Australasian Tax Teachers Association (ATTA) conference

21 January 2010

"Changing Taxes for Changing Times"

Introduction

Thank you for inviting me to speak here today.

This is a marvellous theme for a conference – 'changing taxes for changing times'.

The topic implies a way of thinking about tax that might appear a little unorthodox.

The traditional way of thinking about tax policy relies on the axioms of 'efficiency, equity and simplicity'; what Justice Asprey, in his landmark 1975 Review, called 'the big three' (Asprey, 1975:12).[1] The elegance of those axioms has influenced almost every subsequent reform exercise. Jeff Harmer, John Piggott, Heather Ridout, Greg Smith and I didn't

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[1] Adam Smith is sometimes attributed these axioms from his Wealth of Nations. But like most attributions to that brilliant work, this is an over-simplification. . Smith actually provides four principles in the Wealth of Nations (Book V, p892-3). They are: I. The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities, that is, in proportion to the revenue which they respectively enjoy under the protection of the state; II. The tax which each individual is bound to pay ought to be certain, and not arbitrary; III. Every tax ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the contributor to pay it; IV. Every tax ought to be contrived as both to take out and to keep out of the pockets of the people as little as possible, over and above what it brings into the public treasury of the state. . While I is clearly an 'equity' statement, II and III are more than just concerned with 'simplicity' and IV is only roughly about 'efficiency'.

see any reason to jettison any of them in our recent review of the tax and transfer system either.

But when we set out on our review, we were determined to avoid falling into the trap of thinking that those axioms, a parchment and a quill, might be all that was needed to design a tax system for any age and any economy. This is, in fact, a difficult trap to avoid. It is actually quite tempting to think that the axioms should predominate under any conditions; whether it's a tax system for a developed or a developing economy; a small open economy or a large closed one; a country facing up to its environmental challenges or one that is not. Some might even be tempted to think that rather than assisting policy design, social context might even harm its integrity, introducing unhelpful distractions.

When the five of us got down to work, we quickly agreed that Australia's future tax system design certainly needs to have regard to efficiency, equity and simplicity. But we also agreed that it needs to do so in a way that understands and is influenced by context; specifically, by the challenges that Australia is likely to face. We accepted that those challenges might be quite different from those confronting other countries, and different also from those we have confronted in our own history. We did not consider it an unhelpful distraction that the way in which challenges are addressed might be influenced by history, community norms and societal expectations.

We thought it also worth bearing in mind that it is not desirable to try to do everything at once. Tax reform should always be a project for the coming decade – not just the coming weeks or months.

Matching tax design to society's goals

The power to tax needs to be marshalled by government to serve society's goals. Those goals will change through time.

Of course, tax design is a highly constrained activity. Taxation raises revenue from a limited number of bases — land and other natural resources, labour, capital and consumption. And the size of these bases will differ from country to country and over time in ways over which governments might have very limited control. Their evolution will, however, have an impact on how a government chooses to raise revenue.

If we were able to ask Governor Hunter of the new colony of New South Wales why he introduced the very first taxes in Australia – taxes applying to imports – I suspect his answer would be, simply, that the colony had to finance the building of a new gaol because the old one had 'inexplicably' burnt down, private subscriptions had proved insufficient and Britain had refused further subsidies.

Australia’s first taxes were levied to meet the challenges of those early days. They may also have been relatively efficient, equitable and simple, particularly since most of the revenue for the gaol came from import duties on alcohol – ‘the more the citizens drank, the more money there was to control them’ (Smith, 1994:10).

Import duties remained the major form of taxation until the funding needs of the First World War led to the introduction of federal income tax in 1915. The next major increase in taxation again occurred because of war when, in the 1940s, different State income taxes were consolidated and raised at the federal level. Expanding social programs in the mid-1970s, such as free university education and health care, led to a rise in direct taxation on business and individuals and – eventually, an increase in taxation overall as a share of GDP (Charts 1 and 2).

