

## **Australian tax reform: Post-Henry**

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<sup>1</sup> Views expressed are exclusively those of the author and not necessarily of any other person or organisation.

## Key points

- Tax systems continuously face new pressures and experience erosion of performance.
- Subject to its terms of reference, the Henry review identified the main rationale for, and likely drivers of, further reform over the next 20 years. Its stated vision was for a tax system to meet the range of public policy objectives while supporting “per capita economic growth at the upper end of developed country experience”<sup>2</sup>.
- Henry recommendations on tax architecture cover most of the likely long term agenda:
  - Concentrating revenue collection on four main bases (personal and business income, consumption, and immobile rent), and abolishing less efficient taxes;
  - Rebalancing the weights of the four main tax bases (including lower company tax);
  - Improving equity, efficiency and fitness-for-purpose of the general and retirement savings systems; and
  - Improving efficiency and equity in other taxes, transfers and charges.
- Four additional areas not substantively addressed by Henry may also warrant reform attention:
  - The rate and base of the GST (replacing less efficient revenue sources);
  - Tax administration/compliance arrangements and technologies;
  - Tax avoidance and evasion (particularly inter-jurisdictional); and
  - The inter-governmental allocation of tax revenues.
- Although ultimately dependent on political leadership and the evolution of the political-economic context, prospects for further reform could be increased if additional investments are made in elements supporting the public discourse, including:
  - Demonstrating key tax reforms are a positive sum game;
  - Reframing tax choices for social spending, economic growth, and federal finances;
  - Strengthening understanding of tax system performance (and underperformance); and
  - Broadening intergenerational (sustainability) narratives.

## Background

Since the mid-1980s, Australian tax reforms have been aimed mainly at increasing tax neutrality<sup>3</sup> through base broadening and rate reductions. In addition, improved operational efficiency and system integrity were sought through improvements in tax legislation, administration and compliance.

Reform did not bring much change in the broad tax architecture, nor tax revenues relative to GDP, nor systemic progressivity. The earlier rounds related mainly to income tax (including superannuation arrangements) and tax administration. Introduction of the GST in 2000 brought a measure of indirect tax reform.

Set against the reform effort is the continuous erosion of the performance of the system. This results from sectional interest-based policy making, the emergence of new or

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<sup>2</sup> Australia’s Future Tax System Report Overview (2009) p. xvii

<sup>3</sup> Generally neutrality is a feature of a tax system that does not change relative prices. It is thought likely as a result to have limited effects on both allocative efficiency and horizontal equity (although this is sometimes contested, and in practice a neutral tax structure may lose its neutral qualities as a result of non-neutral impacts on administrative/compliance costs).

increased avoidance and evasion opportunities, and the ongoing pressures from wider changes in technology, socio-economic patterns and demography. Consequently, to maintain performance assessed against standard axioms<sup>4</sup>, tax systems require continuous, or at least regular, adaptive change. However, the political difficulties associated with policy change have in practice meant that reform has proven a punctuated and unreliable process.

The Australia's Future Tax System (Henry Tax) Review (2009) developed the main options for the future broad tax and transfer system architecture, but has not yet lead to substantive further reform. Although relatively broad ranging (covering most taxes and transfers, at each level of government) the review made relatively limited contributions on a number of major issues, including in particular:

- The rate and base of the GST (largely precluded by terms of reference);
- Tax legislation, administration and compliance;
- Tax avoidance and evasion; and
- The intergovernmental allocation of tax revenues.

### **High level goals: The Henry agenda**

The longer term rationale for further tax reform is set out in the Henry Tax Review. The case is built in several familiar ways:

- Analysis of the existing tax system against standard axioms like efficiency and equity;
- Analysis of changes required in response to strategic drivers (demography, globalising factor markets, new technologies etc);
- Comparison with international developments in tax systems; and
- Evidence from recent empirical work (mostly overseas), particularly suggesting how company taxes influence the level of economic activity or growth.

Perhaps the main underlying goal of the Henry architecture was to facilitate the delivery of public policy and service objectives while maximising continued economic (and hence tax base) growth. The specific vision was to sustain growth in per capita incomes at the upper end of developed country experience.

The key features were to:

- Concentrate revenue collection on four efficient tax bases - personal income tax, company tax, taxes on immobile rents (land and natural resources) and private consumption;
- Abolish other taxes (unless they efficiently meet other specific policy goals);
- Shift relative burdens toward less mobile bases (incl. reduced company tax rate to 25 per cent broadly matching movement in overseas company tax rates since 2000);
- Reform the taxes on savings, both for retirement and for general savings, making each more neutral and fit for purpose; and

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<sup>4</sup> The usual axioms, or principles, relate to various forms of equity and efficiency, simplicity, certainty, transparency and revenue adequacy.

