Principles and recommendations for tax reform

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1. Introduction

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 in some cases increasing revenue through increased taxation.

Tax rate reductions before 2010 have been blamed for the current structural budget deficit, implying that those reductions should be reversed. 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.Although tax reform may be pursued independently of the size of government, tax-reducing reform is instrumental to delivering the benefits of smaller government, be they economic or social.

1.1 Two aspect of tax reform – restructure and reduction of taxes

There are two aspects of tax reform, restructuring taxation and reducing the tax burden, and while economists will generally agree that well-designed restructuring is beneficial, 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

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.

All taxes to varying degrees expropriate people’s capital or the return on their capital, distort the choice between work and leisure and discourage investment in human capital. They therefore act as a disincentive to capital formation (investment) and workforce participation. 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. All else equal, a rising tax share of GDP will reduce economic growth; as tax rates increase, the excess burden rises faster than revenue raised. For society to be better off, the value of the marginal dollar spent must therefore rise, rather than fall, as the burden is increased, which is rarely the case with public expenditure programs.

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. The difficulty, simply put, is that no tax system can remove a high share of taxpayers' incomes without imposing substantial economic losses.As suggested above, reform should therefore both restructure the tax system and reduce, where it can, the burden of taxation.

1.2 The moral case for reducing taxes

Just as there is an often-cited moral case for public spending, so there is also 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 voters figure out the degree to which they are being 'plundered'.

2 Objectives of tax reform

The simple objective of 'lower, simpler, fairer' taxes, as articulated in the government's recently announced tax review is commendable, but is open to different interpretations and therefore raises many questions as to its meaning. 'Lower' taxes should be taken to mean lower tax rates, at least on average. However, it is often every bit as important to reduce high marginal tax rates, as these have the most direct impact on economic decisions.

However, it is difficult to see how a reduced tax burden it can be achieved in the short to medium term, given current projections of government expenditure and the budget deficit. The first-round effect of lower tax rates would be to lower revenue. This would be partly unwound over time as lower tax rates produced an economic growth dividend (dynamic revenue gains), but even so there is likely to be a net revenue loss.

This focuses attention on the nexus between tax reform and expenditure reform: the reality is that current projections for government expenditure must be lowered through expenditure savings measures if lower taxes are to be sustainable.

Commentators often cite international (typically OECD) comparisons of tax revenue/GDP ratios to claim that Australia's tax burden is relatively low. However, no comfort should be drawn from such comparisons. To begin with, these comparisons raise many complex methodological issues: for instance, the treatment of compulsory superannuation contributions. Additionally Australia is competing for globally mobile factors (which include human capital as well as savings) with Asian nations, the bulk of which have lower tax/GDP ratios. Finally, because the average for developed countries is elevated as a result of the large public sectors and burdensome tax policies of economically moribund European countries.

There is no reason Australia should be guided by those policies, particularly when they have self-evidently contributed to the European crisis and acted as a handbrake on economic growth. Australia's tax/GDP ratio is also lower because private financing of retirement income is higher. While any appropriate tax/GDP benchmark involves a broad range of factors, a sensible ratio for Australia would be 25% (for all levels of government combined), with allowance for cyclical fluctuations around this level.

The current tax system imposes heavy costs in compliance, administration and uncertainty. Simplification is a worthy goal. However, this involves trade-offs with other objectives. Much of the complexity in the system is a result of attempts to fine-tune it for equity or integrity purposes. It must be accepted that simplification may require broad-brush solutions and rough justice. For example, many of the ideas currently circulating to make superannuation tax supposedly 'fairer' would also make the superannuation system more complex.

The goal of 'fairness' in the tax system is the most open to different interpretations as 'fairness' (or 'equity') involves value judgments. Most people think only of the vertical dimension of equity (even though horizontal equity is just as important), and there is a (sometimes implicit) presumption underpinning current tax policy controversies that the tax system is not sufficiently 'progressive' or redistributive.

Three points can be made about this presumption. First, it is a value judgment, which many do not share. Second, it appears to be based on misinformation: the tax/transfer system is already highly redistributive. Third, it appears to overlook the economic costs of the high tax rates involved in a heavily redistributive system.

