TARGET30

REDUCING THE BURDEN FOR FUTURE GENERATIONS

Shrink Taxation by Shrinking Government!

Robert Carling

T30.04

THE CENTRE FOR INDEPENDENT STUDIES

National Library of Australia Cataloguing-in-Publication Data:

Carling, Robert G. author

Shrink taxation by shrinking government! / Robert Carling.

9781922184191 (paperback)

Target30 ; T30.04,

Tax and expenditure limitations--Australia

Government spending policy--Australia.

Expenditures, Public--Australia.

Waste in government spending--Australia.

Taxation--Australia.

Income tax--Australia.

Centre for Independent Studies (Australia), issuing body.

Dewey Number: 336.30994

Shrink Taxation by Shrinking Government!

Robert Carling

THE CENTRE FOR INDEPENDENT STUDIES

T30.04

CIS TARGET30 publications

TARGET30

T30.03 Jeremy Sammut, *Saving Medicare But NOT As We Know It* (2013).

T30.02 Andrew Baker, *Tax-Welfare Churn and the Australian Welfare State* (2013).

T30.01 Simon Cowan, *Towards smaller government and future prosperity* (2013).

Related CIS publications

CIS Readings

R12 Robert Carling (ed.), *Taxploitation II — Tax Reform for Incentive, Productivity and Economic Growth* (2011)

R11 Peter Saunders (ed.), *Taxploitation — The Case for Income Tax Reform* (2006)

Issue Analysis

IA134 Robert Carling, *Australia's Future Fiscal Shock* (2012)

Contents

Executive Summary 2

Introduction 3

Some facts about Australia's tax burden 3

What is tax reform? 5

Why reducing the tax burden is important 6

Building the foundations for tax-cutting reform 7

Eliminating the deficit 8

Creating a surplus 8

How much is left for tax reduction? 8

Broad directions for reform 8

20 ideas for tax reform: Removal, reduction and restructuring 9

A word of caution about tax trade-offs 12

Sustainability of tax reform 13

Endnotes 13

Executive Summary

The TARGET30 campaign by The Centre for Independent Studies advocates reducing the size of general government in Australia (defined as total federal, state and local government expenses) from 35% of GDP to no more than 30% over the next 10 years.

There are two sides to the 'smaller government' coin, the other being taxation. TARGET30 provides scope for a substantial reduction in the tax burden.

Tax reform is likely to return to the policy agenda, but there are widely varying expectations of what kind of reform it should be. In the context of stubborn budget deficits and pressures for more spending, some see tax reform as both restructuring and increasing the tax take, or at least leaving total revenue unchanged.

While tax restructuring can be beneficial independently of its implications for overall revenue, the most beneficial kind of reform would encompass restructuring and reduction. Indeed, tax-reducing reform is the key driver of the economic benefits of smaller government.

Taxation was reformed and some taxes were lowered in the decade before the global financial crisis, but there is now a view that the tax cuts were fiscally irresponsible and became a source of today's deficits. However, the tax cuts of that period were a welcome reform in their own right. The lesson is not that they were wrong but that they should have been accompanied by stronger public expenditure restraint than was applied either before the global crisis or since.

With stronger and sustained expenditure restraint, it is realistic to expect a return to tax-reducing reform in the years ahead. TARGET30 provides a concrete illustration. Reducing the general government expenditure share of GDP gradually to 30% over 10 years would eliminate structural deficits, create a meaningful surplus, and allow room to lower tax revenue by 2.5% of GDP.

While federal taxation accounts for 80% of the national total, reform should also extend to state taxation. Reform options include measures to remove, reduce and restructure taxes.

High priorities for removal include various state stamp duties and the minerals resource rent tax. The options for reduction are led by substantial cuts in company and personal income tax rates. Not all desirable options for removal and reduction would be fiscally sustainable within the headroom created by TARGET30.

Restructuring options could be used to expand the headroom, with increases in some taxes being traded off for the removal of others. The GST is the most obvious of these options. However, in practice, such trade-offs carry the risk that the increases will be implemented while the reductions are deferred or abandoned. Great care will be needed in the design of the reform package to minimise this risk.

The interest of the government is to tax heavily: that of the community is to be as little taxed as the necessary expenses of good government permit.

— John Stuart Mill

Introduction

In March 2013, The Centre for Independent Studies launched a campaign to promote reducing the size of government in Australia—defined as total general government expenses at the federal, state and local levels as a proportion of gross domestic product (GDP)—from the current 35% to no more than 30% within 10 years.[1]

The purpose of this report is to draw the link between tax reform and the quest for smaller government This is not a new endeavour. Over the years, the CIS has published extensively on tax reform, addressing such issues as how tax is best structured and contained to as low a level as is possible and consistent with, in John S. Mill's words, 'the necessary expenses of good government'.[2]

This report will explain that one of the key benefits of reducing the relative size of government is the opportunity it will create for tax reform that not only restructures the tax system to improve it but also reduces the overall tax burden.

