

TEN PRINCIPLES FOR TAX REFORM

Australia's tax system needs principles that go beyond efficiency, equity, and simplicity, writes **Robert Carling**

Principle 1	Total taxation should be capped as a proportion of GDP.
Principle 2	Taxing powers should be allocated between Commonwealth, state and local governments according to the principles of fiscal federalism.
Principle 3	Tax bases should be broad, tax rates low, and exemptions and concessions few.
Principle 4	Minimising economic harm should be the dominant consideration in the selection and design of taxes.
Principle 5	Redistribution is better pursued through the allocation of government expenditure than through the tax system.
Principle 6	Taxes should be simple and easy to comply with.
Principle 7	The tax system should be transparent.
Principle 8	The tax system should forge a link between public spending and taxing.
Principle 9	Taxation should be stable, predictable and sustainable.
Principle 10	The design of personal income tax should take account of individuals' family circumstances.

The Australian tax system is undergoing a root and branch review by a panel established by the Rudd government.¹ From one perspective, this is a scientific, evidence-based inquiry into what works best in tax policy. But what works best depends on the objectives and values that society ascribes to the tax system. Tax reform principles need to embody value judgments consistent with an economic and social vision for the nation. The review's terms of reference echo the traditional tax policy criteria of efficiency, equity and simplicity. Rather than providing guiding principles that help make trade-offs between these and other policy goals, the terms of reference offer only a bare minimum of guidance.

The following spells out guiding principles that favour optimally sized government; a tax system that puts incentive, reward and a stronger economy ahead of redistribution of income and wealth; and a minimal compliance burden for the taxpayer. These principles unashamedly favour private enterprise, individual effort and liberty, risk taking, and economic growth in the belief that a tax system based on these principles will best contribute to maximising community well-being.

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Principle 1: Total taxation should be capped as a proportion of GDP.

Taxes do not exist for their own sake but to finance government expenditure. The overall tax take ultimately defines the size of government. Conceptually, there is an optimal size that equates the marginal costs and benefits of the last dollar of revenue raised and the last dollar spent by government. Because taxes are levied under the coercive power of the state, the revenue-maximising tax level bears no necessary relation to the optimal size of government and in all likelihood far exceeds it. Revenue maximisation may be best for the rulers, but it is not best for the ruled.

In practice, the size of government varies substantially across countries according to the level of development and differences in cultures and attitudes. General government spending in most developed countries is above 35 percent of GDP, and for many it is closer to 50 percent. In Australia, the figure was close to 35 percent in 2007–08 and is set to rise.

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The tax burdens needed to sustain government spending on this scale involve very high marginal economic costs, which are likely to be well in excess of the marginal benefits of expenditure. The optimal size of government is not easy to measure, but Vito Tanzi and Ludger Schuknecht came to the conclusion that optimal general government spending (excluding government-owned enterprises) is around 30 percent of GDP.² Another approach is to consider the level of taxation that maximises economic growth. Gerald Scully calculated it for the United States and came up with a figure of 23 percent of GDP, which is well below the actual tax burden.³

For these reasons, a cap on the tax revenue share of GDP is desirable, as Stephen Kirchner and I recently proposed in the context of fiscal responsibility legislation.⁴ As the Commonwealth government is responsible for the lion's share of

taxation, a cap on Commonwealth tax revenue is the most relevant to the economy. It would also be desirable to obtain agreement of all governments to a national tax/GDP ratio, which would cover all taxes and be unaffected by any future reallocation of tax powers between the levels of government.

The Rudd government has stated that it will keep the share of Commonwealth tax revenue at or below its 2007–08 level of 25.2 percent, but this is still too high. The terms of reference for the tax review recognise the size of government as an issue and state that 'the review's recommendations should not presume a smaller general government sector and should be consistent with the government's tax to GDP commitments.' The bias towards the current size of government is unfortunate, but the terms of reference at least do not rule out a reduction in the tax burden and size of government.

Tax reform that reduces revenue may at first sight appear unaffordable at a time of large budget deficits, but a reduction relative to a growing revenue baseline over time would be manageable. This would involve implementing reform in stages over a number of years so that tax revenue, while still growing (even in real terms), would grow at a rate below the growth of GDP after decades of trend growth above that of GDP. If the growth of tax revenue is too slow, so must the growth of government spending. This would require a marked change in the behaviour of governments at all levels.

