ISSUEANALYSIS

The Henry Tax Review: A Liberal Critique

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The public release of Australia's Future Tax System—known as the Henry review—in May 2010 sparked an ongoing debate in Australia about the structure and efficiency of the country's tax system. The review recommended substantial reforms be made to state and federal taxes, including dramatic simplification of income tax, wider use of rent and land taxes, and more consistent and appropriate treatment of income from capital gains and savings.

The review was rightly well received—it offered a dramatically better vision for a national tax system than what we have now. But its recommendations are not above criticism. Beyond a desire for lower taxation and government spending in general, proponents of classical liberalism might raise four broad objections.

1. The review proposes too great a reliance on income tax compared to consumption tax. Consumption tax, broadly based and uniformly enforced, is less difficult to enforce and less damages work incentives.
2. State governments should take more initiative to reform their own tax bases, particularly by curtailing the use of transfer duties; the Commonwealth government should let states become more self-sufficient to foster the benefits of federalism.
3. The review leaves further scope to improve the transparency of the tax system, particularly by removing the ability to make tax deductions (provided the savings are used to cut income tax rates).
4. The proposal to apply a discount to income from savings could be simplified and improved by applying a flat rate to savings income regardless of the recipient (with some indexation relief for inflation).

A discussion of how tax systems should be assessed, from a broad liberal perspective, precedes these criticisms.

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Introduction[1]

Tax reform was not the dominant topic of Australian public debate in the campaign that led to formation of the Rudd Labor government in late 2007. In fact, the election was fought largely on the Howard government's industrial relations reforms (Work Choices) and the perceived hubris and inertia of the incumbent government.

This was unfortunate because the Australian tax system needed substantial reform. The damage to Australia's economic welfare—wrought by inefficient and complex taxation—is greater than that from any other single government incursion, including industrial relations regulations. Australian governments collectively levy more than 120 different taxes, many of which are inconsistent, unfair and inefficient.

Nevertheless, the reform process had stalled. The introduction of the Goods and Services Tax (GST) to replace wholesale sales tax in 2000, together with associated income tax cuts, was the last significant tax reform. Tax reform is obviously difficult because it can affect large numbers of voters. It creates winners and losers, who will vociferously defend their interests; however, many of those interests may be contrary to the public good. It is surprising, then, how much tax reform has dominated the Rudd and Gillard governments' agendas.

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It all began in March 2008 when, Malcolm Turnbull, Treasury spokesman for the opposition, announced a wholesale review of the Australian tax system to be conducted by economist Henry Ergas.[2] In April 2008, the Rudd government's 2020 Summit—a forum where renowned Australians proposed ideas for the country's long-term future—came up with the idea of a government-sponsored tax inquiry.

Formally known as Australia's Future Tax System, the review has become known as the Henry review, after former Treasury Secretary and review chairman Ken Henry.[3] Containing 138 recommendations for reform—encompassing federal, state and local taxes—the review was completed in late 2009 and released to the public in May 2010. The review sought to 'create a tax structure that will position Australia to deal with its social, economic and environmental challenges and enhance economic, social and environmental wellbeing.'[4]

Further, the government convened a Tax Forum in October 2011 to encourage further debate, but there has been little practical impact so far, notwithstanding the treasurer's announcement to aspire to raise the tax-free threshold to $21,000 and abolish the Low Income Tax Offset (LITO).

The review has rightly been praised across the political spectrum (albeit with different emphases!).[5] Compared to the status quo, it offers a far simpler, a more efficient and intellectually consistent framework for raising revenue to pay for the Commonwealth government's vast array of responsibilities. In the 2011–12 financial year, the Commonwealth anticipates an expenditure of more than $370 billion.

Since May 2010, the Gillard government has announced a handful of tax changes in keeping with some of the review's recommendations, such as raising the tax-free threshold to $18,200 from the current $6,000.[6] But it has steered clear of any recommendations that might cause political difficulty, such as substantively changing the way income from bank deposits, investor housing, and capital gains are taxed.[7]

The review offers an excellent guide to reform but it is not faultless, at least from a liberal perspective:[8]

1. consumption tax should feature more prominently
2. federal financial relations and state taxes need a wholesale overhaul
3. 'fiscal illusion' should be ameliorated, and
4. capital gains tax could be further simplified.

But before examining those topics, let's consider what liberals think makes a good tax system.

Assessing systems of taxation

Classical liberals advocate limited, defined government subject to the rule of law, as they believe those circumstances provide the best opportunity for individuals to prosper freely and for society to develop peacefully. To that we can add strong liberal support for federal government, which in theory constrains its size and fosters beneficial tax and policy competition.

