

# **Tax reform: opportunities and challenges**

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The following speech was the opening address to the *Australia's Future Tax System: A Post-Henry Review* conference in Sydney on 21 June 2010.

## Introduction

Thank you for this opportunity to speak about the report into *Australia's Future Tax System* (AFTS).

I note that the brochure for this conference depicts a sign-post with an arrow pointing the way to Australia's Future Tax System. That is an apt depiction, as I will discuss today.

As many of you will know, one of the key features of the Review was extensive consultation – with business groups, welfare groups, trade union representatives, tax practitioner groups and academics. With respect to the last of these, the panel wanted to tap into the latest analytical thinking in tax policy and administration.

In June of last year we organised a tax policy conference that brought together leading policy thinkers from around the world. I'm pleased to see some of those same people here today. And it's good to see some new faces.

In opening this tax policy conference, I want to thank all of you for taking such a strong interest in the future of Australia's tax and transfer systems. While our review has set down some frameworks for how we think the systems should develop, there remains considerable scope for significant research and debate.

No doubt, some of you will have difficulty with at least some of our recommendations – and want to engage in a deeper debate. That's okay too. But today, I thought I might say some things about the key building blocks of the review panel's framework, and provide some thoughts on the work that remains to be done.

I am going to be quite deliberate in seeking to avoid, as much as possible, any commentary on the tax policy debate playing out in the political arena here. My comments will focus on issues that one can safely assume to be some years ahead of the political process – that is to say, issues on which the academic debate has not yet had sufficient traction with policy makers.

Yet, in focussing on these particular issues, I do want to say that they are among those challenging matters that should be of growing policy interest over time.

Since the publication of the report, and the Government's initial response to it a few weeks ago, I have found myself pondering this matter – of the political traction of ideas. Many of the ideas you will find expressed in the report have their origins in academic literature that is decades old. The fact that some of those ideas have not yet found expression in the tax laws of significant numbers of countries should give all of us reason for reflection.

Of course, some of the ideas remain contested. It is difficult to find consensus views among academics, perhaps especially in the social sciences in which even the most abstract theoretical proposition will betray a normative position. And yet, in the domain of tax policy debates, achieving academic consensus is the easy part. It is much tougher to convince a wary public; tougher still cynical media. And it is virtually impossible, in Australia at least, to secure political consensus on any tax proposal other than a straightforward tax cut.

None of that would matter if tax design didn't matter. But it does. Few areas of public policy are as important to the lives of citizens.

So I would like to encourage you, over the next couple of days as you ponder 'what' ideas make sense, to give some thought also to 'how' those ideas might be implemented in democratic systems – to give some thought to how tax policy debates might contribute, in fact, to the implementation of better tax systems.

## A future tax system

This review differed significantly from a number of Australian tax reform exercises of the past 25 years. The *Review of Australia's Tax System* in 1985, several reform packages in 1988 through to 1993, then *A New Tax System* (ANTS) in 1998, and the *Review of Business Taxation* in 1999, all focussed on parts of the system that were seen as undermining the ability of the tax system to generate adequate revenue fairly and efficiently and were, for that reason, identified as needing immediate attention.

Given the immediacy of the need, these reform packages were judged as successes or failures based on how many of their components were legislated more or less immediately.

On this occasion, the focus has not been on an immediate need. Instead, the review found that the key architecture of the tax and transfer system, bolstered by 25 years of reforms, serves us well. Instead, the focus has been on how best to structure the tax and transfer system out to the middle of the century. Assessments of the review's success therefore require a different metric, and a timeframe not measured in months, or even years, but perhaps decades.

A close comparator for the present review is the Asprey Review published in 1975. It made a number of recommendations for significant change that were not immediately acted upon and, in early assessments, it was judged less than successful. Time has shown those assessments to have been premature.

Asprey's recommendations received little attention from the Whitlam and Fraser Governments. But the issues it raised did not disappear. By the late 1970s, tax

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avoidance arrangements were flourishing. These included highly artificial 'paper' tax avoidance, or 'bottom of the harbour', schemes.

Evidence of extreme tax avoidance contributed to public pressure for change to a tax system that came to be seen as unfair, distortionary and unnecessarily complex. Consumption and income tax bases were narrow. High rates were required to raise revenues for rapidly increasing government expenditures. Large gaps and loopholes in the law meant that those who had good financial advice could structure their income to minimise tax, further narrowing the tax base and skewing the incidence of income taxes to lower income earners.