Now I am not saying that all of these policies were effective or desirable. For example, we now know a lot more about the detrimental economic effects of import duties. And some of today’s challenges, such as environmental degradation, exploitation and species loss, are the consequence of past generations failing to face up to, or even being aware of, those challenges.

I am just making the point that tax policies of the past have tended to respond to the challenges of the times – even if they have done so in fits and starts, piecemeal ways, or only after long delays.

Policy change is difficult and the challenges society faces are relentless. Tax policy is a community concern. Successful tax policy means the community must understand, appreciate and generally support the reasons for tax reform.

There is, therefore, a case for setting out the challenges clearly – providing an opportunity for the tax reform argument to prove compelling. Even then, reform is not assured. But a tax reform proposition disassociated from the challenges the community feels it is facing has no hope at all.

Guarding against vested interests

Of course, we do need to guard against the inappropriate weighting of challenges and the self-interested offering of appropriate policy responses.

Consider, for example, our peculiar but long-standing acceptance of a monstrous challenge confronting our gold miners that justified extraordinary policy protection. Many of you probably wouldn't remember that income from gold mining was fully tax exempt in Australia until 1991. The concession was introduced because of fears for the international competitiveness of our gold industry in the face of rising costs and falling prices. Numerous reviews recommended removing the exemption, to improve the fairness and efficiency of the tax system. The 1985 *draft White Paper* also recommended its removal. But the final decision to remove it was not taken until 1988.

The Australian gold tax exemption lasted nearly 70 years, despite its having absolutely no support in tax theory. Long before its removal, it had become a source of embarrassment for Australian officials attending international tax policy conferences – we were the only OECD country that accorded a whole industry an exemption from tax (Monem, 1999). Even so, its removal was highly controversial.

Tax reform is always difficult – even the things that are most obvious. That's probably because it almost always confronts sectional interest. And, as the gold tax episode illustrates, reform can be especially difficult when those sectional interests can be dressed up as a concern for exports and jobs.

Thus, consider the intense opposition to the rather innocuous proposition that a worker should pay tax on his or her remuneration even if it is not labelled 'wages' or 'salary'. Who on earth would think it sensible to levy tax on a worker whose bank account balance is enhanced by the receipt from her employer of a payment called a 'wage', but to not levy any tax at all on a worker whose bank account balance benefits from the receipt from her employer of something called an 'expense payment'? Who on earth would consider it sensible that an executive who receives from his employer some part of his remuneration in the form of a Porsche motor vehicle and a holiday apartment on the Gold Coast should not be required to pay tax on that income?

Well, the fact is that until September 1985 all of Australia's governments had, apparently, thought these things sensible. Indeed, even after the Fringe Benefits Tax had been legislated, the then Opposition went to the 1987 election campaigning for its repeal.

Even though I had a deep personal involvement in the development of the FBT and its subsequent negotiation through the Parliament, I still find it hard to believe the intensity of the opposition to this rather obvious requirement of tax system fairness and integrity. Looking back, it seems incredible to me now that the Hawke Government was told by both the Australian motor vehicle industry and its own industry department that the FBT would lead to a complete shutdown of domestic production and the loss of hundreds of thousands of jobs in the automotive and related sectors of the economy. I find it incredible that such claims were made, yet I know it's true that they were.

Making a compelling case

To anybody who knows anything at all about tax policy, the idea that fringe benefits should be completely tax free appears simply absurd – not worth wasting time in discussion.

So why was the introduction of the FBT so difficult? A plausible explanation, I would suggest, is that until 1985 the case for taxing these forms of income had not been advanced in ways that the community would accept as constituting sensible responses to the challenges they saw themselves confronting. There had been neither a sufficiently clear articulation of those challenges, nor of the role that particular tax reform could play in helping to address them.

Patently, it wasn't enough simply to observe – as tax policy people had for many decades – that the absence of fringe benefits taxation offended basic equity and efficiency principles. Of course, once the challenges of the times had been communicated effectively, the need to address tax system fairness became a highly effective argument.