Before the global financial crisis, taxation policies of the federal and state governments were generally headed in the direction of lower tax rates. The Commonwealth, for example, was reducing personal income tax and the states were marking down payroll tax. This was occurring in the context of abundant revenue growth driven by strongly rising commodity export prices, asset prices, and incomes generally.

With the global financial crisis and its aftermath, revenue went into reverse and has failed to recover to pre-crisis levels. The focus of federal and state governments has switched to preserving and increasing revenue through increased taxation, and each budget or mini-budget now arouses speculation as to which taxes will be increased to finance new and expanding government programs rather than which taxes will be reduced.

The purpose of this report is to draw the link between tax reform and the quest for smaller government.

Tax rate reductions before 2010 have been blamed for the current structural budget deficit, implying that those reductions should be reversed.[3] But tax rate reductions were (and remain) a desirable economic reform. An alternative view of the structural budget deficit is that it stems from the failure to contain the steady growth of government spending. The slant towards cutting taxes before 2010 was welcome, but for such an approach to return in the foreseeable future, the growth of government spending will have to be curbed and the size of government as a share of GDP reduced, as proposed by TARGET30.

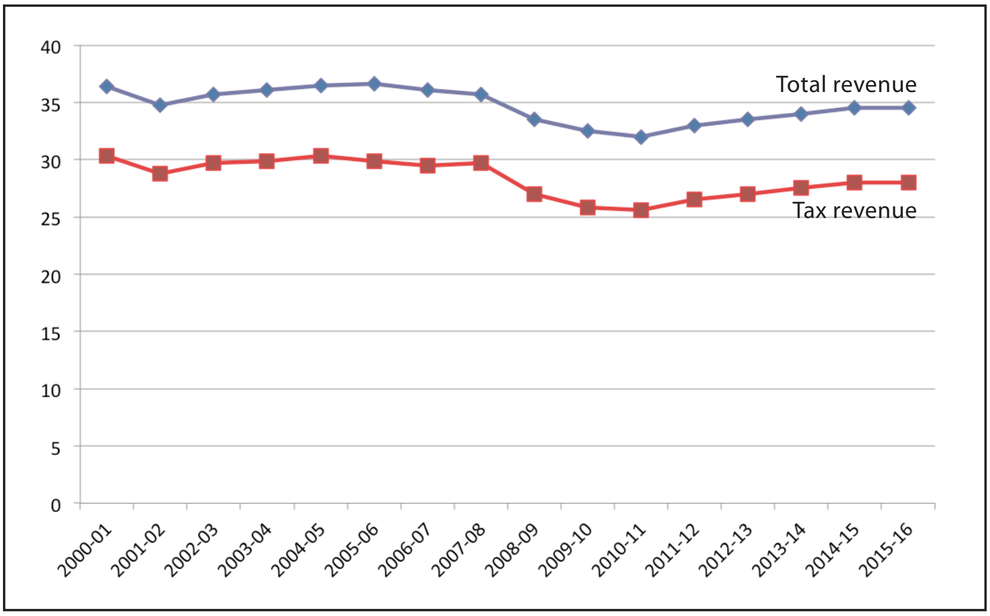
Tax reform has a history of coming, going and returning to the Australian political agenda. With the federal opposition planning a white paper should it win office in the forthcoming general election, tax reform may soon return to the national agenda.

Some facts about Australia's tax burden

The tax burden is usually defined by revenue as a percentage of GDP, even though this is an imperfect measure. GDP *per se* is not a tax base, and for any given set of statutory tax rates, thresholds, and other tax laws, the revenue as a percentage of GDP can vary considerably depending on determinants such as the composition of income and expenditure. It is tax rates, thresholds, and other tax laws and regulations that define the tax burden. However, nobody has yet come up with a simple measure of the burden in those terms. Revenue as a percentage of GDP is the best overall measure we have, but we should remain cognizant of its limitations.

Figure 1 shows total tax revenue as a percentage of GDP and total government revenue, including actual results up to 2011–12 and estimates and projections for subsequent years.

Figure 1: General government revenue as a percentage of GDP (federal, state and local combined)



Source: Australian Bureau of Statistics, *Taxation Revenue 2011–12*, Cat. No. 5506.0 (Canberra: ABS, 2013); and Commonwealth Budget 2013–14, Budget Paper No. 3, *Australia's Federal Relations* (Canberra: Government of Australia, 2013).

The slump in tax revenue as a proportion of GDP reflected mainly compositional changes in the various tax bases rather than reductions in tax rates.

Up to 2007–08, tax revenue was running consistently close to 30% of GDP and total government revenue close to 36% of GDP. Since 2007–08, tax revenue has averaged only 26% and total revenue 33%, having fallen as low as 25.6% and 32% respectively in 2010–11. In 2011–12, there was a partial recovery to 26.5% (tax revenue) and 33% (total revenue). The slump in revenue after 2007–08 reflected a decline in tax revenue rather than non-tax revenue, which remained above 6% of GDP.