The major reforms of the 1980s included capital gains tax, fringe benefits tax, dividend imputation and large cuts to personal and business income tax rates. The taxation of foreign source income would follow later in 1990, and the final piece of the Asprey vision, a broad based value added consumption tax, would have to wait until the launch of *A New Tax System* in 1998.

All of these reforms were stimulated by Asprey. They all sought to broaden the base and, to the extent possible, cut the statutory rates of tax.

But the Asprey report provided more than a series of recommendations. It also provided an enduring vision for tax system design.

## AFTS and the Asprey Review

The final Asprey report noted that the panel members did not approach the review by looking at the existing tax law and recommending options for change. Instead, they first settled the broad outline, or vision, of the kind of tax system that should be established over time, and worked back from that to determine what changes would best support this vision.<sup>1</sup>

The Asprey Review sought to achieve a balance between the traditional tax policy objectives of simplicity, efficiency and equity. That approach proved long lasting. Indeed, these three 'tax axioms' continue to underpin assessments of tax systems.

Today's review panel endorsed the design principles of equity, efficiency and simplicity; and added the principles of sustainability and policy consistency.<sup>2</sup>

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1 Asprey, K (Chairman), Lloyd, J, Parsons, R and Wood, K 1975, *Taxation Review Committee – Full Report*, p 3, AGPS, Canberra.

2 Henry, K (Chairman), Harmer, J, Piggott, J, Ridout, H and Smith, G 2009, *Australia's Future Tax System – Report to the Treasurer*, Part 1, p 17, Commonwealth of Australia 2010.

The panel's approach to considering the future of our tax and transfer system did not focus on optimal tax system design, based on those principles. Instead, we positioned the tax and transfer system in a broader public policy context. We tried to think about how Australia's tax and transfer system could best meet the nation's opportunities and challenges over the next 40 years; opportunities and challenges that arise from:

- deepening international integration together with a re-emergence of China and India;
- frequent and rapid technological advances;
- an ageing population;
- strong growth and increasing cultural diversity of the population;
- deepening stresses between human activities and wider ecosystems; and
- pressures affecting housing affordability and urban amenity.

We came up with 138 recommendations as well as numerous findings of the need for further consideration.

Some recommendations were for immediate action, where the panel considers the need is great. And the Government has responded to some of those. Most notably, it has announced that it will introduce a comprehensive tax on resource rent, effectively replacing state based resource royalties – which the panel had concluded were the least efficient of the state taxes.

But many recommendations are for the long term – as the challenges become more pressing and the opportunities more tangible. It is some of these recommendations that I would like to talk about today.

## The challenge of globalisation and company taxation

I would first like to make some comments on Australia's company income tax regime.

The challenge is the impact of increasing globalisation on our ability to continue to attract the level of investment needed to generate strong productivity growth.

As outlined in the panel's report, deepening international integration, and the shift of the centre of gravity in the world economy towards Asia, is reducing the distance between Australia and its export markets, adding considerable value to our natural resource wealth and presenting new opportunities in investment, trade and

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employment. But capital is becoming increasingly mobile internationally, and the panel considered that, over time, Australia will need to respond if it is to remain an attractive place in which to invest.

### Company tax rate

Given that company tax acts as a final tax on foreign equity investment, lower rates of company tax can attract marginal investments. Foreign direct investment is desirable, especially on grounds of technology transfer and knowledge spill-overs. Lower company taxes would lower the cost of corporate capital at the margin, encouraging capital-deepening in all sectors, in turn increasing labour productivity and boosting real wages.

The review panel found that Australia stands out in its relatively high reliance on company tax as a source of revenue. It recommended that Australia should aim for a 25 per cent company tax rate to place us on the lower side of average in small-to-medium OECD economies. But the review also concluded that Australia should not be at the forefront of any 'race to the bottom' in company income tax rates. The benefits of a lower rate for mobile capital need to be weighed against an enhanced incentive to shift labour income into corporate vehicles and a gratuitous benefit to less mobile investments and capital.

### Company tax models

But these arguments on the rate of company tax will be obvious to most of you here today.

What was more challenging for the panel, and I hope of interest to you, is whether the architecture of company tax should change for a future, increasingly globalised, world.

The academic literature has produced several options for a business expenditure tax: the Meade Committee's R-type and R+F-type models; the US Treasury's Comprehensive Business Income Tax; and the Allowance for Corporate Equity and Allowance for Corporate Capital models.