Policy options for individual taxes are often criticised on the grounds they would be ‘regressive’, or insufficiently ‘progressive’. However, judgments about the degree of redistribution should be based on the distributive effects of the tax/transfer system as a whole, not individual taxes.

3 Principles for tax reform

Several principles can be drawn from these objectives:

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

Taxes do not exist for their own sake but to finance government expenditure. The overall tax take ultimately defines the size of government. Conceptually, there is an optimal size that equates the marginal costs and benefits of the last dollar of revenue raised and the last dollar spent by government.

Because taxes are levied under the coercive power of the state, the revenue-maximising tax level bears no necessary relation to the optimal size of government and in all likelihood far exceeds it. Revenue maximisation may be best for the rulers, but it is not best for the ruled.

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

Taxes over which the Commonwealth has policy control generate 85 percent of national tax revenue, while state and local governments control the other 15 percent. Expenditure responsibilities are much more evenly distributed. Revenue and expenditure at each level of government can onlybe balanced through large-scale transfers of tax revenue from the Commonwealth to the states and local government.

The first criterion for tax assignment is that each entity should, as far as possible, bear the costs and benefits of its decisions, in the sense that if an entity decides to spend more or less, the consequences of so doing fall (and are seen by voters to fall) on it.It follows that at least at the margin, the allocation of powers should equip each level of government with the capacity to finance its own expenditure responsibilities. Taxing powers need to be decentralised to a similar degree to expenditure responsibilities so that each government can set its own policies and be clearly responsible and accountable to its voters.

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

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

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

Tax bases should be broad and subject to low statutory rates and strictly limited exemptions and concessions. Broad bases such as household consumption, personal income, and payroll are preferred because taxing them causes less adjustment by the private sector and involves less disturbance of resource allocation. The more exemptions and concessions there are, the greater the administrative complexity of the tax system, the higher the compliance burden, the greater the

distortion of economic signals to the private sector, and the less transparent the tax system is to taxpayers. For a given revenue need, more exemptions and concessions necessitate higher statutory tax rates. Higher tax rates in turn impose higher economic costs.

Exemptions and concessions have often resulted from the pursuit of non-revenue objectives through the tax system, particularly social and industry assistance objectives, which are better dealt with elsewhere in the tax and transfer system.

However, it must also be recognised that there is a sound economic case for some concessions, particularly those favouring the return on saving, which (under a conventional income base) might otherwise be taxed at punitive and inefficient rates. It is also crucial to distinguish deductions from concessions – for example, if income is being earned, then the right to offset costs incurred in generating income is not a concession but inherent in the definition of the tax base. Moreover, any practical system will confront some distortions which it needs to take as given – such as the limited ability to tax imputed rent on owner-occupied dwellings. In the presence of such distortions, other adjustments in the tax system are desirable for efficiency reasons, for instance, in the tax treatment of rental housing.

Finally, it is important to avoid simplistic reliance on purely notional measurements of tax expenditures. In some cases, for instance superannuation, the counterfactual in terms of which any tax concessions should be measured is controversial; in many others, there are also questions about what the behavioural response would be were the tax treatment altered. All that is certain is that assuming there would be no behavioural response rarely makes sense.

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

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

Designing the tax system to minimise these costs is what economists refer to as 'economic efficiency.' In general, capital taxes are the most damaging and consumption taxes the least, with labour income taxes in the middle. While consumption taxes only distort the labour/leisure decision, income taxes also distort the consumption/savings decisions; however, at low tax takes, the economic costs of a strictly proportional income tax are not much higher than those of a comprehensive consumption tax. Narrow tax bases, high tax rates, and large concessions and exemptions are, as noted above, the more damaging design features, as are steeply graduated (or 'progressive') tax scales.

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

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

Equity (or 'fairness' as it is often called) has vertical and horizontal dimensions. The vertical dimension concerns the treatment of taxpayers with different capacities to pay, while horizontal equity concerns the treatment of those with equal capacity to pay.

Redistribution from higher to lower income households, to the extent it is warranted, is best pursued by making the overall tax system as proportional as possible, and the transfer system progressive. In a proportional tax system, the tax burdens are approximately equal as a percentage of income at all levels, as this minimises the distortion to decisions to work and save. This is a definition of distributive neutrality. It still involves wealthier taxpayers paying larger dollar amounts than poorer taxpayers.

