, have personal tax rates. Chris Edwards and Veronique de Rugy have shown that personal tax rates had fallen on average by 20% in the OECD over the period 1980–2000, while corporate tax rates have fallen by 6% over the period 1996–2002.[35]

At this point, however, we encounter an important source of confusion in the tax competition debate. Tax rates and tax levels are not the same thing. The literature assumes existing tax rates are 'optimal.' It is not clear what 'optimal' implies, but the implication is always that government revenue declines because of a decline in tax rates. This assumes that tax rates are always on the upward sloping side of their respective Laffer curves. Furthermore, the literature suffers from a 'fatal conceit' and the 'pretence of knowledge.'[36] Nowhere is it ever conceded that tax changes may be a consequence of greater understanding of tax policy, or experience, or changing circumstances. These 'errors' are largely due to the conflict of visions that permeate the debate.

The OECD ministers first commissioned the OECD to investigate Harmful Tax Competition in 1996. To the extent that tax competition caused any harm, we might expect to observe declining tax revenue prior to 1996. Figure 2 plots the corporate tax revenue as a percentage of total tax and also GDP for the OECD over the period 1965–2007. Tax competition is said to have a huge impact on corporate tax in particular. Between 1975 and 1995, corporate tax increased from 2.2% of GDP to 3.9%, while it grew from 7.6% to 10.8% of tax revenue. There is no evidence of a decline in tax revenue from the source most vulnerable to tax competition.

Figure 2: Corporate tax: OECD total



Source: OECD Revenue Statistics 1965–2007; Tables 12 and 13, 83.

The post-1995 situation is very interesting. Revenue from corporate taxes increased—just as the OECD attempted to establish a tax cartel. It could well be argued that the dotcom bubble was responsible for the increased tax revenues in 2000. The increase in corporate tax revenue since 1980 is particularly interesting because many OECD economies have reduced their corporate tax rates since 1980. Eurostat calculates an implicit tax rate on capital income for the European Union.[37] This measure adjusts for the fact that different EU members have different corporate tax bases and the like. From 1995 to 2008, the weighted average implicit tax on capital income increased from 26.8% to 32.2% for the EU-25.[38] That measure was slightly down from 33% in 2000, that is, the tax burden increased at a time when 'harmful competition' was said to be driving it down.

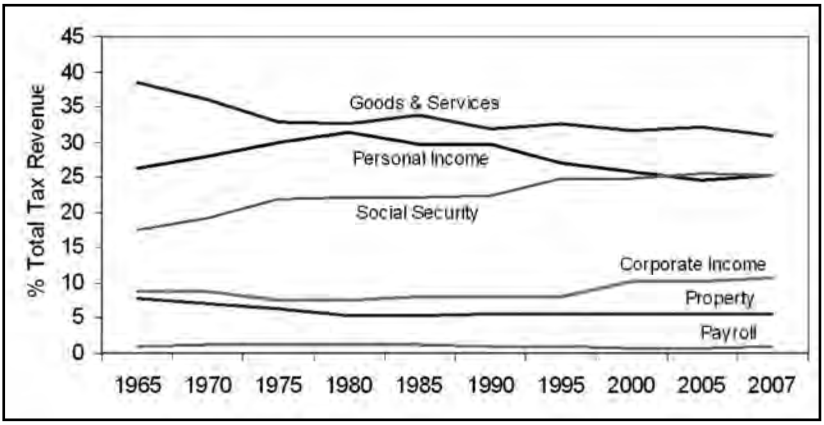
It may well be that ‘harmful tax competition’ has put downward pressure on tax rates, yet it is difficult to conclude that governments have suffered any harm when tax revenues have increased. Indeed, given the increased share, corporate tax revenue has increased faster than both general tax revenue and GDP. The tax burden on individuals also increased over that period (from 7% to 9.4% of GDP for the OECD and for the EU-15 from 7.2% to 10.4% of GDP). In short, there is no evidence to support the notion that the OECD is experiencing reductions in tax revenue because of tax competition.