Let me make some observations about the future of these business tax models in Australia.

The first is that the financial services sector has undergone rapid growth in the past 30 years and is now a major source of company tax revenue.<sup>3</sup> Models which, by design, do not tax the profits of financial companies, such as the R-type and the Allowance for Corporate Capital, have obvious shortcomings.

Secondly, the empirical evidence matters. I note that a number of countries have had some experience with using an Allowance for Corporate Equity. Experience in these countries should be monitored closely.

Thirdly, the international environment matters. The immature development of business expenditure tax practice was one reason why the panel concluded that Australia's current system of company taxation should be maintained for the time being. The rules under international tax treaty conventions relating to the taxes recognised by overseas jurisdictions for crediting purposes also matter. I recall Alan Auerbach in 2006 wondering if, at a future World Trade Organisation or G-7 meeting, protestors against environmental degradation and world poverty might be joined by those frustrated by international agreements that act to prohibit sensible tax reforms.<sup>4</sup>

Finally, the transition path matters. Policy makers will rightly be concerned about both delivering windfalls to existing capital and creating large transitional problems for companies with high gearing ratios.

The Allowance for Corporate Equity model appears to offer the most promise.

On paper, it offers a more neutral treatment at the corporate level between debt and equity financing decisions, which has the added benefit of reducing the need for complex rules. It also provides a more neutral treatment in respect to investment decisions at the intensive margin, theoretically allowing a higher level of production than under the current company income tax system. The choice of depreciation regime – accelerated or effective life – is less relevant under an Allowance for Corporate Equity regime since any differences are reversed through adjustments to the book value of the assets.

The Allowance for Corporate Equity model also offers the most in the way of empirical evidence, with variants having been used in Croatia, Brazil, Italy, Austria, Belgium and Latvia. Also, it appears to offer the least resistance path of reform, probably being the easiest system to integrate into existing company income tax systems.

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3 In 2007-08, financial and insurance services accounted for around 40 per cent of company income tax (net tax) – Australian Taxation Office 2010, *Taxation Statistics 2007-08*, Australian Taxation Office, Canberra.

4 Auerbach, A 2006, *The Future of Capital Income Taxation*, prepared for the 2006 Institute of Fiscal Studies Annual Lecture.

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The obvious limitation of an Allowance for Corporate Equity is setting the imputed rate of return at the 'right' level. Getting the choice wrong would undermine much of the system's neutrality benefits.

I urge you to continue this work; not with a view to an immediate tax reform package, but to ensure that policy makers have access to the analysis and empirical evidence that will be required as the need for change heightens.

## The challenge of demographic change and savings

A major consideration of the Asprey Review was to ensure greater integrity in an income tax system that offered many opportunities for tax minimisation. The recommendations regarding fringe benefits tax, capital gains tax, foreign source income, income splitting and the taxation of superannuation lump sums were all designed to protect revenue.

The present review panel did not reject the idea of maintaining a broad personal income tax base, including capital gains. But we concluded that consistent income taxation – taxing savings income the same as labour income – is not an appropriate policy goal.

Of course, if you take a good look at Australia's tax system you'll see that a strongly differentiated treatment of saving is quite an entrenched feature. For example, proceeds from so-called 'life cycle' assets, like the family home and superannuation, are either untaxed or taxed at highly concessional rates. And these assets make up more than half of total Australian household assets.<sup>5</sup>

Not that the current arrangements reflect application of a coherent theory about how to tax saving. Rather, the review found that real effective marginal tax rates on saving depends heavily on the asset class, the degree to which assets are leveraged, and the marginal statutory tax rate faced by the individual.

But once you move away from taxing income from savings and labour income in precisely the same way, issues arise at the 'border' between the two. The review recommended that further work be undertaken on practical means of drawing the line between capital and labour income in order both to reduce compliance costs and prevent labour income from being artificially re-characterised as capital income.

This is not a new problem. The Asprey Committee noted '... the problem of distinguishing between capital and income ... is one which has always defied easy

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<sup>5</sup> ABS cat. no. 6554.0 *Household wealth and wealth distribution*, 2005-06.



solution and because the criteria for distinguishing between the two ... can, according to circumstances, encompass such a wide variety of matters which may be relevant to its determination ... no universally infallible touchstone is possible.’<sup>6</sup>

The review panel recommended a 40 per cent discount to capital income received by individuals. A pure dual income tax – where capital income is taxed at a flat rate, was also considered. But the panel considered it important to sustain the overall progressivity of the personal income tax system. Challenges in the transition to a low flat rate tax, and the possibility of increased taxes faced by low income earners, were particular reasons for the panel settling on a ‘discount’ approach.