Principle 2: Taxing powers should be allocated between Commonwealth, state and local governments according to the principles of fiscal federalism.

The review is examining taxes at all levels of government—federal, state and local. There is an important distinction between the allocation of tax *powers* and the allocation of tax *revenues*. For example, the states receive *revenue* from the GST but they lack the *power* to determine GST policy. Taxes over which the Commonwealth has policy control generate 85 percent of national tax revenue, while state and local governments control the other 15 percent. Expenditure responsibilities are much more evenly distributed. Revenue and expenditure at each level of government can only

be balanced through large-scale transfers of tax revenue from the Commonwealth to the states and local government.

The first criterion for tax assignment is that the allocation of powers should equip each level of government with the capacity to finance its own expenditure responsibilities. Taxing powers need to be decentralised to a similar degree to expenditure responsibilities so that each government can set its own policies and be clearly responsible and accountable to its voters.

The second criterion is that each level of government should be allocated the kinds of taxes most suitable to them. In broad terms, the more mobile tax bases such as labour should be reserved for the Commonwealth while the less mobile bases such as property are allocated to the states and local government.

The third criterion is that each tax base should be taxed by just one tier of government. This rule is conducive to transparency and clear responsibility. Where it is not possible, the separate taxes of each level of government should be made clear to the taxpayer.

The Australian system of fiscal federalism rates poorly on the first criterion, reasonably well on the second, and well on the third.

Principle 3: Tax bases should be broad, tax rates low, and exemptions and concessions few.

Tax bases should be broad and subject to low statutory rates and strictly limited exemptions and concessions. Broad bases such as household consumption, personal income, and payroll are preferred because taxing them causes less adjustment by the private sector and involves less disturbance of resource allocation. The more exemptions and concessions there are, the greater the administrative complexity of the tax system, the higher the compliance burden, the greater the distortion of economic signals to the private sector, and the less transparent the tax system is to taxpayers. For a given revenue need, more exemptions and concessions necessitate higher statutory tax rates. Higher tax rates in turn impose higher economic costs.

Exemptions and concessions have proliferated in the tax system. One measure of this is provided by the annual tax expenditure statements

of Commonwealth and state governments. Although the estimates are imperfect and subject to conceptual dispute, Commonwealth tax expenditure in 2007–08 was \$74 billion, or about 26 percent of actual tax revenue. In other words, if all tax expenditures were abolished, all Commonwealth taxes could be cut by 20 percent without detriment to the level of revenue raised.

Exemptions and concessions have often resulted from the pursuit of non-revenue objectives through the tax system, particularly social and industry assistance objectives, and now increasingly environmental ones. At the same time, there are many narrowly based taxes that have been motivated or have sprung up out of political convenience and opportunism. Remarkably, Australia now has at least 125 different taxes.⁵ Some exemptions and concessions from broadly based taxes, and some narrowly targeted taxes, can be justified on grounds such as internalising the external costs of consuming a particular product. Excise duty on petrol is a well-known example. Often, however, the tax system is used out of convenience to pursue non-revenue objectives.

Principle 4: Minimising economic harm should be the dominant consideration in the selection and design of taxes.

The purpose of taxation is to transfer resources from private sector to government command. But in addition to this intended subtraction from the private sector, taxes impose an excess burden by causing the private sector to modify its behaviour in ways that make the total economy smaller than otherwise. Individuals and businesses cut back on taxable activities, divert their efforts from more to less heavily taxed activities that are less beneficial to economic welfare, and engage in tax minimisation strategies that are wasteful of scarce resources from a national perspective.

Designing the tax system to minimise these costs is what economists refer to as ‘economic efficiency.’ In general, capital taxes are the most damaging and consumption taxes the least, with labour income taxes in the middle. Narrow tax bases, high tax rates, and large concessions and exemptions are, as noted above, the more damaging design features, as are steeply graduated (or ‘progressive’) tax scales.

The terms of reference for the government's review state that 'through its design it (the tax system) can have an important impact on the growth rate and allocation of resources in the economy' and that 'raising revenue should be done so as to do least harm to economic efficiency ...' This is reassuring, but the terms of reference go on to specify equity, in its various dimensions, as another criterion.