The allocation of government expenditure, particularly transfer payments to households such as social security benefits, can have powerful effects on income distribution. A progressive impact can be achieved through a distribution of payments favouring lower income households and excluding higher income households through means testing.

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

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

Ordinary taxpayers should be able to understand how the tax system affects them and be able to complete a tax return without expert assistance. Currently, more than 70 percent of individual income taxpayers' feel it necessary to engage the services of a tax agent.

There is too much ambiguity surrounding the tax obligations of individualbusinesses and they are unreasonably exposed to the risk of unpredictable tax assessments.

In the personal income tax system, complexity has grown with the proliferation of exemptions, concessions, deductions, offsets, rebates, the Medicare levy and surcharge, and so on. While simplification could remove distortions and improve the economic efficiency of the tax system, simplicity is also sometimes in conflict with efficiency and equity. Some of the current complexity is a result of a quest for exactitude, whereas simplicity calls for broader brush solutions. In some cases rough justice may be better than precise justice, though rough justice should not be an excuse for arbitrary administration.

7. The tax system should be transparent

Fiscal illusion is the enemy of transparency. Governments create fiscal illusion to help sustain and increase high levels of public expenditure. In part, this involves designing the tax system so as to minimise taxpayer resistance to any given level of taxation. Taxpayers gain an incomplete or distorted view of the tax burden they are actually bearing.

Such design features mean that the true marginal rates of personal income tax are not transparent to taxpayers. To take just two examples, the low income tax offset and the Medicare levy cause actual marginal rates to differ from legislated rates.

Another aspect of transparency is that changes in the effective burden of taxes should not automatically occur without legislation. Bracket creep (in which taxpayers move to higher tax brackets because the tax scales are not indexed) is a classic example of unlegislated, automatic growth in the burden of taxes withgraduated scales, as inflation of tax bases pushes a larger proportion of the bases into higher rate brackets.

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

Taxation is the price the community pays for the benefits of public expenditure. One of the disciplines on government spending and its growth is that taxpayers have to foot the bill which they are often reluctant to do. The link between government spending and taxing decisions needs to be clear if this discipline is to work.

The democratic process balances demands for more government spending against the willingness of taxpayers to pay for it. Even though taxpayer willingness is limited, the force of this constraint can only be fully effective if the tax burden is both transparent and widely spread; it is greatly weakened if a large segment of the population (voters) is allowed a free ride by being beneficiaries of government spending programs while bearing little if any of the tax cost. High thresholds before taxpayers have to pay particular taxes therefore undermine democratic accountability.

9. Taxation should be stable, predictable and sustainable.

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

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

4 Analysis of issues with the current system

There are a large number of potential topics for review in the area of taxation. However, for reasons of space and time, it is prudent to limit analysis to some of the most important, and contentious, issues.

4.1 Income tax

Key issues:

- Marginal rates are excessive at all income levels.
- The rate scale is excessively graduated.
- The true rate scale is obscured by levies and offsets.
- Bracket creep is imposing non-transparent tax increases every year.

Over the past 10 years, the thresholds for the various marginal tax rates have been increased very substantially, while most of the marginal rates have been trimmed. At the same time, the operation of the Low Income Tax Offset (LITO) and the Medicare levy creates a different and more complex effective rate scale than the headline scale.

Changes in the rate scale and the associated large sum of budget revenue foregone may suggest that the job of personal income tax reform has been finished or at least deserves lower priority now. Far from it, however, personal income tax reform should be a top priority for the next round of tax reforms.

Marginal rates were high before the changes of the last 10 years and they remain high. This is even more marked when the impact of income and consumption taxes are treated together as they should be.Increases in thresholds—large though they have been—are not a substitute for cuts in marginal rates; they only alter the income ranges over which the various marginal rates apply, and in real terms even this benefit will be eroded over time by inflation in the absence of automatic indexation of thresholds.

High marginal tax rates, erosion of the tax base, and complexity are intertwined. High marginal rates create pressure for selective tax relief in the form of deductions, offsets and concessions, which erode the tax base. Selective relief becomes entrenched and comes at a heavy cost in foregone revenue, which creates pressure to keep marginal rates high.