Certainly, the prevailing size and scope of Western governments, including the Australian government, significantly exceeds the level liberals find desirable. In that sense, classical liberals see less need for government revenue, and therefore, overwhelmingly prefer *lower* taxation.

Nevertheless, beyond arguing for lower taxes and smaller government, classical liberals recognise that taxes are necessary. However, the question of what makes a good tax is more difficult to answer.

Traditional criteria for good taxes provide a useful framework. Broad principles have permeated the tax literature for more than 200 years. These try to answer the question of how tax should be allocated given a particular revenue requirement.

Adam Smith argued that taxes should observe four principles:

- 'The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities.'
- 'The tax which the individual is bound to pay ought to be certain and not arbitrary.'
- 'Every tax ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the contributor to pay it.'
- 'Every tax ought to be so contrived as to take out of the pockets as little as possible, over and above that which it brings into the public treasury of the state.'[9]

Classical liberals see less need for government revenue, and therefore, overwhelmingly prefer lower taxation.

The contemporary tax criteria of equity, efficiency and simplicity are evident throughout all analyses of tax systems. They are promoted in both the Asprey and Henry reviews.[10]

Points two and three foreshadow the 'simplicity' criterion. Point four can be interpreted to mean 'efficiency' in the economists' sense of minimising deadweight losses by virtue of taxes that affect individual behaviour as little as possible.

The first point stipulates a form of equity: people pay tax according to their 'respective abilities.' John Stuart Mill, in his 1848 tome, *Principles of Political Economy*, recognised that such a criterion, while intuitive and popular, still left considerable room for disagreement. It is not clear what 'in proportion to their respective abilities' means.

Mill assumed that marginal utility was a declining function of income, and argued that Smith's criterion should be interpreted to mean 'equality of sacrifice.' This meant 'apportioning the contribution of each person towards the expenses of government so that he shall feel neither more nor less inconvenience from his share of the payment than every other person experiences from his.'[11]

On this reasoning, taxing away $5,000 from a person making an income of $50,000 is a greater burden than taking $10,000 from a person making $100,000.

Mill thought the most practical application of this assumption was an income tax with a tax-free threshold set to accommodate the 'necessities of life ... but not with any indulgence.' Thereafter, all income would be taxed at the same rate, producing a rising average tax rate across all incomes above the threshold.

Mill recognised this wasn't perfect but decided further refinements—including higher tax rates further up the income scale—could not 'be decided with the degree of certainty on which a legislator ... ought to act.' People were simply too diverse, and governments' knowledge too rudimentary and limited, to specify a more precise tax scale.

Modern legislators, however, have held less modest views. For example, Australia's income tax schedule in 1969–70 had 29 progressive marginal tax scales and a top rate of 68.4%.[12] As utilitarianism developed in the nineteenth century, the concept of 'ability to pay' became more sophisticated.

Utilities, it was thought, could be measured and compared across individuals. Time spent working detracted from utility, while income from work augmented it. Ability varied across the population; more able people could earn the same income as a less able person with less effort; therefore, those with greater ability to earn income would be the object of taxation. Pure utilitarians believed it was not fair to tax a high ability person earning $70,000 the same amount as a low ability person earning $70,000, because the latter would have had to work harder to produce the same income.

On this reasoning, a government wanting to minimise aggregate loss of utility from taxation would tax ability, not income. In effect, the more able would be forced to work harder than the less able.

A government with such utilitarian aims would try to ensure everyone had the same income, net of tax. British economist Francis Edgeworth, in 1897, called this 'the crowning height of the utilitarian principle, from which the steps of a sublime deduction lead to the high tableland of equality.'[13]

The sublime deduction, however, was impossible (which Edgeworth himself recognised). Governments can only observe total income (not how many hours it takes to produce the income), while effort is a choice. If taxes are levied too highly on those with higher incomes they will work less, which leaves everyone worse off. Consider what would happen to IQ scores if a higher tested IQ scores made one eligible for even slightly higher taxes!

The 'ability to pay' principle has become the pre-eminent principle for allocating taxation, notwithstanding its lack of clear definition.

The natural information asymmetries between taxpayers and governments, together with the incentive effects of taxation, (thankfully) undermine the utilitarian scheme. James Mirrlees formalised the impact of incentives and information on the utilitarian framework of taxation in the 1970s; he later won the Nobel Prize. Mirrlees demonstrated a trade-off between equity and efficiency, which has since become the crux of tax theory and tax debate.[14]

Nevertheless, finding a way to tax ability without affecting behaviour still stirs the economics profession. Greg Mankiw, a prominent American economist, wrote a paper in 2009 proposing to tax people based on their height, and found that 'each inch of height adds just over two percent to wages.'[15] Height could therefore be a consistent proxy for ability, and a suitable object of taxation in the utilitarian framework!