Changing taxes for changing times

The clear articulation of contemporary challenges can help secure community support for tax reform proposals. But it is also the case that better proposals are likely to emerge from a considered identification and analysis of those challenges that are of most importance to community wellbeing. After all, it is those challenges that the tax system should be preparing to meet.

In its Consultation paper, released more than a year ago (AFTS, 2008:17), the Tax Review Panel outlined its thinking on what might be some of the more important challenges that should guide thinking about the future direction of Australia's tax system.

One of the more profound challenges confronting Australia is the ageing of the population. Other challenges identified by the Tax Review Panel include the pace, depth and shape of globalisation, especially associated with the re-emergence of China and India as global economic super powers; continued environmental degradation; and technological change.

The demographic challenge

The Treasurer will shortly be publishing a new intergenerational report that will provide updated demographic and fiscal projections. Without going into the content of that report, it will, as the Prime Minister has indicated in recent days, re-focus attention on the problem of population ageing.

The ageing of the population raises at least two major issues for the tax system.

First, the tax system needs to be prepared for the probability that, in order to finance the government-provided goods and services demanded by the community, revenue needs will grow strongly in the longer term. Generally, older people demand a lot more from governments – especially in health and aged care services – than younger Australians. Sure, policy reforms that improve the productivity of service delivery in age-sensitive sectors would ameliorate some of these expenses. But it would be prudent to plan on the basis that the tax system will, over time, have to generate revenues to meet substantially larger fiscal costs.

Second, marginal tax rates might need to be adjusted over time to ensure that they reflect the changing abilities and propensities to work of different cohorts at different times in their lives.

In theory, marginal tax rates should be lower where there are more people whose participation is most responsive to tax rates (see survey in Mankiw et al, 2009).

And it makes sense from an aggregate income perspective – and, therefore, from a fiscal financing perspective – to provide especially strong work incentives for those whose productivity is relatively high.

Older people are less likely to be in the workforce due to retirement or working less hours.

Tax policy design has to recognise a growing fiscal need for encouraging highly productive workers and increasing participation by being cognisant of the costs to the community of high marginal tax rates applying to particular groups of workers.

These are not merely abstract issues. The way in which we address them will have significant implications for our ability to ensure that a rapidly growing number of ageing Australians have the opportunity to live with security and dignity in retirement.

Globalisation

As a small, open, developed economy with substantial endowments of commercial natural resources, Australia could be expected to have a unique perspective on the attraction and retention of foreign investment.

Foreign capital generally makes us richer by increasing the demand for our workers, supporting higher wages, and transferring skills and knowledge. No country can tax what doesn’t come to its shores, and nothing is compelled to come to its shores: as the world has globalised, internationally mobile capital has found more and more alternative destinations. It is not surprising that researchers would be finding increasing evidence that the economic burden of taxes on mobile capital (such as the company tax) most probably falls, in the long run, on the immobile factors of production — particularly labour — rather than being fully borne by the owners of capital (both domestic and foreign shareholders).

On the other hand, as Chapter 14 of the Consultation Paper released in December 2008 made clear, company tax partly taxes the profits extracted by foreigners from Australia's natural and immobile resource endowments.

What is particularly challenging for Australian policy makers is that most other developed countries do not face the same circumstances. Many developed countries are either large economies, for which capital might not be so elastic in supply, or have few exploitable natural resources remaining.

No country provides a ready-made blueprint for Australia's taxation of capital income. Like the Australian environment itself, the solutions are likely to be uniquely Australian.

Globalisation may also have implications for the taxation of mobile labour. While the real employment consequences of the global financial crisis are obviously highly significant, and will have a substantial impact on global migration flows in the shortterm, the long-term trend is that increasing numbers of highly skilled people are operating in a global labour market.