At the same time, selective relief makes the system more complex and opaque. The wedge between headline and effective marginal rates results partly from LITO and its phase-out arrangements, but also from the interaction between the tax system and government cash benefits (transfer payments).

Where transfer payments are means-tested, such as Newstart, the withdrawal rate adds to effective marginal rates over the withdrawal range. This effect has been partly ameliorated in recent years through increases in thresholds and reductions in marginal tax rates and benefit withdrawal rates, but high effective marginal rates remain a problem. Harding and colleagues reviewed trends in effective marginal tax rates (EMTRs) over the 10 years to 2006–07 and found little change on average; income tax cuts had reduced EMTRs, but extensions of income-tested welfare payments and tax concessions worked in the opposite direction.14

The percentage of working-age Australians facing EMTRs greater than 50% actually rose slightly, and that percentage was at or above 10% for the fourth, fifth, sixth and eighth deciles of disposable family income in 2006–07.

The solutions to high EMTRs are complex and they cannot be found in tax reform alone; high EMTRs are intrinsic to a system such as Australia's generous but tightly targeted welfare payments. Tax reform can, however, help by lowering marginal tax rates as much as possible and avoiding claw-back mechanisms such as LITO, which add to effective marginal rates over wide income ranges.

It is a common mistake to think high EMTRs are particularly harmful at low ends of the income distribution. In reality, the issue also arises for second earners in middle income families. And high income earners face high EMTRs too, as the progressivity of the tax/transfer system has been increased in recent years (not solely through direct tax changes but also through adjustments to limits and thresholds in areas such as superannuation). From an economic perspective, the loss involved in discouraging people with substantial human capital from working as much as they otherwise would is high relative to that of discouraging lower productivity workers. However, that needs to be balanced against the social desirability of reducing welfare dependency, which makes it all the more important to avoid unnecessarily high EMTRs in poverty alleviation programs.

The phenomenon of bracket creep is also a problem, as it results in unlegislated increases in average income tax rates. Discretionary adjustments to thresholds are then presented for political purposes as 'tax cuts', when they are merely handing back the proceeds of unannounced tax increases. The solution is to do what many other countries do, which is to apply automatic annual indexation of personal income tax thresholds. Legislative activity can then focus on marginal rates and threshold adjustments in real terms.

4.2 Company tax

Key issues:

- The 30% rate of company income tax is uncompetitive and economically inefficient
- Single rate is better than tiered company tax
- The gap between the company tax rate and the top marginal rate of personal tax is problematic.

The Re:think discussion paper, and before it the Australia's Future Tax System review, have mounted a persuasive case for a large reduction in the company income tax rate. Reducing the company tax rate would be one of the most effective ways to spur the economy's long-run potential growth rate, and should therefore be a high priority for tax reform.

Australia has lagged behind the international trend for corporate income tax rates to decline and has been left with an internationally uncompetitive rate. The benefit to growth through higher investment would generate additional revenue and, over time, help offset the first-round revenue loss from a company tax cut.

There is also the importance question of who bears the impact of company tax. Tax incidence studies investigate who bears the economic tax burden, as opposed to who actually pays the tax. These types of studies differentiate between the legal incidence of taxation and the economic incidence of the taxation. The legal incidence refers to the distribution of tax payments based on who has the legal obligation to remit the tax to the government. The economic incidence is based on the economic impact a tax has on behaviour. In part, it is the impact a tax has on economic welfare.

There are three groups that could bear the economic incidence of corporate tax. First, consumers could pay the tax, in the form of higher prices. Second, workers could pay the tax, in the form of

lower wages. Finally, investors could pay the tax, in the form of lower returns. There is a large literature that attempts to untangle the incidence of corporate tax.

Economists agree that investors bear the short-run tax burden, but are they are less certain on who bears the long-run burden. A 2006 paper by the US Congressional Budget Office suggests that in the US over 70% of the corporate tax burden is borne by workers in the form of lower wages, and only 30% by investors. The study found the effect on consumers was very small. The argument is that in an open and competitive economy, it is unlikely that the tax burden could pass forward to consumers. This is most likely the case for the tradable sector, but consumers will bear a small component of the corporate tax in the non-tradable sector. That implies the corporate tax burden is largely shared by investors (which includes superannuation funds) and workers.