The slump in tax revenue as a proportion of GDP reflected mainly compositional changes in the various tax bases rather than reductions in tax rates. Thus, it cannot be said to fully represent an easing in the true tax burden in the sense discussed above.

Without any change in tax policies, the tax revenue/GDP ratio will rise further in the years ahead as the compositional changes that depressed revenue in recent years unwind, although it is unlikely to make a full recovery to the 30% that prevailed up to 2007–08. For example, the 2013–14 federal budget (the Commonwealth being the main driver of national tax revenue) projects that tax revenue will be 2% of GDP higher in 2015–16 than in 2011–12. This would restore Commonwealth tax revenue to around 23.5% of GDP and national tax revenue to around 28.5% of GDP. This is not solely an automatic response to shifts in the economy, as tax policy changes since the 2011–12 budget will account for around 0.7 percentage points of the 2 percentage increase. So if we consider tax policy as it existed in 2011–12 as the base, national tax revenue may recover to around 28% of GDP, and total revenue to around 34.5%.

What is tax reform?

Contrary to modern political discourse, not every change in tax policy, no matter how small, constitutes 'reform'—a word that must surely connote significant change. Usually, it is taken to mean a coherent package of changes touching upon more than one part of the tax system. Beyond that basic definition, however, 'tax reform' can mean different things to different people. To understand these different meanings, it is necessary to distinguish between the structure or composition of taxation and its overall level.

Quite often, tax reform is taken to mean a decrease or increase in the overall tax burden, but it is not necessarily so. For example, the review of Australia's Future Tax System (AFTS, or the Henry review) in 2010 proposed more than 100 recommendations. Had they been accepted, the structure of taxation would have changed radically, but overall revenue would not have because the review's terms of reference called for broad 'revenue neutrality'.[4]

While revenue-neutral tax reform may appear to be a pointless exercise, its advocates are correct in that a change in the mix, structure or composition of taxation can in itself result in benefits assessed against the traditional criteria of economic efficiency, equity and simplicity. For example, the economic cost of taxation is partly a function of the structure of the tax system. Some taxes are intrinsically more disruptive and distorting than others, so a move away from such taxes and narrowly defined tax bases to broadly defined ones will generate economic benefits. This was the emphasis of the Henry review.

Quite often, tax reform is taken to mean a decrease or increase in the overall tax burden, but it is not necessarily so.

While revenue-neutral reform can be beneficial, revenue-reducing reform expands the scope for benefits. The economic burden is a function of the level of each tax and of overall taxation, as well as the structure of the tax system. For a given composition of taxation, a tax system that raises revenue equal to 30% of GDP will impose a larger economic burden *per dollar raised* than a system that raises 25% of GDP. Moreover, the increase in the economic cost per dollar raised is exponential. At 30% of GDP, tax revenue is one-fifth larger than at 25% of GDP, but the economic cost will be much more than one-fifth larger.

Revenue-reducing reform not only expands the scope for benefits but also strengthens the prospects for comprehensive reform. By its very nature, revenue-neutral reform sets losers against winners and increases the political heat surrounding tax reform, whereas revenue-reducing reform expands the universe of winners and makes reform politically more feasible.

There is also a time dimension to assessing the effects of reform on revenue. The effects after a number of years may be different to those at the time of implementation. Reforms that enhance economic efficiency, productivity and growth will generate future revenue growth—and may partially reverse the revenue losses recorded during implementation. Thus, a revenue-reducing package of reforms at implementation may become revenue-neutral or even revenue-positive over time. Conversely, tax increases that generate additional revenue in the short term may harm economic growth over time, which would erode or even eliminate any initial revenue gains.

This report, because of its link to TARGET30, focuses on tax reform within the framework of smaller government, and therefore, less demand for tax revenue, but this approach is not inconsistent with structural reform. The ideal tax reform would combine restructuring and reducing.

Why reducing the tax burden is important

Although tax reform may be pursued independently of the size of government, from the perspective of TARGET30 tax-reducing reform is instrumental to delivering the benefits of smaller government, be they economic or social.

Of the two aspects of tax reform discussed above—restructuring taxation and reducing the tax burden—economists will generally agree that well-designed restructuring is beneficial. But they may not be as ready to support the proposition that reducing taxes will be beneficial because of its connection to the optimal size of government, an issue of much controversy.

The economic case for a lower tax burden is based on the argument that the government sector is larger than its optimal size, in that the economic costs of the last dollar raised exceed the benefits of the last dollar spent. In spending terms, the basis of TARGET30 is the proposition that 30% of GDP is closer to the optimum than 35%.

Diminishing returns apply to growth in the size of government: the larger the government sector, the smaller is the benefit of the last dollar spent and the larger is the cost of the last dollar raised. Lowering the tax burden will generate larger benefits than those foregone as a result of reducing government spending from 35% of GDP. This is not to deny that at 35% of GDP, there may still be a few worthwhile new things for government to do. However, the way to pay for them that will also be best for economic growth is to eliminate wasteful activities of government rather than increase taxes.