Over time a low flat rate of tax on capital income may come to look more attractive, depending upon progress with models that might facilitate income deeming, the accrual taxation of capital gains and the integration of personal income tax with a business level expenditure tax. These are areas in which further academic work can, and should, contribute significantly to a future policy debate.

## The opportunity of technological developments and reducing complexity

The Asprey Review Committee acknowledged that its recommendations would come at a cost to simplicity. Words to the effect of the gains to equity and efficiency outweighing the loss to simplicity are repeated several times in its final report.

Thirty-five years later, the review panel identified the complexity of the tax and transfer system as one of the key areas that posed a challenge to the equity, efficiency and sustainability of the tax system.

But it’s also an area in which the focus on challenges and opportunities offered the panel a way forward.

We found that while delivery agencies had taken steps to improve individuals’ experience of the tax and transfer system, policy and program complexity was continuing to grow. We concluded that policy design and implementation needed to give primacy to users’ experience of the system.

The opportunity to secure this outcome is offered by developments in information and communications technology.

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6 Asprey et al. 1975, *Taxation Review Committee – Full Report*, p 430, AGPS, Canberra.

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Harnessing technological capacity would also allow us to introduce simpler personal tax and more responsive transfer payment arrangements. For example, some of the issues for families who have difficulty keeping up to date with reporting changes in income would be made easier by better information flow and greater use of technology. These types of changes will take time, especially because they require not only timely and accurate information flows, but also adequate protection of private information.

Reducing complexity can, in part, be addressed by better technological solutions. But they will take us only so far. Importantly, tackling complexity demands getting the underlying policy right.

From that perspective, there is still much work to be done in the area of tax and transfer interaction. The panel considered the interactions and the impact of these on participation, and we made some high level and longer term recommendations. However, more research needs to be undertaken to understand fully how the Australian system impacts on participation. While Peter Diamond and other researchers have found that a u-shaped distribution of effective rates of tax is the most efficient,<sup>7</sup> more can be done in an Australian context on the optimal design of marginal tax rates and rates of income support withdrawal.

Improvements in technology also offer ways to price access to resources, such as roads, more efficiently.

As in many of the areas covered in the review, the theory on road pricing is not particularly ground breaking.

Justice Asprey could easily have picked up William Vickrey's 1963 article on transport pricing in the *American Economic Review*, which started with the proposition that 'in no other major area are pricing practices so irrational, so out of date and so conducive to waste as in urban transportation'.<sup>8</sup>

I made much the same point recently when I addressed the Committee for Economic Development of Australia. In 36 years, not much had changed.

Technological impediments are sometimes cited as the reason why otherwise convincing policy propositions fail. Vickrey was well aware that 'talk of direct and

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7 Diamond, P 1998, 'Optimal income taxation: an example with a u-shaped pattern of optimal marginal tax rates', *American Economic Review*, vol 88, pp 83-95.

8 Vickrey, W 1963, 'Pricing in urban and suburban transport', *American Economic Review*, vol 53, no. 2, Papers and Proceedings of the Seventy-Fifth Annual Meeting of the American Economic Association (May 1963), pp 452-465.

specific charges for roadway use conjures up visions of a clutter of toll booths, an army of toll collectors, and traffic endlessly tangled up in queues'. In fact, he suggested, for example, running special meters in cars that would tick over according to 'pulses emitted from cables laid along the roadway, with the pulse rate varied according to traffic density'.<sup>9</sup>

Whether Vickrey's proposals were practical at the time, the absence of appropriate technology is, today, no excuse for poor pricing.

Technology is already in use that can be used to support rational pricing. We already have electronic free-flow pricing on many Australian tollways. The problem is that the prices reflected in toll schedules have little to do with making the most efficient use of the infrastructure. Obviously, a car driving on a near empty road – say at 3 o'clock in the morning – wouldn't face a toll at all if prices were set with efficiency in mind.

There is, of course, a danger in seeking out a problem to suit every technological solution available. There is a point when too much technology would make everything unnecessarily grandiose or complex. But many areas of tax and transfer policy, and not just road pricing, our policy thinking would benefit from awareness that the technological constraints on policy design are being lifted.

## A national approach to tax analysis

While most of our recommendations relate to the activities of the national government in this Australian federation, the panel was struck by the inefficiency of taxes currently relied upon by State and Territory governments.