Another justification for allocating tax is the 'benefit theory.' It argues that fair allocation is where those who benefit most from government pay the most tax.[16]

It is not clear how this would affect the distribution of taxation *a priori*. For example, the rich benefit from the state because it protects their property. But perhaps the poor benefit more because they use the state to extract benefits.

Swedish economist Eric Lindahl, in 1919, tried to make this principle operational.[17] He proposed that the optimal quantity of a public good, say police, military, defence, etc. is where the willingness to pay for one more unit, summed over everyone in a given place, is equal to the cost of providing that extra unit.

Most people would be inclined to understate their demand, however. How much would you personally pay for one extra policeman in your suburb? This is the classic 'free rider' problem—and why the benefit theory struggles in practice, even if it is fair in theory.

The 'ability to pay' principle has become the pre-eminent principle for allocating taxation, notwithstanding its lack of clear definition. Different people will subjectively prefer different places on the equity-efficiency trade-off, which optimal tax theory has formalised. In practice, that debate manifests itself most commonly in relation to

the progressivity of the income tax system, where those who prefer efficiency tend to argue for a flat or at least flatter rate of income tax.[18]

The economist's conceit

Although these criteria permeate analysis of tax design, their practical utility is marred by their naive assumptions about government, which they assume to be a benevolent government that is willing to accept the advice of professional economists to optimise 'social welfare' defined in some impartial way.

Introspection and evidence suggest these are heroic assumptions. The very existence of numerous damaging taxes, across all countries, and the rapid expansion of government spending in the twentieth century beyond the point most economists would consider sensible, suggest government may tax and spend according to incentives determined in the political sphere, not 'some abstracted exercise within the political naiveté of the economist's study.'[19]

Geoffrey Brennan and James M. Buchanan, in *The Power to Tax*, for instance, contribute substantially to a persuasive and formidable line of literature in economics, known as the 'public choice' school, that emphasises the need to restrain government's power to tax in the Constitution.

They incorporate realistic political incentives into an economic framework. For them, government should be ascribed the same self-interested motives as those traditionally imputed to the private sector. Government might act more like a monopoly than a benevolent social planner. It might prefer to make taxation as covert or imperceptible as possible.

Indeed, taxes deemed effective and efficient according to classical criteria—such as a broad-based consumption tax—may in fact encourage and enable governments to acquire even more revenue. The very efficiency of a tax may facilitate its expansion.[20]

Kenneth Hennessey went even further to write, 'a perfectly structured tax code that collects 25 percent of GDP is worse than a flawed tax code that collects 18 percent of GDP. Beware the siren-call of the money-pump VAT.'[21] He clearly worried that government spending may not be independent of government taxation. The standard criteria neglect the likely link between taxation and revenue, and government spending.

The very efficiency of a tax may facilitate its expansion.

For this reason, classical liberals must not also weigh specific tax reform proposals against the criteria of 'pure' simplicity, efficiency and fairness but also against the practical incentives and constraints that government acts under. Whatever the theoretical merits of a particular tax, ultimately liberals should want smaller government and lower taxation over time.

Taxing consumption or income

Although Treasurer Wayne Swan called the Henry review 'the most comprehensive review of Australia's tax system since World War II,'[22] he restricted it in two key ways: prohibiting the broadening of the tax base and lifting the GST rate, and directing the review panel not to presume a smaller size of government.

The GST restriction was disappointing, and one seemingly driven entirely by politics. One tax economist recently wrote that consumption taxes, properly administered, are 'perhaps the most economically efficient way in which countries can raise significant tax revenues.'[23]

Notwithstanding the broad public choice criticism of the consumption taxes discussed above, consumption taxes are generally simpler to administer than income taxes; in practice, they are levied on goods and services and collected from businesses.[24] Businesses are less numerous than individual taxpayers, which reduces the number of collection points. Consumption taxes are also more difficult to evade, which reduces enforcement costs.

Moral arguments for consumption over income taxes go back many centuries. In 1651, Thomas Hobbes wrote in *Leviathan*: 'what reason is there that he which laboureth much, and sparing the fruits of his labour, consumeth little, should be more charged than he that living idly, getteth little, and spendeth all he gets.'[25]

To put it modern language, given a choice between taxing pleasure, sloth and gluttony on the one hand, and effort and thrift on the other, the wiser government would tax the former.

Hobbes' argument is emotionally appealing but not necessarily accurate for two reasons. A consumption tax also undermines the incentive to work because it reduces the quantity of goods and services that can be bought with income, even if less transparently.[26] Lifetime consumption and lifetime income, abstracting from bequests and debt, are the same.

The chief modern arguments in favour of consumption taxes, however, are their relative efficiency and neutrality towards savings. Income taxes, as they are typically applied, can tax income twice: when earned and the income generated from any saving. Naturally, this discourages saving.