Those who defend government spending at current or higher levels tend to see only the benefits of the marginal dollar spent and are oblivious to the high economic cost of the marginal dollar of revenue raised. Politicians have no natural incentive to search for the optimal size of 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 the state, and in all likelihood far exceeds it.

The economic case for a lower tax burden is based on the argument that the government sector is larger than its optimal size, in that the economic costs of the last dollar raised exceed the benefits of the last dollar spent.

Much of the economic case for reduced taxation may be viewed as an empirically observable relationship between the size of government (measured by spending or tax) and economic growth.[5] There is a wealth of empirical evidence for such a relationship. For example, a recent OECD study concluded that an increase in the tax ratio to GDP of 1 percentage point has a long-run effect of -0.5% to -1% on real GDP per capita.[6]

That such a relationship exists should not come as a surprise. All taxes to varying degrees expropriate people's capital or the return on their capital, and therefore, act as a disincentive to capital formation (investment). The greater the level and complexity of taxation and the less predictable it is, the larger the disincentive effect. Taxes create inefficiencies in allocating resources, as participants in the economy restructure their activities from ones that are productive but highly taxed to those that are less productive but attract lower taxes.

These behavioural responses mean that taxation not only takes resources from the private sector equivalent to the amount of taxation but also generates an 'excess burden' or 'deadweight loss' (DWL). As a rule, DWL increases in proportion to the square of the tax rate. A rising tax share of GDP will reduce economic growth; as tax rates increase, the excess burden rises faster than revenue raised.

Vito Tanzi and Ludger Schuknecht have analysed the growth of government in the twentieth century and found that countries with smaller governments not only outperformed economically but also that they did so without underperforming on a broad range of social, environmental and other non-economic indicators.[7] They argue that government spending should be no higher than 30% of GDP, or even lesser, for governments to do everything they can usefully do.

The economic burden of taxation can be reduced through restructuring the system (by lowering rates, broadening tax bases, and shifting from less to more efficient taxes), but the benefits of these efforts will be constrained by the overall size of government. As suggested above, reform should restructure the tax system and reduce taxation.

This is not to suggest that the only arguments for a lower tax burden are economic in nature. There is a purely moral dimension to the case against taxation. As described by David Smith, all taxation is a form of 'plunder' or 'a fundamental injustice, which turns all taxpayers into quasi-slaves who work without reward for many days of the year'.[8] There are counterarguments as to why a non-zero level of taxation is necessary and optimal, but the 'plunder' argument 'explains why a moral state should feel inhibited in the degree to which it levies taxation'. In practice, the main constraint on the state's urge to tax is not a moral one, but the fear of electoral retribution should the populace figure out the degree to which they are being 'plundered'.[9]

Building the foundations for tax-cutting reform

In 2011–12, general government expenses at the federal, state and local levels were 35.4% of GDP. TARGET30 urges reducing it to 30% over 10 years. On a superficial view, achieving this target would create the foundation for an equivalent and a very large reduction in taxation, by 5.4% of GDP—equating to some $80 billion a year in 2011–12 terms. However, there are limitations that will substantially curtail the scope for tax reduction.

First, the structural budget deficit needs to be eliminated. Part of the reduction in spending as a proportion of GDP needs to be reserved for this purpose. Recent estimates by the Treasury and the Parliamentary Budget Office put the federal budget structural deficit at just under 1% of GDP in 2016–17.[10] The Treasury projections, which extend further, foresee a small structural surplus by 2018–19. These estimates do not, however, cover state budgets. Projections for the consolidated general government sector published in the 2013–14 federal budget show an approximate operating balance by 2014–15, although this probably equates to a small structural deficit. This projection envisages expenses falling to 34.2% of GDP by 2014–15.

Second, eliminating the deficit will not be enough if the recent increase in public debt is to be reversed and the future level of debt contained. An operating surplus will be required for two reasons: to provide the funds to pay down debt, and to help fund capital expenditure. While some capital expenditure may be legitimately financed by new borrowings, this is only the case if the expenditure has passed the test of rigorous cost-benefit analysis and can be expected to be productive. As not all capital expenditure by government satisfies this test, some capital expenditure should be financed by operating surpluses. So an additional component of reducing spending to 30% of GDP needs to be reserved to create an operating surplus.[11]

The question is how much of the 5.4% of GDP reduction in spending is needed to eliminate the structural deficit and create a surplus, and how much would be available for net tax reduction?

The question is how much of the 5.4% of GDP reduction in spending is needed to eliminate the structural deficit and create a surplus, and how much would be available for net tax reduction?