In a small, open, capital importing economy, such as Australia's, the post-tax rate of return on capital cannot be less than that in global capital markets. As a result, any tax that falls on normal returns will simply shrink the capital stock, raising pre-tax returns to the point where the post-tax return is equalised to that in world markets. As the reduction in the capital stock lowers labour productivity and the marginal product of labour, the effect is to reduce labour incomes. A tax on globally mobile capital is therefore a tax on labour.

A two-tiered system

A two-tier company tax system with a lower rate for smaller companies (as proposed in the 2015-16 federal Budget) is a retrograde step, all the more so given the myriad other tax incentives small companies obtain. The rate should be lowered uniformly so as to minimise distortions to investment decisions. Moreover, if large companies are mainly financed in global capital markets while smaller companies are financed by less mobile sources of savings, a two-tier system will do nothing to improve our tax system's competitiveness where it matters, that is, in those uses of funds in which we compete with other countries. The fact that our imputation tax system discriminates against foreign equity investment only makes this problem more acute.

The gap between the company tax rate and the top personal income tax rate is a problem that would be exacerbated by a reduction in the company tax rate. However, as argued above, the top personal rate should also be reduced by at least as much as the company rate. If this does not happen, it should not be used as a reason not to reduce the company rate.

4.3 Taxation of savings

Key issues:

- Policy on the taxation of savings should be based on two key principles: avoiding double taxation of savings; and taxing the income from savings at lower rates than labour income.
- Superannuation tax policy should recognize the very long lock-in period for superannuation contributions and earnings.
- The tax treatment of savings that is currently labelled 'concessional' is by and large justified with reference to tax policy principles and serves economic efficiency objectives.
- The disparities in the treatment of different types of saving are excessive.
- A Scandinavian type dual income tax system that taxes most income from capital at a low, flat rate should be considered.

It is nothing new for tax concessions for savings to be criticised, but at this time of entrenched budget deficits and a new emphasis in public debate on perceptions of 'fairness' these concessions have come under more critical scrutiny than ever before.

Much of this criticism is based on a misuse of data, ignorance of the original justification for concessions, and distorted notions of 'fairness'. With respect to the data, criticism of tax concessions typically relies heavily on the official estimates of tax expenditure published in the annual Tax Expenditure Statement.

However, the inherent limitations of such estimates are usually overlooked and they are misinterpreted even against the advice of the Treasury, which is responsible for the estimates. As a result, the discussion of superannuation tax, for example, typically begins from the false premise that concessions in this area are 'costing' more than $30 billion a year.

It would help avoid such misconceptions if Treasury would cease publishing tax expenditure estimates for savings based on the comprehensive income benchmark, and instead use the more appropriate comprehensive expenditure tax benchmark. The policy justification for these savings tax concessions varies but the basic justification is to avoid the punitive tax rates on savings that can result when conventional income taxes are repeatedly applied to the income from savings. These punitive rates can arise from different sources, which include: the compounding effect of tax wedges when a tax is repeatedly applied to a reinvested amount; the failure to recognise the difference between nominal and real returns, and between economic and accounting profits; and the asymmetry which arises when gains are taxed without full carry-forward of economic losses. Individually and collectively, these factors can lead to effective rates which are much higher than those on labour income, causing inefficiencies which affect aggregate savings, the allocation of investment, the ability to smooth consumption over one's lifetime and the return on different forms of investment. As the resulting welfare losses are substantial, there are strong justifications for the capital gains tax discount and superannuation concessions, although in each case there are other unique considerations as well.

In the case of dividend imputation, the justification is to prevent double taxation of dividends, and in the case of so-called negative gearing it is that the expenses incurred in generating income should be deductible for tax purposes. Regarding the 'fairness' dimension, concessions are too often viewed as a social benefit to be 'targeted', which they are not.