The trade-off between economic efficiency and equity has to be confronted because the pursuit of income redistribution through the tax system will reduce the size of the economic pie to be distributed. While some redistribution may be deemed worth the price of lost economic efficiency, if taken too far redistribution will be self-defeating in that beneficiaries will be worse off in *absolute* terms even though they are better off in *relative* terms. There are other ways to effect redistribution that are less damaging to the economy.

Putting efficiency first does not mean going to extremes such as replacing all taxes with a poll tax (equal dollars per capita), which would have no economic efficiency costs but also pay no regard at all to capacity to pay. Rather, it means recognising that certain types and structures of taxation designed for income redistribution are more damaging to wealth creation, productivity, innovation, and economic growth than other types and structures and should be avoided or minimised.

Proportionality is preferable in tax and progressivity in expenditure.

International competitiveness is often given prominence as if it were a principle of taxation in its own right. Kept in perspective, however, it is one dimension of economic efficiency or minimising economic harm. Competitiveness is more important for taxes on internationally mobile bases such as corporate income and capital more generally. It has become a more important aspect of the economic efficiency test as globalisation has increased.

Principle 5: Redistribution is better pursued through the allocation of government expenditure than through the tax system.

Equity (or 'fairness' as it is often called) has vertical and horizontal dimensions. The vertical dimension concerns the treatment of taxpayers with different capacities to pay, while horizontal equity concerns the treatment of those with equal capacity to pay. Redistribution from higher to lower income households, to the extent it is warranted, is best pursued by making the overall tax system as proportional as possible, and the transfer system progressive.

In a proportional tax system, the tax burdens are approximately equal as a percentage of income at all levels. This is a definition of distributive neutrality. It still involves wealthier taxpayers paying larger dollar amounts than poorer taxpayers.

The allocation of government expenditure, particularly transfer payments to households such as social security benefits, can have powerful effects on income distribution. A progressive impact can be achieved through a distribution of payments favouring lower income households and excluding higher income households through means testing. Even without means testing, equivalent *dollar* payments to low and high income households alter the income distribution in favour of low income households.

Proportionality is preferable in tax and progressivity in expenditure because the distribution of each has different incentive effects. In general, progressivity in the distributional impact of government spending does not cause as much economic harm as an equivalent impact achieved through the tax system. Government benefits can certainly have disincentive effects, but they are often confined to a portion of the income range (e.g. the means-tested age pension), while taxes affect the whole income range.

Overall proportionality in the distribution of the tax burden does not mean that each and every tax must be proportional; some may be progressive and some regressive. But progressive (graduated) scales should only be applied when it makes sense to do so—i.e. the tax base reflects capacity to pay and is relatively immobile. In the current tax

system, some taxes are designed ostensibly with a redistributive objective in mind even though they are ill-suited for the purpose, such as land taxes, and they impose higher economic efficiency costs than if designed to be neutral. Graduated tax scales should not be so steep that they result in upper marginal tax rates that impose high marginal economic efficiency costs.

The degree of progressivity in the combined tax/transfer system is a matter of choice that reflects society's preferences and attitudes to the trade-off between equity and economic efficiency. In practice, tax and transfer policy options are often discussed as if the desirability of greater progressivity can be taken for granted. Such implicit assumptions should be made explicit and exposed to scrutiny. It should be recognised that Australia's tax/transfer system is already highly progressive and that from this starting point, the desirability of even more progressivity cannot just be assumed.⁶ Even the current degree of progressivity may well be excessive when the economic costs associated with the instruments of redistribution are taken into account.

The emphasis of fairness is usually on vertical equity, which refers to the comparative treatment of individuals at different income levels. But horizontal equity is at least as important. Taxpayers with the same capacity to pay should be treated the same. This principle is often violated by narrow exemptions and concessions.

Principle 6: Taxes should be simple and easy to comply with.

Ordinary taxpayers should be able to understand how the tax system affects them and be able to complete a tax return without expert assistance. Currently, more than 70 percent of individual income taxpayers feel it necessary to engage the services of a tax agent.⁷ In a truly simple system, few should need to. Some advocates of simplification go further and argue that most individuals should not even need to file a tax return. This could, however, reduce transparency if it makes taxpayers less aware of what they are paying.

Business taxation tends to be inherently complex, but it is more complex in practice than necessary. There is too much ambiguity surrounding the tax obligations of individual

businesses and they are unreasonably exposed to the risk of unpredictable tax assessments.