Table 1: General government sector aggregates (as per cent of GDP)

	8 years to 2007–08 average	4 years to 2011–12 average	2011–12	2011–12 with revenue recovery	TARGET30
Total expenses	33.8	35.2	35.4	35.4	30
Total revenue	35.9	32.8	33	34.5	32
o/w tax	29.7	26.2	26.5	28	25.5
non-tax	6.2	6.6	6.5	6.5	6.5
Federal tax	24.3	21.3	21.6	23	20.5
State and local tax	5.4	4.9	4.9	5	5
Operating balance	+2.1	-2.4	-2.4	-1	+2

Source: Australian Bureau of Statistics, *Government Finance Statistics, Australia, 2011–12*, Cat. No. 5512.0 (Canberra: ABS, 2013).

Eliminating the deficit

As Table 1 shows, federal, state and local governments combined have recently been running an unsustainable operating deficit of 2.4% of GDP. This deficit is likely to automatically narrow to some extent over the next few years as revenue recovers from the depressive influences of recent years, but this recovery may not be sufficient on its own to close the deficit. Revenue is unlikely to recover to the level of 36% of GDP, which was the average in the eight years to 2007–08, but as discussed above, it may recover to around 34.5% of GDP. (The shortfall of 1.5% of GDP, or $22 billion in 2011–12 terms, is a measure of the unsustainable revenue benefit from factors such as rising terms of trade and asset prices that preceded the global financial crisis.) Thus, a reduction in spending to 34.5% of GDP is necessary just to balance budgets, leaving the remaining 4.5% reduction (from 34.5% to 30% of GDP) for surpluses and net tax reduction.

Creating a surplus

Some of that 4.5% reduction in spending is needed to run surpluses and reduce accumulated public debt. For that to occur, the reduction in spending (as a percentage of GDP) would have to run ahead of the reduction in revenue, thereby creating surpluses. However, there is no need to eliminate debt before reducing taxes, as long as fiscal policy is on a sustainable path. In addition, as discussed above, general government should normally run an operating surplus to contribute to its net capital expenditure. Conservatively speaking, reducing operating revenue to 32% of GDP would be sustainable when spending is lowered to 30% within 10 years, leaving a surplus of 2% of GDP.

Revenue is unlikely to recover to the level of 36% of GDP, which was the average in the eight years to 2007–08, but as discussed above it may recover to around 34.5% of GDP.

How much is left for tax reduction?

A surplus target of 2% of GDP combined with a government expenses target of 30% of GDP implies a reduction in operating revenue from the projected 34.5% of GDP to, say, 32%, or a reduction of 2.5% of GDP. In 2011–12 terms, this is about $37 billion a year. This is the amount that should be targeted for net tax reduction, to be reached gradually in the 10-year horizon of TARGET30.

Broad directions for reform

Aside from whether the aim is to raise less, more or the same amount of revenue, the nature and detail of tax reform measures depend on the broad economic, equity and administrative objectives. As much as possible, any review of the tax system should be scientific and grounded in empirical evidence, but it cannot only be that. What works best in taxation also depends on the goals and values ascribed to the tax system. The principles guiding tax reform need to embody value judgments consistent with a particular economic and social vision for the nation. None of the traditional tax policy objectives—economic efficiency, equity and simplicity—can be pursued independently of the others as they are interdependent and involve trade-offs.

The 20 specific ideas for tax reform listed below are based on the general principle that minimising economic harm should be the dominant consideration in designing tax reform, and that redistribution is better pursued through the allocation of government expenditure. This approach favours private enterprise, individual effort and liberty, risk taking, and economic growth in the belief that these factors will best contribute to community well-being. Simplifying the tax system should also be a high priority.[12]

While federal taxation accounts for some 80% of the national total, reform should also extend to state taxation, where some of the worst inconsistencies with the criteria for good tax selection and design are to be found.

20 ideas for tax reform: Removal, reduction and restructuring

These broad directions for tax reform can be categorised into removal, reduction and restructuring. Table 2 briefly describes each option and gives a rough estimate, where possible, of the revenue effect in 2011–12 terms. These are static estimates and do not allow for behavioural responses to each tax policy change over time. A policy change that triggers a positive response in the relevant tax base over time will have a smaller dynamic revenue cost than the static cost.

As discussed above, the envelope for net tax reduction in 10 years under TARGET30 is $37 billion a year in 2011–12 terms. Clearly not all the removal and reduction options could be adopted within that envelope, but adopting the restructuring options could further expand the scope for removal and reduction options.