Exemptions distort consumption choices in favour of more lowly taxed goods.

Consider two people on incomes of $50,000 a year. Both pay income tax of about $10,000. One person spends his income, while the other saves $5,000 of after tax income and spends only $35,000. The income generated by the $5,000 of savings will be taxed again, simply because the taxpayer patiently delayed his or her consumption. It gets worse: the income from savings is compensation for price inflation, so savers also pay tax on inflation—a tax on a tax.

Consumption taxes also go some way to taxing leisure, which is often enjoyed in combination with taxed goods and services. Relying on income taxes distorts the economy towards leisure.

The Henry review calculated the marginal welfare loss from a small increase in selected Australian taxes. Welfare losses, also known as deadweight losses, are burdens on people over and above their payment of tax. These burdens arise because people change their behaviour in response to taxes, substituting leisure, for instance, for work.

Using an economic model supplied by KPMG, the Henry review showed that increasing the GST produced the smallest welfare loss of all the federal taxes considered, fewer than 10 cents per dollar of tax raised. Increasing personal income tax, by contrast, was more than three times as damaging.[27]

The refrain that people don't 'save enough' or don't 'save prudently enough' is not surprising, given Australia's heavy reliance on income taxes relative to consumption taxes. For example, Australian workers on the 31.5% marginal income tax rate can face a real effective marginal tax rate on their savings of up to 60%.[28]

Consumption taxes are impaired to the extent goods and services are exempt from the tax. Exemptions distort consumption choices in favour of more lowly taxed goods. And they can have unusual consequences, for example, rich people who enjoy home cooking will avoid tax while the poorer family who save to dine out will be punished.

Among countries with an indirect consumption tax, Australia has a moderate range of exemptions, almost exactly as the OECD average, including unprepared foods and education services.

According to a recent review of the British tax system by Sir James Mirrlees, 'There is a strong case for broadening the VAT and moving towards a uniform rate.'[29]

In fact, far from reducing equity, which is the usual justification for exemptions, Mirrlees claimed: 'If almost all zero and reduced rates of VAT in the UK were removed, the government could (in principle) compensate every household to leave them as well off as they were before and still have about £3 billion of revenue left over.'[30]

The argument for greater reliance on consumption tax is particularly pressing in Australia. We have a growing group of self-funded retirees, much of whose incomes are exempt from taxation: politicians have ensured that superannuation is largely

untaxed when it is withdrawn. Raising the level of consumption tax would be one way Australia could extract taxation from a growing pool of individuals currently exempt from income tax.

The Henry review suggests it might have recommended broadening the GST, had its hands not been tied.[31] It notes the GST 'is less efficient than it could be because of its failure to tax consumption on a truly comprehensive basis.'[32] As for equity considerations, which are often adduced to argue against such a broadening, the review argues, 'the transfer system, together with progressive personal taxation, is better suited … to influencing the degree of redistribution in the economy.'[33]

State taxes

The Henry review rightly points out that state taxes are the least efficient or fair in Australia. They are narrow, levied at high rates, and elicit volatile revenues. And their real burden can be confusing.

The KPMG model referred to earlier shows that stamp duties on property and insurance, and motor vehicle taxes, are the most damaging in Australia, even less efficient than income tax. Insurance taxes lose almost 70 cents in welfare for every dollar they raise.

States have access to the low hanging fruit of beneficial tax reform. Yet the review only gives one recommendation for state tax reform, number 119, which says changes to state taxes should be coordinated through intergovernmental federal-state agreements.

States should be encouraged to carry out reform alone, especially given the current political landscape.

States already have access to two potentially large and efficient revenue bases—land tax and payroll tax. In NSW, for instance, those taxes make up 12% and 31%, respectively, of the state's total tax revenue.[34]

Land is arguably the best source tax. Indeed, nineteenth century American economist Henry George thought land tax would 'raise wages, increase the earnings of capital, extirpate pauperism, abolish poverty, give remunerative employment to whoever wishes it, afford free scope to human powers, lessen crime, elevate morals, and taste, and intelligence, purify government and carry civilization to yet nobler heights.'[35]

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That is perhaps an exaggeration! Identifying economic rents can be notoriously difficult: They are not observable in practice because they are a theoretical concept.[36] Nevertheless, tax levied consistently, without exemptions, on the unimproved value of all land cannot be evaded, and land cannot move to another jurisdiction, as capital and labour can. It therefore has zero efficiency cost.

But about 70% of land by value is exempt from land tax, including all owner-occupied land. A 0.50% tax on the unimproved value of all land would be sufficient to abolish all stamp duties.[37] As a proportion of the real costs of moving, the Henry review calculated that existing stamp duties are equivalent to a tax on moving of 94% and 101%.[38] These taxes have very significant behavioural costs—people are less inclined to move to take up a new job, for instance.