There is another point worth highlighting from the data on corporate tax revenue. For many nations in the OECD, this source of revenue makes up a small proportion of total tax revenue and a tiny proportion of GDP. Yet the authorities spend a lot of time and effort attempting to track down this revenue, and corporations spend even more time and effort complying with corporate tax legislation. This brings us to another problematic assumption in the tax competition literature. Corporations provide benefits beyond simply paying tax. While the tax authorities and tax economists might assume that taxpayers exist simply to pay tax, shareholders, employees, consumers and governments may take a broader perspective. For example, a government may choose to lower taxation to boost domestic private investment, or reduce unemployment, and the like. Yet, the tax competition literature explicitly assumes that taxation exists for redistributive purposes and to provide revenue for public goods. The data show that governments and economists have had a huge debate over a threat to a very small portion of their overall revenue. Indeed, the figures show that this threat has not yet materialised.

To the extent that harmful tax competition occurs, tax burdens should rise for immobile resources and fall for mobile resources. It is immediately obvious from Figure 3 that the central prediction of ‘harmful tax competition’ is not supported by evidence. The personal income tax burden has fallen relative to other forms of taxation. The social security burden and the corporate tax burden have increased, while the property tax (predicted to increase) has been quite stable. In short, the evidence from the tax-mix does not support any adverse effects from tax competition.

The OECD evidence is not consistent with ‘harmful tax competition.’ The overall tax revenue of these economies has increased over time, and there is no evidence to support a shift of taxation from mobile to immobile factors of production.

Figure 3: OECD tax-mix



Source: OECD Revenue Statistics 1965–2005; various tables.

Comparing the gains

An important question—glossed over by the OECD—is how large are the potential distortions created by tax competition, or the lack thereof. Wallace Oates argued in 2001 that 'we have precious little evidence on this.'[39] Two recent papers have attempted to estimate, at an international level, the relative costs and benefits of tax competition and coordination. Ian Parry estimates that the welfare costs from tax externalities are generally less than 5% of capital tax revenue.[40] He concludes that his results 'cast some doubt on the economic case for harmonizing capital taxes across a bloc of regions such as the European Union.'

Peter Sorensen presents a far more comprehensive analysis of tax competition and coordination.[41] He develops a plausible and realistic model providing a synthesis of the existing knowledge of the competition-coordination trade-off; he also estimates (by calibration) the magnitude of gains from coordination. Importantly, for our purposes, he employs an egalitarian welfare function to evaluate welfare under the alternative tax regimes. In layman terms, that means the government attempts to maximise the 'satisfaction' of the median voter. In this instance, the median voters' satisfaction increases with their own after-tax income and consumption, and decreases if the distribution of income in the country becomes more unequal. The *best-case* scenario is shown in Table 1.

Table 1: Best-case scenario of tax competition and coordination

	Competition	Coordination
Policy Variables		
Capital Tax Rates	12.7	42.3
Labour Tax Rates	44.4	44.4
Transfers	100.0	177.0
Infrastructure Spending	100.0	95.0
Other Variables		
Capital Stock	100.0	88.0
Employment	100.0	99.0
Profits	100.0	95.0
GDP	100.0	95.0
Average Real Wage Rate	100.0	96.0
Real Interest Rate	100.0	109.0
Welfare Gain %GDP		0.94

Source: Adapted from Peter Sorensen (2004), Table 1, 1201.