Environmental degradation

Australia possesses a unique environment, which – despite the extinction of 115 species of flora and fauna in the last couple of centuries – remains rich in biodiversity. But our environment faces numerous challenges – too many to discuss them all here. Let me touch on a few. For obvious reasons, I will not be saying anything about climate change.

Currently, in Australia there are 612 flora species, 47 bird species, 39 mammal species, 16 frogs, 16 reptiles and 19 fish species that are listed as either critically endangered or endangered.[2]

The unsustainable extraction of water resources has resulted in significant environmental impacts such as the exposure of acid sulphate soils in the Lower Lakes of South Australia and the death of mature River Red Gums along the Murray River. It is also estimated that fish stocks in the Murray-Darling Basin are only 10 per cent of pre-European settlement levels.[3]

Additionally, vast areas of native vegetation have been cleared or degraded, resulting in adverse effects on biodiversity, soil

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[2] *Environment Protection and Biodiversity Conservation Act 1999,* Species Profile and Threats Database http://www.environment.gov.au/cgi-bin/sprat/public/sprat.pl

[3] Murray-Darling Basin Authority, Native Fish Strategy, http://www.mdba.gov.au/programs/nativefishstrategy

and water quality and assisting in the spread of weeds, feral pests and diseases.

Invasive species – weeds, feral pests and diseases - impact on both the environment and agricultural production. Due to difficulties in estimating the value of environmental features to the Australian community, it is hard to estimate the full economic impacts of invasive species on the environment. And the impact of weeds, in particular, remains highly controversial, in part because of contributions from Peter Andrews and others who have been prepared to challenge accepted wisdom in this area. However, the impact on agriculture of birds, rabbits, wild dogs, mice, foxes and feral pigs has been estimated at $620.8 million per annum.[4]

Clearly, these and other environmental challenges pose serious risks, not only to the Australian environment but also to our standard of living, now and in the future. In the past, the causes of many environmental problems were ignored — and the consequences of inaction have often been to the detriment of the wellbeing of Australians.

Historically, in Australia, when governments have sought to prevent environmental degradation it has been through direct regulation, such as restricting or banning certain activities or the

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[4] Gong W, Sinden J, Braysher M and Jones R (2009), *The economic impacts of vertebrate pests in Australia,* Invasive Animals Cooperative Research Centre, Canberra. http://www.feral.org.au/feral_documents/IACRC_EconomicImpactsReport.pdf

use of certain products. While in some circumstances regulation may be an appropriate response, in other cases it can be a blunt instrument as it does not allow people and businesses to adjust their behaviour in the most efficient way.

However, we now have a greater understanding of environmental problems and their effects. We also have better technology which can allow governments to use different mechanisms to prevent environmental degradation.

In this sense, the theme of ‘changing taxes for changing times’ is apt as it may be appropriate to use environmental taxes to address some of the environmental challenges that we are facing today.

Technological change

Another key challenge is the continuing effect of technological change.

Technology affects both what people want from government and how the tax system can deliver it. What society wants from government may be represented as a demand for government-provided goods and services. For most government-provided goods and services, the price charged to the beneficiary is very low – often zero. For that reason, quantitative rationing of access is common; consider water, for example.

There are many examples of technology enhancing the quality – and, accordingly, the consumer value – of government-provided services. These sorts of technological advances translate into a higher demand for government-provided services. But they may also be very expensive technological advances. For example, there are likely to be many health procedures in the future that will extend and improve the lives of Australians, but which will likely be very costly.

Without higher levels of government expenditure, the consequence of improved health technologies is even greater rationing – in the form of longer and longer ‘waiting times’ – of government-provided health services.

In the past, the availability of more expensive health technologies has translated into higher levels of expenditure.

In 1969–70, expenditure on pharmaceuticals in Australia was $210 per capita in real terms. That figure wasn’t exceeded over the next 20 years – that is, through to the end of the 1980s. Then a wave of innovation in the 1990s produced a range of new ‘blockbuster drugs’. Largely as a result of this, spending on medication by government and by Australians out of their own pockets, increased to $678 per capita in 2007–08.