Payroll tax, widely thought of as a tax on business, is a tax on labour as much as direct taxes on wages. Businesses rail against it, but in the long run they pay their workers less or hire fewer staff to make up for it. It is akin to the 9% superannuation guarantee: a cost paid by businesses but ultimately borne by employees.

Payroll taxes, like land taxes, also permit far too many exemptions. About 43% of employee compensation is exempt in NSW, for instance. Since 1971, when states obtained payroll taxes from the Commonwealth, they have increased rates from 2.5% to over 6%, and roughly tripled the original tax-free threshold.[39]

Fiscal federalism

The Henry review acknowledged the gross imbalance between states' tax-raising abilities and their actual and constitutional responsibilities. But it did not explicitly propose that Australia's vertical fiscal imbalance should be fixed.

To take NSW as an example again, only one-third of its revenue comes from taxation. A much larger fraction comes from Commonwealth grants, including payments for specific purpose.

This mismatch has long been a serious problem in Australia's federation.[40] State parliaments possess broad legal powers, but they have very little financial clout.

The effects are manifold and serious. First, state governments do not endure the political pain of raising their revenue and so have little incentive to be efficient with the money they are given.

Second, the federal government's relentless interference in areas of clear state responsibility neuters states' incentives to develop and implement beneficial policies themselves. It also confuses the public by blurring the division of responsibilities.

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Together, these create the impression among voters that states are an intrinsically wasteful form of government, when they are only behaving according to the incentives they face. It was not always thus. In the 1940s, the Labor premier of NSW, William McKell, pursued an independent economic and social agenda, and railed against Commonwealth incursions.[41]

Australia has all the costs of duplication but few if any of the benefits that federalism confers—competition and policy innovation that foster economic growth, and a dilution of the Commonwealth's power.

The Commonwealth should return some income tax raising powers to the states. The Fraser government offered to share income tax with the states, but it did not reduce its own taxes to make room.

Here is one way to restore economic sense to Australia's federation. The Commonwealth ceases making contingent grants to the states. Only the untied GST grants (ideally from a broader base) flow from Canberra.

The Commonwealth reduces its income tax by the value of its existing contingent grants, which in 2011–12 totalled $45 billion.[42] That amounts to one-third of income tax revenue.

The states, facing a massive funding shortfall, seek revenue elsewhere. They would be encouraged to calculate a flat rate of income tax applicable within their jurisdiction. The Australian Taxation Office (ATO) would collect it on their behalf and remit the money to the states.

States potentially settle on different income tax surcharges, instilling an element of tax competition. Crucially, they would share the same income tax base with the Commonwealth, and be permitted only a flat percentage surcharge.

In this framework, states would be left with land, income and payroll tax, and ongoing GST payments. Decisions at the margin to raise or lower taxes would be the states' alone. They would be fiscally independent from the Commonwealth, in competition with each other, and able to pursue freely the policies their voters elected them to carry out. The Council of Australian Governments (COAG), and any other bureaucratic appendages, would no longer be necessary. Its disposal, along with other federal public servants currently supervising state public servants, would allow lower taxes all around.

Fiscal illusion

About a hundred years before Adam Smith penned his four tax criteria, the French finance minister Jean-Baptiste Colbert famously said, '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.'

The impetus for fiscal illusion has been well documented. Nobel Prize winner James Buchanan argued: 'political agents find it in their interest to modify the fiscal consciousness of citizens'; in particular, the 'tax impositions will be made to seem less onerous than might otherwise be the case.'[43]

In modern times, perhaps no tax criterion has been met more assiduously. This is either good or bad depending on one's politics. For genuine liberals, it has been a disaster because it undermines transparency and allows government to be larger than a more honest system would permit.

Complexity helps obscure the size of government. The *Tax Act* grew from 126 pages in 1936 to more than 6,000 pages in 2009.[44] It is a particular problem for Australia: over 70% of Australians seek tax advice before lodging their returns, second only to Italy.[45]

The Henry review rightly recommended abolishing the Medicare levy and LITO, two particularly egregious examples of fiscal obfuscation, and various other tax offsets and deductions.

The review also recognised that tax deductions have become too complex and inconsistent. But the recommendation that a standard deduction be available for all taxpayers, although an improvement, is not the best solution.

Tax deductions are the fool's gold of the tax system, and it is better to abolish all personal tax deductions.

Tax deductions in theory might be a valid compensation for the costs incurred in earning an income. But the existing array of deductions is so arbitrary and unfair[46] that it is better to remove them entirely and let prices and wages adjust to reflect the new state of affairs.