The fact that high income earners receive a disproportionate share of the dollar benefits is unexceptional as they are in the best 10 position to save and invest, and must be balanced by the fact that they also pay a disproportionate share of personal income tax. Further, the flat design of superannuation taxes (with the exception now of contributions tax) brings major simplification benefits as it means that funds can be administered without regard to the personal tax situations of members. Moreover, it somewhat reduces the penalty that is imposed on those whose incomes, from labour or savings, fluctuate over time.

That benefit is lost once graduated taxes are imposed, such as the suggested 15% tax on earnings of funds in pension mode subject to a tax-free threshold. Additionally, such a tax would distort, likely materially, decisions about whether to retain savings in superannuation post-retirement or run them down. And in a system which already taxes contributions and accumulation, adding a tax on post-retirement earnings can result in effective tax rates which are both high and opaque.

That is not to say the superannuation tax system is beyond improvement. The most appropriate benchmark for taxation of superannuation is the so-called 'EET' system, which means that

contributions and fund earnings go untaxed but end-benefits are subject to individuals' full marginal rates in retirement. As a general matter, this reduces the distortion to individuals' ability to transfer income from working life to retirement. Additionally, it is more transparent and ensures governments collect revenues as population age. A shift from the current TTE system to EET could be phased in by cohort, retaining the TTE for current savers but allowing subsequent cohorts to save on a EET basis, thus minimising the immediate cost in tax revenues.

While such a fundamental change has merit, the past pattern of frequent tinkering is undesirable and further change should only be made if a compelling case can be made. Many changes have been suggested, but most of them have been poorly thought through and are based on misinformation and faulty analysis.

Any new review of superannuation taxation should observe the following principles:

- Use the EET system as the benchmark for measuring tax expenditure.
- Apply taxes and concessions in a non-discriminatory, neutral way.
- Any changes should not add complexity, and preferably reduce it.
- Ensure the system is fiscally sustainable for the long term.
- Any adverse changes should not be retrospective in effect, and should recognise that current participants have made long-term plans under the current and previous rules.

The uneven treatment of different types of savings is undoubtedly an issue. However the main outlier is interest income, which is taxed at full marginal rates. This treatment is inappropriate and it would be wrong to even out the tax treatment of savings by increasing tax on non-interest forms of savings income.

A better solution would be to discount interest income for tax purposes. A more far-reaching approach would be to introduce a Scandinavian type dual income tax, with one scale for labour income subject to a tax-free threshold and a single low, flat rate for capital income (interest, capital gains, company income, dividends, net rent) without a tax-free threshold. Such an approach should be explored as an alternative to the current mixed approach, though it retains the problems of an income base, albeit on a potentially lesser scale.

Even within such a scheme, however, there would be a case for treating superannuation concessionally in recognition of the very long-term lock-in effect of contributions.

4.4 State stamp duties

Key issue:

- States' dependence on inefficient and distorting stamp duties for around one-third of total tax revenue.

Stamp duties on real property transfers, insurance and motor vehicles are among the least economically efficient (highest marginal deadweight cost) of all taxes in the system, yet the states rely on them for around one-third of total state tax revenue.

Stamp duty on real property transfers dominates in revenue terms and exhibits very strong bracket creep characteristics, which have made it the states' strongest 'growth tax' over the long term. Revenue is highly volatile, which complicates state budget management.

As a tax on housing transactions, stamp duty discourages welfare-enhancing housing choices. As a tax on business property, it is embedded in the business cost structure and cascades through the system. The stamp duties on insurance and motor vehicles have the disadvantages of transaction taxes, and to the extent they take the form of consumption taxes they double up on the GST that applies to these items.

Abolition of stamp duties would leave a large hole in state budgets that would need to be filled at least in part by greater dependence on payroll and land taxes, a broader or higher rate of GST, or the transfer of some taxing power that the states do not currently exercise such as personal income tax.

Greater use of payroll and land taxes would have to include a substantial broadening of the bases for these taxes by removing existing exemptions, such as the land tax exemption for principal residences. Swapping stamp duties for higher GST revenue has the disadvantage that it would leave the states even more dependent on Commonwealth revenue and less in control of their own finances. Any change in the GST should give priority to base-broadening ahead of a higher rate. However, any base broadening needs to avoid taxing private providers of services such as schools and hospitals who compete with notionally free public sector providers. The risk otherwise is of distorting consumption choices, reducing the competitive pressure on public sector providers and inefficiently driving consumers into the most heavily tax-subsidised sources of supply.