- Improve efficiency and equity in other taxes, transfers and charges (in areas like roads, alcohol, means tests, participation incentives etc).

### **Main options for medium term tax reform**

This section simply lists the main potential reform elements (with a few comments on each). Most of the options fit within the broad Henry tax strategy, except for the additional items noted previously. None of the options are easily achieved. The main list is intended to suggest items that might have some prospects in the next few years (say to 2020) either because they already have some support or may prove increasingly urgent. A second brief list of even more difficult, perhaps longer term, items is provided subsequently. These tend to be items that have long been identified as meeting economic reform criteria but which have equally long proven too difficult for the political system to digest.

### **Company tax rate reduction**

- Thirty per cent rate now well above simple average of OECD countries and most Asian countries
- UK, Denmark and others continuing to reduce rates (towards 22 per cent);
- Main impact may be in reduced profit shifting: case also relating to investment margins
- Full benefits from reduced effective tax rate as well as statutory rate reduction. However, if equity returns in Australia mainly constitute rent, case is weakened relative to Europe/Asia
- Constraints (a) initial revenue cost and (b) company tax serves multiple roles (rent tax, personal tax integrity etc)

### **Unit value land taxation**

- Henry proposed tax rate on all land linked to unit (per square meter) value
- Main efficiency gains arising at three behavioural margins (a) reducing/eliminating exemptions based on land use (b) eliminating tax rate variations based on aggregation of holdings and (c) eliminating change of ownership taxes (stamp duties)
- Constraints (a) transitional land value effects (b) state/local tax base sharing

### **Replacement of inefficient state taxes/increased rate and base of the GST/simplified personal tax system and rate scale**

- These three would best be packaged because of price and disposable income effects
- Gains in neutrality, transparency, technical efficiency
- Probably not possible until net tax cuts are feasible (if ever) due to bracket creep
- Wide range of possible scale/scope choices: small scale steps may be possible such as abolition of insurance taxes (relatively low revenue); steps already taken towards rate simplification etc
- Constraints (a) political winners/losers (b) intergovernmental finances (c) base erosion due to shift towards small value importation

## **Longevity and aged care risk solutions in retirement incomes policy**

- Highest long run priority due to strength and costs of the “late aging” trends
- Two elements: one is to reduce fiscal subsidies for early retirement and the other is to increase relative incentives for insuring longevity and aged care risks
- This part of the Henry retirement story has had some recent late converts, however there remains no clear consensus on the best way to address the issues

## **International tax base erosion and profit shifting**

- New technologies (digitisation, low cost communications) threaten both direct and indirect tax bases, with the likelihood that this has much further to go.
- Long established jurisdictional tax concepts do not work well (or at all) in this context
- OECD and G20 etc processes to address problems face the problem that incentives differ for countries with differing intellectual property strengths. Tax treaties all bilateral and so unwieldy: create a complex maze for tax-responsive income/expense flows to negotiate

## **The intergovernmental allocation of tax revenues**

- Little understood, except as an opportunity for political posturing, arguably worsening
- Cannot be properly resolved without a clear vision for a 21<sup>st</sup> century federation.

## **Examples of less likely, perhaps longer term, reforms**

Many of the items listed above are politically very difficult. Yet there is a considerable list of further measures that would have (generally on orthodox analysis) potentially meaningful economic efficiency and often equity benefits that are nonetheless politically even more remote possibilities. Some have never been able to get onto agendas. Others have been tried and failed, making second efforts more difficult. A few present some difficulties in assessing net benefits.

- Taxes on wealth transfers (estate or inheritance taxes)
- Replacing mineral royalties with rent based taxes (round two)
- Conversion of some or all of the company income tax to a rent based tax (allowances for corporate equity or expensing, or at least more rapid capital expenditure (capex) write-off)
- Henry-type more neutral taxation of savings: perhaps further extended through:
  - Replacement of dividend imputation with a low flat rate dividend tax;
  - Abolition of negative gearing (or with similar effect replacement of income tax on rental housing with a flat rate asset tax, low-rate rent excise, or just tax exemption;

- More radical new tax options to address the problems for international taxation resulting from new technologies, e.g. unitary taxation, multi-lateral treaties, financial service taxes;
- Full or partial road use pricing using modern vehicle use tracking technologies;
- Integration (or greater alignment) of the tax and transfer systems and their administration;
- Simplified return-free personal tax system;
- Neutral secondary indirect taxes on alcohol, fuels, gambling etc;
- Henry-type reform of the taxation of the accumulation stage for superannuation<sup>5</sup>;
- Cash flow value added taxation to replace existing invoice-based systems; and
- Rewrite of the tax laws (if a preferred form can be agreed).