Personal deductions total about $32 billion each year, more than half of which are 'work-related expenses.'[47] If deductions were removed, not only would taxpayers enjoy a significant tax cut but they would also be spared the arduous chore of managing their receipts and gaming the deductions system.

Provided all the extra revenue was used to cut income tax rates, and personal deductions were abolished, taxpayers could get a tax cut of about $800 a year. For instance, the government could cut the 15% income tax rate by a few percentage points, and improve the incentives to work for the lowest-paid.

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Having a 'standard' $500 or $1,000 deduction, which the Gillard government has proposed, is a marginal improvement at best. For a start, the complex system of deductions will still exist for taxpayers who believe they are owed more than the standard deduction.

Second, no tax cuts will be available. On the contrary, the proposed standard deduction is costly: tax revenue will fall by about $800 million a year, as the volume of 'deductions' increases dramatically—who wouldn't tick a box to claim it? And Treasury reckons welfare costs will increase by $300 million a year as family tax benefits and baby bonus recipients receive an automatic boost in their payments, which are based on taxable income.[48]

Finally, the government's plan assumes taxpayers are too obtuse to see that a 'standard' deduction of $500 is equivalent to having no deductions and paying less income tax—an unflattering appraisal.

Another way to make the income tax system more transparent is to set tax rates that facilitate easy calculation of tax owed and paid. The review should have proposed a headline marginal income tax rate that is easier to compute than 7/20 (35%). One-third would have been preferable; one-quarter would be even better.

Moreover, it is not sensible to propose a corporate tax rate that is different from the headline marginal income tax rate. The Henry review's recommended corporate tax rate of 25% is a fine choice, but given our system of dividend imputation it interacts poorly with the headline marginal tax rate of 7/20.

In fact, the biggest contributor to fiscal illusion is Pay As You Go (PAYG) withholding tax itself. Withholding of personal income tax was introduced in Australia in 1942, when the Commonwealth government 'temporarily' appropriated the states' income taxes.[49] Every worker is familiar with his or her gross annual wage and net weekly wage. But few know their gross weekly wage or their weekly income tax payment. PAYG weakens the sense of ownership employees have over a significant fraction of their rightful earnings.

Another technique of fiscal illusion is mandating that prices be inclusive of GST. In 2008, the government passed the *Practices Amendment (Clarity in Pricing) Act 2008*, which banned the quotation of prices exclusive of GST. Ideally, prices should be quoted exclusive of GST to remind taxpayers they are in fact paying a tax when making purchases.

Capital taxation

PAYG weakens the sense of ownership employees have over a significant fraction of their rightful earnings.

The Henry review seriously undermines the Haig-Simons comprehensive income tax, which implies that all income should be taxed, regardless of how it was earned—a dollar is a dollar. This view has been applied in Australia since 1985 when capital gains tax was introduced and levied at each individual's marginal tax rates.

The comprehensive income tax defined income as consumption plus the net change in marketable wealth in a given period. Equalisation of the tax rates on income and capital gains was the hallmark of this approach.[50] Australia began taxing capital gains at marginal income tax rates in the 1980s, with indexed relief for inflation.

Following the 1999 Ralph review of corporate taxation, Australia scrapped indexation and introduced a 50% discount on capital gains tax for individuals where assets were held for more than 12 months (companies receive no discount, and superannuation funds a 33% discount). Although hailed as a reduction in the effective marginal tax rate on capital gains, it is not in fact the case when inflation is high.

Capital gains are the return from delaying consumption—saving—and as discussed earlier would not be taxed at all in a neutral tax system. Formal economic models argue for a zero rate of capital gains tax on efficiency.[51] Equity considerations—capital gains mainly accrue to wealthier individuals, at least in the short term—make zero taxation politically difficult, however.[52]

It is widely acknowledged that capital is more responsive to taxation than labour, which can less readily move to another tax jurisdiction. And a country's long-run productivity, which affects wages, is improved by a greater capital stock. It is far from clear that taxing capital fully satisfies the equity objectives it is meant to.

Further, the fear that taxpayers will convert ordinary income into capital gains to avoid taxation is overblown. Alan Greenspan once remarked that he'd heard repeatedly how capital gains tax stymies such conversions, but he himself could never work out how to do it.[53] In fact, it is extremely difficult to convert labour income into capital gains; where ambiguity exists for a particular corporate vehicle or payment, it is incumbent on the tax authorities to make a ruling to maintain the integrity of the tax system.

The Henry review recommends a 40% discount be applied to all savings income, including interest income, capital gains, and net rental income. Taken as a whole, this reform would be a huge improvement on the current system. For example, the existing regime taxes safer forms of savings much more highly than riskier forms like property and shares. Nevertheless, for capital gains subject to a 50% discount, the Henry recommendation is in effect an increase in capital gains tax. Moreover, it still permits taxation of inflationary gains.