Table 2: 20 ideas for tax reform

		Revenue effect in 2011–12 ($ billion)
Removal options		
1.	**Remaining state taxes under the Intergovernmental Agreement on GST reforms** The states agreed to remove a number of their taxes in exchange for receiving the proceeds of the GST, but some states have still not fulfilled all their commitments—notably, NSW and South Australia have repeatedly deferred abolishing stamp duty on business transfers other than real property, duty on certain mortgages, and duty on transfers of unlisted securities.	0.4
2.	**State stamp duties on insurance** Abolishing insurance stamp duties was not included in the GST agreement, but these duties are in the same category of distorting financial transactions taxes as those that have already been abolished, such as mortgage duty. GST applies to insurance and there is no reason to single it out for a second tax.	3.6
3.	**Commonwealth luxury car tax** When the sales tax was replaced by the GST, an additional 'luxury' car tax of 25% was introduced to limit the fall in the price of cars above a certain threshold. The rate was later increased to 33%. The Henry review recommended abolishing this tax, saying there is no reason to single out more expensive cars for a second round of consumption tax.	0.4
4.	**State motor vehicle stamp duties** Stamp duty on motor vehicle purchases is an anachronism. It is a third tax on vehicle purchases in addition to GST and luxury car tax—and should be removed.	2.3
5.	**Commonwealth minerals resource rent tax (MRRT)** The MRRT is distorting and complex, raises little revenue, and encroaches on a state tax base that the states have said they will not vacate. (The estimated revenue effect can only be indicative because it is not clear how much revenue the MRRT will raise in an 'average' year. The figure shown is the 2013–14 budget estimate for 2016–17.)	2.2
6.	**Commonwealth Medicare levy** The Medicare levy is simply a second income tax. It adds complexity to the tax system, sends false signals about the true cost of Medicare, and has become a convenient base for additional opportunistic levies. It should be abolished and folded into general income tax rates, as recommended by the Henry review, with the cost of Medicare (and, in the future, DisabilityCare) funded out of general revenue like all other expenditure programs.	9
7.	**Commonwealth superannuation tax surcharges** Small numbers of high-income superannuation fund members have recently been targeted for additional taxes on superannuation contributions and earnings (for example, the increase in the contributions tax to 30% for those with incomes above $300,000, and the proposed 15% tax on fund earnings above $100,000 when the fund is supporting a pension). These surcharge arrangements are extremely complex to administer, raise little revenue, and are based on dubious equity arguments.	0.5

		Revenue effect in 2011–12 ($ billion)
8.	**Commonwealth and state 'nuisance' taxes** Australia has 125 separate taxes, but 95% of the revenue is raised by 20 of them. The Henry review identified 14 minor taxes that raised only $1.4 billion in 2007–08. A number of these 'nuisance' taxes worth, say, $1 billion a year could be removed following a comprehensive review.	1
Reduction options		
9.	**Cut the company tax rate to 25%** Reducing the company tax rate is one of the most effective ways to spur the economy's long-run potential growth rate. The Henry review recommended a cut from the current rate of 30% to 25%. The government initially warmed to this proposal, but abandoned it when priorities changed. (The estimated revenue effect is net of reduced imputation credits to personal income tax payers.)	8
10.	**Cut personal income tax rates by 15%** Personal income tax has a high deadweight economic cost. Reducing it would do much to spur workforce participation and investment in human capital. Contrary to popular belief, marginal rates have not been reduced by much since the 1990s, and most of the income tax 'cuts' since then have taken the form of increases in thresholds. These were needed, but are not a substitute for lower marginal rates. A 15% across-the-board cut would result in marginal rates of 16, 28, 31 and 38%. This could be further improved, at little or no cost to revenue, by combining the third and fourth rates into a single top rate of 35%.[13]	20
11.	**Reduce fringe benefits tax in line with personal income tax** Fringe benefits tax (FBT) is currently set at the top personal income tax rate. In line with the suggested reduction in the top rate in 10 above, the FBT rate would be reduced to 38% or 35%.	0.8
12.	**A broad savings income discount** The Henry review made a persuasive case that income from savings should be taxed at lower rates than labour income. This principle currently applies to capital gains, retirement savings, and owner-occupied housing but not to other forms of income from saving. The government initially took tentative steps towards a broader application by proposing a 50% discount for interest income, but abandoned it when priorities changed. Information is not available to estimate the revenue cost of a broad discount.	
13.	**Personal income tax threshold indexation** Historically, many personal income tax 'cuts' have taken the form of periodic discretionary increases in thresholds for higher marginal rates, but arguably, these are not 'cuts' but merely corrections for an accumulated inflation that has pushed taxpayers into higher marginal rate brackets. In some countries, thresholds are increased automatically each year under indexation legislation to prevent or limit this 'bracket creep'. Such indexation applied briefly in Australia in the 1970s, but it was soon watered down and abandoned because politicians preferred to take credit for discretionary adjustments. Automatic indexation should be made a feature of the personal tax system once a sensible rate scale is put in place.	
Restructuring options		
14.	**Increase the GST by broadening the base (to include food, water and a larger proportion of low value imports) and/or increasing the rate to 12.5%** This is an economically efficient and administratively inexpensive measure that could raise a lot of revenue, but is regarded with suspicion by advocates of smaller government and a low tax burden for this very reason. It should be considered only as a trade-off for abolishing less efficient taxes such as state stamp duties.	+12 to 20, to be traded off against abolished taxes