## **Prospects for tax reform**

### *Reform Packages*

It is not uncommon to find a reasonable level of support for the general long term goals or ideas of tax reform. It is much less common to find strong enough support for actually making the policy changes directed towards them.

In political practice, tax reform is often best approached through one or more packages, although this is not a guarantee of success. Packages deal not only with specific reform elements but also with their interactions, trade-offs and timing. It is notable that some attempts at packages have not proven sustainable in recent times in the face of other political priorities. Policy packaging was not attempted as part of the Henry review (though some have wrongly assumed the entire report was an intended package).

This note also does not attempt to define possible packages. However, one issue may deserve some further consideration. It may be desirable to attempt to separate packages relating to capital taxes from those relating to personal and indirect taxes. The former needs to be understood mainly through an economic growth perspective, while the latter as a political choice through a consumption allocation/distribution perspective. The latter may usefully be linked also with the policies for government funded transfers and collective household consumption – if these are unavoidably to rise in future, tax mechanisms for higher revenues should aim at households and consumption (rather than taxes on saving and investment).

### *Short term constraints*

The shorter term context often operates against tax reform. In recent times a key problem has been the re-emergence of fiscal balance concerns at all levels of government, due largely to a fall in the revenue robustness of key taxes. Annual tax collections have fallen by about two percentage points of GDP with the result that large tax cuts cannot be offered as part of reform packages. The fall in tax collections has several causes but particularly followed (a) large personal tax cuts announced in economic boom conditions prior to the

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<sup>5</sup> Flat rate of concessions, neutral treatment of all forms of contribution under annual cap, single regime for earnings tax etc

GFC and (b) the fiscal impact on Australia of the five years of global financial/fiscal crisis through reduced prices and activity in asset markets, with consequent impacts on several asset related tax bases.

Coupled with the broader fiscal situation and the shared political aspiration to restore budget surpluses of up to one percentage point of GDP, the loss of revenue means that it will take several more years of financial recovery and further bracket creep (non-indexation of the rate scales) before a nominal tax cut can be included in any future tax reform package. The device of including the return of bracket creep revenue increases as part of tax reform package calculations was a key element in reforms of the 1980s and 2000.

Other short term political priorities that are often pointed to as explaining the current lack of appetite for tax reform, however, are probably long term issues presenting in short term guise. These include:

- Carbon pricing and its likely replacement with policy alternatives, as part of a broader set of issues relating to taxes, energy and infrastructure
- Pressures and changing priorities in relation to social and education spending
- Deepening distrust and political contest between the levels of government

While the current manifestations of issues like these are taking political attention, to the apparent exclusion of other structural reform agendas like tax reform, they will not prove to be short term constraints on structural reform. On the contrary, they will need to be harnessed in time as part of the case for, and the fabric of, tax reform itself.

### *Influencing reform prospects*

For the moment, there is little to suggest that strong support is now building, let alone a consensus forming, for further tax reform in Australia. The constraints are many (fiscal, political, economic, historical etc) but they may not differ greatly in scale from those that always exist in one form or another. Creating the possibility for substantive public reform usually requires the prior alignment of several key factors, and then since these are never fully in place, a bit of political leadership to press over the line. An organisation like CEDA can influence prospects by contributing towards the alignment of the supportive factors, which may include (for example):

- Demonstrating (preferably empirically) that further tax reform is a positive sum game.
  - This might be facilitated by the existence of an independent, trusted and credible tax research institute using with its own modelling to demonstrate options. The government has announced funding for this on a number of occasions but not implemented it.
- Build the dual tax system mindset (more closely linking choices about social spending with labour/consumption taxes and choices about growth, infrastructure and investment with capital taxation). If this is not done, all tax reform will continue to be hostage to simple, short term winner-loser assessments.
- Annual report cards from Government on the performance of key elements of the existing tax system (such as the business tax system, indirect taxes etc) including the impacts of changing technology.

- Linking tax to the reform of inter-governmental financial relations. There is growing dissatisfaction about the federal compact and its apparent duplication and entanglement of responsibilities. At the same time there is a strong case for the subsidiarity principle to apply in the face of complicated and complex social needs. It seems unlikely that this can be resolved unless revenue is part of the equation, and equally the efficiency problems of the current state tax bases cannot be resolved without federal financial reform.
- Strengthening the inter-generational (sustainability) narrative, and its outreach to a wider cross section of the community. Although the intergenerational reports have made some progress in changing community expectations, they have continued to be narrowly focused with gaps in areas like state spending, the future costs of superannuation etc and have not been adequately linked to policy variables like the NDIS and education reform.