It is neither right not efficient that taxpayers pay tax simply because inflation, which is unpredictable and variable, is eroding their purchasing power.

A better proposal would be to levy a single flat rate of tax on all savings, say 10%, and index the base for inflation where possible, without any arbitrary

discount windows. Administration costs could fall significantly too, as tax from savings could be withheld at source. Moreover, empirical evidence shows that lowering capital gains tax rates is frequently associated with large increases in capital gains tax revenue.[54]

Conclusion

It is disappointing how slow the take-up of the Henry review's proposals has been; indeed, the government has not responded to a larger number of recommendations.[55] The government claims to be implementing policies 'consistent' with more than 20 of the 138 recommendations. But in reality, barely any of these policies are consistent with the actual recommendations.

Perhaps this is not surprising. It took more than 10 years for past Australian governments to implement dividend imputation and capital gains tax, changes that were recommended by the Asprey review in 1975.

That said, the Gillard government plans to curb the LITO are welcome, although it should be abolished entirely. The Dependent Spouse rebate and Entrepreneurs Tax Offset have been flagged for removal, which will also reduce complexity and hidden unjust subsidies.

The planned increase in the tax-free threshold to $18,200 is sensible but it is not indexed to inflation, so the benefit will dwindle over time.

Neither side of politics offers much hope for wholesale reform.

Neither side of politics offers much hope for wholesale reform. The Labor Party vaunts 'stronger, simpler, fairer' taxes, while the Liberal Party lauds 'lower, simpler, fairer' taxes. Sadly, efficiency does not rate a mention, even under the guise of a friendlier word like 'better.'

Political parties would be wise to use the economic crisis overseas as an excuse, valid or not, to implement sensible if difficult reforms here. Australians are observing the consequences of lax fiscal policy and ineffective taxation in Europe and the United States—and are naturally concerned.

We could draw inspiration for reform from New Zealand. Roger Douglas, who was New Zealand's finance minister in the 1980s, oversaw huge and successful tax changes there.

In 1989, he implored leaders to 'implement reform by quantum leaps. Moving step by step lets vested interests mobilise.' His sage advice: 'Speed is essential ... delay will drag you down before you can achieve your success.'[56]

Endnotes

1 This is an edited and expanded version of a speech given to the Tax Institute in Sydney on 31 August 2011.
2 The opposition's review has not been released publicly.
3 Ken Henry, et al., *Australia's Future Tax System: Report to the Treasurer* (the Henry review) (2009).
4 As above, v.
5 Political parties have favoured recommendations in keeping with their particular principles. Economists have praised it more broadly. See Saul Eslake, 'Rudd Government's cautious response to ambitious and visionary Henry Review,' *The Age* (Melbourne: 3 May 2010).
6 This reform however is being funded from the imposition of a carbon tax.
7 It has planned a tax discount for $500 of interest income, but this is a pale reflection of the review's recommendation.
8 By 'liberal,' I mean liberal in the traditional sense of lower taxation and limited government.
9 Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776), Book, V Chapter II.