It’s hard to predict when and where the next wave of technological breakthroughs will come. Yet history suggests that technological innovation in health care will fuel future growth in government health spending, for both the Commonwealth and the States. That spending will have to be financed. And that will have implications for tax design. Consider, especially, the implications for state tax systems.

The States raise taxes from all four revenue bases – land and other natural resources, labour, capital and consumption (the last of these restricted heavily by the Constitution) – but usually with taxes – such as stamp duties, land and payroll taxes – levied on bases that have eroded over time and which, for that reason, do not always rate well against the axioms of efficiency, equity and simplicity.

Funding projected increases in state health expenditures from these taxes would have increasingly high social costs – a fact that should encourage the States, over time, to consider a substantial re-design of the taxes applying to their few tax bases.

It is worth noting that new technologies also offer prospects for raising revenues in less socially costly ways. For example, the ATO’s recent pre-filling of parts of individual tax returns through various new technology enablers has freed many people from much of the paper work of meeting their personal tax obligations. And, without being specific, other technologies can be expected to facilitate the redesign of taxes in ways that will allow revenues to be raised at lower social cost. Accordingly, while new technologies are likely to expand the demand for government-provided goods and services, they also offer the prospect of those demands being financed in less costly ways.

Many people think of technological progress in terms only of physical items, such as computers and an ever-increasing variety of hand-held gadgets. But technological progress is also to be found in the way we think about issues.

Today, engineers have better tools for designing buildings than were available a century ago. These tools are largely conceptual – the technological improvement being in the way the engineers are trained and in what they know. Importantly, in engineering thinking the technological improvement is very likely to be a response to community challenges of the times.

In economic thinking too, including in tax economics, technological change is evident. And the adoption of those new technologies offers considerable benefits.

Especially in the area of tax policy design, the way we think has been influenced by the challenges we face. As Professor Alan Auerbach from Berkeley pointed out at the AFTS conference in Melbourne last year, when surveying future directions for tax theory, our thinking about environmental taxation and the taxation of global capital flows has advanced precisely because environmental problems and globalisation are widely understood – among tax economists – to represent significant contemporary challenges (Auerbach, 2009:7).

Perhaps the most significant shifts in thinking in recent times have been in respect of views on the tax bases that best support progressive taxation.

When I began studying tax economics, comprehensive income taxation was the technology standard. But that idea has, for some time now, been considered by most economists to be 'old thinking' – a bit of old technology. Looking at the recent work in this area, one can find arguments for taxing savings at a higher rate than labour, arguments for taxing savings at a lower rate than labour, arguments for subsidising saving and even arguments for taxing savings at age-dependent rates.

That might not seem like progress. But consider the idea that there remains almost no logical reason for taxing capital income at the same rate as labour (Auerbach, 2009:9). That idea is simply revolutionary when put up against the current tax system. Yet it is becoming sufficiently fixed in academic thinking to appear quite conservative in those circles.

Conclusion

The dissemination of good ideas and their victory over bad ideas are forms of technological progress. But good ideas are not developed in the abstract. Good ideas are relevant to contemporary circumstances – even better if they anticipate future circumstances.

That is where you come in. The goal of the Australasian Tax Teachers Association is to improve the standard of tax teaching in Australasia. I therefore see this organisation and its members as being purveyors of the changes in thinking we need if we are to meet the challenges of the times.