In the model, tax competition has no impact on labour income taxes. Further, in the Sorensen model, the largest impact of tax competition is not under-provision of public goods but rather too little income and wealth redistribution. In particular, relative to full-blown tax competition, tax coordination would lead to higher capital taxes (of course) and higher redistribution—but lower infrastructure spending, lower capital stocks, lower profits, lower real wages, lower GDP, and higher real interest rates. All these changes would result in an increase in social welfare of less than 1% of GDP, but only if taxpayers have egalitarian objectives. In the model, GDP falls but inequality falls by a greater amount *with the net effect* being an increase in the median voters' level of satisfaction.[42] It is not clear that voters (or taxpayers) would have egalitarian welfare functions.[43] In short, taxpayers would be 'happier' because they would all be equally poorer. The egalitarianism assumption is very restrictive. Egalitarianism has a specific meaning in the social sciences that is not shared by the general population. Peter Saunders has investigated popular opinion and found that only 5% of Australians can be said to have solely egalitarian principles:[44]

> The egalitarian definition of fairness, which is taken for granted by the social policy intelligentsia as the *only* relevant definition, does not therefore do justice to what most Australians mean by a 'fair go' in the contemporary period. Indeed, if our social affairs intellectuals and pressure groups ever got their way, and taxes and welfare benefits were both raised even higher than they are at present in order to narrow what they call the 'income gap,' the result would be the very opposite of what most Australians think a 'fair go' entails.

It is unlikely that Australians are uniquely non-egalitarian. In other words, Sorensen has a model of human behaviour that generally does not describe humans at all. But as Harold Demsetz has argued, one of the Nirvana fallacies is that 'people could be different.'[45]

Table 1 shows results for the best theoretical case for tax harmonisation. When Sorensen estimates more realistic scenarios, he finds welfare gains would be highest in the Nordic economies (0.95%) and lowest in continental Europe (0.03%). The increased welfare gains for the United Kingdom (0.63%) and the United States (0.13%) are also quite low. In other words, the debate over tax harmonisation has generated substantial heat but little light. In fact, under the most favourable conditions, the most light that tax harmonisation would ever produce is less than 1% of GDP.

Empirical evidence supports Sorensen's theoretical predictions. Mihir Desai, Fritz Foley, and James Hines have reported that tax haven activity increases economic activity in nearby non-tax haven economies.[46] With higher after-tax returns as a consequence of tax havens, multinational firms are able to maintain higher levels of foreign investment. This empirical result is entirely consistent with the Sorensen theory. In other words, far from having a negative impact on their neighbours, tax havens have a positive impact on economic activity; there is no evidence that governments suffer any adverse revenue effects from tax competition, either. What is particularly damning for the harmful tax competition argument is that tax haven governments do not appear to be smaller than governments of non-tax haven countries.[47]

Gebhard Kirchgassner and Werner Pommerehne provide an empirical analysis of tax competition and harmonisation within a single economy.[48] Switzerland has a unique constitutional framework. It has a federal structure with a weak federal government vis-à-vis the cantons (states) and local government. The federal government relies on consumption taxes, while the cantons levy progressive income taxes. Cantons levy income taxes at differing rates, and there are no legal impediments to taxpayers moving from high tax cantons to low tax cantons (i.e. the Tiebout hypothesis appears to work). Kirchgassner and Pommerehne report that some tax competition does occur; high-income earners do appear to choose their residence on the basis of tax burdens. In contrast, however, they also report tax competition has not led to an undersupply of public goods.

> Thus, the negative consequences of competition with respect to direct taxes as feared … have not—at least until now—occurred.[49]

It is possible to speculate about tax harmonisation within Australia. Unlike Switzerland, Australia has a strong central government and weak state governments. The central government levies a progressive income tax equally across the entire federation and a flat consumption tax equally across the entire federation. The bulk of tax revenue, from all sources, is raised by the central government in what can be described as a fully coordinated, harmonised tax regime. In terms of Sorensen's predictions of such a tax regime, we might then expect tax rates to be too high and the like. A full discussion of the benefits and costs of the Australian federation, however, is beyond the scope of this paper.