		Revenue effect in 2011–12 ($ billion)
15.	**Replace state stamp duties on real estate transfers with a broader land tax and additional GST revenue (as in 14)** Stamp duty on real property transfers is one of the most distorting taxes and one of the most volatile in the revenue it raises, but the states rely heavily upon it. Several tax reviews have recommended replacing stamp duty with a broader and higher land tax. The ACT administration is implementing this change gradually over 20 years. The states have not shown any interest in doing so, but it could be made a condition of additional GST revenue.	11.5
16.	**Replace states' fire service levies on insurance with property-based levies** Some states have now replaced inefficient loadings on insurance to help finance their fire brigades with more efficient levies on property. The states that have not yet done so (including NSW) should follow suit.	1.3
17.	**Rationalise Commonwealth excise duty indexation** Excise duties are set in dollar terms but those on alcohol are automatically indexed to the consumer price index (CPI), those on tobacco to average wages, and those on petroleum not at all since indexation was ceased in 2001. As part of a package including full and automatic annual indexation of personal income tax thresholds, petroleum excise could be indexed to the CPI.	
18.	**Make superannuation taxation more sustainable** There is some credence to the view that the abolition of superannuation benefits tax for the over 60s in 2007 will become fiscally unsustainable in the long term. But instead of narrow and administratively complex 'fixes' (see 7) imposed by the government recently, which will raise very little revenue anyway, a broader remedy is preferable. Ideally, superannuation tax would take the 'EET' form (meaning that contributions and fund earnings are exempt, but all end-benefits are fully taxed). Moving to such a system would be impossible for current participants, but a government with long-term vision could adopt it for new entrants to the super system.	
19.	**Raise the personal income tax-free threshold in lieu of family tax benefits** Replacing family tax benefits with a higher tax-free threshold targeted at taxpayers with children would lower marginal effective tax rates and reduce 'churn', whereby people pay tax only to get it back in cash benefits.	
20.	**Reallocate tax powers from the Commonwealth to states** Australia's fiscal federalism arrangements exhibit one of the worst cases of vertical fiscal imbalance, under which the Commonwealth is the dominant taxing power and the states are heavily dependent on federal grants to finance their constitutional responsibilities for public services. These arrangements are detrimental to accountability, and encourage duplication and blame-shifting between levels of government. While states could exercise their taxing powers more fully, the imbalance has become so wide that it could not be meaningfully reduced without transferring some taxing power back to the states. Elsewhere, I have explored a state personal income tax, offset by a partial withdrawal by the Commonwealth from the personal income tax base.[14]	

A word of caution about tax trade-offs

Tax reform proposals often involve trade-offs—swapping more of one tax for less of another in the name of economic efficiency. One of the best examples of this was the introduction of the GST in 2000 in exchange for abolishing wholesale sales tax and a raft of state financial transactions taxes and personal income tax cuts.

But such trade-offs are vulnerable to what economists call a 'time inconsistency' problem: As governments change and their priorities change, the trade-offs can unravel over time. More often than not, what is left standing is the tax increase side of the trade-off. We have seen this in recent years with the resource super profits tax proposal and its offspring, the minerals resource rent tax, which were supposed to be balanced by a cut in company income tax. The new tax was implemented, but the cut in company income tax was abandoned before it ever happened.

There is no absolute safeguard against time inconsistency, but it helps if the 'plus' and 'minus' components of a trade-off package are implemented simultaneously. It also helps if the tax reduction side of the trade-off takes the form of outright abolition of taxes, because it is harder for governments to reintroduce a tax that has been abolished than it is to restore the level of one that has been reduced but continues to exist.

Sustainability of tax reform

One of the criteria for successful tax reform is that it should be sustainable both politically and fiscally. Political sustainability requires that reform garners sufficiently broad support for long-term survival—if not at the point of implementation, then at least within a few years. Fiscal sustainability requires that the post-reform tax system can raise sufficient revenue to finance long-term projections of government expenditure based on realistic assumptions and policy choices determining the overall size of government.

Sustainability of the tax system is important because the future stability and predictability of taxation is vital to private sector confidence and investment. The more frequent and less coherent the changes are, and the more fearful the private sector is of future tax increases, the more will long-term decisions on investment suffer. For example, a temporary cut in personal or company income tax will fail to generate the favourable incentive effects that can be expected to flow from a permanent reduction. (This principle applies not only to investment in physical capital but also to investment in human capital.)

One of the criteria for successful tax reform is that it should be sustainable both politically and fiscally.

Some commentators and fiscal analysts now criticise the personal income tax cuts implemented in 2003–09 as fiscally unsustainable by causing an enduring structural budget deficit. But as government spending was increasing rapidly at the same time, it seems curious to single out the personal income tax cuts for blame. The tax cuts were long overdue and a vital reform in their own right. Not only did marginal rates need to come down but a decade of bracket creep had also, by 2003, left the thresholds for higher marginal rates absurdly low. A good case can be made, therefore, that tax cuts should have been given priority over spending increases. The problem is that we got both tax cuts and rapid spending growth. It is also likely that had the tax cuts not occurred, the additional revenue retained by government would merely have fed even faster spending growth rather than larger surpluses. The lesson for the future is not that revenue-reducing tax reform is wrong, but that spending has to be contained at the same time. This is the approach proposed by TARGET30.