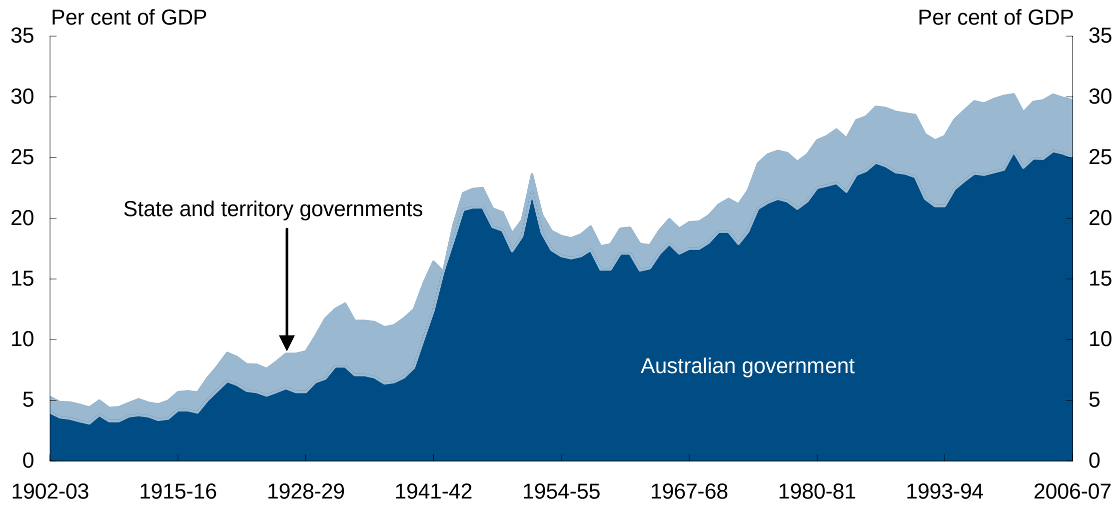
I can see from some of the PhD topics presented at yesterday's workshop that many of you feel the same way. Topics ranged from climate change policy, to broadening the capital gains tax, to simplifying tax returns.

If he were alive today, Governor Hunter might even welcome the paper discussing the taxation of fatty foods – so long, perhaps, as the revenue were directed to funding hospitals!

I look forward to engaging with many of these policy ideas in the years to come.

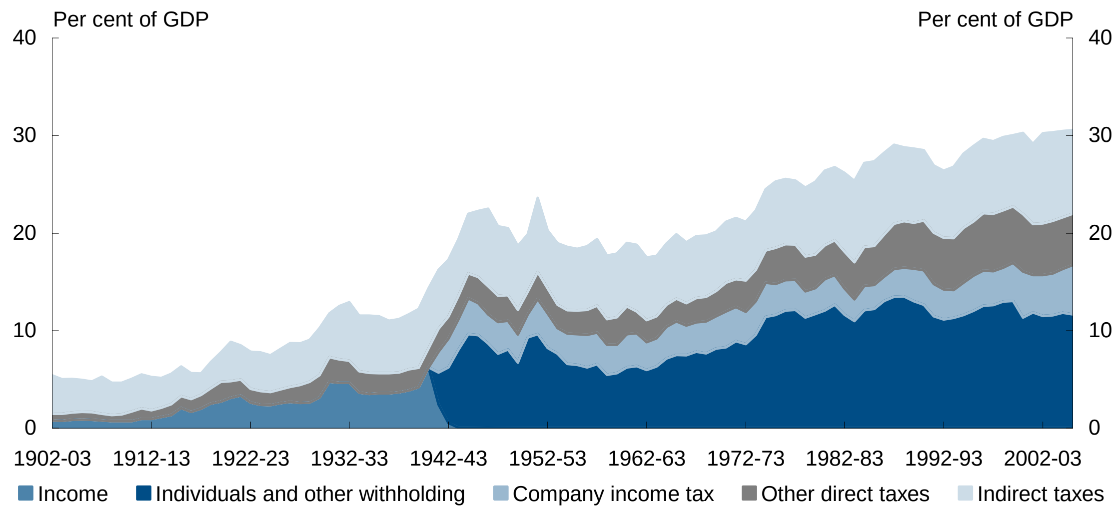
Thank you for inviting me to be with you here today.

Chart 1: Australian Government and State taxation (1902–03 to 2006–07)



Source: Treasury (2008).

Chart 2: Composition of Australian tax revenue (1902–03 to 2006–07)



Source: Treasury (2008).

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