10 The Asprey review, commissioned by the McMahon government and published in 1975, is a previous inquiry into the Australian taxation system. Of course, these criteria might animate evaluation of existing taxes, but sheer political expediency often guides the introduction of taxes.
11 John Stuart Mill, *Principles of Political Economy* (1848), Book V, Chapter II.
12 Stephen Barber, 'Taxpayers in the Top Bracket,' Parliamentary Library Research Note 47 (29 March 2004). As recently as 1981, the US income tax code had 16 different marginal tax rates of up to 70%.
13 Quoted in John Creedy, *Francis Ysidro Edgeworth 1845–1926*, Research Paper 973 (Melbourne: Department of Economics, University of Melbourne, 2006).
14 Consult any standard textbook on public economics, for example, Gareth Myles, *Public Economics* (Cambridge University Press, 1995).
15 Greg Mankiw and Matthew Weinzierl, 'The Optimal Taxation of Height: A Case Study of Utilitarian Income Redistribution,' Harvard Business School Working Paper 09-139 (2009).
16 'Sin taxes' are a third and final justification for tax, traditionally used to change behaviour, either for paternalistic reasons so that people internalise harm that arises from their action. Traditional 'sin taxes' on cigarettes, alcohol and gambling are the most noteworthy. A carbon tax and road congestion charges are good examples of a 'sin tax.'
17 Peyton Young, *Equity in Theory and Practice* (Princeton Paperbacks, 1994), 103.
18 Note that the equity efficiency trade-off takes the underlying utilitarian calculus as a given.
19 Geoffrey Brennan and James M. Buchanan, *The Power to Tax: Analytical Foundations of a Fiscal Constitution* (Indianapolis, IN: Liberty Fund, 1980), Chapter 10.
20 Gary Becker and Casey Mulligan, 'Deadweight Costs and the Size of Government,' *Journal of Law and Economics* XLVI (University of Chicago, October 2003).
21 Kenneth Hennessey, 'Thus Does It Grow: Ten Tips for Economic Dynamism,' *National Review* LXII:22 (29 November 2010).
22 Commonwealth of Australia, Budget Speech (May 2008).
23 Richard Bird, 'Value Added Taxes and Excises: Commentary,' paper prepared for the Institute for Fiscal Studies, *Reforming The Tax System For The 21st Century* (the Mirrlees review) (London: The Institute for Fiscal Studies, 2011).
24 In theory, they could be levied on each individual's consumption expenditures.
25 Quoted in John Kay and Mervyn King, *The British Tax System* (fifth edition) (Oxford University Press, USA, 1990), 36.
26 It undermines the incentive to work less than a progressive income tax because a consumption tax is generally levied at a flat rate.
27 Ken Henry, *Australia's Future Tax System*, 'Overview,' as above, 13.
28 As above, 33.
29 The Mirrlees review, *Tax by Design*, as above, Chapter 9, 229.
30 As above, 216.
31 It did, however, propose a business cash flow tax, which is similar to the GST; the institutional changes required to switch from a GST to a cash flow tax would be significant, however.
32 Ken Henry, *Australia's Future Tax System*, 'Overview,' as above, 51.
33 As above, Henry Review, Vol. 1, 276.
34 NSW State Budget 2011.
35 Quoted in Robert Heilbroner, *The Worldy Philosophers* (2000), 187.
36 Sinclair Davidson, 'The myth of economic rent,' *The Australian Financial Review* (January 2010).
37 Author's calculation based on Robert Carling, 'State Tax Reform: A Review of Progress and Prospects,' in Robert Carling (ed.), *Taxploitation II* (Sydney: The Centre for Independent Studies, 2011), 158.
38 Ken Henry, *Australia's Future Tax System*, as above, Vol. 1, 255.
39 Robert Carling, 'State Tax Reform,' as above, 146.

40 See Jeff Petchey, Tony Rutherford and Mike Nahan, 'Restoring the Balance: Tax Reform for the Australian Federation' (IPA, 1996).
41 Adam Creighton, 'The Future of the ALP may lie in rediscovering a voice from its past,' *The Sydney Morning Herald* (21 October 2011).
42 Commonwealth Budget Paper No. 3 (2011).
43 James Buchanan, 'Tax Reform as a Political Choice,' *Journal of Economic Perspectives* (1987).
44 Joint committee public accounts and audit, Report 410—Tax Administration, Chapter 3: Complex Legislation, 52.
45 Ken Henry, *Australia's Future Tax System*, 'Overview,' as above, 31.
46 Adam Creighton, '*Ditch Deductions to Lower the Tax Rates*,' *The Age* (20 June 2011).
47 Taxation Statistics 2008/09, ATO, www.ato.gov.au/corporate/content.aspx?doc=/content/00275658.htm.
48 These estimates come from Budget Paper No 2 (2010).
49 Sam Reinhardt and Lee Steel, *A Brief History of Australia's Tax System* (2006); the Chifley government in effect made this a permanent feature of Australia's tax architecture in 1946. In fact, Milton Friedman, the bane of big government, was part of the team that designed the income withholding tax in the United States in the 1940s.
50 John Kay and Mervyn King, *The British Tax System*, as above, 98.
51 Christophe Chamley, 'Optimal Taxation of Capital income in General Equilibrium with Infinite Lives,' *Econometrica* 54:3 (May 1986).
52 However, New Zealand doesn't have one, and Australia never used to.
53 Nevertheless, 'carried interests,' remuneration flowing to partners of private equity funds, can give the appearance of capital gains but may more appropriately be designated returns to labour. The issue has animated tax debates in the United States. See Adam Creighton, 'Taxing Private Equity,' *Policy Review* (Hoover Institute, April 2008).
54 Stephen Kirchner, 'Reforming Capital Gains Tax,' in Robert Carling (ed), *Taxploitation II* (Sydney: The Centre for Independent Studies, 2011).
55 Chris Evans, 'Reflections on the Mirrlees Review: An Australasian Perspective,' *Fiscal Studies* 32:3 (2011); this paper provides a nice comparison of three recent tax reviews in the United Kingdom, Australia and New Zealand, and discusses prospects for implementation.
56 Roger Douglas, 'Politics of Successful Structural Reform,' paper presented to the Mont Pèlerin Society in 1989.

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