In the personal income tax system, complexity has grown with the proliferation of exemptions, concessions, deductions, offsets, rebates, shade-out zones, the Medicare levy and surcharge, and so on.

While simplification could remove distortions and improve the economic efficiency of the tax system, simplicity is also sometimes in conflict with efficiency and equity. Some of the current complexity is a result of a quest for exactitude, whereas simplicity calls for broader brush solutions. Rough justice may be better than precise justice. For example, greater resort to withholding taxes as final taxes would represent simplification, but would mean accepting the principle of a flat tax for some types of income.

Principle 7: The tax system should be transparent.

Fiscal illusion is the enemy of transparency. Governments create fiscal illusion to help sustain and increase high levels of public expenditure. In part, this involves designing the tax system so as to minimise taxpayer resistance to any given level of taxation. Taxpayers gain an incomplete or distorted view of the tax burden they are actually bearing. Sinclair Davidson has identified various ways in which the tax burden can be obfuscated.⁸ Examples include tax system complexity and 'opportunistic' taxation (selective levies that cater to sympathetic community attitudes to particular objects of government expenditure).

Such design features mean that the true marginal rates of personal income tax are not transparent to taxpayers. To take just two examples, the low income tax offset and the Medicare levy cause actual marginal rates to differ from the legislated rates of 15, 30, 38 and 45 percent.⁹ Means-tested transfer payments and the associated 'taper' rates have additional effects on marginal effective rates of tax. The tax/transfer system can be redesigned to reduce these non-transparent distortions.

Another aspect of transparency is that changes in the effective burden of taxes should not automatically occur without legislation. Bracket creep is a classic example of unlegislated, automatic growth in the burden of taxes with

graduated scales, as inflation of tax bases pushes a larger proportion of the bases into higher rate brackets. Legislated automatic tax indexation is the solution.

The distinction between legal incidence and economic incidence of taxation creates further opportunities for fiscal illusion. Legal incidence refers to the entity that bears the legal liability to pay a tax, whereas economic incidence refers to who actually pays in an economic sense once the effects of a tax have worked their way through prices, wages, and other incomes. In practice although Australia has more than 125 different taxes, it does not have 125 different tax bases. Businesses bear the legal incidence of many taxes, but households bear the economic incidence of most taxes because they are passed on in lower wages and higher consumer prices.

Payroll tax and company tax are good examples of the popular confusion between legal and economic incidence. Payroll tax is often criticised as a ‘tax on jobs’ and company tax is applauded as an impost on big businesses. In reality, both impose a first-round burden on businesses, most of which is passed on to households in price and wage adjustments.

There are sometimes valid reasons—such as administrative efficiency—to put the legal incidence of a tax onto entities that do not bear the economic incidence, but too often the motivation is a desire to create the illusion that businesses (which doesn’t vote) rather than people (who do vote) are bearing a given tax burden. The result has been a proliferation of taxes many of which are, in effect, taking multiple bites out of the same tax base.

Multiple layers of taxation of the same base result in arbitrary and unpredictable total rates of tax. If government wishes to apply different rates to different tax bases, it should do so openly and transparently.

Principle 8: The tax system should forge a link between public spending and taxing.

Taxation is the price the community pays for the benefits of public expenditure. One of the disciplines on government spending and its growth is that taxpayers have to foot the bill and

are usually reluctant to do so. The link between government spending and taxing decisions needs to be clear if this discipline is to work.

The democratic process balances demands for more government spending against the willingness of taxpayers to pay for it. Even though taxpayer willingness is limited, the force of this constraint can only be fully effective if the tax burden is both transparent and widely spread; it is greatly weakened if a large segment of the population (voters) is allowed a free ride by being beneficiaries of government spending programs while bearing little if any of the tax cost. In relation to income tax, this is one problem with high tax-free thresholds and generously defined low income tax offsets that, combined with graduated tax rate scales, loads most of the burden onto a minority of the population. Against that, ‘churning’ can be a problem in the tax/transfer system if there are substantial numbers of households that have both an income tax liability and an entitlement to receive cash transfer payments from government.