The long-term sustainability of the revenue-reducing tax reform proposed in this report comes from three sources.

First and foremost, such reform must be accompanied by a reduction in government spending relative to the size of the economy. The reduction to 30% of GDP as proposed by TARGET30 would provide the scope for sustainable tax reduction.

Second, as suggested above some of the fiscal space created by the relative reduction in government spending should be reserved to eliminate the structural fiscal deficit and build a structural surplus of around 2% of GDP (in total for all three levels of government). This surplus will allow the current public debt burden to be gradually run down, and provide a buffer against the longer-term effects of population ageing and rising health costs on government spending.

Third, comprehensive tax reform will yield a long-lasting economic growth dividend through its favourable effects on productivity and workforce participation. Higher productivity and participation are the best antidotes to the long-term damage to fiscal sustainability in prospect from population ageing and rising health costs. Stronger economic growth will generate higher government revenue to finance long-term demands on public services without raising tax rates.

Endnotes

1 Simon Cowan, et al. *Target 30—Reducing the Burden for Future Generations* (Sydney: The Centre for Independent Studies, 2013). If public non-financial corporations (government trading enterprises) are included, the proportion rises to 38.7% on an expenses basis and to 41.5% on a cash payments basis (which includes capital expenditure).

2 See for example Peter Saunders (ed.), *Taxploitation—The Case for Income Tax Reform,* CIS Readings 11 (Sydney: The Centre for Independent Studies, 2006) and Robert Carling (ed.), *Taxploitation II—Tax Reform for Incentive, Productivity and Economic Growth,* CIS Readings 12 (Sydney: The Centre for Independent Studies, 2011).

3 For example, Parliamentary Budget Office, *Estimates of the Structural Budget Balance of the Australian Government 2001–02 to 2006–07* (Canberra: Government of Australia, May 2013).

4 Australia's Future Tax System (AFTS), *Report to the Treasurer, December 2009* (Canberra: Government of Australia, 2010).

5 This relationship should not be confused with the one between public debt and economic growth, which has recently been the subject of controversy on the work of Kenneth Rogoff and Carmen Reinhart.

6 Davide Furceri and Georgios Karras, *Tax Changes and Economic Growth: Empirical Evidence for a Panel of OECD Countries* (Paris: OECD, 2013).

7 Vito Tanzi and Ludger Schuknecht, *Public Spending in the 20th Century* (Cambridge: Cambridge University Press, 2000).

8 David B. Smith, *Living with Leviathan—Public Spending, Taxes and Economic Performance*, Hobart Paper 158 (London: The Institute for Economic Affairs, 2006), 88.

9 For a more complete discussion of moral issues surrounding taxation, see Lauchlan Chipman, *The Moral Case for a Flat Tax,* Chapter 5, in Peter Saunders (ed.), *Taxploitation—The Case for Income Tax Reform*, as above.

10 Parliamentary Budget Office, as above; The Treasury, *Estimating the Structural Budget Balance of the Australian Government: An Update,* Treasury Working Paper 2013-01 (Canberra: Government of Australia, 2013).

11 Gross capital expenditure is partly funded by depreciation allowances, which are an operating expense and are therefore reflected in the operating surplus or deficit. The need for surplus funding refers to capital expenditure net of depreciation expense. Net capital expenditure, so defined, was about 1.5% of GDP for all levels of general government in 2011–12.

12 For a more complete discussion of the desirable principles for tax reform, see Robert Carling, 'Ten Principles for Tax Reform,' *Policy* 25:3 (Sydney: The Centre for Independent Studies, 2009).

13 I have advocated a 35% top rate in *The Unfinished Business of Australian Income Tax Reform*, Policy Monograph 108 (Sydney: The Centre for Independent Studies, 2010).

14 Robert Carling, 'A State Income Tax for Australia?' Australian Tax Forum 22:3 (Sydney: Taxation Institute of Australia, 2007).

TARGET30
REDUCING THE BURDEN FOR FUTURE GENERATIONS

Author

Robert Carling is a Senior Fellow at The Centre for Independent Studies. He was a senior official with the NSW Treasury until 2006, and before that, with the Commonwealth Treasury, the World Bank, and the IMF.

Acknowledgment

The author thanks Jeff Pope and Alex Robson for comments on a draft of this paper. However, the views expressed are his own and the responsibility for any errors rests with him.

THE CENTRE FOR INDEPENDENT STUDIES

CIS TARGET30 • T30.04 • ISSN Print: 2201-7615 • ISSN Online: 2202-3240 • ISBN: 978 1 922184 19 1 • AU$9.95
Published April 2013 by The Centre for Independent Studies Limited. Views expressed are those of the authors and do not necessarily reflect the views of the Centre's staff, advisors, directors or officers.

This publication is available from the Centre for Independent Studies.
PO Box 92, St Leonards, NSW 1590 Australia • **p:** +61 2 9438 4377 **f:** +61 2 9439 7310 **e:** cis@cis.org.au