4.5 Vertical fiscal imbalance

Key issues:

- States' existing tax powers are insufficient for them to be sovereign in their sphere.
- State sovereignty is being compromised by excessive dependence on Commonwealth grants, particularly tied grants.
- States need access to more efficient tax bases to reduce their reliance on Commonwealth grants and inefficient taxes.

The problems associated with Australia's very high degree of vertical fiscal imbalance are well known (confusion of accountability, inefficient resource allocation, and so on). One of the criteria for tax assignment to the different tiers of government is that the allocation of tax powers should equip each level of government with the capacity to finance its own expenditure responsibilities, particularly at the margin of decision.

Taxing powers need to be decentralised to a similar degree to expenditure responsibilities so that each government can set its own priorities and be clearly responsible and accountable to its voters. In practice, no federation lives up to this standard, but Australia falls short to a larger extent than most. This is partly because states have declined to use fully the tax powers available to them, but also because they are effectively barred from doing so by extra-constitutional practices (for example through the Commonwealth post-war policy of preventing states from levying their own income tax).

There is an important distinction between the allocation of tax powers and the allocation of tax revenue. The states receive the GST revenue but lack the power (individually or collectively) to determine GST policy.

It is clear from judicial interpretation of the constitution that certain taxes are off limits to the states, but this need not apply to personal income tax. The most obvious way for states' revenue autonomy

to be enhanced is for the Commonwealth to allow then to impose a surcharge on top of Commonwealth personal income tax. To avoid any increase in total personal income tax at the time of the change, the state impost should be fully offset by a reduction at the Commonwealth level. Then over time, states individually would be free to vary their surcharge up or down.

The Commonwealth's loss of revenue would be offset by a cut in tied grants to the states. In effect, for state budgets, personal income tax would replace a portion of tied grants.

Although states have substantial flexibility at the margins to make tax and spending choices, this is not sufficient to significantly reshape the structure of state finances away from the present unhealthy degree of dependence on Commonwealth revenue.

This broad structural dependence has created a culture of control on the part of the Commonwealth and one of dependency on the part of the states and can only be overcome by large changes in the architecture of Commonwealth-state finances.

5 Reform proposals

Income tax policy recommendations

- The top marginal rate should be no higher than 35%, and the second top rate 27%
- There should be no additional levies and no low income tax offset.
- Thresholds should be indexed to inflation annually under legislation providing for this to happen automatically.

Company tax recommendation:

- The differential rate of company tax should be abolished and all companies should face the same tax rate
- The company income tax rate should be reduced to between 20% and 25%.

Taxation of savings recommendations:

- The government should cease issuing tax expenditure estimates for savings income based on a comprehensive income benchmark and use only a comprehensive expenditure tax benchmark.
- The 50% capital gains tax discount should not be reduced.
- So-called 'negative gearing' deductions should continue to be allowed unless rent income is taxed at concessional rates.
- Changes to dividend imputation should be considered only in the context of a very large cut (e.g. to 20%) in the company tax rate. Ideally, the company tax rate would be cut and imputation would continue.
- The ideal superannuation tax system is EET, but a transition to EET can only be phased in gradually. Subject to that transition, current arrangements are broadly appropriate and distributional issues are greatly exaggerated.
- Consideration should be given to a dual income tax system that taxes company income, capital gains, dividends, net rent and interest income at the same low, flat rate (say, 20%) without a tax-free threshold.
- Superannuation contributions and earnings should continue to be taxed at lower rates in recognition of the very long lock-in period.

State stamp duties recommendations

- State stamp duties should be abolished and replaced with broader payroll and land taxes and some broadening of the GST base.
- Exploit new technologies thatenable more sophisticated road user charging, which would help pay for abolition of motor vehicle stamp duty

Vertical fiscal imbalance recommendation

- States should be given access to the personal income tax base through a 'piggy- back arrangement on top of Commonwealth personal income tax, offset fully by a reduction in Commonwealth personal income tax and tied grants to the states.

For more information and references

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