We found that narrow-based state taxes on insurance products, motor vehicles and real estate transfers are among the most inefficient taxes in Australia. Modelling undertaken for the review estimated a marginal welfare loss from stamp duty on insurance products of around 67 cents in the dollar.<sup>10</sup>

Many of you who were at last year's Tax and Transfer Policy Conference will remember Professor Richard Bird describing, somewhat colourfully, state conveyance duties as 'an absolute piece of garbage'.<sup>11</sup>

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9 *ibid.*

10 KPMG Econtech, produced for the Review of *Australia's Future Tax System*, found in Henry et al. 2009, *Australia's Future Tax System – Report to the Treasurer*, Part 1, p 13, Commonwealth of Australia 2010.

11 Bird, R 2009 – Address to the Australia's Future Tax Review Panel in June 2009, Melbourne Institute, University of Melbourne.

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I know that I am preaching to the converted on the need for reform of some of these taxes. Even so, it's a sermon worth reprising.

One of the key concerns of the review panel was to consider the impact on the national economy of Australia's taxes, regardless of the level of government formally responsible for each tax.

Not even the wide-ranging Asprey review could go this far. Its terms of reference issued in 1972 were 'to examine and inquire into the structure and operation of the present Commonwealth taxation system'.<sup>12</sup>

That's not because economists and politicians back then thought that state taxes were perfect.

In Parliament, then leader of the Opposition, Mr Whitlam, asked then Treasurer Snedden whether the Inquiry would 'report on the equity and cost of other forms of taxation in Australia at present in the hands of State governments', noting that 'many State taxes absorb up to one-third of the revenue they produce in the collection thereof'.<sup>13</sup>

So why were state taxes not included in the Asprey review's terms of reference?

Partly because the Government did not think that it was the Commonwealth's role to conduct such an inquiry, these being matters for the States and Territories. The report also excluded state taxes on grounds of expediency. Treasurer Snedden told Parliament that he wanted to receive the report 'as quickly as [he] can get it'.<sup>14</sup> The irony was that he didn't receive the report at all. The Taxation Review Committee signed off on its report in 1975. In a double irony, it was Prime Minister Whitlam who received the report.

Today's review has attempted to chart a course for the reform of state and territory taxes. Reforming existing taxes or introducing new ones is rarely popular – even if the economic arguments for doing so are strong. And simply abolishing Australia's most inefficient taxes would leave the States without the revenue they need to fund the services demanded of them by their citizens. Yet there is also reason to think that those taxes will prove increasingly incapable of supporting the services demanded. Something has to change.

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12 Asprey et al. 1975, *Taxation Review Committee – Full Report*, p xvii, AGPS, Canberra.

13 Commonwealth, *Parliamentary Debates*, House of Representatives, 13 April 1972, 1586 (Mr Whitlam).

14 Commonwealth, *Parliamentary Debates*, House of Representatives, 13 April 1972, 1586 (Mr Snedden, Treasurer).

The economists in the room who have been cataloguing the inefficiency of many of these taxes for some time may feel some impatience. But, as with most tax reforms, change won't come without the case for reform first being accepted by the community. And that means going beyond the concerns of those who may be disadvantaged by the reform and finding compelling ways of explaining the benefits to the wellbeing of all Australians.

## AFTS review going forward

In responding to the challenges of next several decades, the review panel set out to make recommendations to reform the tax system in ways that would support strong and sustainable economic growth: a system that delivers more capital per worker; encourages workforce participation; and which leads to higher entrepreneurship and skills acquisition. These have been enduring goals of academic researchers in public finance.

The review has no pretensions of having made any sort of contribution to academic research. But it does hope to have demonstrated a strong interest in that vast body of work – setting out, in the description of practical pathways, how the insights of academic researchers might be applied to immediate and future challenges of some scale.

I would hope, too, that the report leaves the curious reader with some idea of the shape of the future tax policy research that is likely to be of utility to practical people.

Few areas of policy excite as much 'real world' interest as tax. We don't need to ponder the reasons for that to understand the importance of our work – whether as theoreticians, modellers or policy developers. If this review manages to contribute, in some way, to an appreciation of the importance of 'getting it right' in tax and transfer system design, then its authors will be well satisfied.

Of course, each of us is more ambitious than that. We have sought reform. Your participation in the policy thinking and informed debate that will, over time, enhance the prospects for reform, is greatly appreciated.

Thank you.