Conclusion

The debate over tax harmonisation has been heated and extensive. To some extent, this has been a European debate, partly due to the political desire to harmonise economic activity within the European Union itself. This, however, is only a small part of the issue. High-taxing economies within Europe have attempted to establish a tax cartel beyond Europe. The OECD has run a campaign of vilification against a number of its own members and also non-members. There is, however, no evidence that tax competition is eroding the tax base of OECD economies. As *The Economist* indicated:

> Governments have raised the alarm about globalization so often that their credibility is in doubt. For all the talk of footloose capital heading for low-tax countries, starting a 'race to the bottom' in which governments slash taxes and services to lure global business, the taxman's cut of world income is larger today than it has ever been.'[50]

Furthermore, there is evidence that full-blown tax cooperation would reduce GDP and increase unemployment and real interest rates. If cooperation could work as economic theory indicates, and people had egalitarian preferences, then the best-case scenario would see a welfare gain of less than 1%. As Charles McLure said nearly 20 years ago:

> I have been quite surprised—not to say flabbergasted—by much of the formal literature that presumes to examine the supposed adverse effects of tax competition.[51]

Endnotes

1 Surveys include John Wilson, 'Theories of Tax Competition,' *National Tax Journal* 52 (1999), 269–303; Wallace Oates, 'Fiscal Competition and European Union: Contrasting Perspectives,' *Regional Science and Urban Economics* 31 (2001), 133–145. The Institute of Economic Affairs has a 91-page monograph that spells out many of the arguments and debates—see Richard Teacher, *The Benefits of Tax Competition* (London: The Institute of Economic Affairs and Profile Books, 2005).

2 Quoted in John Braithwaite, *Markets in Vice, Markets in Virtue* (The Federation Press, 2005), 20.

3 Richard Teather, *The Benefits of Tax Competition*, as above, 25.

4 Daniel J. Mitchell, 'The Moral Defense of Tax Havens,' *Notes from FEE* (2006), www.fee.org.

5 As above.

6 Inland Revenue, 'Temporary exemption from tax on foreign income for new migrants and certain returning New Zealanders' (2008).

7 Kevin Rudd, Budget Reply Speech (10 May 2007), available at http://australianpolitics.com/2007/05/10/2007-budget-reply-speech-kevin-rudd.html.

8 Fleur Anderson, 'PM pitches business tax reform,' *The Australian Financial Review* (27 September 2007), 1.

9 Richard Teather, *The Benefits of Tax Competition*, as above, 23.

10 Wouter Bos, 'Harmful tax competition,' speech to the OECD (Dutch Finance Ministry, 29 June 2000).

11 OECD, *Harmful Tax Competition: An Emerging Global Issue* (OECD Publications, 1998), 14.

12 As an economic argument it is very weak. It assumes that these individuals pay no tax in their home country but consume public services. At best these individuals have paid less for their public services than their government may have wished them to pay. Alternatively, the OECD needs to demonstrate that those individuals making use of tax havens also consume public services. It also fails as a moral argument; see Daniel J. Mitchell, 'The Moral Defense of Tax Havens,' as above, for arguments that show tax competition creates value for non-tax haven economies. In this latter view, it is those who do not invest via tax havens who free-ride upon those who do.

13 Enrique Mendoza and Linda Tesar, 'A quantitative analysis of tax competition v. tax coordination under perfect capital mobility,' NBER Working Paper 9746 (2003).

14 OECD, *Harmful Tax Competition: An Emerging Global Issue*, as above, 3.

15 As above, 74.

16 As above, 76.

17 As above, 16.

18 This is nonsense—the costs and benefits of intervention need to be evaluate before any government action is taken to alleviate so-called externalities. See also Arthur Seldon, *Capitalism*, Reproduced as *The Virtues of Capitalism* (Indianapolis: Liberty Fund, 1990), 235.

19 Wouter Bos, 'Harmful tax competition,' as above.

20 Tibor Scitovsky, 'Two Concepts of External Economies,' *Journal of Political Economy* 62 (1954), 143–151.

21 OECD, *Harmful Tax Competition*, as above, 17.

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44 As above, 9.

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