Tax hypothecation (or ‘earmarking’) is sometimes advocated as a way of reinforcing the link between taxing and spending. It involves reserving the proceeds of a tax exclusively for one expenditure purpose. In practice, however, the concept has mostly been misused by Australian governments.¹⁰ The conditions for such taxes to be effective in sending tax-price signals to taxpayers are quite strict, and are met in very few cases.

Principle 9: Taxation should be stable, predictable and sustainable.

Uncertainty is an unavoidable element in the economic decisions made by private individuals and businesses. Government cannot and should not attempt to eliminate uncertainty, but nor should it add to it by frequently changing tax policy. Long-term investment decisions are affected not only by today’s tax policies but also expectations of future policies. Investors have come to expect that tomorrow’s tax burden will be higher than today’s, and act accordingly. In addition, governments that repeatedly take the private sector by surprise with adverse tax policy decisions create expectations of more of the same and discourage long-term commitments.

Changes that are frequent and unpredictable in their detail must heighten the risk profile for investments and other economic decisions of businesses and households that lock them into a course of action for long periods. Stability and predictability are an important principle of tax policy. This does not mean that the tax system should never change, but that major changes should be infrequent, consistent with the principles discussed here, and thoroughly and publicly explored before legislation is tabled in parliament.

To be stable and predictable the tax system needs to be sustainable. Subject to the constraint on the total tax burden proposed under the first principle, tax policies need to meet the revenue needs of public expenditure policy now and into the future. If the outcome of the current tax review fails this test, it will pass part of the cost of today's government spending policies to future generations and breach the principle of inter-generational equity.

Principle 10: The design of personal income tax should take account of individuals' family circumstances.

Horizontal equity requires that how much a given income is taxed depends on the number of family members it has to provide for. This principle has been reflected in the design of Australia's tax/transfer system in different ways over time; in recent years, it has been reflected through the dependent spouse rebate and generous family tax benefits. The latter, despite the nomenclature, are not really part of the tax system but are means-tested transfer payments to households.

This is not the place to go into the details of alternative ways of reflecting this principle in the tax/transfer system, but the benefits of doing so— through differential thresholds, tax offsets or deductions that depend on the number of dependents—have been argued elsewhere.¹¹ Australia's combination of steeply graduated personal income tax rates and generous, but means-tested, family benefit payments creates very high effective marginal rates and huge disincentives to work and save over certain income ranges. It also creates a certain degree of 'churn' whereby some of the recipients of transfer payments are

paying high marginal tax rates in the first place. The alternative is to deliver more of the assistance for family circumstances through lower taxes and less through transfer payments.

Endnotes

- 1 The review panel, Australia's Future Tax System chaired by Dr Ken Henry, Secretary to the Treasury, is to report to the government by December 2009.
- 2 Vito Tanzi and Ludger Schuknecht, *Public Spending in the Twentieth Century* (Cambridge University Press, 2000).
- 3 Gerald W Scully, 'What is the Optimal Size of Government in the United States?' (Dallas, Texas: National Center for Policy Analysis (NCPA), 1994).
- 4 Robert Carling and Stephen Kirchner, *Fiscal Rules for Limited Government: Reforming Australia's Fiscal Responsibility Legislation*, CIS Policy Monograph No. 92 (Sydney: CIS, 2009).
- 5 'Australia's Future Tax System,' Consultation Paper (Commonwealth of Australia, December 2008), 170.
- 6 Peter Whiteford, 'Transfer Issues and Directions for Reform: Australian Transfer Policy in Comparative Perspective,' paper presented to a conference on Australia's Future Tax System, Melbourne (18–19 June 2009).
- 7 Australia's Future Tax System, as above, 171.
- 8 See Sinclair Davidson, *Fiscal Illusion: How Big Government Makes Tax Look Small*, CIS Policy Monograph No. 81 (Sydney: CIS, 2007).
- 9 For a recent elaboration of this point, see John Humphreys, 'Revealing Australia's Real Income Tax Rates,' *Policy* 25:2 (Sydney: CIS, 2009).
- 10 For a full discussion of this point, see Robert Carling, *Tax Earmarking—Is It Good Practice?* CIS Policy Monograph No. 75 (Sydney: CIS, 2007).
- 11 For example, Peter Saunders and Barry Maley, 'Tax Reform to make Work Pay,' in *Taxploitation—The Case for Income Tax Reform*, CIS Readings 11 (Sydney: CIS, 2006).